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USING A MULTI-CLASS CORPORATION TO ACHIEVE ESTATE AND GIFT TAX SAVINGS: DOES IT WORK AFTER CHAPTER 14?

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INTRODUCTION

Prior to Chapter 14,[1] a commonly-recommended estate tax reduction strategy was what practitioners and others referred to as "corporate estate freezes."[2] This strategy was pertinent to families with substantial wealth that were involved in one or more closely held businesses. In the corporate context, it typically involved recapitalization of a family business to a multi-stock corporation, followed by the transfer (either by gift or purchase) of one class of stock, the perceived growth stock, to children and grandchildren.[3]

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1. Chapter 14 was enacted by § 11601 of the Revenue Reconciliation Act of 1990, Publ. L. No. 101-508. Chapter 14 includes I.R.C. §§ 2701-2704 (1988). Unless otherwise indicated, references herein to sections are to be the Internal Revenue Code of 1993, as amended [hereinafter the Code].

2. *See, e.g.*, Robert C. Kopple, *Corporate Recapitalization and Partnership Freezes*, 17 INST. ON EST. PLAN. ¶ 1100 (1983); *The Estate Freezing Rage: A Practical Look at Planning Opportunities and Potential Problems*, 15 REAL PROP., PROB AND TRUST J. (1980); Nelson & Woodward, *Structuring Estate Freezes: Estate and Gift Tax Aspects*, 33 S. CAL. TAX INST. ¶ 13 (1981).

3. In its basic form, the strategy could involve only two classes of stock, a "preferred" stock representing current value and a "common" stock representing future growth. The common stock would be sold or gifted at a minimal value or cost. The preferred stock would be retained by the donor. A similar arrangement could be undertaken in the partnership form if the business was structured as a partnership rather than as a corporation. *See, e.g.*, Michael S. Stolbach, *New Estate Freeze Rules: Gift Leveraging Can Achieve Estate Planning Objectives*, 8 J. PARTNERSHIP TAX'N 99 (1992); *see also infra* notes 18-26 and accompanying text. Permutations to the above-described basic approach were varied. For example, depending on how the donor desired to structure control, three classes of stock could be created: voting common, which would consist of a small number of voting common shares; a non-voting preferred stock, which would represent a large proportion of the current equity in the corporation; and non-voting common, which would seek to absorb future growth. For a discussion of the possible structural approaches, see John A. Wallace, *Recapitalizing the Closely Held Corporation: New Problems for an Old Technique*, 19 INST. ON EST. PLAN. ¶ 400 (1985).

For example, if company C had shares of common stock and a fair market value of $5,000,000, the company could be recapitalized in a tax free transaction[4] to have two classes of stock, preferred and common.[5] The preferred would be given voting rights, preferential (often non-cumulative) dividend treatment, and perhaps put-rights or liquidation preferences. With no definitive statutory or judicial guidelines as to valuation, the preferred stock would often be allocated an unjustifiably skewed, large amount of the value of the company.[6] In the case of C, the preferred stock might be argued to equal ninety percent of the $5,000,000 fair market value of the company.[7] The common stock would have minimal value, and could then be transferred with insubstantial gift tax concerns or at a low sales price to younger generation family members. The rights associated with the preferred stock would not be exercised.[8] Accordingly, the value of the preferred stock would remain constant and any growth in the overall value of C would inure to the benefit of the common stock, then being held by the donees.

The substantial leeway in valuation methodology was the principal attractiveness of the corporate estate freeze. Chapter 14, and

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4. *See* I.R.C. § 368 (a)(1)(E).

5. Preferred stock are shares in a corporation which confer on their holders preferences in earnings or assets in liquidation, or both. HODGE O'NEILL & ROBERT B. THOMPSON, CLOSE CORPORATION § 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.* § 3.29. Common stock is a class of corporate stock which represents the ownership of the corporation. It is equity stock which participates in the profits by way of dividends after preferred stock owners, if any, have been paid their dividends. This stock may or may not have voting rights. *Id.*

6. *See, e.g.*, Kopple, *supra* note 2, ¶ 1104 ("The valuation of any interest in a closely held corporation inevitably poses problems for the tax planner, the taxpayer's representative and the courts").

7. Theoretically, the preferred could be structured in a way that would capture all of the value of the corporation. *See infra* note 21. However, commentators suggested that a valuation in excess of 90% of the fair market value of the corporation would not be respected as valid. *See, e.g.*, Wallace, *supra* note 3, ¶ 403.5.

8. Omission would either be directly, or indirectly by exercising voting control of the corporation and thereby decisions by the board of directors as to whether to issue dividends or to liquidate. Failure to issue a preferred dividend raised the danger of an indirect gift. Accordingly, to avoid a taxable gift, a business reason would need to be propounded as to the failure to pay dividends on non-cumulative preferred stock when retained earnings were sufficient to pay such a dividend.

in particular section 2701, now impose new rules onto the valuation of transfers in family controlled multi-stock companies.[9] In particular, the valuation process is given relative definiteness in order to eliminate perceived abuses.

These new valuation rules require a re-examination of whether a multi-stock corporation can be used to achieve transfer tax savings.[10] The issue can be examined in the context of the two variables, the income tax consequences of paying dividends and the discount rate used in valuing retained interests.[11] These variables are the necessary by-product of the mandated valuation process. Because of these variables, the new Chapter 14 rules will render impractical the corporate estate freeze. The starting point for the analysis is with the structure of corporate estate freezes both historically and as mandated pursuant to section 2701.

I. Fundamental Structural Issues: The Corporate Estate Freeze Explored

The essence of the corporate estate freeze involves the bifurcation of the equity in the corporation. One portion of the equity will approximate the current value of the corporation and typically be retained by the controlling shareholder (most often the parents). The other portion of the equity, representing the growth element, will be sold or gifted at minimal cost to the controlling shareholder's intended donees (typically the children or grandchildren).

Theoretically, there are various strategies to use in valuing the transferred stock.[12] If the stock is gifted, one logical valuation procedure is to value the transferred portion by subtracting the value of the retained interest from the value of the asset as a whole.[13]

With that approach, transfer tax savings will be achieved if the total distributions received by the retained interest holder (for ex-

9. I.R.C. § 2701 (1988). The congressional history provides that the rules are "generally intended to assure more accurate gift tax valuation of the initial transfer." S. Comm. Rep., P.L. 101-508.

10. The term "transfer tax" is hereinafter used to refer to estate and gift taxes.

11. See discussion *infra* note 30 for examples of typical "retained interests."

12. *See, e.g.*, Kopple, *supra* note 2, ¶ 1104, and Wallace, *supra* note 3, ¶ 403.3.

13. *See* Treas. Reg. §§ 25.2511-2 (as amended in 1983), 25.2511-1(e) (as amended in 1986), & 25.2511-1(h)(7) (as amended in 1986). This approach is now the one mandated by the new section 2701 valuation rules. *See infra* notes 34-50 and accompanying text.

ample, five years in the future), discounted by the corporation's actual rate of earnings,[14] is less than the discounted present value for gift tax purposes of the retained interest. If that occurs, the value of the transferred interest will have increased at a rate greater than its assumed gift tax value.[15] Value will have been passed by the retained interest to the transferred interest without any transfer tax cost.[16]

To achieve the possibility of transfer tax gain, a corporation must have at least two disparate classes of stock interests. If equity rights are equivalent, then any gifted interest will appreciate at the

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14. The corporation's "rate of earnings" or "rate of growth," as those phrases are used in this article, refer to annual growth rate in net profits (before the distribution of any dividends) by the corporation. The measuring period to determine this rate is the hypothetical period between the date of the initial transfer to the donees (for example, at the time of creation of the Section 2701 transaction), and the death of the transferor.

15. To illustrate this principle, consider the following example. X pays $10,000 to a company in exchange for: (a) 100 shares of preferred stock which carry with them a cumulative, preferential dividend right to $10 per year and a put right of $100 per share; and (b) 100 shares of common stock which are entitled to any residual value, including dividends in excess of the $10 per share issued to the preferred stockholders. Given the closely-held nature of the company, X argues that a discount rate of 10% should be used to value each share of preferred stock. The value of the cumulative dividends of $10 per year under an assumed discount rate of 10% is $100 (1/.10 × $10; *see infra* note 67 and accompanying text). 100 shares at $100 per share equals $10,000, or the whole value of the company. The common shares arguably have no value, as there is no residual value: $10,000 (the pay to the company) less $10,000 (the value of the preferred stock) equals zero. The common shares are transferred at no gift tax cost to X's children. If the company appreciates at 20% per year, then at the end of two years, $12,200 remains in the company:

Yr.	Corporation's Assets	Payout of $1,000 to Preferred Shareholders at Year End	Increase by 20%	Balance Year End
0	10,000	0	0	10,000
1	10,000	(1,000)	12,000	11,000
2	11,000	(1,000)	13,200	12,200

As a result, $2,200 has inured to the benefit of the common shareholders ($12,200 less the value of the preferred shares, $10,000, equals the residual value). Transfer tax savings has occurred in this situation because the 10% discount rate did not reflect the actual investment return rate experienced by the company, 20%. Had the preferred shares been valued by reference to this 20% rate, they would have equalled only $5,000 (1/.20 × $10 × 100 shares). The common stock would then have been valued at $5,000.

16. This value-enhancing process is often euphemistically referred to as "leveraging." *See, e.g.*, Stolbach, *supra* note 3. The author believes this process could properly be referred to as "the skewing of the gift tax valuation tables based on actual investment return."

same rate as the retained interest. Changes that affect the economic well being of the company, in this instance, impact equally (at least on a proportionality basis) both the retained and transferred interests. Accordingly, there can then be no leveraging of the transferred interest based on the gift tax value of the retained interest.[17]

The axiom can be reduced to the following. In order to achieve transfer tax savings, at a minimum the value of the transferred interest must grow at a rate greater than the growth rate assumed in the valuation of the retained interest. The valuation of the retained interest thus becomes a threshold inquiry.

Prior to Chapter 14, valuation of retained interests in the corporate context could be creatively undertaken for transfer tax purposes.[18] For example, a corporation could be formed or recapitalized with two classes of stock, preferred and common,[19] with the preferred class being given a liquidation preference, put-rights and preferences as to dividends over the common. The value of that preferred stock could be structured so as to (arguably) approximate ninety percent or more of the value of the corporation.[20] The common stock would equal the residual value of the company.

Because the preferred stock would be structured to capture most of the full fair market value of the company, the common stock would have minimal value.[21] The parent would retain this

17. The value of the transferred interest, regardless of the earnings of the corporation, will not be increased because of a gift tax valuation of the retained interest that, in actuality, turns out to be too low.

18. *See, e.g.*, Wallace, *supra* note 3, ¶ 403.15.

19. *See supra* note 5.

20. For example, the liquidation and put rights could equal the full amount of the fair market value of the company. Taking into account that the rights may not be exercised for a period of time, or that the corporation would not have sufficient assets to satisfy the exercise of those rights, the fair market value of the rights could be reasonably discounted by 10%.

21. Assume the initial value of the company is one million dollars and the company has two classes of stock, preferred and common. The preferred stock has rights in preference to the common, and therefore the value of the common stock should equal only the remaining value of the company, after subtracting the fair market value of the preferred stock. If the preferred stock is valued at one million dollars, then mathematically the common would have a zero value (i.e., the fair market of the company, one million dollars, less the fair market value of the preferred stock, one million dollars, is zero). But this is a non-sequitur because any increase in value of the company in excess of one million dollars would pass to the common stock. Clearly a willing buyer would pay valuable consideration for the right to have all the

preferred stock and transfer, at minimal gift tax or sales cost, the common stock. The parent, as the holder of the preferred equity interest, could then determine whether to exercise the retained preferred rights, including indirectly influencing whether to issue dividends.[22] If the retained rights were unexercised, value increases would completely inure to the benefit of the common stock.

For example, assume parent P owns 100% of the stock in company X, valued at $1,000,000. P created X with two classes of equity interests. First, X has 1,000 shares of preferred stock which carry with them the right to be put to the company for $1,000 per share, the right to the first $1,000 per share in assets if the company is liquidated, and the voting right to elect directors.[23] Second, X has 1,000 shares of common stock which carry with them 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 face amount of the put and liquidation rights equals $1,000,000 (and P has retained the right to vote for the directors, thereby controlling decisions as to whether and when X liquidates), the value of this interest should be $1,000,000 less a ten percent discount for the possible delay in immediate enjoyment of the liquidation preference or put right. P transfers the common stock, then valued at $100,000 dollars,[24] to his child, C. P does not intend to exercise the put or liquidation rights and, after ten years, passes away while holding these rights. The value of X at P's death is $3,000,000, but the value of the put

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value in excess of one million dollars. *See* Treas. Reg. § 20.2031-1(b) (as amended in 1965). Accordingly, a discount needs to be taken from the mathematically-arrived at fair market value in order that the common stock has residual value. *See, e.g.*, Wallace, *supra* note 3, ¶ 403.5.

22. *See infra* note 23.

23. Another attribute that could be given to the preferred stock would be the right to preferential dividend treatment. Decisions on whether to issue dividends is vested in the board of directors. As P would retain the right to vote and therefore the right to elect the 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 exercise influence so that dividends were not issued. Dividends not issued would inure to the benefit of X, thereby increasing the overall value of X and accordingly the value of the residual, common stock interest.

24. The value of X is $1,000,000. If the value of the preferred stock equals $900,000, then the residual value of the common stock is $1,000,000 less $100,000, or $900,000.

and liquidation rights have remained stable at $900,000. Therefore, $900,000 is in P's gross estate, but P has transferred $2,000,000 to C, at no transfer tax cost. Further, P has exercised control over when and if C receives this $2,000,000 because at any time during his life P could have exercised the put-right or (indirectly) the liquidation preference.

As illustrated by the example, prior to Chapter 14 this type of strategy with a multi-class stock company maximized the transfer tax savings associated with a gift program. This maximization occurred because in actuality the gift tax value of the retained preferred stock would be grossly overstated. That value, as illustrated by the above example, would substantially exceed its value when discounted by the corporation's rate of earnings.[25] Based on the lack of guidance as to valuation requirements, the parent could thereby grossly understate the gift tax value (or value for sales purposes) of the transferred interest, thereby increasing overall transfer tax savings.[26]

Chapter 14 now imparts a set of rules onto the valuation of retained interests in multi-class family corporations. As a result, maximized transfer tax savings will no longer be possible. The question is whether the Chapter 14 rules, as they apply to valuation of retained interests in the corporate setting, still provide a realistic opportunity for transfer tax savings.

II. Valuing Retained Rights in the Corporate Setting Under Chapter 14

a. *The Reach of the Statute*

Section 2701[27] is the provision in Chapter 14 that is focused primarily with the valuation of equity interests in multi-class family

25. This discounted value is the retained preferred stock's real value. *See supra* notes 14-16 and accompanying text.

26. 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 those rights not being exercised or that when exercised, not being able to be totally satisfied. Third, a discount factor related to the corporation's expected rate of growth would be included for present value purposes. Given the uncertainty of ascribing legitimate probability and discount factors, as well as the administrative inconvenience of implementing this procedure, this type of approach, though mathematically correct, could not prove feasible.

27. I.R.C. § 2701.

corporations. That section applies when a parent transfers certain corporate interests to a child, grandchild, spouse, or spouse of a child or grandchild (a "member of the family"[28]), and the parent retains an interest in the company after the transfer.[29] Specifically, if the parent retains an "applicable retained interest"[30] in the corporation 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.[31]

The general operation of the statute is illustrated by the following example. P owns all of the outstanding stock of company X consisting of 100 shares of common appraised at $600,000 and 100 shares of preferred (which carries with it a non-cumulative dividend right) 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.[32] In this situation, the valuation rules under section 2701 would apply and, because the non-cumulative preferred stock is ascribed no value for gift tax

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28. I.R.C. § 2701(e)(1).

29. The following discussion focuses on section 2701's application to the corporate area. Section 2701 applies to the partnership area as well. *See, e.g.*, Stolbach, *supra* note 3.

30. The term "applicable retained interest" refers to a liquidation, put, call, conversion, or similar right if the exercise or non-exercise of that right would affect the value of the transferred interest (an "extraordinary payment right"). I.R.C. § 2701(b)(1)(B); Treas. Reg. § 25.2701-2(b)(1)(i) (1992). The term also refers to distribution rights 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); Treas. Reg. §§ 25.2701-2(b)(1), (2) (1992).

A right which is a (i) mandatory payment right (a right to receive payments required to be made at a specific time for a specific amount), (ii) liquidation participation right provided the family does not have the ability to compel liquidation, or (iii) non-lapsing conversion right (non-lapsing right to convert an equity interest 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. Treas. Reg. § 25.2701-2(b)(4) (1992). Also, voting rights are not applicable retained interests.

31. *See* I.R.C. §§ 2701.

32. The gift tax on $600,000 is $192,800, I.R.C. § 2501, which is the amount shielded from the payment of gift tax by the unified credit. I.R.C. § 2505.

purposes pursuant to section 2701,[33] the common stock carries with it the full value of the corporation, or $1,000,000.

To avoid applying the special valuation rules to non-abuse areas, certain types of transfers are expressly excluded from the application of section 2701 regardless of whether the transferor holds an applicable retained interest after the transfer. For example, the section will not apply if the interest transferred is the same class or proportionately the same as the applicable retained interest held by the transferor in the company.[34]

b. Application of the Valuation Mandate

For those situations in which section 2701 does apply, a multi-step process is used to value the interests transferred to family members.[35] First, the aggregate value of all family-held equity interests in the corporation is determined.[36] That valuation is pursuant to general principles, but assumes all interests are held by one individual.[37]

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

33. *See* I.R.C. § 2701(a)(3)(A).

34. *See, e.g.*, Treas. Reg. § 25.2701-1(c)(3) (as amended in 1992). With a corporation with only one class of stock, any transferred interest will increase at the same rate as the retained interest. Therefore, there is no abusive transfer tax potential and § 2701 need not apply. *See* discussion *supra* note 17 and accompanying text. 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. Treas. Reg. § 25.2701-(1)(c)(4) (as amended in 1992). For example, if a parent transfers an equal percentage of each class of equity interest in a company, the statute will not apply. *Id.* As with the above, there is no abusive leveraging potential with this type of transfer.

35. Treas. Reg. § 25.2701-3(b) (as amended in 1992).

36. Treas. Reg. § 25.2701-3(b)(1) (as amended in 1992). "Family-held" includes the transferor, lineal descendants of the parents of the transferor or the transferor's spouse, and applicable family members. Treas. Reg. § 25.2701-3(a)(2)(i) (as amended in 1992). "Applicable family members" includes the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor. Treas. Reg. § 25.2701-1(d)(2) (as amended in 1992).

37. *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 John M. Janiga, *Valuation of Closely Held Stock for Transfer Tax Purposes: The Current Status of Minority Discounts for Intrafamily Transfers in Family-Controlled Corporations*, 69 TAXES 309 (1992).

members) are subtracted.[38] Equity interests that carry with them a right to distributions of income or capital that is preferred to the rights of the transferred interest are "senior equity interests."[39] Fair market value of these interests is determined in accordance with traditional valuation principles.[40]

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.[41] Under section 2701, applicable retained interests held by the transferor which consist of extraordinary payment rights[42] are valued at zero.[43] Also valued at zero is an applicable retained interest which is a "distribution right . . . in a controlled entity" unless it is a "qualified payment right."[44] A "qualified payment right," generally valued under traditional principles, include equity interests that carry with them the right to receive cumulative distributions payable on a periodic basis, at least annually, to the extent determined at a fixed rate or as a fixed amount.[45] Accord-

38. Treas. Reg. § 25.2701-3(b)(2)(i) (as amended in 1992).

39. Treas. Reg. § 25.2701-3(a)(2)(ii) (as amended in 1992). An example of a senior equity interest (which is not an applicable retained interest) is a redemption right which requires a payment at a specific time in the future for a specific price. This is not subject to the section 2701 valuation rules.

40. *See, e.g.*, Treas. Reg. § 25.2701-3(d) (as amended in 1992).

41. Treas. Reg. § 25.2701-3(b)(2)(i)(B) (as amended in 1992). 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.*

42. See *supra* note 30 for a definition of "extraordinary payment rights."

43. *See* I.R.C. § 2701(a)(3)(A); Treas. Reg. § 25.2701-2(a)(1) (1992).

44. I.R.C. § 2701(a)(3)(A); Treas. Reg. § 25.2701-2(a)(2) (1992). That zero valuation assumption will most often apply to non-cumulative preferred stock or to non-guaranteed payments of income or principal from a partnership.

45. Treas. Reg. § 25.2701-2(b)(6) (1992). 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." Treas. Reg. § 25.2701-2(a)(4) (1992).

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); Treas. Reg. § 27.2701-2(a)(3) (1992). This rule is intended to preserve the integrity of the arrived at valuation of the qualified payment right.

ingly, 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 for cumulative 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.[46]

Fifth, the amount allocated to the transferred interest in the above step is reduced to take into account minority and similar discounts, if any. Other adjustments are then made, if necessary.[47]

The following example illustrates the above-described methodology. P holds all 1,000 shares of common stock in Company X. The fair market value of P's family-held interests in X is determined to be $1,500,000 (Step 1). P decides to engage in an estate tax reduction transaction under section 2701 and recapitalizes X, in a tax free transaction,[48] to consist of 1,000 shares of preferred stock, which bear an annual cumulative dividend (i.e., "cumulative distribution right") of $80 per share, and 1,000 shares of common stock, which absorb any remaining rights. The preferred stock also

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Further, 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, *see infra* note 67, equals the then full fair market value of the entity. Then, if the entity's rate of growth 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 interests (such as common stock) must equal 10% of the sum of (i) the total value of all equity interests in the entity plus (ii) the total amount of indebtedness of the entity owed to the transferor or applicable family member. Treas. Reg. § 25.2701-3(c) (as amended in 1992); *see also* I.R.C. § 2701(a)(4).

46. Treas. Reg. § 25.2701-(b)(3)(ii) (as amended in 1992). 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 treasury regulation § 25.2702-2(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 § 2701. *Id.*

47. Treas. Reg. § 25.2701-3(b)(4) (as amended in 1992). 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 § 2701 and without applying a family attribution rule. *Id.* For a general discussion of minority discounts in the family-control context, see Janiga, *supra* note 37.

48. I.R.C. § 368(a)(1)(E).

allows the holder to put the stock for $1,500 share. P transfers all of his common stock to his children and retains only the 1,000 shares of preferred stock. Under section 2701, the gift tax value of the common stock 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 annual cumulative dividend preference and the put right; accordingly, the units are 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.[49] In contrast, because the dividends under the preferred stock are cumulative distribution rights, the preferred stock is ascribed a value for these purposes.[50] The value of the dividend rights (and therefore the preferred stock) could approximate $800,000.[51] The gift tax value of the common stock is $1,500,000 less $800,000, or $700,000 (Steps 3 and 4). Because 100% of the common stock has been transferred, no minority discount is applicable (step 5) and the value of the common stock is not reduced.

III. Section 2701 and Transfer Tax Savings: What Remains in the Corporate Context?

Section 2701 mandates that if the rights under the preferred stock interest can be exercised (or not exercised) at the donor's discretion, then the value of the transferred subordinate, non-preferred stock interest carries with it the full value of the family's interest in the corporation.[52] In essence, for gift tax purposes the

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49. *See supra* text accompanying note 43.

50. *See* I.R.C. § 2701(3)(a); Treas. Reg. § 25.2701-2(a)(2) (1992).

51. The statute provides no explicit methodology on how to value the preferred stock in this scenario. The treasury regulations contemplate that this asset will be valued by multiplying the expected stream of payments by a discount rate. *See, e.g.* Treas. Reg. §§ 25.2701-2(a)(5)(Example), 25-2701-4(c)(3) (1992)("The appropriate discount rate *is the discount rate that was applied in determining the value of the qualified payment* . . . .") (emphasis added). 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 to 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 × 1,000 units × (1/.10) (the discount rate), or $800,000. *See infra* notes 66-67.

52. I.R.C. § 2701(a)(3)(A); Treas. Reg. §§ 25.2701-2(a)(1) (1992), 25.2701-3(b) (as amended in 1992).

donor will be treated as having retained no equity interest in the company. Accordingly, there is no transferred interest that can be leveraged (i.e., no transfer tax savings) based on the value of a retained interest.

In order to be ascribed a value for gift tax purposes, the preferred interest must carry with it a qualified payment right, or such a right must be electively presumed to exist.[53] But even though the preferred interest in this instance will be given a value for gift tax purposes, transfer tax gain will still be uncertain. This is because of two results that follow from the section 2701-mandated valuation rules. First, the retained interest must carry with it the right to receive dividends, which means that income tax will be generated with no offsetting deduction to the corporation.[54] Second, the holder of the preferred interest will receive aggregate payments in excess of the initial value of the retained interest.[55]

a. Generating Income Tax by Mandating Dividend Payments

Section 2701 requires that in order for the retained interest to be valued for gift tax purposes, it must entitle the holder to cumulative payments determined at a fixed rate or in a fixed amount.[56]

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53. I.R.C. §§ 2701(a)(3)(A), 2701(c)(3)(C)(ii); Treas. Reg. §§ 25.2701-2(a)(2), -2(b)(5)(iii) (1992). If a distribution which 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 § 2701. Treas. Reg. § 25.2701-2(c)(2) (1992). This clarifies that, solely because for gift tax purposes an election has been made to treat a stock interest as if cumulative distributions were required to be made, the valuation must still be made with the understanding that the distributions are noncumulative. From a transfer tax perspective, this militates in favor of not making the election.

54. For preferred stock to be ascribed a value for gift tax purposes, the stock must entitle the holder to a cumulative distribution right. *See supra* notes 42-45 and accompanying text. In the corporate context, this means that the preferred stockholder be entitled to dividends, either made or accrued, on an annual basis. (There is a four-year grace period in the actual making of the dividends, see I.R.C. § 2701(d)(2)(C)). Dividends effectively represent after-tax profits of the corporation. *See, e.g.*, MODEL BUSINESS CORP. ACT ANN., § 45 (comment) ("[D]ividends ordinarily are the means of distributing the profits to the shareholders"). Further, dividends are taxable income to the recipient, which in the case of the section 2701 transaction, will most likely be the parent. *See* I.R.C. § 61(a)(7). Dividends are not deductible by the corporation. Accordingly, the issuance of dividends is effectively double taxation to the family, with income being taxed at both corporate and individual levels.

55. *See infra* notes 72-88 and accompanying text.

56. *See supra* note 45 and accompanying text.

In the corporate context, these payments will be represented by dividends, taxable to the recipient, non-deductible by the corporation.[57] Payment of the dividends can be delayed for up to four years.[58] This four-year grace period is probably more illusory than real; if payments can be delayed for this period of time, the deferral should have a negative, and likely equalizing, effect on the valuation of the dividends.[59] If payment of an annual dividend is extended beyond the four-year grace period, the statute requires, in effect, that the dividend carry imputed interest for transfer tax purposes.[60]

Accordingly, adherence to section 2701 valuation principles probably will result in payment of dividends at least annually (assuming the corporation's earned surplus is sufficient to allow the dividends). These distributions will result in a tax loss, this time being attributable to the income tax system. The loss will likely be at the highest marginal rate, currently 39.6%.[61] Essentially, this will represent the disappearance of wealth at this rate. Accordingly, the section 2701 transfer tax savings (assuming marginal estate taxation at a fifty-five percent rate) must exceed forty-five percent of the sum of (1) all income taxes on the dividends paid on the retained preferred stock, plus (2) loss income on and appreciation of those income tax payments from the date of payment until the date of death. This is represented by subtracting from the pro-

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57. I.R.C. § 61(a)(7).

58. I.R.C. § 2701(d)(2)(C).

59. In that instance, a greater discount rate must be used in valuing the qualified payment right. A disinterested investor would require a greater interest rate prior to purchasing a dividend right that, despite sufficient corporate earnings, could in the board of directors' discretion be delayed in receipt for up to four years. *See infra* notes 61-71 and accompanying text.

60. Treas. Reg. § 25.2701-4(c) (1992). The imputed interest is determined "as if each payment were paid on its due date and reinvested as of that date at a yield equal to the appropriate discount rate . . . ." Treas. Reg. § 25.2701-4(c)(1)(i)(B) (1992). This militates in favor of not extending beyond the four-year grace period, assuming the corporation has sufficient earned surplus to make the payment.

61. Budget Reconciliation Act of 1993, Pub. L. No. —, § 13202, — Stat. — (19—). The income will presumably be to a person in a high income tax bracket as § 2701 transactions contemplate consideration by only persons of substantial wealth. This highest marginal rate fails to take into account other Code adjustments which could push the actual rate to well above 39.6%. *See, e.g.*, § 151(d)(3), relating to the phaseout of the personal exemption. This rate also does not take into account any taxes due at the state level.

jected transfer tax gain,[62] the following sum: $.45\ [(Y_1)(1+i)^T + (Y_2)(1+i)^{T-1} + (Y_3)(1+i)^{T-2} + \ldots + (Y_T)(1+i)]$, where "Y" equals the aggregate income taxes paid on the preferred dividends in any given year, "i" equals the growth rate that could have been achieved on the amounts otherwise used to pay the taxes, and "T" equals the number of years from the establishment of the 2701 transaction to the death of the retained interest holder.

For example, assume that the preferred shareholder retains 1,000 shares of preferred stock which bear an annual cumulative dividend of $80 per share. At a ten percent discount rate, the shares would be valued at $800,000[63] and would, accordingly, decrease the value of the gift of common shares by that amount.[64] The downside is that the preferred shareholder will receive $80,000 per year in dividends. At a 39.6% income tax rate, $31,680 will be paid annually in federal taxes. This amount constitutes deadweight loss to the family, in that the tax may not have been incurred if the 2701 transaction had not occurred. At the end of five years, $158,400 in taxes will have been paid, as well as the opportunity to realize income or have appreciation on this amount. At a ten percent opportunity cost rate,[65] the following amount is lost to the family: $.45\ [(31{,}680)(1.1)^5 + (31{,}680)(1.1)^4 + (31{,}680)(1.1)^{3+} (31{,}680)(1.1)^{2+} (31{,}680)(1.1)] = \$94{,}312$. Accordingly, the transfer tax savings must exceed $94,312 in order for the family to gain on the 2701 transaction. Whether this occurs will be dependent on the rate of growth experienced by the corporation over these five years as compared to the ten percent discount rate used in valuing the retained, preferred stock interest.

b. *What Is the Real Value of the Retained Interest?*

The starting point for the analysis is with the methodology used in valuing the qualified payment right. That right is no more than a guaranteed, infinitesimal string of constant payments.

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62. *See infra* note 91.

63. *See supra* note 51.

64. The common would be valued by subtracting $800,000 from the fair market value of the family's interest in the corporation. *See supra* notes 41-45.

65. For consistency with the discount rate used in valuing the preferred stock, a 10% rate is chosen. More accurately, however, the rate should equal the corporation's rate of growth. For illustration purposes, the formula and example assume payment of the tax at the beginning of the year.

Although the Code and regulations provide no express guidance on how to value these payments, the regulations implicitly contemplate that the payments will be valued like an annuity, at an assumed discount rate.[66] The formula for determining that amount is A multiplied by 1/i, where "i" equals the discount rate and "A" is the amount of the annual dividend.[67]

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66. *See, e.g.*, Treas. Reg. § 25.2701-2(a)(5) (Example) (1992). 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, *supra* note 3, the valuation methodology appears straightforward. The only uncertain variable is the discount rate to be chosen.

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. Treas. Reg. § 25.2701-3(d) (Example 1) (1992). 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. Rule. 83-120, 1983-2 C.B. 170. In this regard, valuing $1,000 par value stock with an 8% dividend at $1,000 presupposes one premise: 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 67 and accompanying text.

Accordingly, to plan or evaluate a § 2701 transaction, the starting point is to evaluate the appropriate discount rate that needs to be chosen, based on fair market value principles. Revenue Ruling 83-120 provides a starting point in evaluating this rate. The dividend amount per share also needs to be determined. This amount is discretionary with the family and should be based on the expected earnings each year and what the corporation can pay. Once the dividend amount and discount rate have been determined and deduced, the fair market value of the preferred stock can be calculated and, if desired, expressed in the above par value format. The fair market value of each share will be equal to: dividend amount divided by the discount rate. Expressed in the corporate format, the preferred stock's par value will equal the determined fair market value, and the dividend rate will equal the chosen discount rate.

The two variables in the above equation for valuing the preferred stock are (1) the dividend amount and (2) the discount rate. The dividend amount is dependent on that amount selected by the family (which will be based, in part, on the amount of expected earnings that can be distributed) and therefore relatively certain; the discount rate is market driven, and therefore uncertain.

67. 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 the amount of the annual annuity ("A") multiplied by:

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

Since "t" will be infinity, $(1 + i)^t$ will also equal infinity, no matter how small "i", the discount rate, is. Accordingly, 1 divided by infinity will be zero, and the equation then

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.[68] Hence, a discount rate related to existing market rates, such as the prime rate, is more beneficial from a transfer tax perspective than 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,[69] used in other gift and estate tax contents, is not necessarily reflective of the most realistic discount rate. Nor is a discount rate tied to a market rate; distribution rights in a family corporation are more uncertain than those in a publicly-traded corporation.[70] Conceptually, the starting point for choosing the discount rate could be market rates, but that number should be increased to account for the uncertainty of whether the corporation will be able to make timely its payments.[71]

Regardless of the discount rate used, the retained interest will be valued as if it shares in a percentage of future profits (i.e., a pro rata amount determined as if annual profits equalled the assumed discount rate). Therefore, all company growth will not inure to the benefit of the transferred interest. In fact, to the extent the discount rate used for gift tax valuation purposes equals the corpora-

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becomes A multiplied by $\frac{i}{1\ 0}$, or 1/i.

68. For example, 1/20% (which equals 5) is greater than 1/50% (which equals 2).

69. I.R.C. § 7520, which requires 120% of the federal midterm rate then in effect as the rate to value various estate and gift tax interests. *See* Priv. Ltr. Rul. 93-24-018 (June 18, 1993) ("It should be noted that in determining the value of a preferred stock based on the present value of the dividend stream to perpetuity, the use of a discount factor based on the rate prescribed by § 7520 . . . is rarely valid when the corporation is closely held.").

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

71. *Id.* For example, if the corporation's earnings are at 6%, it may not be possible to pay dividends that require aggregate payments equal to 12%. *See* Model Business Corp. Act, § 6.40 (1985); *see also*, Kasner, *Valuation of Interest under Section 2701*, 61 Tax Notes 979 (1993). Also, there is a four year grace period, (i.e. no imputed interest for transfer tax purposes) with regard to the making of qualified payments. I.R.C. § 2701(d)(2)(C); Treas. Reg. § 25.2701-4(c)(3) (1992). If the preferred stock allows the board to defer paying an annual cumulative dividend, without interest, during this four-year grace period, clearly the discount rate needs to be adjusted, upwards, to account for this possibility that each dividend 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 would be improper and would be a valuation abuse.

tion's rate of earnings,[72] no transfer tax savings will occur. The transferor will then be in the same transfer tax position as if only one class of stock existed and the transferor had made outright gifts of a portion of that stock.

This concept is illustrated by the following example. Assume that Corporation C is created to have 1,000 shares of preferred stock which bear an annual cumulative dividend of $80 per share (and a liquidation right of $800 per share) and 1,000 shares of common stock which carries with it the residual value. The value of the company is $1,500,000. The preferred stock is valued at $800,000 under section 2701.[73] The value of the common stock equals the residue, or $700,000, and this stock is gifted to the children (reported on the transferor's filed gift tax return). At the end of 5 years, C has averaged an after-tax rate of growth of ten percent of the corporation's value at the beginning of the year.[74] Therefore, assuming the payment each year of the preferred dividend, the value of C is $1,927,357 at the end of five years, illustrated as follows:

Beginning of Year	Value of Corporation at Beginning of Year	Increase in Corporations Value at 10%	Payout to Preferred Stockholder	Value of Corporation 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	1,731,700
4	1,731,700	173,170	80,000	1,824,870
5	1,824,870	182,487	80,000	1,927,357

Based on the above, one may be inclined to conclude that there has been effective transfer tax savings and a gift tax free transfer of $427,357 to the children. This appears to be so because the value of the preferred stock, using the same valuation methodology that was used during the transferor's lifetime—the right to receive $80,000 per year assuming a discount rate of ten percent—

72. *See supra* note 14 for the definition of "rate of earnings." See *infra* note 91 for the formula to determine the extent of the transfer tax savings when the rate of earnings exceeds the gift tax discount rate used in valuing the retained preferred interest.

73. *See supra* note 51.

74. A 10% rate was used in valuing the preferred stock for gift tax purposes. *See supra* note 51.

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 lifetime, the difference, $427,357, has arguably passed to the children free of transfer taxation solely because of the 2701 transaction.

But, that conclusion is incorrect. If the preferred stockholder dies at the end of year 5, there has been no transfer tax benefit (versus an outright gift). By the end of year five, 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.[75] Clearly, the retained interest, valued at $800,000 for gift tax purposes, has not remained static in value.

The retained interest has grown, or appreciated, at the same rate as the transferred interest. At a 10% growth rate and assuming no distributions to the preferred stockholder, C would equal $2,415,765 at the end of five years.[76] The transferred common stock of $700,000, at a 10% growth rate, accounts for $1,127,357 of this amount.[77] The remaining $1,288,408 belongs to the retained preferred stockholder.[78] In substance, the retained preferred stock interest of $800,000 has also grown at a 10% rate.[79]

Because the retained and transferred interests have appreciated at the same rates, the identical transfer tax savings could have been achieved if the corporation had merely one class of stock interest and an equal gift was made of a percentage of that initial stock.[80] Accordingly, section 2701 in this example achieves no

75. The $400,000 consists of $80,000 annually for five years. For comparison purposes and simplicity, the income tax effects of corporate distributions are ignored in the textual comparisons in this section. The $88,408 is arrived at mathematically by the following formula: $(80,000 (1 + .1)^4 + 80,000 (1 + .1)^3 + 80,000 (1 + .1)^2 + 80,000 (1 + .1) - 320,000)$.

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

77. Calculated by multiplying $700,000 by $(1 + .1)^5$. Also, this figure can be derived by 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.

78. 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.

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

80. Had the corporation consisted of only one class of stock, not both preferred and common, and the transferor merely gifted the equivalent gift tax amount of that

transfer tax benefit.

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. Hence, in that instance transfer tax savings will have been created, but these savings are not necessarily substantial.

For instance, if in the above example, C increased at a twelve-percent rate instead of a ten-percent rate, C would equal $2,643,513 at the end of five years.[81] The retained interest would consist of $400,000 in payments, $108,228 in interest on (or appreciation of) those payments,[82] and the underlying constant value of $800,000, for a total of $1,308,228. The remaining value of C, $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 twelve percent annual rate, or $1,233,639.[83] As a result, $101,646 has passed to the donees free of transfer tax.[84]

Conversely, 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 transfer tax loss. That is, the retained interest will increase at a rate in excess of the rate of increase of the transferred interest (and in excess of the rate of increase of the retained interest assumed for gift tax purposes). Had the transferor merely gifted common stock in a one stock corporation with a gift tax value (assuming no minority discounts) equal to the gift tax value of the transferred interest in the two-stock class company, less property would have been included in the transferor's gross estate.

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stock interest to the donees, $700,000 worth of stock would have been transferred to the donees. The fractional value of $700,000 of C'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.*, Treas. Reg. § 25.2701-1(c)(3). The value of 7/15th of C at the end of five years is $1,127,357 (7/15 × $2,415,765), the same amount as the value of the transferred interest pursuant to the § 2701 transaction.

81. Calculated by multiplying $1,500,000 × $(1 + .12)^5$.

82. The $108,228 is arrived at mathematically by the following formula: $(80,000 (1 +.12)^4 + 80,000 (1 + .12)^3 + 80,000 (1 + .12)^2 + 80,000 (1 + .12) - 320,000)$.

83. Calculated by multiplying $700,000 × $(1 + .12)^5$.

84. This number represents the difference between $1,335,285 (the amount that passes to the donees) and $1,233,639 (the amount that could have passed to the donees).

If in the previous example, C increased at a 8% rate instead of a 10% rate, C would equal $2,203,992 at the end of five years.[85] The retained interest would consist of $400,000 in payments, $59,328 in interest on (or appreciation of) those payments,[86] and the underlying constant value of $800,000, for a total of $1,269,328. The remaining value of C, $2,203,992, less $1,269,328, or $934,664, passes to the donees. $934,664 is less than the value of $700,000, the initial gift, increased at an annual 8% rate, or $1,028,530.[87] As a result, $93,866 less has passed to the donees than if P had only one class of stock and the transferor had made an outright gift of $700,000 of that interest.[88]

CONCLUSION: COMBINING DISCOUNT RATE UNCERTAINTY WITH DIVIDEND-GENERATED INCOME TAX

In addition to the uncertainty of any transfer tax savings potential in light of the mandated 2701 valuation rules, the interplay between the income tax and transfer tax savings maximization is a further disincentive to a 2701 corporate transaction. To increase the transfer tax gain potential, the amount of the preferred dividend retained by the donor should be increased.[89] But as the preferred dividend increases, so does the amount of income tax generated, which constitutes deadweight loss for the family.[90] As a result of these two variables and their inverse proportionality, the transfer tax feasibility of corporate 2701 transactions are in doubt.

Moreover, the potential upside to these transactions is dependent primarily on an uncertain variable, whether the corporation's rate of earnings will exceed the discount rate used in valuing the qualified payment rights retained by the transferor. Most likely, except in those business settings where the family is confident that the corporation's rate of earnings will substantially exceed the dis-

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85. Calculated by multiplying $1,500,000 \times (1 + .08)^5$.

86. The $59,328 is arrived at mathematically by the following formula: $(80{,}000 (1 + .08)^4 + 80{,}000 (1 + .08)^3 + 80{,}000 (1+ .08)^2 + 80{,}000 (1+ .08) - 320{,}000)$.

87. Calculated by multiplying $700,000 by $(1 + .08)^5$.

88. $1,028,530 less $934,664 is $93,866.

89. *See infra* note 91. For example, if in the illustration described *supra* in the text accompanying notes 81-84, the retained preferred stock issued a $100 dividend instead of a $80 dividend, the transfer tax savings would have increased from $101,646 to $127,057. (This conclusion can be derived by either using the formula in note 91, *infra*, or by creation of a chart similar to that following note 74, *supra*, in the text.)

90. *See supra* notes 61-65 and accompanying text.

count rate used in valuing the retained interest, section 2701 transactions in the corporate context will not be chosen.[91]

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91. The transferor will, from a transfer tax perspective, be in an advantageous position under § 2701 if the entity earns at a rate greater than the discount rate used in valuing the retained interest. *See supra* notes 81-84 and accompanying text. The formula for determining the amount which, solely because of the § 2701 transaction, passes free of any transfer tax (that is, the amount of the transfer tax savings solely attributable to the 2701 format), is:

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

where i is the assumed discount rate in valuing the preferred interest (or other qualified payment right), i_2 is the actual rate of earnings, PSDR is the amount to be received each year under the preferred interest (or other qualified payment right), and t is the number of years from the time of the transfer to the date of the transferor's death. This formula has been derived by the author using traditional mathematical principles. However, the above formula ignores loss associated with paying income tax on the preferred dividends. As a result, the following sum needs to be subtracted from the above equation: $.45\,[(Y_1)(1 + i)^T + (Y_2)(1 + i)^{T-1} + (Y_3)(1 + i)^{T-2} + \ldots + (Y_T)(1 + i)]$, where Y is the income tax paid on the dividends in any given year, i is the corporation's rate of earnings, and T is the number of years between establishment of the 2701 transaction and the death of the transferor.