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THE REAL IMPLICATIONS OF THE NEW TRANSFER TAX
VALUATION RULES—SUCCESS OR FAILURE?

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I. INTRODUCTION: THE ANCILLARY PURPOSES OF THE FEDERAL TAXATION SYSTEM

Underlying the basic premise of the Internal Revenue Code—the desire to raise revenue for the federal government—is a congressional desire to achieve policy objectives through the enactment of specific tax legislation. Indeed, the structure of the income tax system, itself, exemplifies this concept. The progressive nature of marginal income tax rates reflects congressional belief that individuals with relatively more taxable income should be subject to income tax at greater tax rates. In addition, the estate tax system, which for those of sufficient wealth¹ imposes a tax at a person's death, has often been cited as a mechanism to prevent family dynasties, prohibiting the passing on of wealth from generation to generation.²

The modern federal estate tax was enacted in 1916.³ Thereafter, substantial modifications to the estate tax system occurred as Congress became aware of the deficiencies in the initial laws.⁴ One of the most significant of these changes

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¹Because of a tax credit, the estate tax will apply to those individuals who die with a gross estate that exceeds the difference between \$600,000 and the value of all lifetime taxable gifts. See I.R.C. §§ 2010(a), 2001(b).

²In addition to the need to prevent accumulated wealth from passing from generation to generation and thereby avoid a permanent aristocracy, the other traditional justifications for the estate tax are a desire to keep younger generations more economically motivated by decreasing family wealth and the generation of revenue for the federal treasury. Under the current scheme of estate taxation, where the effective maximum marginal rate is 60%, see sections 2001(c) and 2010(a), only the last justification can be supported. Suppose, for example that an individual passes \$3,000,000 to his children at his death. This \$3,000,000 is subject to an estate tax payment of \$1,098,000. I.R.C. § 2001(c). After payment of estate tax, \$1,902,000 remains to be paid to the children. The purposes of the estate tax relating to the substantial diminishment of the amount passing to younger generations has not been accomplished.

³Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756. Prior to this time, there were inheritance tax laws. These laws based the tax on the value of the separate shares passing to the beneficiaries rather than on an individual's aggregate wealth. See generally CHARLES L.B. LOWNDES ET AL., *FEDERAL ESTATE AND GIFT TAXES* §§ 2.1 - 2.5 (3d ed. 1974).

⁴For example, the Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253 (1923-25), introduced the gift tax and the state death tax credit. The Revenue Act of 1935, Pub. L. No. 407, 49 Stat. 1014 (1935-36), increased the highest marginal estate rate to 70%. Equalization of transfer taxes in community property and common law states was attempted in the Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798 (1942). The Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969), modified the estate and gift tax deductions for charitable contributions consistent with income tax law changes for such contributions. See generally LOWNDES ET AL., *supra* note 3.

was the unification of the estate and gift tax rates in 1976.⁵ By unifying the tax rate structure, Congress sought to treat gifts during life as subject to the same tax rate structure as gifts at death.⁶ Although Congress did retain minor inconsistencies between the estate and gift tax system (other than tax rates),⁷ it sought to reduce the substantial transfer tax⁸ advantage of making lifetime gifts, as opposed to gifts at death.

After the unification of the tax rates in 1976, estate planners developed estate tax reduction strategies that went beyond those lifetime gifting strategies expressly allowed by the Code.⁹ Introduced were techniques planners often described as "estate freezes."¹⁰ Importantly, many of the strategies underlying the estate freeze were no more than abuses of the gift tax system, premised on questionable valuation strategies either sanctioned by the system itself¹¹ or on which the system was ambiguously silent.¹² By engaging in an estate freeze during life, an individual could potentially pass more property to her beneficiaries than would have passed pursuant to an outright gifting program¹³ or at death under the estate tax laws.¹⁴

⁵ Tax Reform Act of 1976, Pub. L. No. 94-455, § 2505(d), 90 Stat. 1846, 1849 (1976).

⁶ See I.R.C. § 2001(b). Prior to enactment of the Tax Reform Act of 1976, the tax imposed by federal law on gratuitous transfers varied depending on whether the transfer was *inter vivos* or testamentary. *Inter vivos* transfers were subjected to the federal gift tax, whereas testamentary transfers were subjected to the federal estate tax. Each tax was governed by different rules and tax rates. As a general rule, for example, the gift tax rates were lower than the estate tax rates.

Through the Tax Reform Act of 1976, Congress intended to remove differences between gift tax and estate tax by "elimina[ting] ways by which estate planners can reduce the estate and gift tax burden through special patterns of transferring their property." H.R. REP. NO. 1380, 94th Cong., 2d Sess. 5, reprinted in 1976-3 C.B. 735, 741. Of particular significance was the fact that Congress replaced the separate gift and estate tax rate schedules with a unified transfer tax rate schedule. Thus, under current law, *inter vivos* transfers and testamentary transfers are subjected to the same marginal tax rates. For transfers taking effect after 1992, the marginal rates vary from a minimum of 18% to a maximum of 55%. I.R.C. § 2001(c). An additional 5% rate applies to the amount of taxable transfers that exceed \$10,000,000, but that do not exceed \$20,040,000. I.R.C. § 2001(c)(2).

An individual is entitled to only one trip through the estate and gift tax brackets. See *infra* note 24.

⁷ For a discussion and tax analysis of these inconsistencies, see FINANCIAL AND ESTATE PLANNING ¶ 1910 (CCH, Sidney Kess ed., 1993).

⁸ The terms "transfer tax" and "transfer taxes" are used in this Article to refer to estate and gift taxes, but not to refer to the generation-skipping transfer tax.

⁹ See Richard L. Dees, *Section 2036(c): The Monster That Ate Estate Planning and Installment Sales, Buy-Sells, Options, Employment Contracts and Leases*, 66 TAXES 876 (1988).

¹⁰ In its purest sense, an outright gift during life, with the donor retaining no interest in the gifted property, is an "estate freeze." See *infra* notes 25-28 and accompanying text. But as used by planners and in this Article, the term "estate freeze" refers to strategies in which the donor transfers property but retains control over or equity rights in the transferred property, and the transferred property appreciates at a rate in excess of the rate of the retained right.

¹¹ For example, the ability of these freezes to avoid the reach of section 2036(a), discussed *infra* notes 40-50 and accompanying text, was upheld by the courts. See *infra* note 42.

¹² For example, the system provided no rules on how to value assets that could be affected by actions or omissions by the holder of that asset, such as "put" rights attached to preferred stock. For a discussion of this problem, see *infra* notes 44-58 and accompanying text.

¹³ An outright gifting program involves no retained rights over the transferred property and therefore does not involve the valuation abuses discussed in this Article. See *infra* notes 25-28 and accompanying text.

¹⁴ See *infra* notes 46-50 and accompanying text.

In 1987, Congress tried to eliminate the perceived abuses associated with certain estate freezes by enacting into law section 2036(c).¹⁵ This section was intended to treat family transfers in certain multistock corporations or multitier partnerships, done to achieve estate freezes, as incomplete transfers for gift tax purposes, which would result in inclusion of all transferred property in the transferor's gross estate.¹⁶ Unfortunately, section 2036(c) was drafted broadly enough to include within its reach transactions that were not stock recapitalizations or partnerships done to effectuate estate freezes.¹⁷

Realizing the impracticality of section 2036(c), Congress in 1990 repealed it, retroactive to its date of enactment, and in its place substituted Chapter 14.¹⁸ Chapter 14¹⁹ includes extensive rules on valuing certain intrafamily transfers of interests in corporations, partnerships, or trusts when another interest in the corporation, partnership, or trust has been retained by the transferor or by the transferor's spouse, an ancestor of either, or a spouse of an ancestor.

This Article focuses on the effect of Chapter 14 in addressing valuation and related problems associated with the traditional retained interest transfers, including estate freezes.²⁰ Part II examines pre-Chapter 14 estate freeze strategies,

¹⁵ Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402(a), 101 Stat. 1330, 1330-431 (1987), added section 2036(c)(1), which in its original form provided merely: "For purposes of subsection (a), if any person holds a substantial interest in an enterprise, and such person in effect transfers . . . 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 retained interest shall be considered to be a retention of the enjoyment of the transferred property."

¹⁶ The operation of section 2036(c) can be illustrated by the following simplified example. A father, X, owns two interests, asset A and asset B, in enterprise E. A and B constitute more than 10% of the total outstanding interests in E. On January 23, 1990, X transfers asset B to his son for no consideration. The transfer results in a taxable gift equal to the current fair market value of asset B. X retains asset A. At the time of the transfer, the appreciation potential of asset B is greater than the appreciation potential of asset A. At X's death thirty-five years later, asset A is still owned by X. Asset B has appreciated ten times its value as of the date of transfer. At X's death, the current value of asset B, even though it was transferred thirty-five years previously and even though treated as a taxable gift at the time of the transfer, will be included in X's gross estate for estate tax purposes.

¹⁷ In fact, immediately after the enactment of section 2036(c) practitioners and commentators began ruminating on whether the statute would apply to such traditional estate planning transactions as gift transfers of a minority stock interest in a family-owned corporation with only one class of stock, gift transfers of nonvoting common stock in a corporation that have only voting and nonvoting common stock, gift transfers of limited partnership interests when the transferor is also one of the general partners, buy/sell agreements, grantor retained interest trusts, purchased life estate/remainder interests, redemption of a transferor's interest in a closely held corporation in exchange for notes or other debt, irrevocable life insurance trusts, and so on. See, e.g., PRACTICAL DRAFTING 1415-37 (Richard B. Covey ed., 1988).

¹⁸ Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11601, 104 Stat. 1388, 1388-490 (1990). Chapter 14 is directed more toward proper gift tax valuation than toward punitive estate tax inclusion. In the example *supra* note 16, illustrating the operation of now-repealed section 2036(c), new Chapter 14 would not act to include asset B in X's gross estate. Rather, Chapter 14 would probably result in a higher value for asset B, for gift tax purposes, than under prior law.

¹⁹ See I.R.C. §§ 2701-2704.

²⁰ As these valuation and related problems tend towards an understatement of transfer tax liability, this Article refers to them as valuation abuses.

including improper valuation techniques and other perceived abuses that led to the enactment of Chapter 14. Parts III and IV discuss the impact of Chapter 14 on these strategies. These parts conclude that, as a result of Chapter 14, estate freezes and other strategies based on questionable valuation principles have been effectively eliminated. Further, these parts demonstrate that the valuation principles developed by Chapter 14 are fair and consistent with the overall congressional objective of subjecting gifts during life to the same tax rates as gifts at death.

II. ESTATE FREEZES: EXPLORING THE STRATEGY

A. Freezing an Interest for Estate Tax Purposes

If an individual makes a taxable gift²¹ during her lifetime, the value of this gift for gift tax purposes is the value on the date the gift is made.²² If an individual makes a gift at death, the value of this gift for estate tax purposes is the value at the time of death (or alternate valuation date).²³ Importantly, regardless of whether made during life or at death, gifts are subject to the same transfer tax rates.²⁴

²¹ The individual making the gift, the transferor, is commonly referred to as a donor if the gift is outright and as a grantor if the gift is to, or in, a trust. The term "taxable gifts" refers to the total amount of gifts made during the calendar year, less allowable deductions. I.R.C. § 2503(a). The first \$10,000 of gifts to each donee in a calendar year is not included in the total amount of gifts for that year. I.R.C. § 2503(b).

²² I.R.C. § 2512(a). This section also provides that when property is gifted, the "value thereof . . . shall be considered the amount of the gift." *Id.* Despite the significance placed on the term "value" by the Code, the statute does not define that term. Regulations sections 20.2031-1(b) and 25.2512-1, however, equate value with "fair market value," which in turn is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Regs. §§ 20.2031-1(b), 25.2512-1.

²³ See I.R.C. §§ 2031(a), 2032.

²⁴ Upon an individual's death, the amount of all taxable gifts will be added to that individual's taxable estate for purposes of "grossing up" the taxable estate, that is, pushing the estate into a higher tax bracket. I.R.C. § 2001(b)(1)(A). However, the donor will be entitled to subtract from this, the amount of gift tax payable on these "adjusted taxable gifts" included in the tax base when the individual's estate tax is calculated. I.R.C. § 2001(b)(1)(B). For example, when an individual who gratuitously transfers \$1,000,000 during life dies with \$1,000,000 more in her gross estate, that additional \$1,000,000 is not taxed at the lower 18% through 39% brackets applicable to the first \$1,000,000 in taxable transfers. Rather, it is taxed at the 41% through 45% rates. The Code accomplishes this by equating the amount with respect to which the tentative tax is to be computed to the taxable estate (i.e., the property included in an individual's estate for estate tax purposes minus allowable deductions) plus the amount of adjusted taxable gifts. I.R.C. § 2001(b)(1). Adjusted taxable gifts are taxable gifts made after 1976, other than gifts which are includible in the gross estate of the decedent. Thus, although the decedent in this example dies with a gross estate of only \$1,000,000, all taxable gifts which she made during her lifetime (other than gifts which are included in the gross estate) are added to the gross estate for purposes of determining how much estate tax will be paid. Therefore, the person who transfers \$1,000,000 during her life, and thereafter dies with a gross estate of \$1,000,000, will compute her estate tax based on the \$2,000,000 amount (the gross estate plus adjusted taxable gifts). After the estate tax has been calculated, that individual is allowed a credit for the amount of gift tax that "would have been payable" with respect to gifts made by the decedent after December 31, 1976. I.R.C. § 2001(b)(2). Therefore, the total transfer taxes paid (gift tax plus estate tax) by the individual who transfers \$1,000,000 the day before she dies, and dies with an additional \$1,000,000 in her estate, will be the same as the total transfer taxes (just estate taxes) paid by the individual who dies with \$2,000,000 in her gross estate.

Therefore, when a donor makes a taxable gift during life, that donor has frozen the value of the property gifted, for estate and gift tax purposes, as of that date. If the value of gifted property increases subsequent to the date of the gift, that increase inures to the benefit of the recipient of the gift and is not subject to estate tax in the donor's estate when the donor subsequently dies.²⁵

In enacting a unified gift and estate tax system, Congress was no doubt aware of this disparity²⁶ and concluded that the disadvantages associated with a lifetime gift²⁷ outweighed, or at least equalled, the benefit of the freeze. Congress may also have been concerned by the substantial administrative costs of trying to attach to a gift made during lifetime a tax appreciation factor in order to capture future appreciation.²⁸

B. Retaining an Interest in Transferred Property: How the Freeze Became Abusive

As part of the process of unifying the estate and gift tax rates in 1976, Congress retained section 2036(a).²⁹ This section provided that, if an asset is transferred and the transferor retains an interest in that asset for a period not ending prior to the transferor's death, then the full value of the asset as of the transferor's death would be included in the transferor's gross estate for calculating estate tax liability.³⁰ Essentially, a gift transfer in which the transferor retains an interest in the property transferred was treated as incomplete for estate

²⁵ The following example illustrates this concept. Donor A gratuitously transfers assets currently worth \$600,000 to her daughter, D. Over the next twenty years, the value of these assets in D's hands grows from \$600,000 to \$3,000,000. At the end of this twenty-year period, A dies. At the time the gift is made, A is treated as having made a taxable gift of \$600,000, which results in a gift tax owed of \$192,800. At the time A dies, twenty years after the transfer, no additional estate or gift tax is owed as to the transfer of these assets. In other words, A froze the value of the assets for transfer tax purposes at \$600,000 by transferring the assets twenty years before she died. Comparatively, if A had not made the transfer at that time and instead held on to those assets, worth \$3,000,000 at A's passing, then A would have incurred an estate tax on \$3,000,000.

²⁶ HOUSE WAYS AND MEANS COMM., ESTATE AND GIFT TAX REFORM ACT OF 1976, H.R. REP. NO. 1380, 94th Congress, 2d Sess. 3 (1976). See also Stanley S. Surrey, *Reflections on the Tax Reform Act of 1976*, 25 CLEV. ST. L. REV. 303 (1976).

²⁷ One disadvantage of a lifetime gift is that gifts are irrevocable and, at least theoretically, not subject to return at the discretion of the donor. In addition, a gift made during lifetime could decrease in value. This means that if the donor had held on to the property until death, that donor would have paid less estate tax at that time than the gift tax paid when the gift was made.

²⁸ Any appreciation factor would be arbitrary and, perhaps, unfair. In this regard, not all gifts are investment property or will increase in value. For example, gifts of tangible personal property may decline in value. This raises the question of whether a depreciation factor, which takes into account inflation costs, should be incorporated in certain circumstances.

²⁹ I.R.C. § 2036(a).

³⁰ Specifically, section 2036(a)(1) requires inclusion in the value of a decedent's gross estate for estate tax purposes the value of all property which the decedent transferred, for less than adequate and full consideration, under which he retained a right to the enjoyment or income from the property for his life. This is often referred to as "a transfer with a retained interest."

tax purposes.³¹

As a result of estate tax problems associated with straightforward section 2036(a) retained interest transfers, techniques were developed to allow for retained interests that prevented the application of section 2036(a). Popular approaches included preferred stock recapitalizations and family partnerships, family holding companies, grantor retained income trusts, donative options, and purchase life estate/remainder interests.³² By far, the two most dominant categories

³¹ Consider the following example. Transferor T gives 100 shares of IBM stock, worth \$50,000, to his daughter, D. T treats the transfer as a taxable gift of \$40,000 (\$50,000 less the annual gift tax exclusion amount, \$10,000). T retains the right to all of the dividends issued on the stock. Ten years later, T dies and the value of the stock is \$100,000. Pursuant to section 2036(a)(1), T will include in his estate the full value of the IBM stock, even though T only retained the right to the dividends. The full value at T's death is \$100,000.

Holding a lifetime interest in property prevents the remainder, gifted component from coming into possession until the grantor's death. In retaining section 2036, Congress decided that individuals should not be allowed to structure gifts of essentially testamentary transfers in the form of lifetime gifts in order to avoid the generally higher estate tax liability from any appreciation in value that occurs between the date of the gift and the date of death. Consistent with a unified estate and gift tax system, section 2036(a) achieves several policy objectives. First, an estate tax would be imposed upon property transferred during life where the transferor retained the economic benefit of the property, as when possession or enjoyment of the transferred property is in fact held until death. Second, an estate tax would be imposed upon property transferred during life when the transfer was essentially testamentary. Third, an estate tax would be imposed upon property transferred during life when the transferor reserved significant powers over possession or enjoyment over the transferred property.

³² A preferred stock recapitalization involves an income tax-free reorganization of the capital structure of a corporation. The recapitalization is intended to establish two types of equity interests, common stock and preferred stock. Within certain boundaries, each type of equity interest is assigned various ownership attributes, such as control, income, current equity, and future appreciation. Generally, older generation shareholders receive only preferred stock while younger generation shareholders retain their old common shares or exchange them for new common shares of equal value, if such individuals already exist as shareholders, or, if they are not already shareholders, receive new common shares either by gift or purchase. Traditionally, the ownership attributes of the preferred shares can be valued at a price approximating the current fair market value of the older generation shareholders' interest in the company prior to the exchange. See Robert C. Kopple, *Corporate Recapitalization and Partnership Freezes*, 17 INST. ON EST. PLAN. ¶ 1104 (1983).

The family holding company, similar to a closely held corporation, generally consists of the wealth of a particular family, including any active businesses and any passive investments. The capital structure of a family holding company often includes several classes of preferred stock as well as common stock. As with a preferred/common stock recapitalization, the preferred stock interest in a family holding company is structured to capture the value of the company at the time of inception, whereas the common stock is structured to benefit from the appreciation of the company.

With a multiclass partnership, there are at least two partnership equity interests. One interest claims all future appreciation and also shares all income after any required amounts have been set aside for the preferred interest. The preferred, or second, partnership interest ordinarily represents a substantial portion of the current equity value in a partnership. It has a fixed liquidation value and a preferred income position. If this interest is a limited partnership unit, it will, to a large extent, resemble preferred stock. See, e.g., Gary Stolbach et al., *New Estate Freeze Rules: Gift Leveraging Can Achieve Estate Planning Objectives*, 8 J. P'SHIP TAX'N 9 (1992).

of these strategies were the business recapitalization³³ and grantor retained income trust.³⁴

These types of retained interest transfers actually bifurcated a specific asset into two ostensibly distinct assets, with each asset being ascribed a value. The transferor would retain one asset and transfer, during life, the other one to the intended beneficiaries.

Although in theory two distinct assets were created, these techniques allowed the transferor to retain sufficient control of the transferred asset to regulate, most often to increase, the value of that asset beyond what was contemplated for gift tax purposes.³⁵ Essentially, the transferor could increase the value of the transferred asset at a rate greater than the assumed growth rate used in the calculation of the gift tax.³⁶ At a minimum, the transferor could control the beneficial

A grantor retained income trust is a type of grantor retained interest trust, undertaken for the primary purpose of saving transfer taxes. Essentially, it is an irrevocable trust to which a grantor transfers property but retains certain rights in the trust for a period of years. See *infra* notes 59-67 and accompanying text. The strategy gained popularity in 1983 with the introduction of the so-called 10% tables. See generally PRACTICAL DRAFTING 403-21 (Richard B. Covey ed., 1984).

Donative options were at one time given viability by *Dorn v. United States*, 86-2 USTC ¶ 13,701, 59 AFTR 2d 87-1198 (W.D. Pa. 1986), *rev'd*, 828 F.2d 177 (3d Cir. 1987). The strategy is for the donor to grant to his or her donees an option to purchase shares of stock at their fair market value, determined as of the time the option is granted. The unwritten intent is for the donees not to exercise the option prior to the death of the donor. At the donor's death, the stock would not be included in the donor's estate at its fair market value, but rather at its option value. Thus, any appreciation between the date that the option is granted and the date of the donor's death would pass free of estate and gift tax, and during this period the donor would have retained the use of the asset.

Under the purchased life estate/remainder interest approach, the parent generally purchases the income interest in an asset while the children or grandchildren purchase the remainder interest in the asset. Prior to the Revenue Reconciliation Act of 1990, see *supra* note 18, the value of each interest was based primarily on discount rate assumptions. Therefore, the value for purchase purposes of the remainder interest could be substantially less than its actual value. At the parent's death, no assets would be included in the parent's estate with regard to the purchased asset because the parent's life income interest would then terminate.

³³ See Kopple, *supra* note 32, at ¶ 1100. Despite arguments by the Service to the contrary, stock recapitalizations and other techniques done to effectuate estate freezes were not generally within the reach of section 2036(a). See, e.g., *United States v. Byrum*, 408 U.S. 125 (1972) (holding that section 2036(a) did not apply to a taxpayer who transferred recapitalized stock to a trust but retained stock with certain voting rights). For the Service's view of the transfer tax consequences of such transactions, see Private Letter Rulings 8401006 (Sept. 28, 1983) and 8510002 (Nov. 26, 1984).

³⁴ See Harry F. Lee, *Economics of a GRIT*, 68 TAXES 555 (1990); Richard S. Franklin & Andrew J. Krause, *GRITs Created Under Prior Law Offer Unique Opportunity*, 19 ESTATE PLANNING 82 (1992).

³⁵ See, e.g., *infra* notes 44-58 and accompanying text.

³⁶ See Lee, *supra* note 34. A true bifurcation, where the values of each asset are independent of one another, is essentially equivalent to an outright gifting program sanctioned by the Code. This follows because the retained interest is independent of the transferred interest. Accordingly, the transferor will be in a position equivalent to making an outright gift equal in value to the transferred interest. In that instance, the value of the transferred interest cannot be increased after the transfer based on actions or inactions of the transfer vis-à-vis the retained interest. As discussed *supra* notes 25-28 and accompanying text, outright gifts are sanctioned by the Code and do achieve estate freezes, but without carrying with them the transferor-retained control or potential valuation abuses of the retained interest transfers discussed above. Although Congress was willing to allow an asset to be bifurcated and therefore avoid the reach of section 2036(a), it became concerned when bifurcations resulted in two assets not truly independent of one another, resulting in fair market values that could be transmogrified by the owners of each asset. This concern was the genesis of Chapter 14.

enjoyment of the transferred property, a benefit that section 2036(a) was intended to limit.

C. The Business Estate Freeze: The Strategy as It Existed Prior to Section 2036(c) and Chapter 14

Since the enactment of the estate tax, an issue that has confronted owners of closely held businesses is how to pass the business on to their families at a minimal transfer tax cost.³⁷ For example, if a parent holds the complete stock interest in a corporation worth \$3,000,000, then at the parent's death the estate tax owed would be \$1,098,000.³⁸ If at death the parent gifted the stock to his children, then to the extent the business did not have liquid assets to pay this estate tax the children faced practical concerns, including the need to sell a portion or all of the stock.³⁹

Accordingly, strategies were developed to address that concern. One feasible solution was to transfer, during the parents' lifetimes, equity in the company while the parents retained control of the corporation. If the company was a corporation with one class of stock, this goal could be accomplished by recapitalizing the capital structure of the corporation to create two classes of stock,⁴⁰ one carrying with it voting rights and the other not.⁴¹ Thereafter, all of the nonvoting stock could be transferred to the children or other successors in interest.⁴² Although this strategy achieved one objective—the transfer of equity to the children while allowing the parents to retain control—it failed to minimize

³⁷ For a discussion of this concept, see EDWARD F. KOREN, ESTATE AND PERSONAL FINANCIAL PLANNING ch. 36 (1992). The term "family" most often refers to children, but also refers to spouses, grandchildren, cousins, and other relatives.

³⁸ The estate tax on \$3,000,000, assuming a maximum 55% rate, is \$1,290,800. I.R.C. § 2001(c). The tax payable is reduced by a credit of \$192,800. I.R.C. § 2010(a).

³⁹ Although sections 6161 and 6166 provide for an extension of time in which to pay the estate tax in installments, an extension will carry with it interest on the unpaid amount. As a result, in order to pay the estate tax, whether in lump sum or installments, an estate consisting primarily of closely held business interests would need to have those interests generate sufficient funds to pay the amounts due. If the businesses did not generate sufficient funds (including through loans), then a portion or all of the businesses would need to be sold to generate those funds. For a discussion of the liquidity issues facing an estate in this situation, see Koren, *supra* note 37.

⁴⁰ If a transfer of a fractional interest of one class of stock were made, this would not accomplish the goal of reducing estate tax exposure. First, what would be achieved is to transfer a proportional amount of the company's equity to the children; the amount retained would grow at the same rate as the transferred interest. Second, there could be difficult gift tax concerns with transferring during life a substantial portion of the stock of a company which has a value in excess of one million dollars. An overriding problem was that the transfer of stock in a one class corporation would thereby transfer voting rights, which the parents may not have been willing to do.

⁴¹ A one-class corporation can restructure its stock, free of income tax, to create two classes, one voting and one nonvoting. See, e.g., I.R.C. § 368(a)(1)(E).

⁴² In a corporate or partnership setting, the retention of one class of stock or partnership interest and the gifting of another class of stock or partnership interest has not been deemed to invoke section 2036(a). See, e.g., Estate of Boykin v. Commissioner, 53 T.C.M. 345 (CCH), T.C.M. ¶ 87,0134 (P-H) (1987).

substantially the transfer tax costs.⁴³

As a result, there developed strategies in which the two classes of created stock interests differed in terms of equity rights. A preferred class of equity interest was created and given liquidation interests; put, call and conversion rights; and preferences as to dividends over other shareholders.⁴⁴ The value of the equity interests with those rights was designed to approximate the full value of the corporation at the time of the recapitalization. The parent would retain this preferred class of equity interest.

The second class of equity interest would be nonvoting common stock, which would carry with it all residual equity interests in the company. Because the preferred class of equity interest was designed to approximate the full fair market value of the company, the common stock class of interests arguably had minimal value.⁴⁵ The foundation of this type of retained interest estate freeze was that the holder of the preferred equity interest could determine whether to exercise the retained preferred rights. If the retained rights were unexercised, value would actually shift to the benefit of the common equity interests.

This result is illustrated by the following example. Assume Parent, P, owns 100% of the common stock of company X, valued at \$1,000,000. X has only one class of stock. The Board of Directors of X (controlled by P) authorizes an income tax-free recapitalization in which two classes of stock are created, preferred and common. The preferred class carries with it the right to put that stock to X at any time for a price equal to \$1,000,000, the right to the first \$1,000,000

⁴³ The value of the voting and nonvoting stock would be similar, and therefore a substantial cost would be incurred in the initial transfer of the nonvoting stock, arguably close to 50% of the corporation. Further, any future gain in the value of the corporation theoretically would be split proportionally between the voting and nonvoting stock. Accordingly, the parents would not have frozen their interest because the nonvoting stock would participate in the increase in value of the company. In essence, this would be equivalent to an outright transfer of a proportional amount of the parent's common stock interest, which does not achieve a retained interest estate freeze or otherwise reduce substantially the parents' transfer tax exposure.

⁴⁴ Preferred stock are shares in a corporation which confer on their holders preferences in earnings and assets in liquidation, or both. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 2.21 (3d ed. 1992). Typically, stock clauses will spell out the rights of the preferred shareholders by specifying dividend preference of the preferred shares and whether the dividends are to be cumulative or noncumulative; the liquidation preference, if any; whether the corporation can redeem the shares and, if so, on what terms; whether the shares are to have conversion or put rights; and whether the shares are to have voting rights. *Id.* at § 3.29.

⁴⁵ Assume that the value of a corporation is \$1,000,000 and the corporation has two classes of stock, preferred and common. The value of the common stock will equal the residual value of the company, after subtracting the fair market value of the preferred shares. If the preferred shares are valued at \$1,000,000, then the common stock would have a zero value (i.e., the fair market of the company, \$1,000,000, less the fair market value of the preferred stock, \$1,000,000, is zero). But this is a non sequitur because any increase in value of the company, in excess of \$1,000,000, would pass to the common shares. A willing buyer would pay valuable consideration for the right to have all the value in excess of \$1,000,000. This conclusion means that the preferred stock was not correctly valued at \$1,000,000. Rather, the value of the preferred has to be reduced by the probability that rights attached to the preferred will not be exercised. This reduction for the probability of nonexercise rarely figured into valuation equations, and arguably formed the basis of the abusive valuation with preferred stock. See *infra* note 50 and accompanying text.

in assets if the company is liquidated, and a voting right to elect directors.⁴⁶ The common stock carries with it all remaining rights, including the right to any dividends issued and to assets in excess of \$1,000,000 on liquidation. P values the preferred stock at \$900,000, arguing that because the put and liquidation rights equal \$1,000,000 (and P has retained the right to vote, thereby controlling the Company and decisions as to whether and when X liquidates), the value of this interest is \$1,000,000 less a 10% discount for the possible delay in immediate enjoyment of the liquidation preference or put right. P gifts the common stock, then valued at \$100,000,⁴⁷ to his child, C. P does not intend to exercise the put or liquidation right and, after ten years, passes away while holding these rights. The value of X at P's death is \$3,000,000 and the value of the put and liquidation rights have remained stable at \$900,000. Therefore, \$900,000 is in P's gross estate, but P has transferred \$2,100,000 to C, at a minimal gift tax cost since this portion was already gifted when the value of this portion, for gift tax purposes, was \$100,000. Further, P has exercised control over when C is to get this \$2,000,000 since, at any time during his life, P could have exercised the put or liquidation right.⁴⁸

As illustrated by the example, one of two results could be obtained by undertaking a retained interest freeze with a partnership or corporation. At a minimum, the transferor could freeze the value, for transfer tax purposes, of the transferor's retained interest in the business while transferring all future growth to the transferred interest, in contravention of the principles of section 2036(a).⁴⁹ Moreover, based on the lack of guidance as to valuation principles, the transferor could grossly understate the gift tax value of the transferred interest, contrary to the overall purpose of unifying the estate and gift tax system.⁵⁰

⁴⁶ Another possible attribute of the preferred stock interest would be the right to noncumulative preferential dividend treatment. As P would retain the right to vote and therefore the right to elect the board of directors, P could influence whether dividends were issued to him on an annual basis. To the extent P did not need the funds, P could determine that dividends not be issued. Dividends not issued would inure to the benefit of X, thereby increasing the overall value of X and accordingly the value of C's stock interest.

⁴⁷ The value of X is \$900,000. If the value of the preferred stock equals \$1,000,000, then the residual value of the common stock is \$100,000. See *supra* note 45.

⁴⁸ The preferred equity interests could have been lapsing, which would have further increased the value of the common stock to the extent the rights were not exercised prior to the lapse. For instance, in the discussed example, the put and liquidation rights could have been structured so as to expire, if unexercised, at the end of five years. Once those rights had expired unexercised, the value associated with those rights, \$900,000, would also have been lost, or in essence, shifted to the holders of the common stock. To the extent no gift tax was associated with the lapse, additional value would then have been transferred at no transfer tax cost. See *infra* notes 51-58 and accompanying text.

⁴⁹ See *supra* note 31 and accompanying text.

⁵⁰ See *supra* notes 5-7 and 45 and accompanying text. The correct approach in valuing preferred and common equity interests would have been as follows. First, the value of all preferred rights, assuming the rights were exercised, would be determined. Second, a discount factor would be used to determine the probability of that right not being exercised or, if exercised, the probability of that right not being totally satisfied. Third, a discount factor would be included for present value purposes, probably based on the corporation's expected rate of growth. Given the uncertainty of ascribing legitimate probability and discount factors, as well as the administrative inconvenience of implementing this procedure, this type of approach, although mathematically correct, could not prove feasible.

D. Lapsing and Other Evaporating Rights: Increasing the Abuse Potential of the Partnership or Corporate Freeze

The transfer tax savings of the corporate and partnership freeze techniques could be increased if retained voting or liquidation rights disappeared, or "lapsed," at a point in time if not exercised. At the time of the lapse, the value of the underlying equity interest associated with the lapsing right would also disappear. Although a transfer tax should have been imposed at the time of the lapse when the value of the equity interest decreased, these transactions were successfully argued to be outside of the transfer tax system.⁵¹

The case of *Estate of Daniel Harrison*⁵² illustrates this concept. In *Harrison*, the decedent obtained during his life partnership interests with an aggregate value of \$59,476,523. This value represented decedent's share of the partnership if the partnership was liquidated, and decedent had the right during life to dissolve and liquidate the partnership.⁵³ At the decedent's death, the right to dissolve and liquidate the partnership effectively ceased as to decedent's interest in the partnership. As a result, at death the value of decedent's partnership interests decreased from approximately \$60,312,136, the value immediately before death, to \$33,757,116, to which both the Service and the estate agreed.⁵⁴ In effect, decedent's right to dissolve and liquidate the partnership increased the value of his other interests in the partnership by \$26,555,020.

The Service attempted to include this additional \$26,555,020 in the decedent's estate, arguing that the lapse of the liquidation right at death should be treated as a transfer and given a value for estate tax purposes.⁵⁵ The Tax Court in *Harrison* refused to accept the Service's argument, and concluded that a lapse is not a transfer for tax purposes.⁵⁶ The court held that for estate tax purposes the value of the decedent's partnership interests was \$33,757,116, thereby allowing \$26,556,020 to disappear free of transfer tax at decedent's death.⁵⁷

The problem argued by the Service—that \$26,555,020 was transferred to the decedent's family without the payment of any gift tax or estate tax—was realistic. In effect, the *Harrison* court's ruling substantiated the transfer tax abuse potential of lapsing rights.⁵⁸

⁵¹ Alternatively, the existence of the lapse should have been taken into account in the initial valuation of the retained equity interest. But as a practical matter, as illustrated by the *Harrison* case *infra*, that approach was rarely followed.

⁵² 52 T.C.M. 1306 (CCH), T.C.M. ¶ 87,008 (P-H) (1987).

⁵³ *Id.* at 1307 (CCH), 41 (P-H).

⁵⁴ *Id.* at 1308 (CCH), 41 (P-H).

⁵⁵ *Id.* at 1308 (CCH), 41-42 (P-H).

⁵⁶ *Id.* at 1309 (CCH), 42 (P-H).

⁵⁷ *Id.* at 1308, 1310 (CCH), 41, 44 (P-H).

⁵⁸ This problem is now addressed by section 2704, discussed *infra* Part III.D.

E. The Grantor Retained Interest Trust

1. The Concept Explained

A grantor retained interest trust (GRINT) is a transfer tax strategy not dependent on the business setting. With it, a grantor establishes an irrevocable trust and retains one or more property rights from the trust for a term of years, or for a period ending on the first to occur of the grantor's death or the expiration of the term of years.⁵⁹

The typical property right is either (1) a retention of a use or income interest (a grantor retained income trust, or GRIT); (2) a retention of an annual fixed dollar amount, analogous to an annuity interest (a grantor retained annuity trust, or GRAT); or (3) a retention of a percentage of the periodic fair market value of the trust, known as a unitrust interest (a grantor retained unitrust, or GRUT). At the expiration of the term of the retained property right, the funds are distributed outright or continue to be held in trust for the remainder beneficiaries designated by the grantor at the establishment of the trust. If the grantor dies prior to the expiration of the grantor's retained interest term, the funds either pass to the remainder beneficiaries or, depending upon the specific terms of the trust, may revert to the grantor's estate or be subject to a general power of appointment held by the grantor.

Because a GRINT is irrevocable and the grantor retains no right to alter the terms of the trust, the transfer of funds to the trust is a completed gift.⁶⁰ The value of this gift for gift tax purposes is the value of the property transferred less the value of the grantor's retained interests.⁶¹ The grantor's retained interests are the right to receive the income, or an annuity-type payment, for a certain number of years, or for a period ending on the first to occur of the grantor's death or the expiration of the term of years. The grantor may also retain a reversion in or general power of appointment over the property if he dies prior to the expiration of the specified number of years. The greater the value for gift tax purposes of these retained interests, the lower the value of the taxable gift.

If the grantor survives the term of years during which he has the retained interests, the remaining property in the trust passes to the beneficiaries, free of additional gift or estate tax.⁶² The only gift or estate tax cost associated with the transfer is the gift tax imposed at the time the trust was established.⁶³ If the

grantor dies prior to the expiration of his retained property interest, the amount to be included in the grantor's estate depends on the type of the retained property interest. If the retained property interest was an income interest, then the current value of the trust is included in the grantor's gross estate pursuant to section 2036(a).⁶⁴ If the retained property interest was an annuity interest, a fraction of the current value of the trust is included in the grantor's gross estate pursuant to section 2036(a).⁶⁵ In either case, inclusion in the gross estate is required because the transfer was initially a transfer with a retained interest, and a retained interest is held at death.⁶⁶ Prior to Chapter 14, retained interests were valued pursuant to section 7520 and Regulations section 25.2512-5.⁶⁷

2. Discounted Present Value Theory and Leveraging Techniques

Understanding the effect of discounting property to present value is crucial to understanding the transfer tax value of GRINTs, both under pre-Chapter 14 and post-Chapter 14 law. For example, ignoring discounted present value theory would lead one to conclude incorrectly that if a grantor establishes a \$1,000,000 GRINT that results in gift tax on a gift of \$600,000, the grantor saves transfer taxes associated with a \$400,000 gift at the end of the GRINT term. One may conclude that a transfer tax savings associated with a \$400,000 gift is logical since at least \$1,000,000, and not the \$600,000 gift element, passes to the remainder interests at the end of the term. But such an analysis fails to take into account discounted present value considerations. Before a conclusion about the actual transfer tax savings can be reached, the question must be asked, "What is the value today of \$1,000,000 to be received five years in the future?" If that value would have been less than \$600,000, which is plausible depending on the average rate of return and growth experienced during this period, then the GRINT is actually an inferior method of saving transfer taxes than an outright gift transfer.

The concept of leveraging is also pertinent when analyzing a GRINT. Leveraging, as that term is often used in the gift transfer context, refers to the use

⁵⁹ The phrase "retained interest term" is used herein to refer to the period that the grantor retains one or more property interests in the trust. GRINTs, GRATs, GRUTs, and GRITs are acronyms used by the author but are not statutory terms. The term "remainder beneficiaries" as used throughout this article, refers to individuals or organizations, set forth in the governing instrument, who are to take property after the expiration of a preceding interest, such as an interest for a term of years or life estate.

⁶⁰ Regs. § 25.2511-2.

⁶¹ For gift tax purposes, a gift is technically incomplete as to the value of that portion of the interest transferred which is retained by the grantor. *Id.*; see also Regs. § 25.2511-1(e), -1(h)(7).

⁶² See Lee, *supra* note 34.

⁶³ Technically the gift is of the remainder interest, which is a future interest. Therefore, the gift does not qualify for the gift tax annual exclusion. I.R.C. § 2503(b).

⁶⁴ I.R.C. § 2036(a)(1). Inclusion in the gross estate may also be mandated by section 2037(a). Generally, section 2037(a)(2) includes in the value of a decedent's gross estate for estate tax purposes the value of all property that the decedent has transferred for less than full and adequate consideration, under which he retained a reversionary interest in the property which exceeded 5% of the value of the property immediately before the decedent's death. I.R.C. § 2037(a)(2).

⁶⁵ I.R.C. § 2036(a)(1). See Rev. Rul. 76-273, 1976-2 C.B. 268, for a possible approach to determine the amount of property included in the grantor's gross estate if death occurs during the time the grantor has a retained annuity or unitrust interest, as opposed to a retained income interest.

⁶⁶ I.R.C. §§ 2036(a), 2037(a). There is no three-year rule pursuant to section 2035 when the grantor's income or annuity-type interest expires. This is because there is no "transfer" at that time; it is merely treated as a "lapse." I.R.C. § 2035(d)(2).

⁶⁷ See *infra* note 73 and accompanying text.

currently of an individual's transfer tax credit⁶⁸ in order to allow that credit to, in effect, appreciate in value.⁶⁹

3. Identifying the Abuse Areas

The transfer tax savings components of pre-Chapter 14 GRINTs can be isolated and compared with the transfer tax savings associated with outright lifetime gifts.⁷⁰ From this comparison, the abusive valuation aspects of pre-Chapter 14 GRINTs become apparent, as do the nonabusive aspects.

First, if properly valued and administered,⁷¹ a pre-Chapter 14 GRINT was not abusive even though there was a possibility for transfer tax savings. The possibility of transfer tax savings resulted if the discount rate assumed for gift tax purposes was greater than the average rate of return on investments experienced during the retained interest term or if a properly valued GRIT outperformed the assumed discount rate. The transfer tax savings potential in these instances was minimal because the rate of the savings was only the spread between the assumed discount rate and the actual investment return rate.⁷²

Take, for example, the case in which the gift tax discount rate exceeds the average investment return rate during the retained interest term.⁷³ Assume that

⁶⁸ The Code provides a credit of \$192,800 against gift and estate taxes incurred by an individual (the "unified credit"). I.R.C. §§ 2010, 2505. Under current estate tax rates, the unified credit will shield the first \$600,000 in taxable transfers from any actual payment of tax. To the extent the unified credit is used during life, it will not be available at death to shield any property from the payment of estate tax.

⁶⁹ If A gratuitously transfers assets worth \$600,000 currently, thereby fully utilizing her unified credit, and these assets appreciate to \$3,000,000 twenty years from now, then that \$3,000,000 will be out of A's gross estate for estate tax purposes. If this transfer is not made currently, then those assets, worth \$3,000,000 at A's death, will be included in her estate, and only \$600,000 of that amount could then be shielded by A's unified credit available at death. Of course, additional considerations become relevant when deciding whether to use the unified credit during life. One consideration is the interplay between taxable gifts and annual exclusion gifts. See I.R.C. § 2503(b). For example, if an individual has three potential donees (i.e., three donees that individual wants to benefit), the grantor can transfer \$60,000 per year to those donees (assuming the grantor's spouse consents) and, in ten years, give away \$600,000. If the same donor had used the unified credit in year one to gift \$600,000, but had not combined that gift with additional gifts of \$20,000 per beneficiary per year, then the donor would have, in effect, partially wasted the unified credit.

⁷⁰ In this comparison, the transfer tax savings associated with outright lifetime gifts is a constant, or permissible level. This follows because the Code permits and contemplates that lifetime taxable gifts will be made.

⁷¹ In this context, the term "properly valued and administered" refers to (1) a gift tax discount rate reflecting the actual, average investment rate of return during the retained interest period and (2) assets invested to yield reasonable amounts of income to the grantor. Cf. *infra* notes 85-89 and accompanying text.

⁷² The transfer tax savings was a result of the skewing of the discount tables. It resulted in property in excess of the assumed discount rate passing free of transfer tax to the remainder beneficiaries.

⁷³ Prior to Chapter 14, the initial gift of the remainder interest in a GRINT was calculated under both an assumed income payout rate and an assumed discount rate (both rates were the same) to determine the present value of the remainder interest for gift tax purposes. Regs. § 25.2512-5. The rate was 120% of the federal midterm rate. I.R.C. § 7520(a)(2). For example, if the applicable section 7520 discount rate was 8.2%, this assumed that the grantor was receiving an income payout of 8.2% in an investment environment in which the average yield was also 8.2%. If the assumed rate

the gift tax discount rate for a five-year, \$1,000,000 GRIT valued pursuant to section 7520 is 10.20%, and the actual, average after-tax rate of return on investments experienced during those five years is 8.20%. For purposes of calculating the gift tax, the discounted present value of the remainder interest transferred is \$615,307.⁷⁴ At the experienced appreciation rate of 8.2%, at the end of the five-year period an initial gift of \$615,307 would equal \$912,490.⁷⁵ In contrast, at the end of five years, the GRIT (assuming the 8.2% it earns annually is represented all by income, which is distributed to the grantor), equals \$1,000,000, the original funded amount.⁷⁶ The remainder interest collects \$87,510 (i.e., \$1,000,000 rather than the \$912,490) more than it would have had the gift tax value of the remainder interest been properly calculated at the 8.2% rate.⁷⁷ This result occurs because the 2% differential in assumed versus actual discount rates has actually shifted property from the retained income to the transferred remainder interest.⁷⁸

The transfer tax savings from this disparity are not substantial. Further, there is an analogous risk of a transfer tax loss. This would occur if the actual rate of after-tax investment return experienced during the retained interest term was greater on average than the assumed rate. In that event, if the GRIT produced only income and no appreciation, the grantor in the above example would have passed less property to the remainder beneficiaries than she was deemed to have passed for gift tax purposes.

Similarly, a second type of skewing of the valuation tables occurs if a GRINT experiences a rate of return and growth greater than the assumed gift tax valuation rate. For example, assume that \$2,052,686 was transferred to a GRIT in which the grantor retained the right to the income for a fixed ten-year term. Assume further that the gift tax valuation rate was 10.80%. The gift tax value is \$736,080.⁷⁹ The gift tax valuation assumes that the GRIT would earn 10.80% in income each year in which income will be returned to the grantor and that the

was not exactly equal to the actual, average rate of after-tax return experienced by investments during the retained interest term, then there occurred a partial transfer tax advantage.

⁷⁴ This is calculated by using the formula for calculating present value: $PV = FV / (1 + r)^n$, where "PV" is the present value of "FV", the future value, in "n" years at a discount rate of "r". In the current example, the value assumed for calculating the gift tax of the remainder interest in the GRIT is \$1,000,000 multiplied by $1 / (1 + .102)^5$, or \$1,000,000 multiplied by .615307.

⁷⁵ Calculated by multiplying \$615,307 by $(1 + .082)^5$.

⁷⁶ The grantor initially transferred \$1,000,000 to the GRIT. This amount earns \$82,000 in income each year, which is distributed to the grantor. At the end of the fifth year, \$1,000,000 still remains in the GRIT.

⁷⁷ In order to receive \$1,000,000 at the end of the retained interest term, assuming a 8.2% rate, the original gift should have been \$674,316 $((1 / (1 + .082)^5) \times \$1,000,000)$.

⁷⁸ The value of the retained income interest at a 10.2% discount rate is .384692 (i.e., $1 - 1 / (1 + .102)^5$). The actual value received under the realized rate of 8.2% is .325683 (i.e., $1 - 1 / (1 + .082)^5$). The difference is .059009, or \$59,009 of the value. In other words, the 2% difference resulted in a \$59,009 overstatement of the retained income interest at the time the GRIT was established. Assuming an 8.2% growth rate, this difference amounts to \$87,509 after five years (\$59,009 multiplied by $(1 + .082)^5$).

⁷⁹ Calculated by multiplying \$2,052,686 by $(1 / (1 + .108)^{10})$.

value of the GRINT at the end of the ten-year term will therefore be \$2,052,686.⁸⁰ If the GRINT grew at an annual rate of 12.80%, with income at a 10.80% rate returning to the grantor each year, then the value of the GRIT will be in excess of \$2,052,686 at the end of ten years. In fact, the \$2,052,686 will yield \$2,502,213 to the remainder beneficiaries.⁸¹

The \$449,527 (\$2,502,213 less \$2,052,686) is not the true transfer tax savings. The remainder component of the GRINT, had it been gifted outright in year one instead of gifted pursuant to the trust, under the same 12.80% assumption, would have grown to \$2,454,799 at the end of ten years.⁸² Therefore, there is a difference of only \$47,414 in the amount shielded from transfer taxes.⁸³

The concerns raised by outperformance of the valuation tables, or average investment return rates less than the assumed gift tax discount rates, were insubstantial and arguably nonabuse areas. Accordingly, Chapter 14 does not address these concerns and there remains the possibility of transfer tax savings with post-Chapter 14 GRINTs pursuant to the two principles outlined above.⁸⁴

Conversely, two abusive valuation techniques could be applied to pre-Chapter 14 GRINTs. The initial abuse area concerned the ability of the trustee to reduce the grantor's retained income interest to the benefit of the remainder beneficiaries. The trustee of a GRIT could decide to invest in high-growth, low-yield assets, thereby transferring more property to the remainder beneficiaries than was assumed for gift tax valuation purposes, while depriving the grantor of her assumed retained income. For example, if the gift tax valuation discount rate was 10.80%, then the grantor was assumed to be receiving a 10.80% rate of return each year as a result of her income interest.⁸⁵ If the trustee invested the GRIT in assets that yielded 6.80% in income and 4% in growth each year, then 6.80% in income was returned to the grantor while the 4% in growth was transferred, free of gift tax, to the remainder beneficiaries. This was abusive since the initial gift tax valuation assumed that the grantor would be receiving

income equal to 10.80% of the GRIT each year.⁸⁶ In effect, the trustee froze the grantor's retained interest at 6.80% and transferred the additional 4% appreciation, free of transfer tax, to the remainder beneficiaries.

To illustrate the abuse potential with this technique, assume that \$2,052,686 is transferred to a GRIT in which the grantor retained the right to the income for a fixed ten-year term. If the gift tax valuation rate is 10.80%, the gift tax value is \$736,080.⁸⁷ The gift tax valuation presupposes that the GRIT will earn 10.80% each year in which income will be returned to the grantor and that the value of the GRIT at the end of the ten-year term will be \$2,052,686. If income equal to 6.80% of the property is paid to the grantor at the end of each year, then the initial value of the property is increasing in value at a 4% rate each year. At the end of ten years, the fair market value of the property is \$3,038,477.⁸⁸ Therefore, \$985,791 passes to the remainder beneficiaries free of any transfer tax.⁸⁹

The second abuse area to the pre-Chapter 14 GRIT occurred when the grantor retained both an income interest and a reversion⁹⁰ or general power of appointment⁹¹ during the retained interest term. The retained reversion or general

⁸⁶ As a result of this perceived abuse, the Service imposed a "reasonable rate of return" requirement on GRITs. If the remainder interest was initially valued assuming an income interest at X%, and the grantor did not receive a "reasonable rate of income" (which was not defined but was probably something approximating X%) then in each year in which the grantor did not receive a reasonable rate of return, the Service deemed the grantor to have made a taxable gift. P.L.R. 8806082 (Nov. 18, 1987). See also P.L.R. 8801008 (Oct. 7, 1987) (In a trust funded with Subchapter S stock whose dividend rate was substantially lower than the average rate for publicly traded corporations, the grantor made a gift each year equal to the lost income which would have been recognized had the trust property been more productive.); P.L.R. 8642028 (July 16, 1986) (The valuation tables may not be used when property that produced a low rate of return, averaging less than one percent for the immediately preceding five years, was transferred to the GRIT and the grantor had no right to compel the trustee to make the property more productive.); P.L.R. 8905045 (Nov. 8, 1988) (Failure of the grantor each year to exercise power to make the trust "normally productive under the standards usually applicable to simple trusts" will result in an additional gift.).

The new valuation rules established by the 1990 Act require in effect that the grantor's retained interest must be in an annuity form in order to decrease the gift tax value of the remainder. That requirement eliminates the potential abuse associated with GRITs that did not earn a "reasonable rate of return." See *infra* notes 175-217 and accompanying text.

⁸⁷ Calculated by multiplying \$2,052,686 by $(1/(1 + .108)^{10})$. The value of \$736,080 which returns 10.80% annually is, in ten years, \$2,052,686.

⁸⁸ This can be calculated in various ways. Two shorthand ways are (1) to multiply \$2,052,686 by $(1 + .04)^{10}$ or (2) to multiply \$2,052,686 by $(1 + .108)^{10}$, the growth rate, and by the unitrust factor for the value of the remainder interest in a 6.80% retained interest unitrust, payable at the end of a twelve-month interval based on values as of the beginning of each interval, for ten years under an assumed 10.80% rate of return. I.R.S. Publication 1458, *supra* note 81, will allow one to arrive at an interpolated factor of .53081255. (The real factor should be .530806007 but interpolation results in an approximation.)

⁸⁹ Calculated by subtracting the actual fair market value at the end of the term, \$3,038,477, from what the fair market value should have been under the assumed discount rate, \$2,052,686.

⁹⁰ A "reversion" is the grantor's right to the future enjoyment of property, at present in the possession or occupation of another. A reversionary interest is the same as a remainder interest except that in the case of the remainder interest, the property passes to someone other than the original owner (for example, the grantor of a trust) upon the expiration of the intervening interest.

⁹¹ A "power of appointment" is a power to select and nominate the person or persons who are to receive and enjoy an estate or income therefrom after the termination of an existing right or interest, such as at someone's death.

⁸⁰ The value of \$736,080 which returns 10.80% annually is, in ten years, \$2,052,686.

⁸¹ This can be calculated in numerous ways. Two shorthand ways are (1) to multiply \$2,052,686 by $(1 + .02)^{10}$, or (2) to multiply \$2,052,686 by $(1 + .128)^{10}$, the growth rate, and by the unitrust factor for the value of the remainder interest in a 10.80% retained interest unitrust, payable at the end of a twelve-month interval based on values as of the beginning of each interval, for ten years under an assumed 12.80% rate of return. See I.R.S. Publication 1458 (1989).

⁸² The remainder component was \$736,080. The value of \$736,080 ten years in the future at an assumed 12.8% growth rate is \$2,454,799. There is a slight difference between that number and the value of the GRINT at the end of ten years, \$2,502,213, to account for the fact that the value of the remainder interest when income is paid at X% will be slightly more if the discount rate is greater than the assumed X% rate. In essence, the remainder interest is entitled to the percentage growth each year of the income element. For example, the right to receive 10.8% of \$2,052,686 would yield \$221,690 to the grantor in the first year ($\$2,052,686 \times .108$). But if the total return experienced by the property is 12.8% (for example, 10.8% income and 2% growth), the 2% difference multiplied by the income element, \$221,690, or \$4,433, is growth which inures to the benefit of the remainder interests.

⁸³ The minimal nature of this amount is further evidenced if the \$47,414 is presented in discounted present value dollars to the beginning of the GRINT, which is \$14,217 ($\$47,414 \times (1/(1 + .128)^{10})$).

⁸⁴ See *infra* notes 210-17 and accompanying text.

⁸⁵ See *supra* note 73.

power of appointment discounted the value of the remainder interest for gift tax purposes, but resulted in no additional property flowing to the grantor. The discount in the remainder interest occurred because the grantor was allowed to ascribe a value for gift tax valuation purposes to both the retained income interest and the reversion or power of appointment.

A reversion or power of appointment was the distinguishing feature that made properly valued retained interest trusts⁹² beneficial, in terms of transfer tax, over an outright transfer of the remainder interest component of the GRIT. Accordingly, if the assumed discount rate for gift tax valuation purposes approximated the average, after-tax rate of return experienced by investments during the retained interest term, the discounting of the remainder value by the reversion was the reason that the transfer tax savings from a GRIT were greater than the transfer tax savings associated with an outright gift of the remainder component.

For example, assume that on February 16, 1989, the grantor, age 75, transfers \$1,000,000 to a GRIT in which he retains an income interest for five years. If he dies prior to the end of this term, the remaining income for the five-year term continues to be paid to his estate. The value of the remainder interest in this instance, at an assumed interest rate equal to 8.20%, is \$674,316.⁹³ If the GRIT experiences a rate of return for those five years equal to 8.20%, all represented by income, at the end of the five-year term the GRIT will still be worth \$1,000,000. Assuming that \$674,316 had been gifted outright in year one, not pursuant to a GRIT, and earned a cumulative rate of return equal to this same 8.20%, then at the end of five years the donee would also have had \$1,000,000.⁹⁴ If a reversion is retained, the gift tax value is reduced to \$512,632.⁹⁵ The value of \$512,632 five years in the future at a growth rate of 8.20% is \$760,225.⁹⁶ Therefore, the retention of a reversion has resulted in \$239,775 (\$1,000,000 less \$760,225) more in property passing to the remainder interests without being subjected to gift tax.⁹⁷

III. VALUING RETAINED RIGHTS IN THE CORPORATE OR PARTNERSHIP SETTING UNDER CHAPTER 14

In evaluating the effectiveness of Chapter 14, the question seems simple: does it eliminate the valuation abuses associated with the traditional business

⁹² See *supra* note 71 for a definition of "properly valued."

⁹³ Calculated by multiplying \$1,000,000 by $(1/(1 + .082)^5)$.

⁹⁴ Calculated by multiplying \$674,316 by $(1 + .082)^5$.

⁹⁵ See Appendix A.

⁹⁶ Calculated by multiplying \$512,632 by $(1 + .082)^5$.

⁹⁷ An alternative way to examine this point is to compare the remainder component with and without the reversion. With the reversion, the remainder component is decreased by .161684 of the amount of property initially transferred, .674316 less .512632; or \$161,684 (.161684 x \$1,000,000). Since the reversion does not occur, it is essentially property which passes to the remainder interests free of transfer tax. The value of \$161,684 five years in the future at an assumed 8.20% growth rate equals \$239,775.

estate freeze?⁹⁸ The conclusion depends on, first, whether Chapter 14 addresses the issue that discretionary equity rights may go unexercised,⁹⁹ and second, whether a transferor can actually freeze the value of an interest under Chapter 14 and pass all future appreciation in a business to future generations.¹⁰⁰

A. The Reach of the Statute

Section 2701¹⁰¹ addresses the abuses associated with the business estate freeze. That section applies when a parent transfers certain stock or partnership interests to a child, grandchild, spouse, or spouse of a child or grandchild,¹⁰² and the parent retains an interest in the corporation or partnership after the transfer.¹⁰³ Specifically, if the parent retains an "applicable retained interest"¹⁰⁴ in the corporation or partnership after the transfer, the transferred interest may be subject to section 2701. Application of that section will result in special valuation rules to determine the value of the transferred interest.¹⁰⁵

The above analysis would equally apply to reversionary interests (or powers of appointment) retained by the grantor in GRUTs or GRATs. However, in that context there may be estate tax reasons for not retaining a reversion or power of appointment over the full amount of property since the full amount of property may not otherwise be returned to the gross estate if the grantor dies during the retained interest term. See Rev. Rul. 76-273, 1976-2 C.B. 268.

⁹⁸ See *supra* notes 44-53 and accompanying text.

⁹⁹ See *supra* notes 48-58 and accompanying text.

¹⁰⁰ See *supra* notes 46-48 and accompanying text.

¹⁰¹ I.R.C. § 2701.

¹⁰² I.R.C. § 2701(e)(1).

¹⁰³ The general operation of the statute is illustrated by the following example. P owns all of the outstanding stock of a company, consisting of 100 shares of common appraised at \$600,000 and 100 shares of noncumulative preferred appraised at \$400,000. P created the two classes of stock in an estate freeze done in 1982, but did not at that time transfer the common stock. P wishes now to transfer the common and to use the \$600,000 appraised value of the common for gift tax purposes so that no gift tax will be paid. In other words, the gift tax on \$600,000 is \$192,800, section 2501, which is the amount shielded from the payment of gift tax by the unified credit. I.R.C. § 2505. In this situation, the valuation rules under section 2701 would apply and, because the noncumulative preferred stock is ascribed no value for gift tax purposes pursuant to section 2701, section 2701(a)(3)(A), the common stock carries with it the full value of the corporation, or \$1,000,000. See also *infra* notes 119-23 and accompanying text.

¹⁰⁴ The term "applicable retained interest" refers to a liquidation, put, call, conversion or similar right if the exercise or nonexercise of that right would affect the value of the transferred interest (an "extraordinary payment right"). I.R.C. § 2701(b)(1)(B); Regs. § 25.2701-2(b)(1)(i). The term also refers to distribution rights, such as dividend rights associated with preferred or common stock, in a "controlled" entity, i.e., a corporation or partnership in which 50% of the total voting power or fair market value of equity interests were held before the transfer by the transferor, applicable family members (the transferor's spouse, an ancestor of either, or a spouse of an ancestor), and any lineal descendants of the parents of the transferor or the transferor's spouse. I.R.C. § 2701(b)(1)(A), (c)(1)(A), (b)(2); Regs. § 25.2701-2(b)(1), -2(b)(2).

A right that is (1) a mandatory payment right (a right to receive payments required to be made at a specific time for a specific amount); (2) a liquidation participation right provided the family does not have the ability to compel liquidation; or (3) a nonlapsing conversion right (nonlapsing right to convert an equity interest in a corporation into a fixed number or fixed percentage of shares of the same class as the transferred interest, provided it is subject to certain defined adjustments), is not an applicable retained interest. Regs. § 25.2701-2(b)(4). Also, voting rights are not applicable retained interests.

¹⁰⁵ See *infra* notes 113-30 and accompanying text.

To avoid application of the special valuation rules to nonabuse areas, certain types of transfers are expressly excluded from section 2701, regardless of whether the transferor holds an applicable retained interest after the transfer. For example, the section will not apply to transfers of publicly traded securities;¹⁰⁶ to transfers of stock representing the only class of stock in the corporation (such as in a subchapter S corporation);¹⁰⁷ or if transfers are of the same—or proportionately the same—class as the applicable retained interest held by the transferor in the corporation or partnership.¹⁰⁸

The statute literally applies to “transfers,” and therefore to situations other than merely gifts or sales.¹⁰⁹ For example, a contribution to the capital of a new or existing entity constitutes a transfer,¹¹⁰ hence invoking application of the statute.¹¹¹ A redemption, recapitalization, or other change in the capital structure of an entity is also a section 2701 transfer, but only if the parent or other applicable family member (1) receives any applicable retained interest in the capital structure transaction, (2) holds an applicable retained interest prior to the transaction and receives any property other than an applicable retained interest, or (3) holds an applicable retained interest whose fair market value is increased by the transaction.¹¹²

¹⁰⁶ These are defined as interests in which there are “readily available market quotations on an established securities market.” See Regs. § 25.2701-1(c)(1), -1(c)(2). There is no abuse potential with publicly traded securities because there is an established valuation market.

¹⁰⁷ See, e.g., Regs. § 25.2701-1(c)(3). With a corporation that has only one class of stock, or a partnership with only one class of interest, any transferred interest will increase at the same rate as the retained interest. Therefore, there is no abusive freeze potential and section 2701 need not apply.

¹⁰⁸ Regs. § 25.2701-1(c)(3). Also, the section will not apply if the interest transferred results in a proportional reduction in each class of equity aggregately held by the transferor and applicable family members. Regs. § 25.2701-1(c)(4). For example, if a parent transfers an equal percentage of each class of equity interests in a corporation, the statute will not apply. *Id.*

¹⁰⁹ See *supra* note 103.

¹¹⁰ Regs. § 25.2701-1(b)(2)(i)(A).

¹¹¹ This covers the situation in which parent and child start a new business and the parent receives noncumulative preferred stock while the child receives common. Under that situation, the child's common stock would be valued under section 2701 principles, and the parent would be treated as having made a gift to the child of the difference between the value of the business and the amount paid by the child for the common.

¹¹² Regs. § 25.2701-1(b)(2). If a capital structure transaction occurs in which the parent does not receive an applicable retained interest, then the potential for abusive valuation does not exist. That is, the transferred interest cannot be reduced by assigning arbitrary values to the parent's new or increased applicable retained interest.

The statute and regulations provide an exception to these types of transfers if in the capital structure transaction (other than a contribution to capital or “other increase in the value of the entity”), the transferor, each applicable family member, and each member of the transferor's family hold substantially the same interest after the transaction as that individual held before the transaction. Regs. § 25.2701-1(b)(3)(i). The regulations treat common stock with nonlapsing voting rights and nonvoting common stock as interests that are substantially the same. *Id.*

Shifts of rights occurring upon the execution of a qualified disclaimer or upon the exercise, in limited circumstances, of a nongeneral power of appointment are not treated as transfers invoking section 2701. Regs. § 25.2701-1(b)(3)(ii), -1(b)(3)(iii).

B. Application of the Valuation Mandate

For those situations in which section 2701 does apply, a multistep process is used to value the interests transferred to family members.¹¹³ First, the aggregate value of all family-held equity interests in the corporation or partnership is determined.¹¹⁴ That valuation is pursuant to general principles, but assumes that all interests are held by one individual.¹¹⁵

Second, from that initially determined sum, the fair market value of all family-held senior equity interests (other than applicable retained interests held by the transferor or applicable family members) is subtracted.¹¹⁶ Equity interests that carry with them a right to distributions of income or capital, which is preferred to the rights of the transferred interest, are defined as “senior equity interests.”¹¹⁷ Fair market value of these interests is determined in accordance with traditional valuation principles.¹¹⁸

Third, the value of all applicable retained interests held by the transferor or applicable family members, using the valuation rules in section 2701, is subtracted from the fair market value of the above sum.¹¹⁹ Under section 2701, applicable retained interests held by the transferor that consist of extraordinary payment rights¹²⁰ are valued at zero.¹²¹ Also valued at zero is an applicable retained interest that is a “distribution right . . . in a controlled entity” unless it is a “qualified payment” right.¹²² A qualified payment right, generally valued under traditional principles, is a right to receive distributions that are: (1) dividends payable on a periodic basis, at least annually, under any cumulative preferred stock, to the extent such dividends are determined at a fixed rate; (2) any other cumulative distribution payable on a periodic basis, at least annually,

¹¹³ Regs. § 25.2701-3(b).

¹¹⁴ Regs. § 25.2701-3(b)(1). “Family-held” includes the transferor, lineal descendants of the parents of the transferor or the transferor's spouse, and applicable family members. Regs. § 25.2701-3(a)(2)(i). “Applicable family members” include the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor. Regs. § 25.2701-1(d)(2).

¹¹⁵ *Id.* This in essence applies a family attribution rule, treating distinct, separate interests as if they were all owned by one individual, and allows the value to be increased to account for a control premium. For a discussion on family attribution in the valuation context, see Wayne L. Warnken & Pamela R. Champine, *Securing the Minority Discount for Family Business Transfers*, 132 Tr. & Est. 309 (1991).

¹¹⁶ Regs. § 25.2701-3(b)(2)(i).

¹¹⁷ Regs. § 25.2701-3(a)(2)(ii). An example of a senior equity interest (which is not an applicable retained interest) is a preferred class of stock that requires a payment at a specific time in the future for a specific price. This is not subject to the section 2701 valuation rules.

¹¹⁸ See Regs. § 25.2701-3(d).

¹¹⁹ Regs. § 25.2701-3(b)(2)(i)(B). Any “applicable retained interest” received as consideration for the transfer is not taken into account. *Id.* Further, there is an adjustment if the percentage of applicable retained interests held by the transferor and applicable family members is greater than the largest proportion of any class of junior equity or other subordinate interest held by the family. *Id.*

¹²⁰ For a definition of “extraordinary payment rights,” see *supra* note 104 and accompanying text.

¹²¹ I.R.C. § 2701(a)(3)(A); Regs. § 25.2701-2(a)(1).

¹²² I.R.C. § 2701(a)(3)(A); Regs. § 25.2701-2(a)(2). That zero valuation assumption will most often apply to non-cumulative preferred stock or to non-guaranteed or non-cumulative payments from a partnership.

with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or (3) any distribution right for which an election has been made to treat the distribution right as a qualified payment right.¹²³ Accordingly, section 2701 assumes that discretionary rights underlying applicable retained interests will not be exercised in the intra-family situation. Only if the retained equity rights provide mandatory payment rights will they be given value for gift tax purposes.

Fourth, the remaining value is allocated among the transferred interest and other interests of the same or subordinate classes held by the family.¹²⁴

Fifth, the amount allocated to the transferred interest in the fourth step is reduced to take into account minority and similar discounts, if any. Other adjustments are then made, if necessary.¹²⁵

The following example illustrates this methodology. P, an individual, holds all 1,000 shares of corporation X's stock, which is voting common.¹²⁶ The fair market value of P's family-held interest in X is \$1,500,000 (Step 1). P decides

¹²³ Regs. § 25.2701-2(b)(6). Assuming that the transferor retains a qualified payment right, then the retained interest evidencing the qualified payment right is to be valued "as if any right valued at zero does not exist . . . but otherwise without regard to section 2701." Regs. § 25.2701-2(a)(4).

The value of the qualified payment right determined in accordance with traditional valuation principles may be reduced if the transferor also retains an extraordinary payment right. If that extraordinary payment right could be exercised in such a manner as to produce a lesser amount of property to the transferor, then the value of the qualified payment right is in essence reduced to that lesser amount. I.R.C. § 2701(a)(3)(B); Regs. § 27.2701-2(a)(3). This rule is intended to preserve the integrity of the valuation of the qualified payment right.

Theoretically, the gift tax value of the transferred interests could be reduced to zero by retaining a qualified payment right which, when discounted based on the expected future payment stream, equals the current full fair market value of the entity. Then, if the entity's earnings rate does not exceed the assumed gift tax discount rate, there will be no transfer tax loss because there was no gift tax cost. To address this potential abuse area, the statute provides that the minimum value of all junior equity interest (such as common stock) in a corporation or partnership must equal 10% of the sum of (1) the total value of all equity interests in the entity plus (2) the total amount of indebtedness of the entity owed to the transferor or applicable family member. Regs. § 25.2701-3(c). See also I.R.C. § 2701(a)(4).

¹²⁴ Regs. § 25.2701-3(b)(3). If more than one class of family-held subordinate equity interest exists, the remaining value is allocated, beginning with the most senior class of subordinate equity interest, in the manner that would most fairly approximate their value if all rights valued under section 2701 at zero did not exist (or would be exercised in a manner consistent with the assumption of the rule of Regulations section 25.2701-2(a)(4), if applicable). *Id.* Alternatively, if the preceding sentence does not provide an appropriate method of allocating the remaining value, the remaining value is allocated to the interests in proportion to their fair market values determined without regard to section 2701. *Id.*

¹²⁵ Regs. § 25.2701-3(b)(4). The reduction is equal to the difference between the pro rata portion of the fair market value of the family-held interests of the same class (applying a family attribution rule) and the value of the transferred interest without regard to section 2701 and without applying a family attribution rule. *Id.* For a general discussion of minority discounts in the family-control context, see Warnken & Champine, *supra* note 115.

¹²⁶ Given the potential for double income taxation in the corporate context, a section 2701 transaction is more tax beneficial if structured in the partnership form. Nevertheless, for illustration purposes this Article discusses section 2701 in the corporate context and ignores the further deleterious impact of these double income taxation issues associated with the retained preferred stock.

to engage in an estate freeze under section 2701 and causes X to issue, in a tax-free transaction,¹²⁷ 1,000 shares of 8%, \$1,000 par value cumulative preferred stock, which bears an annual cumulative dividend of \$80 per share. The preferred stock also allows the holder to put all of the stock to X at any time for \$1,500,000. P transfers all of the common stock to P's children and retains only the preferred stock. Under section 2701, the gift tax value of the common is determined by subtracting from the value of the family-held interests, \$1,500,000, the value of P's retained preferred stock (Step 2). The preferred stock consists of two applicable retained interests, the dividend right and the put right; accordingly, the stock is valued pursuant to the special valuation rules set forth in section 2701 (Step 3). The put right is valued at zero because it is an extraordinary payment right.¹²⁸ In contrast, because the dividend right under the preferred stock is cumulative, the preferred stock is ascribed a value for these purposes.¹²⁹ The value of the dividend right, and therefore the retained preferred stock, could approximate \$800,000.¹³⁰ The gift tax value of the transferred common is thus \$1,500,000 less \$800,000, or \$700,000 (Steps 3 and 4). Because all of the common has been transferred, no minority discount is applicable (Step 5), and the value of the common is not further reduced.

C. Elimination of Corporate and Partnership Valuation Abuses

Section 2701 eliminates the two common valuation abuses of pre-Chapter 14 business estate freezes. First, section 2701 assumes that discretionary rights will go unexercised. To the extent that these rights are attached to preferred stock, they are given no value for gift tax purposes.

Second, section 2701 prevents the estate freeze accomplished by ascribing a value to an asset held by a donor, allowing that donor to retain that value, and thereafter allowing all increases in value in the asset to pass to one or more donees. Prior to section 2701, one method used to achieve this type of freeze in the corporate setting was for a donor to create two classes of stock: a preferred class retained by the donor, which had discretionary nonlapsing put, liquidation preference, or other rights that could be valued in such a way as to equal the

¹²⁷ I.R.C. § 368(a)(1)(E).

¹²⁸ See *supra* note 104.

¹²⁹ See I.R.C. § 2701(a)(3)(B); Regs. § 25.2701-2(b)(6)(B).

¹³⁰ The statute provides no explicit methodology on how to value the preferred stock. The regulations contemplate that this asset will be valued by multiplying the expected stream of payments by a discount rate. See, e.g., Regs. §§ 25.2701-2(a)(5), -4(c)(3) ("The appropriate discount rate is the discount rate that was applied in determining the value of the qualified payment. . . ."). For example, a discount rate of 10% could be used to value the preferred stock (i.e., taking into account the risk that X may not be able to pay P \$80 per share per year, as well as the future economic climate, P determines that 10% is the equivalent rate that P could receive on similar investments under similar situations). See Rev. Rul. 83-120, 1983-2 C.B. 170. At a 10% discount rate, the value of the preferred stock is then \$80 x 1,000 shares x (1 / .10) (the discount rate), or \$800,000. See also *infra* note 140 and accompanying text.

current fair market value of the corporation; and a common class of stock transferred to the donees.¹³¹

Section 2701 mandates that if the rights under the preferred class of stock can be exercised (or not exercised) at the donor's discretion, then the value of the transferred common stock carries with it the full value of the corporation.¹³² In essence, for gift tax purposes the donor will be treated as having retained no equity interest in the company. Accordingly, there is no retained interest that can be frozen.¹³³

A freeze could also be obtainable prior to section 2701 when a donor retains

¹³¹ See *supra* notes 46-48 and accompanying text. Arguably, the retention of the right to put the equity interest to the company (or liquidate) at current fair market value captured most of the current value of the company (another approach would have been to value this right at the put price times the probability of the right being exercised, multiplied by a discounted present value factor). The other equity rights in the company, which in essence represented the right to receive the company's value in excess of current fair market value, are then given to one or more donees. To the extent the value of the company increases, this increase in value inures solely to the benefit of the donees. The donor has "frozen" the value of her interest in the asset at the then fair market value and has given away all future appreciation in the company.

¹³² I.R.C. § 2701(a)(3)(A); Regs. §§ 25.2701-2(a)(1), -3(b).

¹³³ Not only will a freeze be unachievable in this situation, but it could result in estate tax confusion because the preferred class of stock retained by the transferor at her death is valued in accordance with normal valuation principles. This could result in double taxation because the full value of the corporation has been transferred for gift tax purposes during life, but the transferor is confronted with an estate tax on the value of the retained preferred stock at her death. For example, assume P owns all the outstanding stock of company X, consisting of 100 shares of preferred stock, which pays a noncumulative preferred dividend, and 100 shares of common stock. The value of the corporation is \$1,000,000. The 100 shares of common stock are appraised at \$600,000 and the 100 shares of noncumulative preferred are appraised at \$400,000. P transfers by gift the 100 shares of common stock to her children. Section 2701 applies to treat P's retained preferred stock as an "applicable retained interest" to which the special valuation rules apply. For gift tax purposes, P's retained noncumulative preferred is treated as being zero and the common stock carries with it the full value of the corporation, or \$1,000,000. Constructively, for gift tax purposes, P has been treated as transferring the value of the retained preferred stock, or \$400,000.

Nevertheless, if P dies while retaining the preferred stock interest, the value of this stock is computed under general fair market value principles. Unfortunately, the \$600,000 gift of the common stock made to P's children was previously increased by \$400,000, the current value of the preferred stock, under the application of section 2701. If the value of the preferred stock in P's gross estate is \$400,000, then P would have had this \$400,000 amount accounted for twice in computing transfer tax, once for gift tax purposes and once for estate tax purposes.

To account for this type of inequity, Congress in section 2701(e)(6) provided that regulations are to make appropriate adjustments for subsequent transfers, or inclusions in the gross estate, of any applicable retained interest valued under section 2701(a). Proposed Regulations section 25.2701-5 is directed at providing these adjustments. Prop. Regs. § 25.2701-5, 56 Fed. Reg. 46,245 (1991), amended by 57 Fed. Reg. 4278 (1992). These adjustments apply only if an "applicable retained interest" was valued pursuant to the special rules in section 2701. 56 Fed. Reg. at 46,246. This legitimately excludes applicable retained interests which represent "qualified payment rights" because these rights are valued pursuant to general valuation principles, and not pursuant to section 2701 principles. *Id.*

The adjustment is in the form of a reduction in the tentative transfer tax base on which the estate tax is calculated. 57 Fed. Reg. 4278. Generally, the reduction will be the lesser of the amount by which the transferor's taxable gifts were increased because of section 2701 or the estate tax value of the retained preferred interest. *Id.* In most instances, this adjustment should eliminate the double taxation problem.

only the right to receive a stream of annual payments from the transferred property. Theoretically, a freeze occurs if the donor receives aggregate payments equal to the fair market value of the donor's retained interest (at the time the freeze was undertaken).¹³⁴ But if the donor receives, in total, aggregate payments in excess of that amount, then the donor has in actuality received a portion of the increase in the value of the partnership or corporation (i.e., a portion of the net profits). In that instance, not all growth in the value of the entity will pass to the nonfrozen interest and, at best, the donor will have only partially frozen the donor's retained interest.

Prior to section 2701, this type of freeze could have been achieved when the donor retained noncumulative¹³⁵ preferred dividends. Through donor-exercised control of the corporation, the corporation could be certain to issue aggregate dividends less than or equal to the initial calculated value of the donor's retained preferred dividend right.

Section 2701 eliminates this type of freeze. First, noncumulative preferred stock is valued at zero.¹³⁶ Accordingly, the retention of noncumulative preferred stock cannot form the basis of a freeze because that retained interest is valued at zero for gift tax purposes.¹³⁷

Second, in order to be ascribed a value for gift tax purposes, the preferred stock must result in a qualified payment right, or such a right must be electively presumed to exist.¹³⁸ But even though the preferred stock in this instance will be given a value for gift tax purposes, a full freeze will still not be obtainable. This is because the holder of the preferred stock will receive aggregate payments in excess of the initial value of the retained interest.

The starting point for this analysis is with the methodology used in valuing the qualified payment right. That right is no more than an infinitesimal string of constant payments. Although the Code and regulations provide no express guidance on how to value these payments, the regulations implicitly contemplate

¹³⁴ This equalization assumes no discounting for payments received in the future.

¹³⁵ With noncumulative dividends, if the corporation determines not to issue dividends in any one year, the right as to dividends in that year lapses and future dividends are issued and determined without regard to the lack of issuance of dividends in prior years. Issuance of dividends is in the discretion of the Board of Directors. See O'Neal & Thompson, *supra* note 44.

¹³⁶ I.R.C. § 2701(a)(3)(A); Regs. § 25.2701-2(a)(2).

¹³⁷ See *supra* notes 119-23 and accompanying text.

¹³⁸ I.R.C. § 2701(a)(3)(A), (c)(3)(C)(ii); Regs. § 25.2701-2(a)(2), -2(b)(5)(iii). If a distribution that is not a qualified payment right is electively treated as a "qualified payment right" then the value of this right must be equal to or less than its fair market value without regard to section 2701. Regs. § 25.2701-2(c)(2). This clarifies that, although for gift tax purposes an election has been made to treat the stock as if cumulative dividends were required to be made, the valuation must still be made with the understanding that the dividends are non-cumulative. From a transfer tax perspective, this militates in favor of not making the election.

that the payments will be valued like an annuity, at an assumed discount rate.¹³⁹ The formula for determining that amount is $1/i$, where "i" equals the discount rate.¹⁴⁰

Generally, the lower the discount rate, the greater the value of the retained interest, and therefore the lower the value of the gift of the transferred interest.¹⁴¹ Hence, a discount rate related to existing market rates, such as the prime rate, is more beneficial from a transfer tax perspective than, say, one based on a junk bond rate.

The Code and regulations provide no guidance as to what discount rate to use in valuing the retained qualified payment right. The section 7520 rate, used in other gift and estate tax contexts, is not necessarily the most realistic discount rate.¹⁴² Nor is a discount rate tied to a market rate; dividend rights in a closely held business context are more uncertain than those in a publicly traded corporation.¹⁴³ Conceptually, the starting point for choosing the discount rate could be market rates, but that number should be increased to account for the uncertainty

¹³⁹ See, e.g., Regs. § 25.2701-2(a)(5); P.L.R. 9324018 (Mar. 19, 1993) (accepting the valuation of preferred stock "based on the present value of the dividend stream to perpetuity"). Despite grumblings by estate planning practitioners that the valuation methodology will be extremely complex and possible only with the aid of a computer, see Stolbach et al., *supra* note 32, the valuation methodology appears straightforward. The only variable is the discount rate to be chosen. This author believes that these grumblings are the result of what John Allen Paulos refers to as "innumeracy," which he defines as "an inability to deal comfortably with the fundamental notions of number and chance." JOHN A. PAULOS, INNUMERACY 3 (1990).

In the corporate setting, the qualified payment right will typically be represented by preferred stock. Preferred stock is at times expressed as a par value, with the dividend being at a percentage of that par value. For example, a corporation may issue shares of \$1,000 par value voting preferred stock, with each share carrying a cumulative annual dividend of 8% of its par value. Regs. § 25.2701-3(d), Ex.(1). The par value will represent the fair market value of the stock but only if the dividend rate represents the return rate that should be achieved with that class of stock in a similarly-situated company. See Rev. Rul. 83-120, 1983-2 C.B. 170. In this regard, valuing \$1,000 par value stock with an 8% dividend at \$1,000 presupposes that the discount rate used to value the stream of expected dividends is 8%. An 8% dividend on \$1,000 par value stock yields \$80 multiplied by $1/i$, where "i" is the appropriate discount rate. At a discount rate equal to 8%, the product equals \$80 multiplied by $1/.08$, or \$1,000. See *infra* note 140 and accompanying text.

¹⁴⁰ This is an author-derived formula pursuant to common algebraic principles. The formula for the value of an annuity for a terms of years is:

$$\frac{1 - \frac{1}{(1+i)^t}}{i}$$

where "t" is the number of payments, and "i" is the applicable discount rate. Since "t" will be infinity, $(1+i)^t$ will also equal infinity, no matter how small "i" is. Accordingly, 1 divided by infinity will be zero, and the equation then becomes, $(1-0)/i$, or $1/i$.

¹⁴¹ For example, $1/2$ is greater than $1/5$.

¹⁴² P.L.R. 9324018 (Mar. 19, 1993).

¹⁴³ See, e.g., Rev. Rul. 83-120, 1983-2 C.B. 170.

of whether the corporation or partnership will be able to make its payments.¹⁴⁴

Regardless of the discount rate used, the retained interest will be valued so as to share in a percentage of future profits (i.e., a *pro rata* amount determined as if annual profits equalled the assumed discount rate), and therefore a full freeze of the value of the retained interest will not have been created. In fact, to the extent the discount rate used for gift tax valuation purposes equals the entity's rate of earnings, then not even a minimal freeze will have been created under the statute. Thus, the transferor will be in the same transfer tax position as if he had not created an additional class of equity interests but instead had made outright gifts of a portion of his common stock or partnership interest.

This concept is illustrated by the following example. Assume that corporation P has issued 1,000 shares of common stock and 1,000 shares of 8%, \$100 par value cumulative preferred stock, that bears an annual cumulative dividend of \$80 per share. The value of the company is \$1,500,000. The preferred stock is valued at \$800,000 under section 2701.¹⁴⁵ The value of the common equals the residue, or \$700,000, and is gifted to the children (reported on the transferor's filed gift tax return). At the end of five years, P has averaged an after-tax rate of return and growth ("rate of earnings") of 10% of the corporation's value at the beginning of the year.¹⁴⁶ Therefore, assuming the payment each year of the preferred stock dividend, the value of P is \$1,927,357 at the end of five years, illustrated as follows:

Year	Value at Beginning of Year	Increase in Value at 10%	Payout to Preferred Shareholder	Value at End of Year
1	\$1,500,000	\$150,000	\$80,000	\$1,570,000
2	1,570,000	157,000	80,000	1,647,000
3	1,647,000	164,700	80,000	1,731,000
4	1,731,700	173,170	80,000	1,824,870
5	1,824,870	182,487	80,000	1,927,357

Based on these calculations, one may be inclined to conclude that there has been an effective estate freeze and transfer of \$427,357 to the children. This

¹⁴⁴ *Id.* Also, there is a four-year grace period (i.e., no interest) with regard to the making of qualified payments. I.R.C. § 2701(d)(2)(C); Regs. § 25.2701-4(c)(3). If the stock allows the corporation to defer payment, without interest, during a four-year grace period, clearly the discount rate needs to be adjusted, upward, to account for this possibility that each payment may be four years late in delivery. Therefore, this four-year grace period should not provide a planning opportunity. If the four-year grace period is ignored at the valuation stage, this is improper and would be a valuation abuse.

¹⁴⁵ See *supra* note 130.

¹⁴⁶ A 10% rate was used in valuing the preferred stock for gift tax purposes.

appears to be so because the value of the preferred stock, using the same valuation methodology that was used during the shareholder's lifetime—the right to receive \$80,000 per year assuming a discount rate of 10%—results in \$800,000 being included in the taxpayer's gross estate. The remaining value of the corporation, which is \$1,927,347 less \$800,000, or \$1,127,357, is not included in the taxpayer's gross estate. Because the preferred stockholder made a gift on \$700,000 of this amount during his lifetime, the difference, \$427,357, has arguably passed to his children free of transfer taxation because of this apparent freeze.

But that conclusion is incorrect. If the preferred stockholder dies at the end of year 5, there has been no freeze. By the end of year 5, the preferred stockholder has received \$400,000 in payments, plus income and appreciation at 10% on the amounts received each year, which totals \$88,408, and also has a retained interest valued at \$800,000.¹⁴⁷ Clearly, the retained interest, valued at \$800,000 for gift tax purposes, has not been frozen.

Moreover, the retained interest has grown, or appreciated, at the same rate as the transferred interest. At a 10% growth rate, P would equal \$2,415,765 at the end of five years.¹⁴⁸ The transferred common stock of \$700,000, at a 10% growth rate, accounts for \$1,127,357 of this amount.¹⁴⁹ The remaining \$1,288,408 belongs to the retained preferred.¹⁵⁰ In substance, the retained preferred of \$800,000 has also grown at a 10% rate.¹⁵¹

Because the retained and transferred interests have appreciated at the same rates, P could have achieved the same transfer tax savings by merely gifting a percentage of the common stock to the children.¹⁵² Freezes achieved by outright gift transfers are permitted.¹⁵³ Accordingly, section 2701 in this example achieves a permissible transfer tax result.

To the extent the corporation's rate of earnings exceeds the discount rate used in valuing the retained preferred stock, that excess rate will inure to the benefit

of the holders of the transferred common stock.¹⁵⁴ Hence, as to that excess, there is a minimal freeze created but that is not abusive because the reverse could also occur. If the corporation's earnings are at a rate less than the discount rate used in valuing the retained preferred stock, then there will actually be a reverse freeze, or a transfer tax loss.¹⁵⁵ That is, the retained interest will increase at a rate in excess of the rate of increase of the transferred interest.¹⁵⁶

D. Addressing the Lapsing Right Concern

Section 2704(a) provides that a lapse of any voting or liquidation right in a partnership or corporation is to be treated as a transfer by gift, or a transfer that is includible in the gross estate of the decedent, if the individual holding the right and members of his family control the partnership or corporation both before and after the lapse.¹⁵⁷ A voting right is any right to vote with respect to "any matter of the entity."¹⁵⁸ For example, the right of a general partner to participate in management is a voting right. A liquidation right is a right to "compel the entity to acquire all or a portion of the holder's equity interest in the

¹⁵⁴ If in the textual example, P increased at a 12% rate instead of a 10% rate, P would equal \$2,643,513 at the end of five years ($\$1,500,000 \times (1 + .12)^5$). The retained interest would consist of \$400,000 in payments, \$108,228 in interest on those payments, $(80,000 (1 + .12)^4 + 80,000 (1 + .12)^3 + 80,000 (1 + .12)^2 + 80,000 (1 + .12) - 320,000)$, and the underlying constant value of \$800,000, for a total of \$1,308,228. The remaining value of P, \$2,643,513, less \$1,308,228, or \$1,335,285, passes to the donees. \$1,335,285 is greater than the value of \$700,000, the initial gift, increased at a 12% annual rate, \$1,233,639 ($\$700,000 \times (1 + .12)^5$). As a result, \$101,646 has passed to the donees free of transfer tax.

¹⁵⁵ Had no recapitalization taken place and the transferor merely gifted common stock with a gift tax value (assuming no minority discounts) equal to the gift tax value of the transferred interest in the recapitalization, less property would have been included in P's gross estate. If in the textual example P increased at a 8% rate instead of a 10% rate, P would equal \$2,203,992 at the end of five years ($\$1,500,000 \times (1 + .08)^5$). The retained interest would consist of \$400,000 in payments, \$59,328 in interest on those payments $(80,000 (1 + .08)^4 + 80,000 (1 + .08)^3 + 80,000 (1 + .08)^2 + 80,000 (1 + .08) - 320,000)$, and the underlying constant value of \$800,000, for a total of \$1,269,328. The remaining value of P, \$2,203,992, less \$1,269,328, or \$934,664, passes to the donees. \$934,666 is less than the value of \$700,000, the initial gift, increased at an annual 8% rate, \$1,028,530. As a result, \$93,866 less has passed to the donees than if P had only one class of the stock and the transferor made an outright gift of \$700,000 of that one class of common stock.

¹⁵⁶ The transferor will be, from a transfer tax perspective, in an advantageous position under section 2701 if the entity earns at a rate greater than the discount rate used in valuing the retained interest. The formula for determining the amount that, solely because of the section 2701 transaction, passes free of any transfer tax (that is, the amount of the real freeze), is:

$$\left(\frac{1}{i} - \frac{1}{i_2}\right) \times PSDR \times (1 + i_2)^t + \left(\frac{1}{i_2}\right) PSDR - \left(\frac{1}{i}\right) PSDR;$$

where "i" is the assumed discount rate in valuing the cumulative preferred stock (or other qualified payment right); "i₂" is the actual corporate (or partnership) earnings rate; "PSDR" is the amount to be received each year under the cumulative preferred stock (or other qualified payment right); and "t" is the number of years from the time of the freeze and transfer to the date of the transferor's death. This formula has been derived by the author using traditional mathematical principles.

¹⁵⁷ I.R.C. § 2704(a).

¹⁵⁸ Regs. § 25.2704-1(a)(2)(iv).

¹⁴⁷ The \$400,000 consists of \$80,000 annually for five years. The \$88,408 is arrived at mathematically by the following formula: $(80,000 (1 + .1)^4 + 80,000 (1 + .1)^3 + 80,000 (1 + .1)^2 + 80,000 (1 + .1) - 320,000)$.

¹⁴⁸ Calculated by multiplying 1,500,000 by $(1 + .1)^5$.

¹⁴⁹ Calculated by multiplying \$700,000 by $(1 + .1)^5$. Also, this figure can be derived from the chart in the text, which illustrates that P is worth \$1,927,357 at the end of five years. From this amount, \$800,000, the value of the preferred stock, is subtracted.

¹⁵⁰ The retained preferred has received \$400,000 in payments, \$88,408 in interest on these payments, and has an underlying, constant value of \$800,000. See *supra* note 147.

¹⁵¹ Calculated by multiplying \$800,000 by $(1 + .1)^5$.

¹⁵² Had no stock recapitalization been undertaken and P merely transferred the equivalent gift tax amount of common stock to the children, \$700,000 of the common stock would have been transferred to the children. The fractional value of \$700,000 of P's value as a whole, assuming that no minority discounts are taken for the transfer, is 7/15th. In that situation, section 2701 does not apply because there is only one class of stock. See, e.g., Regs. § 25.2701-1(c)(3). The value of 7/15th of P at the end of five years is \$1,127,357 ($7/15 \times \$2,415,765$), the same amount as the value of the transferred interest pursuant to the section 2701 transaction.

¹⁵³ See *supra* notes 25-28 and accompanying text.

entity."¹⁵⁹ A right to put stock to a corporation in exchange for its par value would qualify as a liquidation right.

The amount of the transfer is the value that disappears because of the lapsing right, which is the excess of (1) the value of all interests the individual holds in a partnership or corporation immediately before the lapse, using the assumption that voting and liquidation rights do not lapse, over (2) the value of such interests after the lapse (increased by any consideration received on account of the lapse).¹⁶⁰ Logically, if the lapse of voting rights results in the transferor losing voting control, the value of the control premium would be included in the value of the transfer.

The shift of a transferor from a voting control position to a minority position via the transfer of stock carrying with it voting rights to a member of the transferor's family will not invoke the statute.¹⁶¹ Nevertheless, a transfer that reduces an individual's aggregate voting power is a lapse of a liquidation right to the extent the transfer results in the elimination of the individual's right to compel liquidation of an interest other than the interest tied to the voting power.¹⁶² Section 2704(a) does not apply to the lapse of a voting or liquidation right previously valued in the hands of the holder under section 2701(a).¹⁶³

IV. SPECIAL VALUATION RULES FOR TRANSFERS OF TRUST INTERESTS

A. Application of the Statute

Section 2702 was enacted to correct valuation abuses associated with GRINTs. Section 2702 now applies in determining the gift tax value of a transfer of certain interests in trust to or for the benefit of a member of the transferor's family when the transferor retains an interest in the trust.¹⁶⁴ The statute does not apply to an incomplete transfer,¹⁶⁵ and hence has no application to the so-called

¹⁵⁹ Regs. § 25.2704-1(a)(2)(v).

¹⁶⁰ I.R.C. § 2704(a)(2); Regs. § 25.2704-1(d).

¹⁶¹ Regs. § 25.2704-1(f), Ex. (4).

¹⁶² Regs. § 25.2704-1(f), Ex. (5).

¹⁶³ Regs. § 25.2704-1(c)(2)(ii). For example, assume D owns all of the single class of stock of corporation Y and recapitalizes Y so that he retains nonvoting common and voting preferred stock. The preferred stock carries a right to put the stock for its par value at any time during the next ten years. D transfers the common stock to D's grandchild for no consideration. In valuing the amount of D's gift, section 2701 will apply and D's retained put right will be valued at zero. If D owns the preferred stock at the time his put right lapses, the preferred stock could be revalued pursuant to section 2704(a) and D treated as having made a transfer of the value of the unexercised put right. But this would result in D being taxed twice on the put right. The regulations prevent this result. Because the put right was previously valued in D's hands under section 2701, section 2704(a) does not apply to D when and if this put right lapses.

¹⁶⁴ I.R.C. § 2702(a)(1). "Members of the family" include the transferor's spouse, lineal descendants and ancestors, brothers and sisters, lineal descendants and ancestors of the transferor's spouse, and spouses of any of the foregoing. I.R.C. § 2702(e); Regs. § 25.2702-2(a)(1).

¹⁶⁵ I.R.C. § 2702(a)(3)(A)(i). This refers to a transfer of which no portion would be treated as a gift for gift tax purposes even if no consideration was received by the transferor. Regs. § 25.2702-1(c)(1).

living trust. The rules also do not apply to charitable remainder trusts or pooled income funds.¹⁶⁶

Under section 2702, the gift tax value of the transfer of an interest in trust to a member of the family is the full value of the property transferred less the value, determined pursuant to specific rules, of the property rights retained by the grantor.¹⁶⁷ A retention of a right determined by reference to the income, a GRIT, or a contingent reversionary right to trust corpus is for gift tax purposes valued at zero.¹⁶⁸ Valuation will be made only with respect to "qualified interests" which consist of (1) a fixed amount payable at least annually, a GRAT; (2) an amount payable at least annually which is a fixed percentage of the fair market value of the trust's assets (called a GRUT); or (3) a noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2).¹⁶⁹ Certain GRINTs funded with a personal residence or tangible property are outside the special rules of section 2702.¹⁷⁰

As with stock and partnership interests now valued pursuant to section 2701 rules, GRITs, GRATs, GRUTs, GRINTs funded with a personal residence, and GRINTs funded with tangible property no longer provide effective freeze techniques and, moreover, are outside the realm of prior, abusive valuation strategies.¹⁷¹

B. Application to Retained Income Interest Strategies

If a grantor establishes a GRIT-variety of a retained interest trust by retaining an income and reversionary interest for a term of years, the value of the gift will be the full value of the property transferred.¹⁷² As a result, the valuation tables cannot be used to reduce the value of the remainder interest.

Because the grantor is treated as having retained no interest for gift tax purposes, there can be no retained interest to freeze. At best, this strategy is analogous to an outright gift. Most likely, however, this strategy will result in a transfer tax loss.¹⁷³

¹⁶⁶ Regs. § 25.2702-1(c)(3), -1(c)(4).

¹⁶⁷ I.R.C. § 2702(a).

¹⁶⁸ I.R.C. § 2702(a)(2)(A).

¹⁶⁹ I.R.C. § 2701(a)(2)(B), (b)(1)-(3).

¹⁷⁰ See *infra* notes 219-48 and accompanying text.

¹⁷¹ See *supra* notes 85-97 and accompanying text.

¹⁷² I.R.C. § 2702(a)(2)(A).

¹⁷³ From a transfer tax perspective, a GRIT valued pursuant to these rules could not result in a transfer tax gain and would most likely result in a transfer tax loss. Consider, for example, the following. If \$1,000,000 were transferred to a GRIT and the grantor retained the right to the income for ten years, the gift tax value of the transfer would be \$1,000,000. In the best case scenario from a transfer tax perspective, assume the GRIT produced no income but only growth and at the end of the ten-year period the \$1,000,000 doubled, to \$2,000,000. This \$2,000,000 passes to the remainder beneficiaries free of additional gift or estate tax cost. Of course, that would be the same result if the \$1,000,000 were transferred outright (or in a non-retained interest trust) to the beneficiaries in year

C. Application to Retained Unitrust Strategies

Other than an income interest, a grantor could also retain a unitrust interest, which is a percentage right to the periodic fair market value of the trust, *i.e.* a GRUT.¹⁷⁴ A GRUT is the transfer tax equivalent to an outright gift because the retained interest shares proportionately in any growth in the trust property.¹⁷⁵

For example, if a grantor transfers \$100 to a GRUT and retains a 9% unitrust interest, then this interest is valued at .375908,¹⁷⁶ or \$37.59. In a typical freeze, at the end of a period of time, such as five years, the grantor's interest would remain at \$37.59 and all appreciation would have inured to the benefit of the transferred interest. One hundred dollars, increased by 13% per year for five years, equals \$184.24.¹⁷⁷ Subtracting the value of the retained interest of \$37.59, this would leave \$146.65 to pass to the remainder beneficiaries. In a GRUT, however, only \$114.97 passes to the remainder beneficiaries;¹⁷⁸ \$69.27 passes to the retained interest holder.¹⁷⁹ No freeze or transfer tax gain will have been created because both the retained and transferred interests will have increased proportionately at the same rate as the GRUT property increases.¹⁸⁰

This result follows regardless of the rate of return on investments experienced during the life of the GRUT. Under any assumed growth rate, the discounted present value of the GRUT property at the end of the unitrust period will generally be equal to the gift tax value of the property transferred. This makes the transfer of a remainder interest in a GRUT the transfer tax equivalent of an outright gift.¹⁸¹ Accordingly, there is no transfer tax abuse potential with a GRUT.

one, rather than having the GRIT established. More importantly, this analysis ignores the probability that a GRIT which returns no income to the grantor would most likely be subject to a *Dickman*-type argument by the Service with regard to lost income each year. *Dickman v. Commissioner*, 465 U.S. 330 (1984); *See, e.g.*, P.L.R. 8806082 (Nov. 18, 1987) and discussion *supra* note 86. Consider also the worst case scenario from a transfer tax perspective, in which the GRIT generates sufficient income each year (and no appreciation) so that at the end of the ten-year period only \$1,000,000 passes to the remainder beneficiaries. In that situation, had the \$1,000,000 been transferred outright to the remainder beneficiaries in year one rather than via a GRIT, the remainder beneficiaries would have received the benefit of the \$1,000,000 plus all of the income from that amount during the ten-year period, at the same gift tax cost as establishing a GRIT under new section 2702.

¹⁷⁴ See *supra* note 169 and accompanying text.

¹⁷⁵ The valuation of the remainder interest in a GRUT is merely a percentage of the contributed property based on the grantor's retained percentage interest, and is not generally dependent on discount rates. For example, the remainder interest in a one-year 9% GRUT is 91% of the property transferred (100% less the 9% retained interest), in a two-year 9% GRUT, it is 82.81% (91% less 9% of that amount), and so on. Accordingly, the value of the retained interest cannot be frozen and will increase at the same or greater rate as the remainder interest in the GRUT property.

¹⁷⁶ Table D, I.R.S. Publication 1457 (1989).

¹⁷⁷ Calculated by multiplying \$100 by $(1 + .13)^5$.

¹⁷⁸ The initial remainder interest is \$100 less the value of the retained interest, \$37.59, or \$62.41. That amount, \$62.41, multiplied by $(1 + .13)^5$ equals \$114.97. See also *infra* note 181.

¹⁷⁹ Calculated by multiplying \$37.59 by $(1 + .13)^5$. See also *infra* note 181.

¹⁸⁰ In this example, all interests have increased at a 13% rate.

¹⁸¹ Assume, for example, that the grantor retains the right to receive 9% of a GRUT annually, payable at date of funding and thereafter at the anniversary date, for a term equal to five years. Pursuant to table D (I.R.S. Publication 1458, *supra* note 176), the present worth of the remainder interest in a five-year 9% GRUT, with annuity payments made at the beginning of the year, is .624032 of the interest transferred. If the GRUT is funded with \$1,000,000, then the grantor will

D. Application to Retained Annuity Trust Strategies

Whereas a retained unitrust interest has no potential for a freeze, a retained annuity interest has a possibility to achieve a partial, albeit minimal, freeze. Nonetheless, a total freeze is not possible because the grantor is treated as sharing in a certain amount of the appreciation of the transferred asset.¹⁸² This occurs because the retained interest is valued under the assumption that the GRAT property will grow at a rate equal to the assumed gift tax discount rate and will return to the grantor's retained interest a pro rata portion of this growth.

For example, consider a five-year GRAT funded with \$1,000,000, in which the grantor retains the right to 5% of the initial fair market value of the GRAT, or \$50,000 per year.¹⁸³ Assume that 120% of the federal midterm rate in effect for the month of the transfer is 10.60%.¹⁸⁴

Under this scenario, the grantor is treated as having retained a .18667 interest of the value of the property transferred, or \$186,670.¹⁸⁵ Conversely, the grantor

have made a gift of \$624,032. If the GRUT experiences a 13% rate of return, compare this \$624,032 with the discounted present value of the property that ultimately passes to the remainder beneficiaries at the end of the five-year term:

Year	Amount of Property	9% of Property Returned to Grantor	Appreciation By 13%	Property Remaining At End of Year
1	\$1,000,000	\$90,000	\$118,300	\$1,028,000
2	1,028,300	92,547	121,648	1,057,401
3	1,057,401	95,166	125,091	1,087,325
4	1,087,325	97,859	128,631	1,118,097
5	1,118,097	100,629	132,271	1,149,739

Had the gift of \$624,032 been made outright rather than transferred to the GRUT, it is a logical assumption that the \$624,032 could have experienced the same growth rate as the property in the GRUT. The discounted present value of \$1,149,739 received five years in the future, under an assumed discount rate of 13%, is \$624,032, which is the same as the initial gift tax value incurred in establishing the GRUT. In other words, had the grantor transferred \$624,032 outright to the remainder interests in year one (or in a nonretained interest trust) rather than pursuant to a GRUT, that amount would have grown to \$1,149,739 at the end of the five years (assuming the same 13% growth rate assumptions).

¹⁸² The amount will be at a rate equal to the discount rate used in valuing the retained interest. See *infra* notes 184-97 and accompanying text.

¹⁸³ The grantor can retain any annuity. See I.R.C. § 2702(b).

¹⁸⁴ The value of qualified annuity interests is determined by taking into account 120% of the federal midterm rate in effect for the month of the transfer. Regs. § 25.2702-2(b)(2).

¹⁸⁵ At an interest rate of 10.60%, the value of an annuity interest at a 5% of initial fair market value payout rate in a five-year GRAT is calculated as follows. First, using I.R.S. Publication 1457, *supra* note 176, the value of an annuity interest in \$1 for five years at an assumed interest rate of 10.60% equals 3.7334 (p. 3-22, column 2). Second, since the annuity is at 5% of \$1, the value of a 5% annuity on \$1 equals 3.7334 x .05, or .18667.

This can also be calculated by use of the following formula: $(1 - (1/(1 + .106)^5)/.106) \times .05$.

is treated as having transferred the remaining fractional interest, .813330 or \$813,330, for gift tax purposes.¹⁸⁶ For there to be a freeze at the end of five years, all growth in the GRAT property would have to shift to the transferred interest. If the \$1,000,000 in the GRAT had grown at a 10.60% rate, then at the end of five years the property theoretically should be equal to \$1,654,914 (ignoring, for the moment, the need to make annual \$50,000 distributions to the grantor).¹⁸⁷ As the grantor had initially retained \$186,670 and had transferred \$813,330, there has been appreciation equal to \$654,914.¹⁸⁸ In a true freeze, this \$654,914 should have passed to the remainder, gifted interest. Stated numerically, at the end of five years, \$1,468,244 would remain in the GRAT if there had been an effective freeze.¹⁸⁹

In a GRAT, however, under this scenario only \$1,345,992 remains at the end of the five years, as follows:

End of Year	Amount Transferred (Increased Annually by 10.60%)	Payout to Annuity Holder	Value of Property After Payment of Annuity Interest
0	\$1,000,000	0	\$1,000,000
1	1,106,000	\$50,000	1,056,000
2	1,167,936	50,000	1,117,936
3	1,236,437	50,000	1,186,437
4	1,312,199	50,000	1,262,199
5	1,395,992	50,000	<u>1,345,992</u>
Amount Remaining:			<u><u>\$1,345,992</u></u>

The additional \$122,252 of growth¹⁹⁰ inured to the benefit of the \$186,670 retained interest. First, the donor received a total payment of \$250,000 (i.e., five annual annuity payments of \$50,000 each). That accounts for \$63,330 of the

missing \$122,252 of growth.¹⁹¹ The remaining \$58,922¹⁹² is more subtle in its accountability. That amount represents the growth attributable to each \$50,000 payment during the five-year period.¹⁹³

As a result, the retained interest of \$186,670 has, in fact, appreciated at a 10.60% rate.¹⁹⁴ Because this amount has been retained by the donor, that appreciation has not inured to the benefit of the transferred interest. No freeze has occurred because both the retained interest and the transferred interest have grown at the same rate.¹⁹⁵ The GRAT in this instance is the functional equivalent of an outright gift transfer of \$813,330;¹⁹⁶ outright gifts are consistent with the current gift and estate tax structure.¹⁹⁷

A slightly different analysis applies if the GRAT property grows at a rate different than the assumed gift tax discount rate. If the GRAT grows in value at a rate less than the assumed rate for gift tax purposes, there will actually be a reverse freeze. In that instance, the retained interest will appreciate at a rate greater than the transferred interest.¹⁹⁸

For example, assume that a grantor establishes a five-year GRAT, retaining a \$50,000 annual annuity interest in the \$1,000,000 transferred to the GRAT. Assume that 120% of the federal midterm rate in effect for the month of the transfer is 10.60%.¹⁹⁹ The value of this annuity interest is .18667 of the value of the interest transferred.²⁰⁰ Hence, the value of the remainder interest is .81333 of the value of the interest transferred (1 less .18667, the value of the grantor's retained interest). Because \$1,000,000 was transferred to the trust, there is a gift of the remainder interest equal to \$813,300.

If the rate of growth experienced by the property in the trust is on average 9% annually, then at the end of five years, the property would be equal to \$1,538,624

¹⁹¹ Calculated by taking the difference between the total payments received, \$250,000, and the initial fair market value of the retained interest, \$186,670.

¹⁹² Calculated by subtracting \$63,330 from \$122,252.

¹⁹³ For example, the \$50,000 paid at the end of the first year increases at a 10.60% rate for the next four years, the \$50,000 paid at the end of the second year increases at a 10.60% rate for the next three years, and so on. Stated algebraically, this results in the following:

$[50,000(1 + .106)^4 + 50,000(1 + .106)^3 + 50,000(1 + .106)^2 + 50,000(1 + .106)]$ less 200,000 = 58,992

¹⁹⁴ Calculated by multiplying \$186,670 by $(1 + .106)^5$, which equals \$308,922 (i.e., \$250,000 + \$58,922).

¹⁹⁵ The discounted present value of the right to receive \$1,345,992 five years in the future, under an assumed investment return rate of 10.60%, equals \$813,330, which is .813330 of the interest transferred. (The formula is $1/(1+x)^t$, where x equals the interest rate and t equals the term for years.) This amount is the same amount as the taxable gift made in year one.

¹⁹⁶ *Id.*

¹⁹⁷ See *supra* notes 25-28 and accompanying text.

¹⁹⁸ In this scenario, the transferor would have been better off from a transfer tax perspective without a GRAT by making an outright gift equal in value to the remainder component of the GRAT.

¹⁹⁹ See I.R.C. § 7520.

²⁰⁰ See *supra* note 185. The grantor could retain a reversionary interest in the property if she dies prior to the expiration of her income interest, but the value of this reversion for gift tax purposes would be zero. I.R.C. § 2702(a)(2)(A).

¹⁸⁶ Calculated by subtracting \$186,670 from \$1,000,000.

¹⁸⁷ Calculated by multiplying \$1,000,000 by $(1 + .106)^5$.

¹⁸⁸ Calculated by subtracting from the appreciated value, \$1,654,914, the respective values of the transferred and retained interests, \$813,330 and \$186,670.

¹⁸⁹ Calculated by subtracting from the appreciated value of the property, \$1,684,914, the value of the retained interest, \$186,670. With pre-Chapter 14 GRIT, this would have been possible by the Trustee investing in high growth, low yield assets. See *supra* notes 85-89 and accompanying text.

¹⁹⁰ Calculated by subtracting from the freeze value, \$1,468,244, the value of the property remaining at the end of the GRAT term, \$1,345,992.

(ignoring, for the moment, the need to make annual \$50,000 distributions to the grantor).²⁰¹ Subtracting from this sum the value of the retained interest, \$1,351,954 should theoretically remain at the end of the GRAT term if all appreciation passed to the remainder interest.

In a GRAT, however, under this scenario, only \$1,239,388 remains at the end of five years, as follows:

End of Year	Amount in Trust	Payout to Grantor	Property Remaining in the Trust
0	\$1,000,000	0	\$1,000,000
1	1,090,000	\$50,000	1,040,000
2	1,133,600	50,000	1,083,600
3	1,181,124	50,000	1,131,124
4	1,232,925	50,000	1,182,925
5	1,289,388	50,000	1,239,388
Amount Remaining:			<u>\$1,239,388</u>

The additional \$112,566 of growth²⁰² inured to the benefit of the grantor's retained interest. First, the grantor received in total \$250,000 in annuity payments, or \$63,330 more than the \$186,670 interest he was deemed to have retained for gift tax purposes. The remaining \$49,236²⁰³ represents the growth attributable to each \$50,000 payment during the five-year period (at a 9% rate).²⁰⁴

In total, then, the grantor has received the initial \$186,670 plus \$112,566 of growth, or \$299,236. At a 9% investment return rate, his retained interest of \$186,670, had he owned it outside of the GRAT, would have equalled \$287,215.²⁰⁵ And so, in fact, the grantor's retained interest has grown at a rate greater than 9%. Essentially, the grantor's retained interest has grown at the assumed gift tax discount rate of 10.80%, less an adjustment figure to account for earnings on the \$50,000 distributed each year at 9% (and not the assumed 10.60%).²⁰⁶

²⁰¹ Calculated by multiplying 1,000,000 by $(1 + .09)^5$.

²⁰² The additional growth is calculated by subtracting from the freeze value, \$1,351,954, the amount that actually remains in the GRAT and passes to the remainder beneficiaries, \$1,239,388.

²⁰³ Calculated by subtracting \$63,330 from \$112,566.

²⁰⁴ Calculated as follows: $(50,000 (1 + .09)^4 + 50,000 (1 + .09)^3 + 50,000 (1 + .09)^2 + 50,000 (1 + .09) - 200,000)$.

²⁰⁵ Calculated by multiplying \$186,670 by $(1 \times .09)^5$.

²⁰⁶ At a 10.60% discount rate, the grantor's retained \$186,670 interest would equal \$308,923 at the end of five years $(\$186,670 \times (1 + .106)^5)$. Subtracting out the difference between earning 9% versus 10.60% on the received \$50,000 payments each year, \$9,686, yields the grantor's received amount of \$299,236.

Conversely, the remainder interest, the gifted component, increased at a rate less than 9%. Had the initial remainder element of \$813,330 increased at 9% for five years, the value at the end of five years would have been \$1,251,409.²⁰⁷ But as the chart above indicates, the remainder value of the GRAT at the end of five years is only \$1,239,388, or \$12,021 less than what it would have been at a 9% rate.²⁰⁸ That \$12,201 difference has inured to the benefit of the retained annuity interest, which has increased at a rate of 9% plus \$12,201.²⁰⁹

Accordingly, this has resulted in a reverse freeze in that the retained interest has appreciated at a rate (i.e., in excess of 9%) greater than the rate at which the transferred interest has appreciated (i.e., less than 9%).

The only time that the establishment of a GRAT will result even in a partial freeze is when the GRAT experiences an average rate of return and growth greater than the discount rate used for gift tax purposes to value the GRAT when it was established. A partial freeze results in that situation because the discounted present value of the annuity for gift tax purposes will be greater than its true value under the rate of return experienced by the GRAT.²¹⁰

For example, assume that a grantor establishes a 5% GRAT funded with \$1,000,000, and that 120% of the federal midterm rate in effect for the month of a transfer is 10.60%. The value of an annuity interest for five years, at a rate equal to 5% of the property initially transferred, is .18667 of the value of the interest transferred, or \$186,670.²¹¹ Hence, the value of the remainder interest is .813330 of the value of the interest transferred, or \$813,330.²¹²

If the after-tax income and appreciation experienced by the property is on average 12%, then at the end of five years the value of the remainder, gifted interest should be \$1,433,365.²¹³ In a GRAT, however, under this scenario the remainder, gifted interest is \$1,444,699, as follows:

²⁰⁷ Calculated by multiplying 813,330 by $(1 + .09)^5$.

²⁰⁸ Represented by \$1,251,409 less \$1,239,388.

²⁰⁹ Calculated as follows: 186,670 multiplied by $(1 + .09)^5 = \$287,215$, plus \$12,021, equals \$299,236. This is the amount received by the grantor during this period. See *supra* notes 205-206 and accompanying text.

²¹⁰ The actual transfer tax savings is expressed algebraically as follows:

$$\frac{1 - \frac{1}{(1+i)^t}}{i} - \frac{1 - \frac{1}{(1+i_2)^t}}{i_2} \times A \times F \times (1+i_2)^t$$

In this formula, i is the assumed gift tax valuation rate; i_2 is the actual investment return and growth rate; t is the number of years of the retained interest in the GRAT; A is the percentage of the initial value of the GRAT paid as an annuity; and F is the initial funding amount of the GRAT. By removing the factor, $(1 + i_2)^t$, the equation produces the result in discounted present value dollars.

²¹¹ See *supra* note 185.

²¹² Calculated by subtracting 1 minus .18667, the value of the grantor's retained interest.

²¹³ Calculated by multiplying the value of the gifted interest, \$813,330, by $(1 + .12)^5$.

End of Year	Amount Transferred (Increased Annually by 12%)	Payout to Annuity Holder	Value of Property After Payment of Annuity Interest
0	\$1,000,000	0	\$1,000,000
1	1,120,000	\$50,000	1,070,000
2	1,198,400	50,000	1,148,400
3	1,286,208	50,000	1,236,208
4	1,384,552	50,000	1,334,552
5	1,494,699	50,000	1,444,699
Amount Remaining:			<u>\$1,444,699</u>

This difference occurs because the retained interest was valued assuming a discount rate of 10.60%, when in fact the actual rate of growth was 12%. At a 12% growth rate, the value of the retained interest should have been \$328,976.²¹⁴ In essence, the grantor's retained interest has increased at only the assumed 10.60% gift tax rate, plus an adjustment to account for the result that the grantor's received annuity payments increased each year at a 12% rate.²¹⁵

This means that the retained interest has appreciated at a rate greater than 10.60% but less than 12%, whereas the transferred interest has appreciated at a rate slightly higher than 12%.²¹⁶

In that instance, a minimal freeze occurs because a portion of the growth has been shifted, free of transfer tax, from the retained interest to the transferred interest. But the freeze is so small as to be negligible.

In order to achieve the freeze, the growth rate must be greater than the initial gift tax rate in valuing the transfer. And even if the growth rate were, as in this example, 1.4% greater than the initial gift tax valuation rate, this would still be only a transfer tax gain (versus an outright gift) of 1.13% of the original property.²¹⁷

²¹⁴ Calculated by multiplying the value of the retained interest, \$186,670, by $(1 + .12)^5$.

²¹⁵ This is calculated as follows. First, \$186,670 multiplied by $(1 + .106)^5$ equals \$308,922. Adding to this number the difference between earning 12% versus 10.6% on the received annuity amounts, \$8,720, equals \$317,642. This is \$11,334 less than what it should have been under an assumed 12% rate (\$328,976). This \$11,334 difference passes to the benefit of the remainder transferred interest.

²¹⁶ Technically the remainder interest has increased at a rate equal to 12% plus \$11,334.

²¹⁷ Calculated by dividing the gain, \$11,334, *supra* note 215, by \$1,000,000.

Certainly, the likelihood of abuse here is minimal, if it exists at all. Moreover, because the rate of growth may be less than the gift tax discount rate, there could always occur a transfer tax loss, or reverse freeze. As a result of this symmetry between the potential for a partial tax freeze versus the potential for a partial tax reverse freeze, the GRAT as valued under section 2702 can no longer be considered an effective freeze or abusive valuation technique.²¹⁸ The technique is, with slight variations, the transfer tax equivalent of an outright gifting program.

E. The Personal Residence Exceptions to Section 2702

The new valuation rules set forth in the 1990 Act do not apply to certain transfers of interests in a personal residence.²¹⁹ A GRINT could be created and valued as under current law if funded solely with a personal residence. In that situation, the retained interests would be valued pursuant to section 7520 and Regulations section 25.2512-5. The grantor could retain both the right to use of the trust property for a fixed term and the right to receive the trust property if the grantor died during that term (that is, a reversion).

Without the application of the new section 2702 valuation rules, both retained interests will be ascribed a value for gift tax purposes, thereby reducing the value of the remainder interest in the GRINT. Despite this result, the Pandora's Box of valuation abuses associated with pre-Chapter 14 GRINTS should generally not be opened, for four reasons. First, the exception is limited to scope and applies only to personal residences, typically representing only a fraction of a family's worth. Second, the pre-Chapter 14 abusive technique of investing in high-growth, low-income investments has no relevance here. Transfer tax savings will be based on the rate of appreciation of a personal residence, which may be substantially less than an investment asset that had been gifted outright.²²⁰

²¹⁸ In order to minimize the risk associated with the GRAT property decreasing at a rate less than the gift tax discount rate, practitioners have suggested retaining a large enough annuity amount so that the gift tax element approaches zero. See generally PRACTICAL DRAFTING 2470-72 (Richard B. Covey ed., 1991).

²¹⁹ I.R.C. § 2701(a)(3)(A)(ii); Regs. § 25.2702-5(a).

²²⁰ For example, assume the value of a residence transferred to a GRIT is \$500,000 and that 120% of the federal midterm rate for the month of the proposed transfer is 6.80%. Assuming the grantor (age 60) retains the right to use the residence for five years, the value of the remainder interest for each one dollar transferred to this type of GRINT is .66279, or for the \$500,000, \$331,395. See Appendix C. Assuming the property does not increase in value, the property in five years remains at \$500,000.

If instead of gifting the personal residence, the grantor had gifted cash of an equal gift tax value—\$331,395—then that amount, if properly invested, could equal or exceed the value of the personal residence in five years, provided the asset appreciates at a sufficient rate. For example, if the stock appreciates at a 9% rate, then at the end of five years, the stock is worth \$509,892, which is \$9,892 more than the personal residence (calculated by multiplying \$331,395 by $(1 + .09)^5$). This comparison does not take into account a further disadvantage to the personal residence GRIT— inherent taxable gain in the property gifted. The remainder beneficiaries will generally assume the basis of the donor, possibly adjusted by gift tax paid. I.R.C. § 1015(a); see also P.L.R. 9109027 (Nov. 30, 1990). As a result, after the payment of income taxes related to this inherent gain, the remainder beneficiaries, in an economic sense, have less property than apparent market value. In

Third, a personal residence often has a low income tax basis. If the residence is gifted to a GRIT, the property will lose its step up in basis that would otherwise apply if the residence were distributed at death.²²¹ Fourth, the transactional costs of establishing and administering these types of trusts are substantial.²²²

Nevertheless, because the reversion is given a value, and in light of the possibility of appreciation, a personal residence GRIT provides transfer tax savings opportunities. For example, assume that Penelope is age 60 and is willing to relinquish the right to use her personal residence after ten years. Accordingly, Penelope retains the right to use the residence for the next ten years and a reversion to her estate if she should die prior to the expiration of ten years. Assume that the value of the residence transferred to the GRIT is \$500,000 and that 120% of the federal midterm rate for the month of the proposed transfer is 10.80%. Pursuant to the valuation rules set forth in Regulations section 25.2512-5, the value of the remainder interest for each one dollar transferred to this type of GRIT is .2923, or for the \$500,000 transferred, \$146,150.²²³ Penelope would thus owe a gift tax on a gift equal to \$146,150 even though the value of the residence was \$500,000. By retaining the right to use the property for ten years Penelope would be treated as owning an interest valued at \$363,850.²²⁴ At the end of the ten years, the current value of the residence, which includes any increase in the residence's value experienced during that ten-year period, passes to the remainder beneficiaries free of additional gift or estate tax cost.²²⁵ Even if the residence does not increase in value, there still

that instance, the outright cash gift is more beneficial, in terms of transfer tax, than the personal residence GRIT.

²²¹ I.R.C. § 1014. For example, if the residence has a value at the end of the retained interest term of \$500,000, and the carry over basis is \$50,000, then there is inherent capital gain of \$450,000, which will result in a capital gains tax of \$126,000 when the property is sold. Had the property been gifted at death, that tax could have been avoided. I.R.C. § 1014. Also, had the property been sold during life, the one time capital gains exclusion, if applicable, could have avoided gain to the extent of \$125,000. I.R.C. § 121. As a general rule, gifting with high basis assets is always preferable to avoid inherent capital gain. For gift tax purposes, the value of property does not take into account that gain.

Commentators have suggested that the inherent capital gain issue can be mitigated by retaining grantor trust status for income tax purposes at the expiration of the retained interest term, and thereafter selling the property from the trust back to the grantor. *See, e.g.,* Edith M. Doyle, Planning and Drafting a Qualified Personal Residence Trust, Address to Southern California Tax & Estate Planning Forum (Oct. 20, 1993). There should not be capital gains in a sale between a grantor and a grantor trust. Rev. Rul. 85-13, 1985-1 C.B. 184 (transfer of trust assets to a grantor who owns the entire trust is not recognized as a sale for federal income tax purposes); *Cf. Rothstein v. United States*, 735 F.2d 741 (1984). Accordingly, cash would flow to the remainder beneficiaries in an amount equal to the fair market value of the residence, with no capital gains tax. On the surface, this strategy works and grantor trust status can be achieved without running afoul of the retained interest estate tax includability sections. *See* I.R.C. §§ 2036, 2038.

²²² *See infra* notes 235-39 and accompanying text.

²²³ *See* Appendix B.

²²⁴ *Id.*

²²⁵ To determine the extent, if any, of the transfer tax savings, one would compare the value of the residence at the end of ten years with the value of \$146,150 increased by the cumulative rate of return and growth that could have been earned during this period had \$146,150 been used to fund alternative investments.

should be transfer tax savings (versus an outright gift). If the investment return rate during this ten-year period averages 10.80%, then the transferred \$146,150 should be \$407,565 at this point.²²⁶ Because the value remains at \$500,000, \$92,435 has passed to the remainder beneficiaries free of any transfer tax cost. This difference occurs because the value of the retained interest was allowed to be increased by the value of the reversion. However, because the grantor did not die during the retained interest term, the reversion did not occur and in actuality added no real value to the retained interest.²²⁷

This exception to section 2702 is narrow in scope; it applies only to personal residences. Further qualifications to its use include the following. A personal residence must be either a principal residence of the term holder, as defined in section 1034, any other residence of the term holder, as described in section 280A(d)(1) but without regard to section 280A(d)(2), or an undivided fractional interest in either of the above.²²⁸

Additions of cash to the trust are allowed, and the trust is permitted to hold cash not in excess of the amount required for expenses already incurred or reasonably expected to be incurred within any six-month period, for improvements to the residence to be paid for in six months and, generally, for purchase of a personal residence within three months.²²⁹ As a result, a personal residence subject to a mortgage can be contributed to a GRIT.²³⁰

An individual may not be the holder of a term interest in more than two personal residence trusts nor may a personal residence GRIT include household furnishings or other personal property.²³¹ A personal residence must be used exclusively as the term holder's residence "when occupied by the term holder."²³² However, the residence may be rented provided the requirements of section 280A(d)(1) are satisfied.²³³ Further, a personal residence may include a pertinent structure used for residential purposes on adjacent land "not in excess of that which is reasonably appropriate for residential purposes."²³⁴

The drafting of a personal residence GRIT must be done with care and will add to the administrative costs of the transaction. Provisions that must be included in the governing instrument of a personal residence GRIT depend on whether the trust (1) is intended to hold only a personal residence with no sales

²²⁶ Calculated by multiplying \$146,150 by $(1 + .108)^{10}$.

²²⁷ *See supra* notes 90-97 and accompanying text.

²²⁸ Regs. § 25.2702-5(b)(2), -5(c)(2); *see also* P.L.R. 9151046 (Sept. 26, 1991) (ownership in a cooperative housing corporation does not preclude qualification as a personal residence).

²²⁹ Regs. § 25.2702-5(c)(5)(ii)(A).

²³⁰ *See* Regs. § 25.2702-5(c)(2)(iii); P.L.R. 9340009 (June 29, 1993).

²³¹ Regs. § 25.2702-5(c)(2)(ii).

²³² Regs. § 25.2702-5(b)(2)(iii), -5(c)(2)(iii).

²³³ *Id.* *See also* Regs. § 25.2702-5(d), Ex. (2).

²³⁴ Regs. § 25.2702-5(b)(2)(ii). *See also* P.L.R. 9328040 (Apr. 21, 1993) (small ranch style structure on a vacation home permissible); P.L.R. 9349014 (Aug. 3, 1993) (two penthouse apartments and hall space between them constitute one qualified residence); P.L.R. 9343034 (Aug. 3, 1993) (distinct parcels of land can constitute "adjacent land").

possibility or (2) will be permitted to sell the residence or otherwise hold cash.²³⁵ An addition of cash would be treated as an additional taxable gift. For example, the governing instrument should either prohibit sale during the retained use term or provide that if the personal residence is sold, then either (1) the proceeds be held in a separate account and used within two years from the date of sale (or prior to the expiration of the retained interest term, if earlier) to purchase another residence to be used by the term holder as a personal residence; (2) the proceeds not so used be distributed to the term holder or converted into a GRAT.²³⁶

Further, if the trust is intended to hold cash as permitted by the regulations, the instrument must prohibit distributions of corpus to any beneficiary other than the term holder during the period of the term interest, require that income be distributed to the term holder at least annually, and prohibit commutation of the term holder's interest.²³⁷ Further, it must require that the cash held by the trust in excess of permissible amounts be distributed at least quarterly to the term holder and, upon termination of the term holder's interest in the trust, any cash held for the payment of expenses must be distributed outright to the term holder.²³⁸ Further, the governing instrument must require that if the residence held by the trust ceases to be a personal residence of the term holder (subject to the sale or destruction exception discussed above), the trust must terminate and all trust property must be distributed outright to the term holder.²³⁹

Accordingly, the income tax concern, limited application, high transaction costs, and the need for appreciation, all militate against concluding that the personal residence GRIT will be an abuse area.

F. The Tangible Property Exception to Section 2702

The new valuation rules also do not apply to a retained term interest in tangible property.²⁴⁰ Notably, the retained term interest is not allowed to be valued pursuant to the pre-1990 Act GRIT valuation rules. Rather, the retained interest is valued pursuant to the traditional willing buyer/willing seller test.

²³⁵ Generally, the regulations distinguish between governing instrument requirements for a basic personal residence trust, Regulations section 25.2702-5(b), and a more sophisticated one designed to hold cash or allow for the sale of the personal residence or conversion to a qualified annuity interest during the retained interest term. Regs. § 25.2702-5(c).

²³⁶ Regs. § 25.2702-5(b), -5(c)(7), -5(c)(8). See also P.L.R. 9151046 (Sept. 26, 1991). Similar provisions need to be included to permit the trust to hold insurance proceeds received as a result of damage to or destruction of the residence. Regs. § 25.2702-5(c)(7)(B). If conversion to a qualified annuity interest is permitted, then the trust must also (1) contain all provisions relating to a grantor retained annuity trust and required by Regulations section 25.2702-3, (2) provide that right to receive annuity amount begins on date of sale (or damage or destruction rendering the residence incapable of use) or when the residence ceases to be used or held for use as a personal residence, and (3) require that the annuity amount equal or exceed that amount determined by the formula in the regulations. Regs. § 25.2702-5(c)(8).

²³⁷ Regs. § 25.2702-5(c)(3), -5(c)(4), -5(c)(6).

²³⁸ Regs. § 25.2702-5(c)(5)(ii)(A)(2).

²³⁹ Regs. § 25.2702-5(c)(7), -5(c)(8).

²⁴⁰ I.R.C. § 2702(c)(4); Regs. § 25.2702-2(c)(1).

Under this test, the value of the retained interest is the price a willing buyer would pay to a willing seller for such a term interest, each being under no obligation to buy or sell.²⁴¹

This exception only applies to the transfer of tangible property (1) for which no deduction for depreciation or depletion would be allowable if the property were used in a trade or business or held for the production of income (subject to a de minimis allowance) and (2) as to which the failure to exercise any rights under the term interest would not increase the value of the property passing at the end of the term interest (land harboring mineral or timber interests would fail this test).²⁴²

The best evidence of the value of any term interest is comparable sales or rentals.²⁴³ Appraisals that do not evidence actual comparable sales or rentals will be given little value.²⁴⁴ Further, the value of the right to use property for a term of years, such as a painting for five years, is not determined by multiplying the painting's annual rental value by five.²⁴⁵ Rather, the painting's actual five-year rental value must be determined.²⁴⁶

Because retained use interests in tangible property cannot be valued under pre-Chapter 14 valuation rules and are subject to the strict valuation rules discussed above, the abusive valuation potential of this area is nonexistent. For example, the grantor could retain the right to use a painting, with a fair market value of \$50,000, for a ten-year period. If the grantor can determine that a purchaser would pay \$10,000 to have the right to use the painting for ten years, then the value of the gift equals \$40,000.²⁴⁷ At the end of the ten-year term, the \$50,000 painting, plus any appreciation, is transferred to the remainder beneficiaries free of additional estate or gift tax cost. However, this strategy will be transfer tax beneficial only if the value of the painting at the end of the ten-year period is greater than the value that the remainder beneficiaries could have received had \$40,000 in cash been transferred in year one by the grantor (not pursuant to a GRIT) and invested in such a way as to maximize after-tax income and growth. If the painting is worth \$60,000 at the end of ten years, and \$40,000 could have been invested to grow at a 5% after tax rate, an outright gift of \$40,000 is transfer tax beneficial. That \$40,000 will yield \$65,156 to the donees,²⁴⁸ versus \$60,000 to the donees from the painting.

²⁴¹ *Id.*

²⁴² Regs. § 25.2702-2(c)(2).

²⁴³ Regs. § 25.2702-2(c)(3).

²⁴⁴ *Id.*

²⁴⁵ Regs. § 25.2702-2(d), Ex. (9).

²⁴⁶ *Id.* If a term interest in tangible property is valued pursuant to these rules, and thereafter converted to a use that would not qualify, the conversion is treated as a transfer of the value of the unexpired portion of the term interest unless the term holder's interest is then converted into a qualified annuity interest. Regs. § 25.2702-2(c)(4). Additions or improvements to the tangible property during the retained term will trigger additional gift tax concerns. Regs. § 25.2702-2(c)(5).

²⁴⁷ Calculated by subtracting the value of the retained use interest, \$10,000, from the value of the painting, \$50,000.

²⁴⁸ Calculated by multiplying \$40,000 by $(1 + .05)^{10}$.

V. CONCLUSION

The unification of the estate and gift tax system was structured to tax lifetime gifts at the same transfer tax rates as gifts at death. Nonetheless, prior to Chapter 14 certain lifetime gifts in the business and retained interest trust contexts could be structured at effectively lower gift tax rates than outright gifts. Chapter 14 was enacted to address this concern and to eliminate the abuses associated with those strategies.

Through the enactment of a complicated system of rules and procedures, Chapter 14 has effectively addressed these abuses. For valuation purposes, gifts made in the business context, as well as gifts in a retained interest trust format, are now the functional equivalent of outright, lifetime gifts of full interests in property. Although there are limited exceptions to that conclusion, those windows of opportunity are narrow and not abusive. The valuation rules set forth in Chapter 14 are fair and accomplish their mission to further consolidate the unification of the estate and gift tax system.

Appendix A

Calculating the Value of Remainder Interest

The assumed interest rate = 8.2%. The grantor's age is 75 years. All calculations are pursuant to I.R.S. Publication 1457 (1989).

I. Value of Remainder Interest if Grantor Retains Income Interest for Entire Five Year Term.

The value of the Income and Remainder Interests are calculated as follows:

- (a) Table B, column (3), 8.2%, 5 year term income factor: .325684
- (b) Table B, column (4), 5 year term remainder factor: .674316
- (c) Value of Remainder Interest = \$1,000,000 x .674316, or \$674,316.

II. Value of Remainder Interest if Grantor Retains Income Interest for the Fixed Five Year Term or Until Death (Whichever Comes First), and Retains Reversion if Death Occurs During Retained Income Term.

(a) The value of the income interest—the right to receive the income until the earlier of death or five years—is calculated as follows:

N factor (age 75) minus	948.7018
N factor (age 80, at the latest time the income interest may terminate)	(404.2715)
÷ D factor (age 75)	153.9204
= Annuity Factor	3.53708995
Annuity Factor x Interest Rate (.082) = Required Income Factor	<u>.2900413</u>

(b) The value of the reversionary interest—the right to receive back the principal if the grantor dies during the first five years of the trust—is calculated as follows:

M factor (age 75) minus	76.12683
M factor (age 80)	(45.75423)
	30.3726
÷ D factor (age 75)	153.9204
= Reversion factor	<u>.1973266</u>

(c) The gift tax on the transfer of X dollars to the trust is calculated on the following amount. The gift equals X times the following: 1 minus the grantor's retained interests, the right to receive the income until the first to occur of his or her death and five years (.2900413) and a reversion if death occurs in the first five years (.1973266), which equals .512632. Assuming X = \$1,000,000, there will be a gift of \$512,632.

Appendix B

Value of Remainder Interest if Grantor Retains Income Interest for a Fixed Ten Year Term or Death (Whichever Comes First) and Retains Reversion if Death Occurs During Retained Income Term

The assumed interest rate = 10.80%. The grantor's age is 60 years. All calculations are pursuant to Table H (10.80) (from I.R.S. Publication 1457 (1989)).

(a) The value of the income interest—the right to receive the income until the earlier of death or ten years—is calculated as follows:

N factor (age 60) minus	13039.71
N factor (age 70, at the latest time the income interest may terminate)	(3189.434)
	9850.276
÷ D factor (age 60)	1780.224
= Annuity Factor	5.5331
Annuity Factor x Interest Rate (.1080) = Required Income Factor	<u>.5976</u>

(b) The value of the reversionary interest—the right to receive back the principal if the grantor dies during the first ten years of the trust—is calculated as follows:

M factor (age 60) minus	371.9358
M factor (age 70)	(175.9045)
	196.0313
÷ D factor (age 60)	1780.224
= Reversion factor	<u>.1101</u>

(c) The Gift Tax on the transfer of X dollars to the trust is calculated on the following amount. The gift equals X times the following: 1 minus the grantor's retained interests, the right to receive the income until the first to occur of her death and ten years (.5976) and the reversion if death occurs in the first ten years (.1101), which equals .2923. Assuming X = \$500,000, there will be a gift of \$146,150.

(d) The Gift Tax on the transfer of X dollars to the trust is calculated on the following amount. The gift equals X times the following: 1 minus the grantor's retained interests, the right to receive the income until the first to occur of his or her death and five years (.5976) and a reversion if death occurs in the first five years (.1101), which equals .2923.

Appendix C

Value of Remainder Interest if Grantor Retains Income Interest for a Fixed Five Year Term or Death (Whichever Comes First) and Retains Reversion if Death Occurs During Retained Income Term

The assumed interest rate = 6.80%. The grantor's age is 60 years. All calculations are pursuant to Table H (6.80) (from I.R.S. Publication 1457 (1989)).

(a) The value of the income interest—the right to receive the income until the earlier of death or five years—is calculated as follows:

N factor (age 60) minus	15936.34
N factor (age 65, at the latest time the income interest may terminate)	(9507.908)
	6428.432
÷ D factor (age 60)	1616.535
= Annuity Factor	3.9767
Annuity Factor x Interest Rate (.0680) = Required Income Factor	<u>.2704</u>

(b) The value of the reversionary interest—the right to receive back the principal if the grantor dies during the first five years of the trust—is calculated as follows:

M factor (age 60) minus	532.8640
M factor (age 65)	(424.8888)
	107.9752
÷ D factor (age 60)	1616.535
= Reversion factor	<u>.06679</u>

(c) The Gift Tax on the transfer of X dollars to the trust is calculated on the following amount. The gift equals X times the following: 1 minus the grantor's retained interests, the right to receive the income until the first to occur of her death and ten years (.2704) and the reversion if death occurs in the first ten years (.06679), which equals .66279. Assuming X = \$500,000, there will be a gift of \$331,395.