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ARTICLES

Sections 2703 and 2704 of the Internal Revenue Code (or, if you are not winning, try changing the rules)

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Sections 2703 and 2704 are part of Chapter 14 of the Internal Revenue Code that became law under the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508, Nov. 5, 1990). Generally, Chapter 14 imposes special valuation rules that are exceptions to the normal willing buyer-willing seller rules that otherwise apply.[1] Put in other words, to prevent perceived abuses, Chapter 14 requires that certain property interests be valued at above fair market value. These perceived abuses are commonly referred to as "freeze devices," which Congress defines as a technique that has the effect of limiting the estate tax value of property held by an older generation at its value at the time of the freeze and passing any appreciation in the property to a younger generation.[2] Chapter 14 addresses preferred stock recaps and like freezes (§2701), trusts and term interests in property and joint purchases (§2702), options and buy-sell agreements (§2703), and rights that terminate over time or lapse at death (§2704). This article addresses the last two sections of Chapter 14, §§2703 and 2704.

SECTION 2703

What the Law Says

Section 2703 is a very short section that reads as follows:

> (a) General rule. — For purposes of this subtitle [Chapters 11-14], the value of any property shall be determined without regard to —
>
> (1) any option, agreement, or other right to acquire or use the property at a price less than fair market value of the property (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use such property.
>
> (b) Exceptions. — Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:
>
> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

This section affects buy-sell agreements (as well as options for the purchase of stock or other business interests) entered into or modified substantially after the effective date (October 8, 1990) because a buy-sell agreement is, by its very nature, an agreement to acquire property at a price set forth in the agreement (which price may be less than fair market value), and often is an agreement that will restrict the right to sell property.

Analysis of the Law

A restriction on the sale or transfer of property may reduce its fair market value. In fact, the estate tax regulations provide that a buy-sell agreement will not be disregarded in determining the value of securities[3] if three conditions are met: (1) the decedent was not

[1] This rule can be found in Regs. §20.2031-1(b) and reads, "fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[2] 1990 Senate Report on Proposed Revision of Estate Freeze Rules, 136 Cong. Rec. S15679 (*reprinted in* 835 T.M., *Estate Freezes (Chapter 14)*).

[3] For convenience, securities are often referred to. However, the material applies to any property that is the subject of a buy-sell agreement.

free to dispose of the shares during his lifetime; (2) the agreement is a bona fide business arrangement; and (3) the agreement is not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.[4] The IRS also addressed the effect of buy-sell agreements on estate tax valuation in Rev. Rul. 59-60.[5] This ruling states, in part:

> Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona fide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.[6]

Courts have held that buy-sell agreements will fix the value of securities for estate tax purposes if five conditions were met: (1) the agreement is valid and enforceable; (2) there is a valid business purpose for the agreement; (3) the agreement contains restrictions on lifetime transfers; (4) the estate is obligated to sell; and (5) the price is fixed or determinable.[7] In meeting the second requirement, a number of courts have held that maintaining family control and ownership is a business purpose that precludes the possibility that the agreement serves as a testamentary device.[8]

Where §2703 applies, the old rules that were effectively overruled by the statute ought to be irrelevant in determining the effect, if any, that a buy-sell agreement may have on valuation of securities for estate tax purposes. To the extent §2703 carries forward the old rules (for example, the requirement that the agreement be a bona fide business arrangement) or where §2703 does not apply, the old rules remain important, and cases that discuss them should retain their relevance.

Analysis of the Exceptions Contained in §2703

The §2703 regulations state that each of the three exceptions must be independently satisfied for a right or restriction to meet the §2703(b) exception. Thus, for example, the mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish that the right or restriction is not a device to transfer property for less than full and adequate consideration.[9]

The Agreement Must Be a Bona Fide Business Arrangement

The regulations do not address when an agreement will be considered a bona fide business arrangement. Therefore, prior case law that addressed whether or not a buy-sell agreement had a bona fide business reason ought to be germane in determining whether or not buy-sell agreements subject to §2703 meet the first requirement of the §2703(b) exception.

In *Bischoff Est. v. Comr.*, the Tax Court reviewed buy-sell agreements effecting partnership interests held by the decedent. The IRS argued that the agreements should be disregarded because they lacked a bona fide business purpose and were merely a substitute for a testamentary disposition to the natural objects of the decedent's bounty. In addressing this point the Tax Court stated, "[IRS] fails to cite, and we are unable to find, any support for this contention. On the contrary, the cases have held that the maintenance of family ownership and control constituted a legitimate business consideration."[10] (Citations omitted)

In *Hall Est. v. Comr.*,[11] the Tax Court reviewed a buy-sell agreement and an option agreement dealing with the Hallmark greeting card company. The IRS contended that the agreements purporting to fix the value of the stock should be disregarded because they were merely estate planning devices and serve no bona fide business purpose. The Tax Court responded:

> There is no justification, in our view, for totally ignoring the transfer restrictions in this case and the prices set in the buy-sell and option agreements. Despite respondent's suspicion and speculation about decedent's estate planning and testamentary

[4] Regs. §20.2031-2(h). Also, compare the language of the regulations with the first two requirements set forth in §2703(b).
[5] 1959-1 C.B. 237.
[6] *Id.* at 243.
[7] *See, e.g., Weil v. Comr.*, 22 T.C. 1267 (1934), *acq.* 1955-2 C.B. 10. *See also,* Gamble, "Buy-Sell Agreements, Transfer Restrictions and Section 2703: Have Buy-Sells Gone Bye-Bye?" *NYU 50th Inst. on Fed. Tax'n,* Chap. 19, at §19.03 (1992).
[8] *See Bischoff Est. v. Comr.*, 69 T.C. 32 (1977) and *Roth v. U.S.*, 511 F. Supp. 653, 1981-1 USTC ¶13,406 (DC Mo. 1981).
[9] Regs. §25.2703-1(b)(2).
[10] 69 T.C. at 39-40.
[11] 92 T.C. 312 (1989)

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> objectives, there is no persuasive evidence to support a finding that the restrictions, or the offers to sell set forth in the agreements, were not susceptible of enforcement or would not be enforced by persons entitled to purchase under them.[12]

Although, from the above quote, the Tax Court in *Hall* was not ready to give full effect to the agreements before it, the Tax Court did find a valid business purpose. In *St. Louis County Bank v. U.S.*,[13] the Eighth Circuit held that the maintenance of family ownership and control of the business standing alone was an insufficient ground for giving effect to a buy-sell agreement. However, the Eighth Circuit conceded that such purpose established a business purpose.

The requirement under §2703(b) that the agreement be a bona fide business arrangement would appear to be met, just as it has been met prior to the enactment of §2703, when the agreement is entered into for the purpose of maintaining control among a family or another select group.

Full and Adequate Consideration

At first blush, it may seem that if the agreement is a bona fide business arrangement, then it cannot be a testamentary device. However, the two requirements can be separated and in *St. Louis County Bank*, above, the Eighth Circuit properly considered the health of the decedent when the arrangement was made, the disparity of the sale price from fair market value, and the enforcement of the agreement against other parties. Thus, this requirement is a "facts and circumstances" requirement not capable of being defined or delineated in objective language.

To demonstrate that this must be so, an agreement that is entered into for the purpose of keeping control of a business in a family would be disregarded for estate tax purposes if the circumstances surrounding the execution of the agreement were sufficiently egregious so as to be a testamentary substitute. For example, an agreement entered into between a parent and child when the parent is terminally ill and that establishes a nominal price to be paid for the parent's securities at the parent's death ought to be disregarded, notwithstanding that the agreement has the valid business purpose of keeping control in the family. Although we may easily recognize the extreme case, stating with unstinting clarity the precise circumstances where the requirement is met and where it is not met is impossible to do. Therefore, we are, of necessity, required to rely on our "gut" feelings, telling our clients in a manner appropriate to the circumstances that there is always a risk that the IRS may argue that the requirement that the agreement must not be a device to transfer the property to members of the decedent's family for less than full and adequate consideration in money or in money's worth has not been met.

This requirement refers to members of the decedent's family, but §2703 does not define who comprises a family.[14] The regulations state that family "includes the persons described in Regs. §25.2701-2(b)(5) *and any other individual who is a natural object of the transferor's bounty.*" [15] (Emphasis added). Interestingly, Regs. §25.2701-2(b)(5) does not define the members of one's family but defines a controlled entity. This regulation states, in part, that a controlled entity is a corporation or partnership controlled by "the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse." This potential definition is broader than any other definition of family found in the other sections of Chapter 14. Regs. §25.2703-1(b)(3), which refers to the regulations under §2701 creates an exception to the need to meet the three requirements set forth in §2703(b) by stating that the exception will be deemed met when more than 50% by value of the property subject to the restriction is owned by nonfamily members. In stating who are the members of a transferor's family, the sentence begins, "For purposes of this section, ..." Arguably the IRS can require any definition of family in order to meet a safe harbor that it has created by regulatory grace. In this vein, one can argue that this definition does not apply at all to the statute, but only to this regulatory exception to the statute.

In PLR 9222043, the Service may have taken advantage of the absence of a statutory definition of who exactly is a member of a family and, relying on its regulations, ruled that nephews and nieces are members of a family because they are the lineal descendants of the transferor's parents. This broad definition of family members must make one wonder who might be described as a natural object of one's bounty and yet not already be a member of one's family (as defined by the IRS). Black's Law Dictionary (Sixth Edition) defines "natural object of testator's bounty" as follows: "In testamentary law, term comprises whoever would take, in the absence of a will, because they are the persons whom the law has so designated, and in the ordinary case the law follows the normal condition of near relationship." [16] If the regulation is to be given meaning, it would seem that natural objects of one's bounty could include nonfami-

[12] *Id.* at 334-335.
[13] 674 F.2d 1207 (8th Cir. 1982).

[14] The phrase "member of a family" is defined in §2701(e)(1), Regs. §25.2701-1(d)(1), §2702(e), Regs. §25.2702-2(a)(1), §2704(c)(2), and Regs. §25.2704-1(a)(2)(ii). The definition contained under §2701 is not as broad as the definitions found under §§2702 and 2704.
[15] Regs. §25.2703-1(b)(3).
[16] This definition was relied on in TAM 8541005 (revoked by TAM 8634004 for other reasons).

ly members.[17] The IRS has already taken this position and has stated that the class of persons who may be the objects of an individual's bounty is not necessarily limited to persons related by blood or marriage.[18] If the Service gets aggressive with its definition of members of a family and the objects of one's bounty, courts will soon be called on to be the final arbiter.

The Terms of the Agreement Are Comparable to Similar Arrangements Entered Into by Persons in an Arms' Length Transaction

This requirement, not found to be necessary in upholding buy-sell agreements before the enactment of §2703 may be the most vexing. The regulations, in part, state:

> A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length.[19]

This language is also found in the legislative history.[20] Both the regulations and the legislative history states, "If comparables are difficult to find because the business is unique, comparables from similar businesses may be used." If the business is unique, can there be similar businesses from which comparables are to be found?

The regulations state that a right or restriction will be considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business; however, general business practice is not met by showing isolated comparables.[21]

The regulations do not indicate where one may find or expect to find samples of buy-sell arrangements entered into by unrelated parties in the context of closely held businesses. Will provisions that are found commonly in form books or articles be sufficient evidence of comparable rights and restrictions? Should practitioners begin publishing articles stating their opinions as to what rights and restrictions are commonly entered into by unrelated parties in negotiated buy-sell agreements?

If no comparables can be found, the test appears to be whether or not there is a "fair bargain," and an inquiry into such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.[22] The IRS does not explain any of these factors.

Comparability is a factual question and this particular requirement in §2703(b) may leave all buy-sell agreements exposed to attack. If one starts with the premise that unrelated parties each seeking a fair bargain in a negotiated agreement would each require fair market value, and if the IRS contends that an agreement is less than fair market value, then one seems led to conclude that the agreement cannot be comparable to similar arrangements entered into by persons in an arms' length transaction.

The fact is that many buy-sell agreements between unrelated partners do not necessarily reflect fair market value. A strong consideration, from my experience, is concern that the purchase of the stock not financially hinder the company from continuing to operate. Other factors often enter into the equation: friendship; lack of greed (a novel thought); and a desire for simplicity in the arrangement.

Safe Harbor

The statute does not provide any safe harbor; it applies to all rights and agreements described under it regardless of the relationship among the parties. Given the history of Chapter 14, the potential for abuse and, thus, the need for corrective action, is not present when unrelated parties enter into agreements.[23] The regulations provide a safe harbor stating that a right or restriction is considered to meet each of the three requirements discussed in the above section if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family.[24] It is this particular regulation that defines the members of a transferor's family, and this definition perhaps should be germane only to determining whether or not this safe harbor has been met. The property owned by the nonfamily members must be subject to the right or restriction to the same extent as the property owned by the transferor.

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[17] *Tax Notes* (9/21/92), reported on Jerry Kasner speaking at Santa Clara University School of Law on §2703 and stating that in one case in which a transfer arose, the IRS went to extremes to prove that partners in a business qualified as the natural objects of each other's bounty. The IRS questioned whether the two partners ever vacationed together, socialized often, or gave gifts to each others' children.

[18] 57 Fed. Reg. 4253 (2/4/92).

[19] Regs. §25.2703-1(b)(4). Can a fair bargain be reached if unrelated parties are not dealing at arm's length?

[20] 1990 Senate Report on Proposed Revision of Estate Freeze Rules, 136 Cong. Rec. S15683 (*reprinted in* 835 T.M., *Estate Freezes (Chapter 14)*).

[21] Regs. §25.2703-1(b)(4)(i), (ii).

[22] Regs. §25.2703-1(b)(4)(i).

[23] That the IRS does not consider transactions among unrelated parties as abusive in the transfer tax arena is perhaps demonstrated by Regs. §25.2512-8, which states that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from donative intent), will be considered as made for an adequate and full consideration in money or money's worth."

[24] Regs. §25.2703-1(b)(3).

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Effective Date

Section 2703 applies to any right or restriction created or *substantially modified* after October 8, 1990, and is effective as of January 28, 1992.[25] If a grandfathered agreement is substantially modified after October 8, 1990, rights and restrictions under the agreement are treated as a right or restriction created on the date of the modification. The regulations provide the following "guidance:"

> Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a *de minimus* change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless the addition is mandatory under the terms of the right or restriction or the added member is assigned to a generation (determined under the rules of §2651 of the Internal Revenue Code) no lower than the lowest generation occupied by individuals already party to the right or restriction).[26]

The regulations further provide that (1) a modification required by the terms of the right or restriction, (2) a discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction, (3) a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate, and (4) a modification that results in an option price that more closely approximates fair market value, will not be considered substantial modifications.[27]

Toward the end of 1992, one commentator predicted that the substantial modification rule would lead to a flood of ruling requests.[28] This may be correct. The Service has ruled that the following actions did not result in a substantial modification: an amendment to corporate articles and bylaws to change the number of directors, to change the indemnity and immunity provisions, and to increase the number of shares to permit a stock split;[29] an amendment to a buy-sell agreement that increased the value of the partnership interest, substituted the applicable federal interest rate (AFR) for a 4% rate on deferred payments, and broadened the agreement to cover the reorganized partnership;[30] a change to an agreement to shift voting to shareholders who were active in the business and to equalize the voting power of such shareholders;[31] a change to an the agreement to provide that the down payment, which was the greater of insurance proceeds or 10% of the price, was to be determined without regard to policy loans;[32] a change to an agreement to extend the right of first refusal to new investors;[33] a change to the interest rate and term of an installment buy-sell agreement;[34] a change providing for reciprocal rights and a change to the strike price to be fair market value;[35] and other changes.[36]

Where a buy-sell agreement exists and is not subject to §2703, one must consider the circumstances that potentially compel modifying the agreement, the goals sought by the modification, and whether the problems that exist under the current agreement cannot be resolved by other means. If the parties intend and believe that the price determined under the buy-sell agreement reflects fair market value (for example, where the agreement requires an appraisal of the interest at the time it is to be sold), §2703 ought not be a concern.[37] This does not eliminate the risk that the IRS will still dispute the appraisal, but the issue will not be whether §2703 applies, but the correct value of the interest.

SECTION 2704

What the Law Says

Section 2704 addresses the treatment of lapsed voting or liquidation rights and, in general, provides that if there is a lapse of any voting or liquidation right in a corporation or a partnership, and the individual holding such right immediately before the lapse and members of his family hold, both before and after the lapse, control of the entity, the lapse is treated as a transfer for transfer tax purposes.[38]

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[25] Regs. §25.2703-2; P.L. 101-508, §11602(e)(1)(A)(ii).
[26] Regs. §25.2703-1(c)(1).
[27] Regs. §25.2703-1(c)(2).
[28] Kasner, " 'Substantial Modification' of a Buy-Sell Agreement?," *Tax Notes* (9/14/92).
[29] PLR 9141043.
[30] PLR 9152031.
[31] PLR 9218074.
[32] PLR 9226051.
[33] PLR 9248026 *substituting for* PLR 9226063.
[34] PLR 9322035.
[35] PLR 9417007.
[36] PLR 9432017; PLR 9324018 (which also held that the addition of donees to the agreement *was* a substantial modification); PLR 9310003; PLR 9248026; PLR 9241014; PLR 9151045.
[37] However, value, like beauty, is in the eye of the beholder and the IRS may be more beholden than the taxpayer.
[38] §2704(a)(1).

The value of this fictional transfer is the excess (if any) of (1) the value of all interests in the entity held by the individual immediately before the lapse (determined as if such interests were nonlapsing), over (2) the value of such interests immediately after the lapse.[39]

Also, for purposes of Chapters 11-14 of the Code, if there is a transfer of an interest in a corporation or partnership to, or for the benefit of, a member of the transferor's family, and the transferor and members of his family hold control of the entity both before and after the transfer, then any "applicable restriction" will be disregarded in determining the value of the transferred interest.[40] Basically, any restriction imposed by the governing instrument that is more strict than restrictions found in the law will be an "applicable restriction" and disregarded if the above conditions are met.

The Target of §2704

The legislative reports state that the §2704 rules are intended to overturn the result and reasoning of *Harrison v. Comr.*[41] In *Harrison v. Comr.*,[42] Daniel Harrison died on January 14, 1980, at the age of 60 years. In 1975, Mr. Harrison, whose health was declining, gave his son, Dan, a power of attorney to manage his assets, including extensive ranching and other real estate interests. On August 1, 1979, Dan and his brother, Bruce, acting individually and under the power of attorney, formed Harrison Interests, Ltd. for the principal purpose of consolidating and preserving Mr. Harrison's assets. Dan contributed assets and took back a 1% general partnership interest and a 77.8% limited partnership interest on behalf of his father. Dan and Bruce individually contributed assets in return for a 10.6% general partnership interest. The value of the property contributed on behalf of Daniel Harrison by his son had a value of $59 million at the time of contribution.[43]

Under the partnership agreement, each general partner had the right during life to dissolve the partnership, but neither a limited partner nor a successor to a general partner had such a right. Also, upon the death of a general partner, his legal representative was required to give the remaining general partners an option to buy the deceased partner's general partnership interest.

On February 4, 1980, 21 days after Daniel Harrison's death, Dan and Bruce purchased the decedent's 1% general partnership interest for $757,116, which the IRS agreed was the value of the decedent's general partnership interest.

Daniel Harrison's estate claimed that the decedent's 77.8% limited partnership interest was worth $33 million (more than $26 million less than the value of the property contributed to the partnership, or a discount of about 45%). The IRS asserted that the limited partnership interest was worth approximately $59.5 million. The difference between the two values was attributable entirely to the right that Daniel Harrison had as a general partner up until his death to force a dissolution of the partnership.

The IRS relied on most sections found under the estate tax laws to support inclusion of the interest at a value of $59.5 million, but to no avail.[44] The IRS also argued that the partnership agreement was an attempt to artificially depress the value of Daniel Harrison's property for estate tax purposes. The court, citing *Bischoff*, above, held that the agreement would be disregarded if there was no business purpose or if the agreement was merely a substitute for testamentary disposition. As to the first part, the opinion states that the petitioner presented convincing proof that the partnership was created as a means of providing necessary and proper management of the decedent's properties and that the partnership was advantageous to the decedent. As to the second part, the court noted that (1) the agreement applied to all partners, (2) the decedent received adequate consideration for his transfer, and (3) although the creation of the partnership eventually resulted in a substantial decrease in estate taxes, *there is no proof in the record that the partnership was created other than for business purposes.*[45]

The court held that the value of the limited partnership interest for estate tax purposes was $33 million. This holding may lead one to the rhetorical question, "When hogs escape slaughter, can changes in the tax laws be far behind?" [46]

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[39] §2704(a)(2).

[40] §2704(b).

[41] 1990 Senate Report on Proposed Revision of Estate Freeze Rules, 136 Cong. Rec. S15679, at S15683; Conference Report on H.R. 5835, the Omnibus Budget Reconciliation Act of 1990, 101st Cong., 2d Sess., at 1137 (*reprinted in* 835 T.M., *Estate Freezes (Chapter 14)*).

[42] T.C. Memo 1987-8.

[43] Actual contribution was $59,476,523. Total value contributed was $75,439,225. 78.8% of the total contributed equals $59,446,109 (close enough for government work).

[44] The IRS relied on §§2033, 2035, 2036, 2037, 2038, and 2041.

[45] T.C. Memo 1987-8. The court did not discuss the fact that the decedent was in failing health, that the partnership was formed less than six months before the decedent's death, the partnership was created by virtue of a durable power of attorney exercised by one of the other partners, the decedent was the only limited partner, or what type of proof the IRS could be expected to present. *Cf., Murphy Est. v. Comr.*, T.C. Memo 1990-472 (a gift of stock representing .88% of stock made 18 days before death and reducing the decedent's ownership to 49.65% did not result in any discounting of the stock held at death).

[46] The decision appears correct. All actions undertaken certainly were permissible and lawful, and arranging one's affairs in order to minimize one's tax burden is proper. However, *Harrison* is the type of case that, because of its particular facts and the sheer size of the dollars involved, cannot escape the attention of the Congress.

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Definitions of Key Words and Phrases

As stated above, under §2704, the lapse of any voting or liquidation right will be treated as a transfer if the individual who had the right just before the lapse together with members of his family, hold control of the entity both before and after the lapse. The words and phrases of §2704 are critical to its applicability to a given situation and, thus, the meanings and interpretations of key words and phrases also is critical. Although the statute only provides definitions for "control," "members of the family," and "applicable restriction," the regulations set forth definitions for "directly or indirectly held," "voting right," and "liquidation right."

Control. With respect to a corporation, control means holding at least 50% (by vote or *value*) of the stock of the corporation. In the case of a partnership, control means holding at least 50% of the capital or profits interest in the partnership, or, in the case of a limited partnership, the holding of a general partnership interest.[47]

Members of the Family. The members of one's family means (1) such person's spouse, (2) any ancestor or lineal descendant of such person or such person's spouse, (3) any sibling of such person, and (4) any spouse of any individual described in (2) and (3).[48]

Applicable Restriction. The phrase, "applicable restriction," means any restriction that effectively limits the ability of the corporation or partnership to liquidate, and (1) the restriction lapses, in whole or in part, after the "transfer" referred to in the general rule of §2704, or (2) after the transfer, the transferor or any member of the transferor's family, either alone or collectively, has the right to remove, in whole or in part, the restriction.[49] However, an applicable restriction does not include (1) any commercially reasonable restriction that arises as part of any financing by the entity with a person who is not related to the transferor or transferee, or a member of either's family, or (2) any restriction imposed or required to be imposed by any federal or state law.[50]

Directly or Indirectly Held. An interest is directly or indirectly held only to the extent the value of the interest would have been includible in the gross estate of the individual if the individual had died immediately prior to the lapse.[51]

Voting Right. Voting right means a right to vote with respect to any matter of the entity. In the case of a partnership, the right of a general partner to participate in partnership management is a voting right. The right to compel the entity to acquire all or a portion of the holder's equity interest (a put option) by reason of aggregate voting power is treated as a liquidation right and not as a voting right.[52]

Liquidation Right. Liquidation right means a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity.[53]

Analysis of the Law

The valuing of an entity and the aggregate value of its particular interests that make up the entity are not equal; that is, the sum of the parts rarely equals the whole. Similarly, a change in value to the parts that make up an entity is not always a zero-sum game; a decrease in value of one part will not necessarily be offset by a like increase in value in the other parts. To show how this can occur, suppose three individuals form a corporation by each contributing $100 for one share of stock. They each have converted cash of $100 into one share of stock in a closely held company. Because one share of stock represents only 33⅓% of the company, no one shareholder can compel a liquidation of the company so as to receive back her $100. Under normal valuation rules (willing buyer and willing seller), the value of one share will be discounted to take into account the loss of the right to liquidate; the value of one share may be worth only $65. Where did the lost $35 go? It did not go to the other shareholders because their shares also suffered the same loss. The lost $35 did not go anywhere; there was no transfer. As a result, there is nothing to which the transfer tax can attach.

Continuing with the above example, we can label the phantom $35. It represents the value of being able to unilaterally liquidate the company. The $65 represents, generally, the present value of anticipated cash flow or anticipated investment return. The underlying reasoning of §2704 is that families will form and liquidate companies at will in order to artificially take advantage of phantom losses of value representing the value of being able to liquidate such companies. The law, however, is not intended to alter minority discounts or other discounts available under the law

[47] §2704(c)(1), referencing §2701(b)(2). Interestingly, the regulations to this section, Regs. §25.2704-1(a)(2)(i) in addressing the meaning of "control," refers the reader to Regs. §25.2701-2(b)(5), as if that regulation has greater weight than the definition contained in the statute.

[48] §2704(c)(2). Regs. §25.2701-(a)(2)(ii), in addressing the meaning of "members of the family," refers the reader to Regs. §25.2702-2(a)(1).

[49] §2704(b)(2).

[50] §2704(b)(3).

[51] Regs. §25.2704-1(a)(2)(iii).

[52] Regs. §25.2704-1(a)(2)(iv).

[53] Regs. §25.2704-1(a)(2)(v).

prior to enactment of §2704.[54] In essence, §2704 imposes the gift or estate tax when one's ability to obtain liquidation value lapses and the liquidation value exceeds the fair market value of the interest that remains after the lapse.

Exceptions

Section 2704 does not apply to the lapse of a liquidation right to the extent that the holder (or the holder's estate) and family, immediately after the lapse, cannot liquidate an interest that the holder held directly or indirectly and could have liquidated prior to the lapse.[55] This is in accord with the underlying reasoning of §2704 because, under the exception, the family cannot freely liquidate the entity it has formed in order to receive full liquidation value.

Whether an interest can be liquidated immediately after the lapse is determined under applicable state law, as modified by the entity's governing instruments, but without regard to any restriction that would be disregarded under §2704(b).[56] Under Ohio law, where the governing instruments do not change state law: (1) the sale or disposition of all, or substantially all, of a corporation's assets requires the affirmative vote of the shareholders entitled to two-thirds of the voting power;[57] (2) a corporation may be dissolved on the affirmative vote of the shareholders entitled to two-thirds of the voting power;[58] (3) a general partnership may be dissolved by the express will of all partners who have not assigned their interests or suffered them to be charged for their separate debts;[59] and (4) a limited partnership may be dissolved upon the consent of all its partners[60] or upon the withdrawal of a general partner, unless there is at least one other general partner, the certificate of limited partnership permits the remaining general partner to carry on the business, and the remaining general partner does so.[61]

Example: Two brothers form a corporation and the stock is owned by the two brothers and their respective wives and children. Each brother has the right to liquidate the corporation while both brothers are living. Upon the death of one of the brothers, the right to liquidate the corporation will lapse. The corporation may also be liquidated by the agreement of all shareholders and this requirement continues after the death of either brother. Upon the death of one of the brothers does §2704 apply to the lapse of the liquidation right? No. The deceased brother's estate, together with members of the deceased brother's family, cannot liquidate the corporation because to do so will require the consent of nieces or nephews who are not members of the deceased brother's family. Further, this requirement neither lapses, nor may it be removed by the family of the deceased brother.

Section 2704 will not apply to the lapse of a liquidation right previously valued under §2701 to the extent necessary to prevent double taxation.[62] Also, §2704 will not apply to the lapse of a liquidation right that occurs solely by reason of a change in state law.[63]

Certain Restrictions on Liquidation are Disregarded

Restrictions that limit the ability of a corporation or partnership to liquidate may be disregarded for purposes of applying §2704. An applicable restriction (defined above) is a restriction that will be disregarded. An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence or the restriction.[64] All of the following conditions must be met for a restriction to be an applicable restriction:

1. There must be a transfer of an interest in a corporation or partnership;

2. The transfer must be to, or for the benefit of, a member of the transferor's family;

3. The transferor and members of the transferor's family must hold, immediately before the transfer, control of the entity;

4. The restriction must effectively limit the ability of the corporation or partnership to liquidate and either (a) the restriction lapses, in whole or in part, after the transfer, or (b) the transferor or any member of the transferor's family, acting alone or collectively, has the right to remove, in whole or in part, the restriction;

5. The restriction must not be a commercially reasonable restriction that arises as part of a financing by the entity with a person who is not related transferor or transferee, or a member of the family of either; and

6. The restriction must not be imposed, or required to be imposed, by any federal or state law.[65]

If an applicable restriction is disregarded, the trans-

[54] Conference Report on H.R. 5835, the Omhibus Budget Reconciliation Act of 1990, 101st Cong., 2d Sess., at 1137 (*reprinted in* 835 T.M., *Estate Freezes (Chapter 14)*).
[55] Regs. §25.2704-1(c)(2)(i).
[56] Regs. §25.2704-1(c)(2)(i)(B).
[57] O.R.C. §1701.76.
[58] O.R.C. §1701.86.
[59] O.R.C. §1775.30(A)(3). If no definite term is specified, or if no particular undertaking is specified, any partner may dissolve the partnership. O.R.C. §1775.30(A)(2).
[60] O.R.C. §1782.44(B).
[61] O.R.C. §1782.44(C).
[62] Regs. §25.2704-1(c)(2)(ii).
[63] Regs. §25.2704-1(c)(2)(iii).
[64] Regs. §25.2704-2(b).
[65] Regs. 25.2704-2(a), (b).

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ferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the applicable state law, but for the restriction.[66]

Example: Mother owns a 76% interest and two of her three children each owns a 12% interest in General Partnership X. The partnership agreement requires the consent of all the partners to liquidate the partnership. Under the state law that would apply in the absence of the restriction, the consent of the partners owning 70% of the total partnership interests would be required to liquidate General Partnership X. On Mother's death, her partnership interest passes to her third child. The requirement that all the partners consent to liquidation is an applicable restriction. Because the three children acting together after the transfer can remove the restriction on liquidation, Mother's interest is valued without regard to the restriction; *i.e.*, as though Mother's interest is sufficient to liquidate the partnership.[67]

The IRS may by regulation provide that other restrictions are to be disregarded when intrafamily transfers take place if the restriction has the effect of reducing the value of the interest transferred for purposes of the gift, estate, and generation-skipping transfer taxes but does not ultimately reduce the value of the interest to the transferee.[68]

Has *Harrison* Been Overruled?

In the *Harrison* case, at Daniel Harrison's death, his right to liquidate the partnership lapsed[69] and, both before and after his death, he and his family had control of the partnership. Therefore, §2704(a) would have applied if it had been in effect, and the lapse would have been treated as a transfer for estate tax purposes.

Has *Harrison* Been Effectively Overruled?

At this time we can only conjecture as to the answer. As noted above, §2704 applies if there is a lapse of any voting or liquidation right, and that the reasoning for §2704 was to prevent situations like *Harrison* from happening again. The question posed to estate planners is how may families structure their affairs that carry out nontax family objectives and minimize transfer taxes by avoiding the grasp of §2704. Several possibilities are discussed below.

Do Not Allow Any Voting or Liquidation Right to Lapse. The regulations state that a lapse of a voting or liquidation right occurs at the time a presently exercisable right is restricted or eliminated.[70] A transfer of an interest conferring a right is not a lapse of that right because the right with respect to the interest is not restricted or eliminated.[71]

Example: Father owns 84% of the single outstanding class of stock of Corporation Y. The by-laws require at least 70% of the vote to liquidate Y. Father give one-half of his stock in equal shares to each of his three children (14% to each). Section 2704 does not apply to the loss of Father's ability to liquidate Y, because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer.[72]

In *Harrison*, Daniel Harrison had the unilateral right to liquidate the partnership, which ability disappeared on his death. If the partnership had been established originally so that neither Daniel Harrison nor any other single partner ever had the unilateral right to liquidate the partnership, and if §2704 was in effect at Daniel Harrison's death, would the result reached by the court be different? I would think not because the IRS argued in *Harrison* that the higher value was the proper value because the decedent could liquidate the partnership up until the moment of his death. Under the facts as altered above, the decedent could not have liquidated the partnership during his life, undercutting the IRS' argument. Also, the restriction preventing any one partner from liquidating the partnership ought not be disregarded under §2704(b). First, under the revised facts, there is no transfer of an interest in the partnership as is required to trigger §2704(b). Secondly, the restriction is no more strict than what Ohio law[73] would otherwise require if the agreement were silent and §2704(b)(3)(B) provides that a restriction imposed by state law is not an applicable restriction that may be disregarded.

Many families will create or reorganize family enterprises so that no one member of the family may liquidate the enterprise and that rights given to the members of the family will not lapse.

Example: Mother owns all the stock of Corporation X, consisting of 100 shares of nonvoting preferred stock and 100 shares of voting common stock. Under the by-laws, X can only be liquidated with the consent of at least 80% of the voting shares. Mother transfers 30 shares of common stock to her children. The transfer is not a lapse of a liquidation

[66] Regs. §25.2704-2(c).
[67] Regs. §25.2704-2(d), Ex. 1.
[68] §2704(b)(4).
[69] One commentator argues that no right lapsed in *Harrison*. *See* Eastland and McBryde, "The Use of Discount Partnerships in Estate Planning," 19 *ACTEC Notes* 253, 257 (1994).
[70] Regs. §25.2704-1(b), (c).
[71] Regs. §25.2704-1(c).
[72] Regs. §25.2704-1(f), Ex. 4.
[73] O.R.C. §1782.44(B), (C).

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right with respect to the common stock because the voting rights that enabled Mother to liquidate prior to the transfer are not restricted or eliminated. The transfer is not a lapse of a liquidation right with respect to the retained preferred stock because the preferred stock is not subordinate to the transferred common stock.[74]

Have the Interest Be Worth the Same Before and After the Lapse. As stated above, §2704 imposes the gift and estate tax when one's ability to obtain liquidation value lapses and such liquidation value exceeds the fair market value of the interest that remains. If the right that lapses would have no effect or a minimal effect on the fair market value of the retained interest, then §2704 will have no practical effect because the value of the deemed transfer is zero or minimal.

Example: Father owns 40% of the single outstanding class of stock of Corporation U, and each of his three children owns 20% of the outstanding stock. The by-laws require at least 70% of the vote to liquidate U. Upon the death of a shareholder, his or her stock is converted to nonvoting stock. On Father's death, his right to vote his stock lapses, §2704(a)(1) applies and the lapse is treated as a transfer. The value of the transfer equals the amount by which the value of his stock with the voting right exceeds, if at all, the value of his stock without the voting right. Father, prior to death, did not have the right to control or to liquidate Corporation U. Notwithstanding that the stock had voting rights, the willing buyer would discount this right to take into account the inability to liquidate the company. This discounted value might not be very different from the value determined for the stock with no voting rights.

If this example is modified so that Father owned 60% of the woting shares but the by-laws still required at least 70% of the vote to liquidate Corporation U, this restriction in the by-laws might be disregarded if under state law father's 60% interest would normally give him the right to unilaterally liquidate the company and the other requirements of §2704(b) are met.

Do Not Have the Family Have Control Both Before and After the Lapse. We do not expect families to cede control of family enterprises to third parties in order to avoid the grasp of §2704. However, in family enterprises that have spread to an extended family group, with stock held by cousins or more remote degrees of relationship, no one family (as defined by §2704(c)(2)) may have control of the enterprise.

[74] Regs. §27.2704-1(f), Ex. 7.

Payment of the Transfer Tax

If §2704 applies to a situation, a transfer is deemed to have occurred by the individual who held the right immediately prior to the lapse. The deemed transferor is responsible for paying the tax because the statute treats the deemed transfer as a transfer by gift, for which the donor is responsible,[75] or as a transfer includible in the decedent's gross estate, for which the decedent's estate is responsible.[76] What happens if the transferor is unable to pay the tax on the phantom transfer? Section 6901 states that gift and estate taxes may be collected from the transferee. Under §2704, who is the transferee? One commentator states that the only possible recipient is the holders of the other interests in the entity.[77]

Example: Dan Harrison repeats his father's transaction, but his estate cannot repeat his father's victory against the IRS. As a result, his gross estate is increased by $26.5 million and correlatively, his estate tax liability is increased by $14.5 million. After liquidating his entire estate, it is $10 million shy of the tax due. Who is the transferee who bears the burden of transferee liability? Because the deemed transfer is fictitious, no transferee exists.

Effective Date

Section 2704(a) applies to lapses occurring after January 28, 1992, of rights created after October 8, 1990. Section 2704(b) applies to transfers occurring after January 28, 1992, of property subject to applicable restrictions created after October 8, 1990.[78]

CONCLUSION

The uncertainty of the application and interpretation of §§2703 and 2704 adds anxiety to the already complex arena of estate planning. Families will continue to arrange their affairs to meet their particular circumstances; attorneys will continue to counsel families and to prepare agreements specially drawn to cover these circumstances. However, the potential transfer tax impact of such arrangements will not be as certain as it once was, and the uncertainty will translate into higher taxes and reduced productivity. Perhaps the silver lining surrounding this dark cloud is that Chapter 14 and its four sections represents the final efforts by the IRS in attacking the valuation of family arrangements.

[75] §2502(c).
[76] §2002.
[77] 835 T.M., *Estate Freezes (Chapter 14).*
[78] Regs. §25.2704-3; P.L. 101-508, §11602(e)(1)(A)(iii).

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The Beneficiary as Trustee: A Pandora's Box

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One of the most significant issues confronting the grantor of an irrevocable trust is who should be appointed as trustee. Frequently, the grantor will wish to appoint the beneficiary as a trustee. The grantor may, for instance, wish to place the assets being given to the beneficiary in trust because of the creditor protection afforded by a trust, but want the beneficiary to have as much control over the trust assets as the beneficiary would have had if the assets were owned outright. The appointment of the beneficiary as trustee raises a host of complicated tax and nontax issues. For example, under state law, the trust may merge into a life estate if the beneficiary is serving as sole trustee and the beneficiary/trustee may be prohibited from exercising certain powers. In addition, if the grantor is seeking to exclude the trust assets from the beneficiary's estate, the appointment of the beneficiary as trustee may prevent the accomplishment of that objective unless the trust is carefully drafted. This article addresses some of the concerns that must be addressed if a client wishes the beneficiary to serve as a trustee of an irrevocable trust.

STATE LAW CONCERNS

The Doctrine of Merger

Of initial concern in determining whether a beneficiary should serve as trustee is whether, under applicable state law, the trust will fail in its inception as a result of the doctrine of merger. Under the law of most states, in order to have a valid trust you must have a trustee, a beneficiary and a trust res (*e.g.*, trust assets.) [1] Under the doctrine of merger, where the sole trustee is the sole beneficiary (the trustee's legal interest and the beneficiary's equitable interest being of the same quality and duration), the legal and equitable interests are merged by operation of law, the trust terminates, and the beneficiary/trustee holds the property free from the trust.[2] However, in some jurisdictions, where it appears that it is the intention of the grantor that the trust exist (*e.g.*, to continue for the benefit of the remaindermen) or that a successor trustee be appointed, a court may act to prevent extinguishment and termination of the trust. Indeed, in certain jurisdictions, the state courts have obliterated the merger doctrine on the basis that no grantor or testator intends a trust expressly created shall be extinguished and terminated merely because one person becomes the sole beneficiary/trustee.[3]

As a general rule, the merger doctrine only applies where the sole beneficiary is sole trustee. If the sole income beneficiary is one of two or more co-trustees, as a general rule, there is no merger of the legal title and beneficial interests.[4] Similarly, there should be no merger of legal title and beneficial interests where the trustee is one of more than one current beneficiaries of a trust.

Consequently, state law needs to be reviewed before the initial appointment of a beneficiary as trustee to see if the doctrine of merger will be applied and the trust fail as a result of such appointment.

State Law May Prevent the Beneficiary/Trustee from Exercising Certain Powers

As will be discussed in greater detail below, under state common law or state statutes, a beneficiary who is serving as trustee may be prohibited from engaging in certain actions. For example, New York's EPTL §10-10.1 provides:

> A power conferred upon a person in his capacity as trustee of an express trust to make discretionary distribution of either principal or income to himself or to make discretionary allocations in his own favor of receipts or expenses as between principal and income, cannot be exercised by him. If the power is conferred on two or more trustees, it may be executed by the trustees who are not so disqualified. If there is no trustee qualified to execute the power, its execution devolves on the supreme court, except that if the power is created by will, its execution devolves on the surrogate's court having jurisdiction of the estate of the donor of the power.

Thus, under New York law, if a beneficiary is serving as trustee, the beneficiary, as trustee, cannot participate in a decision to distribute income or principal to himself or herself. Under North Carolina law (N.C.G.S. §32.34) and Florida law (F.S.A. §737.402), the beneficiary, as trustee, could not participate in exercising any power that constituted a general power of appointment.

[1] *See* Scott, *The Law of Trusts* §3 (4th ed. 1987).

[2] *Kagan Est.*, 118 Misc.2d 1084, 462 N.Y.S.2d 128 (Bronx Co. 1983). *See also The Restatement of Trusts (Second)* §341, comment b; "Trusts: Merger of Legal and Equitable Estates where Sole Trustees are Sole Beneficiaries," 7 ALR4th 621.

[3] *See, e.g., In re Will of Seidman*, 88 Misc.2d 462, *mod.*, 58 A.D.2d 72 (2d Dept. 1977.)

[4] *See, e.g., Matter of Brown*, 93 N.Y.S.2d 881 (West. Co. 1949).

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Consequently, if a grantor wishes to appoint a beneficiary as trustee and the beneficiary as trustee is unable under applicable state law to exercise certain powers, the grantor should provide for the appointment of an independent co-trustee who can exercise those powers.[5]

FEDERAL TAX LAW CONCERNS

Avoid Giving the Beneficiary/Trustee a General Power of Appointment

To avoid the inclusion of the trust assets in the estate of the beneficiary/trustee or having the exercise or failure to exercise a power treated as a gift by the beneficiary/trustee, none of the powers granted to the beneficiary as trustee may fall within the purview of a *general* power of appointment under §2041 or §2514. Under §2041(a)(2), a decedent's gross estate includes the value of all property with respect to which the decedent at the time of death has a general power of appointment created after October 21, 1942.[6]

The term "general power of appointment" is defined to mean "a power which is exercisable in favor of the decedent, his estate, his creditors or the creditors of his estate," subject to certain exceptions, *e.g.*, as for a power which is limited by an ascertainable standard relating to the health, education, support, or maintenance of a decedent or a power which is exercisable by the decedent only in conjunction with the creator of the power or another person who has a substantial interest in the property subject to the power, which is adverse to the exercise of the power in favor of the decedent.[7] The term "power of appointment" is defined in the regulations to include "all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations."[8] What powers, if held by a beneficiary as trustee, would fall within the purview of a general power of appointment?

Unrestricted Power to Distribute Income or Principal

In describing what constitutes a power of appointment, Regs. §20.2041-1(b)(1) provides that "if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending or revoking the trust instrument or terminating the trust is a power of appointment."[9] Applying this provision, it is clear that if a beneficiary is serving as trustee and as trustee the beneficiary has the power to participate in decisions concerning the exercise of unrestricted discretion to distribute income or principal to the beneficiary, the beneficiary will have a taxable general power of appointment.[10] Similarly, if the beneficiary/trustee has the unlimited discretion to permit the use of the trust assets by the beneficiary, the beneficiary should also have a general power of appointment.

However, if under the trust instrument the beneficiary/trustee has a fixed right to income from the trust or an interest in income or principal of the trust limited by an ascertainable standard, the power to participate in decisions with respect to the distribution of income or principal to the beneficiary/trustee would not cause the beneficiary to hold a general power of appointment. A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the holder of the power (*e.g.*, the beneficiary/trustee) which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the holder is not a general power of appointment.[11] A power is considered limited by an ascertainable standard to the extent that the holder's ability to exercise or not exercise the power is reasonably measurable in terms of the possessor's needs for health, education, or support. Examples of powers limited by an ascertainable standard are powers exercisable by the beneficiary/trustee for his or her "support," "support and reasonable comfort," "maintenance and health and reasonable comfort," "support in his or her custom manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism."[12] However, a power to use property for the comfort, welfare, or happiness of the powerholder is not limited by the requisite standard.[13]

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[5] If such a co-trustee is not appointed, the courts may mandate the appointment of such a co-trustee to prevent the authority for exercising the powers that the beneficiary/trustee cannot exercise from devolving upon the court. *See, e.g., In re Matter of Moser*, 139 Misc.2d 958, 529 N.Y.S.2d 958 (Nassau Co. 1988); *Kagan*, fn. 2, above.

[6] *See also* §2514(b) (the exercise or release of a general power of appointment is a transfer of property by the individual possessing such power for gift tax purposes). All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[7] §§2041(b)(1), 2514(c); Regs. §§20.2041-1(c), 25.2514-1(c). For purposes of this article (except where otherwise noted), it is assumed that any co-trustee is not an adverse party or the creator of the power.

[8] Regs. §§20.2041-1(b)(1), 25.2514-1(b)(1).

[9] *See also* Regs. §25.2514-1(b)(1).

[10] *See, e.g., Walter Est. v. U.S.*, 761 F.2d 442 (7th Cir. 1985); *Little Est. v. Comr.*, 87 T.C. 599 (1986); TAM 8121010. *Cf. Sheedy v. U.S.*, fn. 33 and accompanying text, below.

[11] Regs. §§20.2041-1(c)(2), 25.2514-1(c)(2).

[12] *Id.*

[13] *Compare Tucker v. U.S.*, 74-2 USTC ¶13,026 (S.D. Cal. 1974); Rev. Rul 78-398, 1978-2 C.B. 237; and Rev. Rul. 77-60, 1977-1 C.B. 282 (beneficiary/trustee's power limited by ascertainable standard) *with Miller v. U.S.*, 387 F.2d 866 (3d Cir.

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Although a beneficiary/trustee may not have the authority to participate in the exercise of unlimited discretion to distribute income and/or principal to himself or herself as beneficiary, the beneficiary/trustee still may have a general power of appointment, in any event, if the beneficiary/trustee may participate in the unrestricted discretion to distribute income and/or principal to discharge an obligation of support of the beneficiary/trustee. Regs. §20.2041-1(c)(1) provides that "[a] power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors." [14] Thus, if under the trust instrument the beneficiary/trustee may participate in decisions concerning the distribution of income or principal (unlimited by an ascertainable standard) to pay for the support and education of the beneficiary's minor child (which assumes the beneficiary has an obligation to support under applicable local law), the beneficiary will have a general power of appointment over the property, the exercise of which will result in a taxable gift and the possession of which will result in the property (to the extent it may be used to discharge the beneficiary/trustee's obligation of support) to be included in the beneficiary/trustee's estate.[15]

Power to Terminate Trust

Under Regs. §20.2041-1(b)(1), a power given to a decedent to effect the beneficial enjoyment of trust property or its income by terminating the trust is a power of appointment.[16] The power to terminate the trust may be held directly or indirectly by the beneficiary/trustee. For example, in *Pittsburgh National Bank v. U.S.*,[17] a trust was set up for the benefit of the decedent of which the decedent and his brother-in-law were named as trustees. The trustees were given extensive power of management, including the sale of the trust assets. Under the trust terms, if the trust assets were sold, the trust would terminate. The Service took the position that this power gave the decedent a general power of appointment. After establishing that the co-trustee was not an adverse party, the court rejected the taxpayer's argument that the power to terminate the trust was only an incidental consequence of the decedent's exercise of his fiduciary power to sell. Although the trustee's action would not diminish or enlarge any beneficial share, the court found that it would provide immediate enjoyment of the assets by each beneficiary, including the decedent/trustee. Therefore, the court found that the power to sell and thereby terminate the trust was a general power of appointment.[18]

Power to Allocate Between Principal and Income

Regs. §§20.2041-(b)(1) and 25.2514-1(b)(1) provide that the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interest therein, except as an incidental consequence of the discharge of such fiduciary duties, is not a general power of appointment. Thus, as a general rule, where the trustee under applicable state law is restricted by fiduciary standards in exercising such power, the power of the beneficiary/trustee to allocate receipts between income and principal should not be treated as a general power of appointment. Nevertheless, there is always the risk that the IRS may argue, and a court may find, that the regulation is inapplicable because there is a diversion or shifting of beneficial interests which is more than an "incidental" consequence of the exercise of such power and, consequently, the beneficary/trustee has a general power of appointment.[19] To avoid this result, the beneficiary/trustee should be prohibited from participation in any decision concerning the allocation of receipts and disbursements of any principal and income.

Administrative Powers

As regards certain administrative powers held in a fiduciary capacity, Regs. §20.2041-1(b)(1) sets limits on what powers are powers of appointment:

> The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interest therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.[20]

The critical determination is whether, by virtue of the administrative power, the beneficiary/trustee may enlarge or shift beneficial interests.

The Service has discussed the application of this regulation in several private letter rulings and technical advice memoranda. For example, the Service in

1968); *McIlvaine v. U.S.*, 358 F. Supp. 300 (E.D. Pa. 1973); and *Lanigan v. Comr.*, 45 T.C. 247 (1965) (beneficiary/trustee's power is not limited by ascertainable standard.)

[14] *See also* Regs. §25.2514-1(c)(1). *See also* PLR 9030005; PLR 8924011.

[15] *See* PLR 8951049. *Cf. Sullivan Est. v. Comr.*, T.C. Memo 1993-531.

[16] *See also* Regs. §25.2514-1(b)(1).

[17] 319 F. Supp. 176 (W.D. Pa. 1970).

[18] *See Maytag v. U.S.*, 493 F.2d 995 (10th Cir. 1974) (holding that where the decedent was co-trustee of a trust for his benefit under which he had the power as a co-trustee, with the unanimous consent of the other trustees, to terminate the trust, the decedent possessed a general power of appointment); *Maxant Est. v. Comr.*, 40 T.C.M. 1328 (1980).

[19] *See* AOD 1972-365 to *Tull v. U.S.*, 74-2 USTC ¶13,010 (E.D. Mich. 1971).

[20] *See* also Regs. §25.2514-1(a)(1).

TAM 8504011 ruled that a decedent did not possess a general power of appointment, by reason of his power as a corporate director, to veto or consent to the redemption of preferred stock for only its par value instead of an increased value. In this TAM, the decedent and his siblings held all the voting stock of a closely held family corporation. Prior to the decedent's death, the corporation was recapitalized and the decedent and his siblings made certain transfers to trusts. During the time that the recapitalization plan was formulated, the board of directors of the company consisted of the decedent, his siblings and one nonfamily member. As part of the recapitalization plan, the corporation declared a stock dividend of nonvoting preferred stock. The nonvoting preferred stock was redeemable at $100 per share and was entitled to a percentage of all dividends paid by the corporation based on the amount of dividends paid to the voting stock. After the recapitalization, the decedent (and his siblings) transferred the voting common shares to trusts for the benefit of their descendants. Under the provisions of the trust, the decedent and his siblings were appointed trustees with a corporate fiduciary and nonfamily member as independent trustees. Income was accumulated until the decedent's child attained age 21, then income was to be distributed to the children. The independent trustees had the power to invade principal, limited by an ascertainable standard. The trust also provided that the common stock of the family company could only be liquidated or sold by unanimous vote of all the trustees. In essence, the decedent, as a trustee, had the power to veto the sale of liquidation of the company stock. The decedent and each of his siblings transferred their shares of voting stock to the respective trusts for the benefit of their own children (and one sibling transferred his stock equally among the trusts). Among other rulings in this TAM, the Service ruled that because all of the voting common shares were held in the respective trusts to which they had been transferred, each trustee (including the decedent) had the power to veto or consent to a liquidation of the corporation. Upon liquidation, the decedent's income interest would have been extinguished and he would have received $100 for each share he owned. Moreover, the decedent possessed the power, as a corporate director, to join the other directors in forming a majority vote in vetoing or consenting to a stock redemption. Upon a redemption of his own preferred stock, as in a liquidation, the decedent's income interest would have been extinguished and he would have received $100 for each of his preferred shares.

Nevertheless, because the decedent's powers as a director were fiduciary in nature, the Service first ruled that he was limited in exercising those powers to prevent a redemption of his preferred shares or a liquidation by his fiduciary responsibility to the corporation and other shareholders, citing to *U.S. v. Byrum*.[21] Moreover, by reason of his ownership of preferred shares, the decedent was also a mino stockholder to whom all the corporate directors ov a fiduciary duty. The decedent could have institu an action if the directors had acted in bad faith or i fraudulent manner in the redemption of the sto Moreover, although the decedent could have preve ed a voluntary dissolution of the company through t exercise of his veto power, he could only exercise t veto power in his capacity as a trustee, rather than an individual stockholder. He was consequently du bound, as a fiduciary, to disregard his own interes and consent to a liquidation or veto it solely in t best interests of the trust beneficiaries. A failure act in the best interests of the beneficiaries, t Service ruled, would have subjected the decedent an action in equity. Consequently, the Service rule that the decedent did not have a right within th scope of §2036(a)(2).

Moreover, the Service ruled that because the dec dent could only exercise his powers as director in fiduciary capacity (as trustee of the trust for hi descendants rather than in favor of himself, his estate his creditors, or the creditors of his estate) and coul not shift any of the beneficial interests except as an incidental consequence of the discharge of his fiduciary duties, the decedent also did not possess a general power of appointment. Thus, the decedent/trustee's power to shift the flow of assets to the trust and to himself as a preferred shareholder through vetoing or consenting to a liquidation was a mere fiduciary power that did not cause a shift in beneficial interests except as an incidental consequence of the discharge of fiduciary duties.

A similar conclusion was reached in PLR 9038037, in which the taxpayer requested a ruling concerning whether the appointment of the settlor's child as an additional trustee of a trust created for the benefit of that child would cause any portion of the trust to be includible in that child's gross estate. In this ruling, five separate trusts were created, each for the benefit of one of the children of the settlor. A bank was named as trustee. Under the trust provisions, the trustee was directed to accumulate the net income of the trust until the income beneficiary attained age 35 and then to distribute the net income to or for the benefit of the income beneficiary during the remainder of the income beneficiary's life. Upon the death of the income beneficiary, the principal of the trust was to be distributed to the income beneficiary's then-living issue or in default to the settlor's then-living issue. The ruling specifically noted that the trustee did not have any power to make discretionary distributions of income or principal to the trust beneficiaries. In addition, the trustee was not authorized to

[21] 408 U.S. 125 (1972), *reh'g denied*, 409 U.S. 898 (1972).

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terminate prematurely any trust created or to accelerate any beneficial interest in the trust property. As trustee it is assumed, however, that the child/trustee had all standard management and investment powers (including the power to sell assets, to vote stock, to borrow, etc.). Moreover, the ruling stated that, under the state law governing the administration of the trust, the trustee was required to administer the trust so as adequately to protect and preserve the respective interests of the income beneficiaries and the remaindermen. Citing to Regs. §20.2041-1(b)(1), the Service ruled that each child, as co-trustee of that child's trust, will not have a general power of appointment. The Service noted that the child, as trustee, merely had management powers with no power to shift the beneficial interests.[22]

Based on the conclusions reached in TAM 8504011,[23] PLR 9038037, and PLR 9034031, general management, investment, and administrative powers exercisable by a beneficiary/trustee should not constitute general powers of appointment even though a consequence of the exercise of the fiduciary power is the shifting of beneficial interests, assuming that under applicable state law fiduciary standards restrict the exercise of such powers. For example, the beneficiary/trustee should be able freely to participate in investment decisions, including decisions to invest in unproductive property or high income yielding property, even though as a result of that decision there may be a shift in beneficial interests. Moreover, the beneficiary/trustee should be able to participate in decisions to vote any stock held as part of the trust corpus.[24]

Power to Remove and Replace Co-Trustee

Even if the beneficiary/trustee is prohibited from exercising any powers that would constitute general powers of appointment, if the beneficiary/trustee can remove and replace the co-trustee who holds those powers, the Service may argue that the beneficiary/trustee has a general power of appointment. The regulations include in the term "power of appointment" an individual's power to remove a trustee and appoint a successor (including such individual). Regs. §20.2041-1(b)(1) states:

> A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment. However, the decedent is not considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestrictive power of removal.[25]

This provision has been interpreted broadly by the Service. For example, in PLR 8916032, the Service ruled that a beneficiary who has the power to remove a trustee and appoint a successor corporate trustee has a general power of appointment where the trustee had the power to invade corpus for the beneficiary's comfort and enjoyment. (The ruling noted, however, that, if the spouse's removal power was only exercisable with the joinder of persons having a substantial adverse interest, it would not be regarded as a general power of appointment.) The Service's position in this ruling was derived from Rev. Rul. 79-353,[26] in which the Service ruled that where the grantor retained the unrestrictive power to remove a corporate trustee and replace the trustee with a successor corporate fiduciary and the trustee had the power to shift beneficial interests by sprinkling income and principal among the grantor's children, the property was includible in the grantor's gross estate under §§2036(a)(2) and 2038(a)(1). The Service's position in this revenue ruling has been successfully challenged in *Wall Est. v. Comr.*[27] Nevertheless, it is possible that the Service might continue to follow PLR 8916032 and assert that a beneficiary/trustee who, although prohibited as beneficiary/trustee from participating in any powers

[22] *See* PLR 9034031 (reaching the same conclusion based on same facts). *See also Katz v. U.S.* 382 F.2d 723 (9th Cir. 1967). *Cf.* TAM 8538007.

[23] The interpretation of Regs. §20.2041-1(b)(1) in TAM 8504011 is similar to the approach taken by the courts and the Service in *Byrum*, fn. 21, above, and its progeny (*e.g., Gilman Est. v. Comr.*, 65 T.C. 296, *aff'd*, 547 F.2d 32 (2d Cir. 1976), *non acq.*, 1978-2 C.B. 3) which concluded that an individual does not have the right to alter the beneficial enjoyment of property solely because the individual can vote corporate stock and arguably thereby control the election of directors and the flow of dividends. *See also Chambers v. Comr.*, 87 T.C. 225 (1986) (holding that taxpayers made a completed gift to trusts for their children where each taxpayer transferred her interest in the life estate of a trust which owned stock in a family company to another trust benefitting her children of which she designated herself as trustee, notwithstanding that the two taxpayers each (or together) had the power to exercise voting control over the company because that right to vote the stock arose solely from their positions as trustees and as such trustees they were under a fiduciary obligation to the beneficiaries of the trust).

[24] *See Byrum*, fn. 21, above.

[25] *See also* Regs. §25.2514-1(b); *Wilson Est. v. Comr.*, T.C. Memo 1992-479 (holding that, because Mrs. Wilson had the sole power to discharge any successor trustee and appoint the replacement trustee (*including herself*), the trustee's powers are attributed to her (including the power to appoint corpus to her), and, thus, Mrs. Wilson had a general power of appointment).

[26] 1979-2 C.B. 325, *mod.*, Rev. Rul. 81-51, 1981-1 C.B. 458.

[27] 101 T.C. 300 (1993).

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that constitute a power of appointment, has the power to remove and replace the co-trustee who holds such powers, has a general power of appointment. However, in view of the *Wall* decision, that position probably could be successfully challenged.

Power to Amend Administrative Provisions

Regs. §20.2041-1(b)(1) provides that "a power to amend only the administrative provisions of a trust instrument, which cannot substantially affect the beneficial enjoyment of the trust property or income, is not a power of appointment."[28] Thus, a beneficiary/trustee should be able to be given the power to amend the administrative provisions of a trust.

Effect of Co-Trustee Who Is Adverse Party

Under §2041(b)(1)(C), a power of appointment is not a general power of appointment if the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to the exercise of the power by the decedent, or with the creator of the power.[29] An interest adverse to the exercise of the power is considered "substantial" if its value in relation to the total value of the property subject to the power is not insignificant. In order to have an interest which is both "substantial" and "adverse," a person must have a present or future chance to obtain a personal benefit from the property itself.[30] For this purpose the interest is valued in accordance with the actuarial principles set forth in Regs. §25.2512-5 or §20.2031-7 or, if not susceptible of valuation, in accordance with Regs. §25.2512-1 or 20.2031-1. A taker in default of appointment under a power has an interest which is adverse to the exercise of the power. A co-holder of the power has no adverse interest merely because of his or her joint possession of the power nor merely because he or she is a permissible appointee under a power.[31]

Thus, if as a result of the powers held by the beneficiary/trustee, the beneficiary/trustee would have a general power of appointment, the appointment of a co-trustee with an adverse interest would prevent the beneficiary/trustee from being deemed to hold a general power of appointment. Such an appointment, however, may not resolve the potential estate tax inclusion problem because, if the adverse trustee ceases to act as trustee, the beneficiary/trustee would again have a general power of appointment.

[28] *See also* Regs. §25.2514-1(b)(1).
[29] *See also* §2514(c)(3)(B).
[30] *See Maxant Est. v. Comr.*, fn. 18, above.
[31] Regs. §§20.2041-3(c)(2), 25.2514-3(b)(2).

Application of State Law to Prevent a Beneficiary/Trustee from Exercising Prohibited Powers

If a beneficiary/trustee holds a power that is general power of appointment, applicable state la may prohibit the trustee from exercising the powe Both the courts and the Service have concluded that a state statute or state common law precludes beneficiary/trustee from exercising a power th would otherwise constitute a general power of a pointment, the beneficiary/trustee does not hold general power of appointment.

For example, in *Sheedy v. U.S.*,[33] the decedent w the sole trustee and a beneficiary of a family tru under her husband's will. Under the provisions of th trust, the decedent had the power to distribute princ pal to herself not limited by an ascertainable stan ard. Under the Wisconsin statutes, the decedent i her capacity as trustee was prohibited from makin discretionary distributions of principal to herse Nonetheless, in violation of the Wisconsin statute, th decedent made distributions of principal to herse The court found that the Wisconsin statute in fact di prohibit the decedent from making discretionary dis tributions of principal to herself and that the applica tion of the statute had not been negated by th decedent's husband's will. Therefore, the court con cluded that the decedent did not have a general powe of appointment notwithstanding that her actions (*e.g.* the distributions of principal to herself) violated th Wisconsin statute.

[32] *See, e.g.*, F.S.A. §737.402; N.Y. EPTL §10-10.1 N.C.G.S. §32-34; Ohio Rev. Code Ann. §1340.22; Wis. Stats §701.19(10).

State statutes which prohibit a beneficiary/trustee fron exercising a power of appointment often state that they ar declaratory of existing law. It is possible that the Service migh argue successfully that any such statute is not declaratory o existing law. If the Service is successful in making this argu ment but a court should find nonetheless that the section is binding on a beneficiary/trustee, the provision would expung an existing right. Thus, the issue arises as to whether tha elimination of an existing right is constitutional under applica ble state law. If it was found not to be constitutional, the beneficiary/trustee would continue to have the powers tha constitute general powers of appointment. *Cf. In re West*, 289 N.Y. 423 (1943), *aff'd, Demorest v. City Bank Farmers Trust Co.*, 321 U.S. 36 (1944).

Moreover, it is questionable whether the Service is bound by a state legislature's construction of state common law. The Service is not prohibited from arguing that a state statute is not declaratory of existing law. Under *Comr. v. Bosch Est.*, 387 U.S. 456 (1967), the Service is only bound by the decision of the highest court in the state. Thus, the additional issue arises as to whether the Service is bound by an act of the legislature—that is, whether a declaration of a state's legislature is the best evidence of state law. It appears that the Service may be so bound. *Cf. Boyter v. Comr.*, 668 F.2d 1382 (4th Cir. 1981).

[33] 691 F. Supp. 1187 (E.D. Wis. 1988).

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Similarly, in *Garfield & Cohen v. U.S.*,[34] the decedent and another individual were trustees of a trust for the benefit of the decedent. During the decedent's lifetime, the trustees were authorized to distribute income and principal in their absolute discretion for the benefit of the decedent and his issue. The Service sought to include the trust in the decedent's estate on the basis that the decedent had a general power of appointment by virtue of his power as one of the trustees to distribute income and principal in his favor. The court found that, under Massachusetts common law, a beneficiary/trustee could not participate in decisions to distribute principal to himself unless a contrary intent was expressed in the trust instrument. In this case, the court found that the trust document contained no clear provision permitting the decedent to participate in decisions concerning distributions of trust principal to himself and, moreover, found that the trust agreement required that there always be an independent trustee, which indicated an intent to achieve favorable tax results. Accordingly, the court held that the decedent was bound by the general trust doctrine in Massachusetts forbidding a beneficiary/trustee from participating in decisions concerning payment of principal and income to himself and, accordingly, the decedent did not possess a general power of appointment.[35]

The Service in its rulings has followed the position taken in these cases. For example, in Rev. Rul. 54-153,[36] the Service ruled that where a trustee, who is also beneficiary of a trust, was prohibited by a state (New York) statute from participating in a decision to distribute corpus to himself, his estate, his creditors, or the creditors of his estate, the trustee did not have a general power of appointment and, therefore, the property was not includible in his estate under §811(f)(2) (the predecessor to §2041(a)(2)). In Rev. Rul. 82-63,[37] following the decision in *Garfield*, above, under Massachusetts law a beneficiary who is also the trustee could not participate in the trustees' decision as to the amount that could have been distributed for her own benefit under the discretionary power, and, therefore, did not possess a power of appointment under §2041.[38]

Thus, under these precedents, where a beneficiary/trustee is granted a power which is a general power of appointment under §§2041 and 2514 (*e.g.*, the power to invade principal for the beneficiary/trustee's benefit) and a state statute or state common law prohibits the beneficiary/trustee explicitly from exercising that power, the trustee/beneficiary should not be treated as having a general power of appointment.

However, what is the federal estate and gift tax effect of the enactment of a state statute which effects any general powers of appointment held by a beneficiary/trustee? This issue was recently addressed in Rev. Proc. 94-44.[39] On May 9, 1991, Florida enacted F.S.A. §737.402(4) which provides, among other matters, that any fiduciary power conferred upon a trustee to make discretionary distributions of principal or income to or for the trustee's own benefit cannot be exercised by the trustee, except to provide for that trustee's health, education, maintenance, or support as described in §§2041 and 2514. F.S.A. §737.402(4)(a) also contains prohibitions with respect to the exercise of other fiduciary powers exercisable for the trustee's own benefit, including the power to allocate receipts and expenditures between income and corpus and the power to distribute property in satisfaction of the trustee's legal support obligation. Although the statute applies to any trust created under a document executed before July 1, 1991, if the trust is irrevocable, the statute does not apply if all interested parties elect affirmatively not to be subject to the application of the statute.[40] This election must have been made on or before the later of July 1, 1994, or three years after the date on which the trust becomes irrevocable.

In Rev. Proc. 94-44, the Service announced that the enactment of the statute will not trigger federal estate or gift tax liability. The Rev. Proc. applies to all trustee/beneficiaries of irrevocable trusts executed before July 1, 1991 that are subject to the provisions of this statute and all parties in interest under an irrevocable trust executed prior to July 1, 1991 who elect not to be subject to the application of this statute. For all irrevocable trusts within the scope of this Rev. Proc., the Service will treat F.S.A. 737.402(4)(a) as effective on and after July 1, 1991.

In the case of the death before July 1, 1991, of a beneficiary/trustee of an irrevocable trust within the

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[34] 80-2 USTC ¶13,381 (D. Mass. 1980)

[35] *See also Maytag v. U.S.*, fn. 18, above (holding that where case law prevents a beneficiary who is also a trustee from holding a general power of appointment the trustee who is a beneficiary will not be deemed to hold that general power of appointment).

[36] 1954-1 C.B. 185.

[37] 1982-1 C.B. 135.

[38] *See also* PLR 9323028 (ruling that, because a fiduciary under Ohio law cannot make discretionary distributions to himself unless a power to make such distributions is limited by an ascertainable standard, the taxpayer/co-trustee was prohibited from exercising a power to invade principal for his own benefit unless it was exercised pursuant to an ascertainable standard and, therefore, did not have a general power of appointment); PLR 9235025 (acknowledging that under New York law a beneficiary/trustee could not participate in the decision to distribute any part of the corpus or income of a trust established for his own benefit to himself); PLR 7935051 (ruling that under applicable state law because the beneficiary/fiduciary was prohibited from making discretionary distributions of principal or income to herself or discretionary allocations in her own favor of receipts or expenses as between income and principal, the taxpayer, who was co-trustee and primary beneficiary of a testamentary trust under which principal could be distributed to her not limited by ascertainable standard, did not possess a general power of appointment).

[39] 1994-28 I.R.B. 1.

[40] F.S.A. §737.402(4)(b)(3).

scope of this Rev. Proc. or a lapse, release, or exercise of a power held by a beneficiary/trustee of such a trust before July 1, 1991 (regardless of whether the beneficiary/trustee dies before, on, or after that date), the Service ruled that it will apply §§2514 and 2041 without reference to the Florida statute. In this regard, the Service ruled that it would not recognize the effectiveness, for federal transfer tax purposes, of state legislation purporting to change retroactively an individual's property rights or powers after the federal tax consequences have attached.

Moreover, the Service ruled that the Florida statute would not be treated as causing a lapse of a power of appointment of a beneficiary/trustee under an irrevocable trust within the express scope of this Rev. Proc. 94-44 for purposes §§2041(b)(2) and 2514(e).

Finally, the Service ruled that any party in interest under an irrevocable trust within the scope of the procedure who elects not to be subject to the Florida statute will not be treated as making a gift for purposes of §2511. If the Florida statute does not apply by reason of such an election, the Service ruled that §§2041 and 2514 would apply to the power and to any lapse, release, or exercise of the power to the extent the power may be exercised under Florida law.

Trust Instrument Prohibits Exercise of Prohibited Powers

Regardless of whether applicable state law prohibits a beneficiary/trustee from exercising any power that would constitute a general power of appointment under §§2041 and 2514, the trust instrument appointing the beneficiary, as trustee, should contain a general prohibition against the trustee participating in the exercise of any such powers. This provision is advisable, for example, because the situs of the trust (and thus the law governing the administration of the trust) could be changed to a jurisdiction where there is no state statute or state common law which prohibits the trustee from exercising powers that constitute general powers of appointment, even if the originally governing law contained such a prohibition.

The following language might be considered to be included in the trust to avoid the beneficiary/trustee from holding a general power of appointment:

No Trustee who is a beneficiary of any trust created hereunder or who is obligated to support a beneficiary of any trust created hereunder shall ever participate in, with respect to all trusts created hereunder, (i) the exercise of, or decision not to exercise, any discretion over payments, distributions, applications, uses or accumulations of income or principal by the Trustee, (ii) the exercise of discretion to allocate receipts or expenses between principal and income, (iii) the removal of any Trustee, (iv) the exercise of any power to amend or affect beneficiaries' powers of withdrawal over additions, or (v) the exercise of any general power of appointment described under sections 2041 or 2514 of the Internal Revenue Code of 1986, as amended. The determination of the remaining Trustee or Trustees shall be final and binding upon the beneficiaries of such trust.

CONCLUSION

Appointing a beneficiary as a trustee of an irrevocable trust opens a Pandora's box of problems and issues. The trust instrument must be crafted carefully to avoid having the property made includible in the beneficiary's gross estate and having the exercise of powers by the beneficiary, as trustee, result in adverse gift tax consequences. Applicable state law must be consulted to insure that the appointment of the beneficiary, as trustee, does not cause the trust to fail under the doctrine of merger and that a co-trustee is appointed to exercise any powers that the beneficiary/trustee is prohibited under applicable state law from exercising. Moreover, the beneficiary/trustee should be prohibited in the governing instrument from participating in the exercise of any powers that constitute general powers of appointment including, for example, any unrestricted distributions of income or principal to the beneficiary or to any person whom the beneficiary has an obligation to support, the power to terminate the trust, and the power to allocate expenses between income and principal. The beneficiary, as trustee, however, should be able to participate in investment and management decisions of the trust and have the power to amend administrative provisions.

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Partnerships as the Answer to an Archaic Tax Provision: Retaining Interests in Gifted Assets in a Permissible Way to Avoid Estate Tax

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INTRODUCTION

Congress has a tendency to amend the Internal Revenue Code to achieve short-term goals without concern about the consistency these amendments have with other Code provisions.[1] Frequently, the changes required in other provisions because of the enactment of a new Code section are not made until years later by a technical corrections act.[2] Occasionally, needed conforming changes are forgotten in their entirety.[3]

In 1976, Congress unified the estate and gift tax rates, but failed to consider the propriety of retaining §2036(a)(1) of the Code.[4] Section 2036(a)(1) provides that if an asset is transferred and the transferor retains an income 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 is included in the transferor's gross estate for estate tax purposes.[5] Essentially, a gift transfer in which the transferor retains an interest in the property transferred is treated as incomplete for estate tax purposes.[6]

Consider, for example, the following. Transferor T gives 100 shares of SGL stock, worth $50,000, to his daughter, D. T files a gift tax return treating the transfer as a taxable gift of $50,000. As a condition of the gift, 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 worth $100,000. Pursuant to §2036(a)(1), T will include in his estate the full value of the SGL stock, $100,000, even though T only retained the right to the dividends.[7]

Holding a lifetime interest in property (or a term interest if the term outlasts one's life) prevents the remainder, gifted component from coming into possession until the transferor's death. In originally enacting §2036, Congress felt that individuals should not be allowed to structure gifts of this nature, which were essentially testamentary transfers, in the form of lifetime gifts in order to avoid the generally higher estate tax liability.[8] But with unification of estate and gift tax rates in 1976, that justification lost its viability.[9] Because gift and estate tax rates are now unified, a gift transfer which may not come into full possession to the donee until the donor's death, such as a remainder interest, should nevertheless be subject to transfer tax at only one time, the time the donor parts with dominion and control over the gifted interest. This conclusion is bolstered by the enactment in 1990 of §2702, which imposes fair valuation rules for gifts of remainder interests.

Nevertheless, like gifts from revocable trusts made within three years of death,[10] §2036(a)(1) provides an additional weapon to the Internal Revenue Service for estate tax includability. For those individuals who are willing to make lifetime taxable gifts, but would also like to retain enjoyment from the transferred property, a structure should be considered that avoids the anachronistic application of 2036(a)(1).[11]

Congress provided the vehicle in 1990, by enacting Chapter 14 of the Code.[12] That chapter is intended to eliminate perceived abuses in the valuation process associated with corporate and partnership estate freezes and certain other gifts made in the family context.[13] Indirectly, by enacting Chapter 14, Congress legitimized a strategy — the retained interest partnership — by which a donor may retain an interest in gifted property without invoking §2036(a)(1).[14]

This article discusses how transferors can use partnerships to give away assets while still retaining an interest in the transferred assets. In analogizing to the §2036(a)(1) transaction, the retained interest partnership will be discussed in the context of two objectives: (1) to allow the transferors, typically the parents in a family setting, to retain a stream of constant payments; and (2) to minimize transfer taxes [15] on the growth in value of the partnership assets and to create the possibility for transfer tax savings in excess of the savings associated with an outright gift (with no retained interest).[16]

CREATING TRANSFER TAX SAVINGS BY CONTRASTING ASSUMED FUTURE VALUE WITH ACTUAL FUTURE VALUE: THE IMPORTANCE OF THE REMAINDER INTEREST

When gift tax valuation of a remainder interest actually equals true future value, a gift of interests outright, *e.g.*, X shares of stock in a corporation, versus a gift of an equal value of partial interests, *e.g.*, the right to receive X + Y shares of stock in the same corporation three years in the future, should have equivalent transfer tax consequences.

Consider, for example, shares of stock in X corporation with a par value of $10,000 per share paying a cumulative dividend of 10% of their face value. As-

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sume each share is valued at par and partial shares can be issued. A gift of five shares equals $50,000 (5 × $10,000). This could be equivalent to the gifting of 6.655 shares, with vesting occurring three years in the future, if the valuation and return rates are both 10%.[17] In that instance, the value of the right to receive 6.655 shares of X corporation three years in the future will also result in a taxable gift of approximately $50,000.[18] Assume that over the next three years, X earns on average 10% per year — the same as the assumed discount rate — and pays this out as dividends. At the end of this time, the 6.655 shares of stock are still worth $66,550. Five shares of X are worth $50,000, but the five shares gifted in year one have produced dividends of $1,000 per year. The dividends in year one allow for a 10% return for two years. The dividends received in year two result in a 10% return for one year. These receipts also total $66,550.[19] Both interests — the gift of five shares outright in year one and the gift of 6.655 shares to vest three years in the future — are worth the same amount:

End of Year	Amount Given Away	Dividends	Interest on Dividends	5 Shares of Stock Plus Dividends	6.655 Shares in 3 Years
1	$50,000	5,000	$0	$55,000	$55,000
2	0	5,000	$500	$60,500	$59,920
3	0	5,000	$1,050	$66,550	$66,550

Often two influences cause outright gifts and gifts of remainder interests not to be equivalent. First, gift tax values of partial interests rarely, as a mathematical proposition, turn out to be equal to actual future values. If the gift tax value is less than the discounted, actual future value of the interest, then the gifted interest has achieved transfer tax savings.[20]

Second, on a practical level, transferors at times desire to retain an equity interest in gifted property. Typically, a donor will want to keep the income interest associated with the property while allowing future appreciation to inure to the benefit of the donees,[21] a transaction prohibited by §2036(a)(1).[22]

STRUCTURING THE RETAINED INTEREST PARTNERSHIP

The objective of the retained interest partnership is to allow the transferors of property — typically one or both parents — to retain a stream of payments from the transferred property while maximizing the shift of future appreciation to the transferees — typically the children.[23] These objectives need to be cast in light of the valuation rules mandated by §2701,[24] as well as traditional partnership rules.

Multiple Classes of Interests

Use of the partnership format in this context contemplates the bifurcation of one or more assets into two classes of interests, one representing annual payments and one representing future growth. The parents will retain one class of interests, that representing annual payments; the other, that equivalent to future growth, will be transferred to the children. To achieve the above objectives, the two classes of equity interests must be dissimilar.

If equity rights of the partnership classes are equivalent, then the retained and transferred interests will both represent annual payments and future growth. Further, transfer tax savings cannot be maximized. Changes that affect the economic well being of the partnership in that instance will impact equally (on a proportionality basis) on both the retained and transferred interests.[25] Accordingly, maximizing the shift of future appreciation to the transferees will not be achieved.

Instead, the transferred interest must be structured as the functional equivalent of a remainder interest and the retained interest must be analogous to a fixed annuity interest. The valuation of the two interests will then be based on assumptions relating to future value. If these assumptions underestimate actual future value — the partnership outperforms the tax assumptions used in valuing the retained interest — then the increase in value will inure to the benefit of the transferred interest (*i.e.*, the transferred interest will absorb all residual partnership value).[26] If the retained and transferred partnership interests have the same equity rights, there can be no increase in value of the transferred interest based on what turns out to be an incorrect gift tax value of the retained interest.[27]

The Retained Interest

The class of partnership interest representing the annual distributions is a preferred interest because that interest will have priority as to payment of distributions. Instead of retaining a true income interest from the transferred interest, *e.g.*, all net income generated by the partnership assets, the parent should estimate that rate the partnership is anticipated to generate in net income. The preferred interest should

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then represent a fixed amount of annual return slightly less than that projected rate. For example, if $1,000,000 is contributed to the partnership, and the partnership is expected to generate 7% annually in income ($70,000), the preferred interest could yield a fixed $50,000 per year to the interest holders.[28]

In this regard, the planner should be cautious of indirect §2036(a)(1) retentions. For example, if the parent retained a rate that approximated the partnership's net income, and the parent gifted the nonpreferred interests to the children, the Service may argue that §2036(a)(1) still applies. In that instance, the Service could contend that the retained annuity right was no more than a disguised retained income interest, and the transfer of the nonpreferred interest to the children was therefore a transfer with a retained income interest. Analogous positions were taken by the Service in two earlier letter rulings.[29] Those rulings, however, should be inapplicable to the situation where the preferred interest does not approximate net income. In addition, those rulings, as well as §2036(a)(1), are inappropriate to the situation where the children purchase from their own funds the nonpreferred interest.[30] Further, in light of congressional recognition of preferred partnerships by the enactment of §2701, it is unlikely that the Service's prior letter rulings reflect of current law, even if partnership net income were equivalent to the preferred return.[31]

The preferred interest evidencing this payout right can be structured as either a guaranteed payment or a preferred allocation of partnership net income. A guaranteed payment is a required partnership distribution made without regard to the income of the partnership and is for the use of a partner's capital.[32] To the preferred interest holder, the guaranteed payment will constitute ordinary income, regardless of the extent of the partnership's taxable income.[33]

Guaranteed payments are deductible by the partnership, although whether under §162 or §212 is not always entirely clear.[34] As a result, these payments reduce taxable income allocable to the partners. If, however, the partnership does not have sufficient taxable income or the deduction is not a direct offset against partnership income, then the making of a guaranteed payment could have deleterious income tax effects, such as double taxation.[35] In that event, an income tax will be imposed that could have otherwise been avoided had there been no guaranteed payment structure.

For example, assume the partnership is structured as a limited partnership and the general partnership interests represent the preferred interest. The preferred interest holder is entitled to receive 1% of all distributions and annual guaranteed payments of $15,000. The limited partners are entitled to receive the remaining 99% of all distributions. In the first year, partnership gross income is $10,000, but the preferred interest holder is entitled to receive guaranteed payments aggregating $15,000. The $15,000 in payments earned in that year (whether or not actually paid) will constitute ordinary income to the preferred interest holder and constitute deductions to the partnership. Importantly, only $10,000 of that amount is useful as an offset against partnership income because the partnership only had $10,000 of gross income. The additional $5,000 of loss, generated by the making of the qualified payment, will most likely be carried out pro rata to the partners, which means that the limited partners will be allocated 99% of the loss.[36] The loss may not be useable immediately and, accordingly, the qualified payment has accelerated $5,000 in taxable income.

Alternatively, instead of guaranteed payments, the retained right could be structured as a preferred allocation of partnership net income ("preferred payment"). The preferred partner will be allocated income, and receive a cash distribution, only if there is sufficient partnership net income. Preferred payments will then in effect carry out taxable income to the preferred interest holder each time a payment is made, thereby effectively decreasing the partnership taxable income allocated to the other partners. Accordingly, preferred payments have potential, albeit minimal, income tax benefits over guaranteed payments. Also, because preferred payments share in the income of the partnership, the debt versus equity concern associated with guaranteed payments should not be an issue.[37]

Importantly, preferred payments more closely resemble a retained income interest than a guaranteed payment. This invokes §2036(a)(1) concerns.[38] As a result, in a partnership in which a gift is made of the nonpreferred interest, the structuring of the retained interest as a guaranteed payment rather than a preferred interest will circumvent §2036(a)(1).[39]

Preferred Interests and Achieving Fair Market Valuation

To lower the value of the transferred interest in a §2701 partnership, the retained preferred interest must be structured so as to be ascribed a fair market valuation.[40] In light of §2701's potential reach to these types of partnerships, two alternatives exist.

First, the retained preferred interest can be structured as a "qualified payment right."[41] A qualified payment right will be ascribed a value under §2701 in family multitier partnership situations.[42] A qualified payment right includes "any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such a dividend (or comparable payment) is determined at a fixed rate."[43]

Second, outside the reach of the special valuation rules of §2701 is "any right to receive any guaranteed

payment described in section 707(c) of a fixed amount." [44] That right may not be contingent as to time or amount.[45] A guaranteed payment that satisfies these criteria will be valued according to traditional fair market value principles and will be outside of the special, zero valuation assumptions of §2701.[46]

A preferred payment, which garners income tax treatment superior to that of a qualified payment, needs to be carefully structured to constitute a qualified payment right. A preferred partnership interest that provides the holder with an 8% return, payable annually to the extent of partnership income, will not constitute a qualified payment right.[47] That interest will be given zero value when determining the gift tax value of the transferred, nonpreferred interest.[48]

Alternatively, if the preferred interest also provides that if not paid in any year, it carries over into the next succeeding year in which partnership income is sufficient, this interest then should constitute a qualified payment right.[49] If the partnership does not have sufficient taxable income to make the distribution in any one year, then the regulations contemplate a four-year grace period in the making of the distribution.[50]

Maintaining Control

If the parents wish to retain control, then the preferred interest can be given management responsibilities. This can be done by establishing a limited partnership and structuring the preferred interest as the general partnership interest.[51] The general partnership interests would then have control over the partnership.[52]

Alternatively, with a general partnership, two classes of equity will be created, one representing the preferred interest and one representing the residual interest. If a general partnership is contemplated, then the retained preferred interest can have associated with it the rights to elect the managing partner.[53] A general partnership will be the preferred structure for §2701 partnerships when liability is not a concern.[54]

If the retained preferred interest is to have management rights, then the partnership should be structured to avoid §§2036(a)(2) and 2038 retained control and, in the limited partnership setting, §2704(a) lapsing rights.

Section 2036(a)(2) provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . under which he has retained for his life . . . the right, either alone or in conjunction with any other person, to *designate* the persons who shall possess or enjoy the property with the income therefrom.[55] (Emphasis added)

In essence, the objective is to prevent the transferor from having powers which would affect the donee's timing or enjoyment of income from the gifted property. Extraordinary management powers, such as the ability to: (1) allocate distributions in a manner not provided for in the partnership agreement; (2) withhold one or more partner's distribution when the partnership makes a distribution; or (3) unilaterally restrict the alienation of a partner's interest, could present §2036(a)(2) or §2038 problems.[56] Control restricted to ordinary business and investment management decisions which a general partner or managing partner typically has in a partnership, such as powers which are merely administrative or fiduciary in nature — the ability to determine investments and the management of those investments, to encumber or sell partnership assets, to hire agents and other employees, and to determine compensation — should not cause §2036(a)(2) concerns.[57]

Conversely, there is a concern if the transferor, as a general partner, controls whether the partnership makes a partnership distribution. Analogizing to the trust area, arguably this control is equivalent to a trustee's determination to distribute or accumulate income. The ability of the donor of property to decide, as trustee, whether to distribute or accumulate income has been held to be a transfer subject to §§2036(a)(2) and 2038.[58]

These trust rulings have not yet been extended to the partnership area. In private letter rulings, the Service has ruled that the ability of a general partner to control partnership distributions is not analogous to a §2036(a)(2) power because the general partner must adhere to fiduciary standards.[59]

If the parents retain management rights, these should be non-lapsing to avoid §2704(a) concerns.[60] Section 2704(a) provides, inter alia, that the lapse of a voting or liquidation right in a partnership is 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 both before and after the lapse. A voting right is any right to vote with respect to "any matter of the entity." [61] For example, the right of a general partner to participate in management is a voting right.[62]

The amount of the transfer is the value that disappears because of the lapsing right. This amount is the excess of (1) the value of all interests the individual holds in a partnership 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 (determined as if all such interests were held by one individual).[63]

The shift of a transferor from a voting control position to a minority position via the transfer of partnership interests with management rights to a member of the transferor's family will not invoke the statute.[64] A transfer that reduces an individual's aggregate voting power, however, is treated as a lapse of a liquidation right to the extent the transfer results in

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the elimination of the individual's right to compel liquidation of an interest other than the interest tied to the transferred voting power.[65] Accordingly, in a limited partnership, where the parent may hold both a general and limited partnership interest, §2704(a) could pose a problem; that should not be the result in a general partnership.

For example, assume D and his two children, A and B, are partners in partnership X. Each has a 3⅓% general partnership interest and a 30% limited partnership interest. The partnership agreement provides that when a general partner dies, the partnership must redeem the general partnership interest for its liquidation value. Under the agreement, only a general partner can liquidate the partnership. D dies. Under the agreement, only a general partner (not a limited partner) can liquidate the partnership. Therefore, the liquidation at death of the general partnership interest is a lapse of D's liquidation right with respect to his limited partnership interests since after his death, D's estate can no longer liquidate those interests.[66]

If the limited partnership rights include preferred payments, the value of these interests are decreased because the holder of the limited partnership interests no longer controls the partnership to ensure that those payments are made.[67] Section 2704(a) mandates ignoring this decrease, which causes a bizarre result. D will include in his estate the value of the limited partnership interests, assuming D has control of the partnership.[68] But D's beneficiaries will receive the limited partnership interests with no control. If the limited partnership units are valued in D's gross estate at X, but pass to his spouse at a value of X minus Y, only X minus Y qualifies for the marital deduction. As a result, the difference between these two values (Y) results in an estate tax even though the entire interest should have qualified for the marital deduction.[69]

Accordingly, the structure of the management rights must be carefully coordinated with the structure of the preferred interest to avoid a lapse with respect to the preferred interest. If the preferred interest has associated with it both management control and equity rights, and the preferred interest holder dies, the management rights should expressly not lapse. Accordingly, a limited partnership agreement should not convert the preferred general partnership interest to a limited partnership interest at death.[70] Also, if permissible, the general partnership interest should be, in the agreement, expressly transferable at death to third parties without losing its status as a general partnership interest.

Ensuring Partnership Treatment

Other partnership attributes should be followed to ensure that the arrangement is taxed as a partnership. If the arrangement is not a partnership or the preferred interest holder is not a partner, the transaction begins to resemble more closely a straightforward §2036(a)(1) transaction.[71]

Accordingly, the partnership should be structured so that the parents' retained preferred interest and the children's residual interest are true partnership interests. If the parents' preferred interest is represented by only guaranteed payment rights, and are not tied specifically to partnership net income, then the preferred interest resembles debt and the parents can be argued to be creditors, not partners.[72] Therefore, if guaranteed payments are used, the preferred interest holder should also be entitled to another equity right, such as a minimal percentage of net profits.[73]

In addition, the children's residual interest should be structured as a true partnership interest. Because the partnership will be among family members, at first glance §704(e)(1) appears to pose an obstacle to that structuring. Under that section, an interest will be recognized for income tax purposes as a partnership interest only if (1) a person is the real owner of the interest in partnership capital and (2) capital is a material income-producing factor.[74]

In light of two principles, §704(e)(1) does not pose a realistic concern in the §2701 partnership. First, §704(e)(1) was aimed at income tax abuses, where a parent was trying to shift income tax liability to the children, who were presumably at lower income tax rates.[75] There are no analogous income shifting desires in a §2701 partnership. The reverse could be true from a transfer tax standpoint. Economically, the parents would be better off if they paid income tax on the children's partnership interest.[76]

Second, §704(e)(1) imposes a "real owner of interest" test to qualify for partnership treatment. With a §2701 partnership, the objective is to transfer equity to the children, as residual interest holders. The children are intended to be (in §704(e)(1) vernacular) real owners of equity interests. Further, retained controls that could violate §704(e)(1) could invoke the §§2036(a)(2) and 2038 estate tax includibility sections, in contradiction to the overall goal of keeping transferred property out of the transferor's growth estate.

The §704(e)(1) regulations set forth various categories to review on a facts and circumstances basis [77] to determine if a person is the real owner of a general partnership interest.[78] Most relate to whether the donee has a substantial ownership interest and will be unambiguously satisfied in a §2701 partnership.

The first category of significance indicating that the donee does not have a substantial ownership interest is if the donor retains control of the transferred interest. Retention of control over the distribution of income indicates retained control.[79] The objective of a §2701 partnership is to generate enough in profits to satisfy the preferred payout requirements

and to realize capital appreciation on the remainder. Under the drafted §2701 partnership agreement, any income in excess of the preferred interest should be capable of being reinvested in the partnership without running afoul of the retained control concern.[80]

Another example of retained control is when the partnership agreement limits the right of the donee to liquidate or sell his or her interest "without financial detriment." [81] The objective of a §2701 partnership is to shift economic value to the donee's interest. Accordingly, any restriction financially detrimenting the donee's interest would be a non sequitur in the §2701 partnership setting.

Also, if the transferor's retained management powers are "inconsistent with normal relationships among partners," this is indicia that the donees do not have a sufficient ownership interest.[82] This means more than retention or control of business management or of voting control "as is common in ordinary business relationships." [83] A management power that prevents a partner from liquidating his or her interest without approval by the managing partner would be atypical and a problem under §704(e)(1). Such a power would also create a problem under §§2036(a)(2) and 2038 and be inconsistent with the goals of a §2701 partnership.[84] The retention of management powers that are atypical should therefore not be present in a properly planned §2701 partnership.[85]

A second category provides that indirect controls are treated the same as direct controls. Like the §§2036(a)(2) and 2038 problems associated with directly retained controls, indirectly retained controls present similar issues and should not be present in a §2701 partnership.

A third category is that the donees must have management participation rights.[86] In a general partnership, with each general partner voting on actions impacting the partnership, this criterion should be satisfied.[87]

A fourth category involves the actual distribution to a partner of a major portion of his or her distributive share of business income. In a §2701 partnership, a substantial majority of partnership net income will be distributed to the preferred interest holder to satisfy preferred or guaranteed payment rights.[88] The residual amount, if any, can be accumulated up to reasonable reserve amounts.[89]

A fifth category involves conducting the business in a true partnership form, including the filing of Form 1065s, written agreements, and general adherence to partnership formalities.[90] Section 2701 partnerships will comply with these formalities to evidence valuation compliance.[91]

Contributions to the Partnership

To enhance the transfer tax potential of the partnership, either cash or assets which show a substantial potential for appreciation should be transferred to the partnership.[92] Generally, no gain or loss will be recognized if property is contributed to the partnership.[93] Two important exceptions modify this rule. First, if assets with phantom income potential — liabilities in excess of basis — are contributed to the partnership, contribution of those assets may constitute taxable gain.[94]

Second, under §721(b) there will be gain recognition if the partnership is the equivalent of a corporate investment company.[95] This will occur if the partnership results in a diversification of the transferors' interests and the partnership has more than 80% of its value in assets held for investment that are readily marketable stocks or securities or interests in regulated investment companies or REITs.[96] Accordingly, when low basis property is contributed to the §2701 partnership, to avoid gain recognition the partnership should have at least 20% of its value in nonreadily marketable assets, such as real estate.[97] Also, if there is essentially only one contributor, then §721(b) should not apply because there has been no diversification.[98] The same is true if there are two or more transferors but each transferor contributes identical assets.[99]

VALUING THE TRANSFERRED RESIDUAL INTEREST IN THE PARTNERSHIP

The nonpreferred residual partnership interest may either be gifted or sold to the other family members. The valuation of the residual partnership interest, for gift tax or sales purposes, is made pursuant to §2701.[100]

Section 2701 [101] is the provision in Chapter 14 that is focused primarily on the valuation of equity interests in multitiered family partnerships. That section applies when a parent transfers certain partnership interests to the transferor's spouse, child, grandchild, child or grandchild of the transferor's spouse, or spouse of a child or grandchild (a "member of the family" [102]), and the parent retains an interest in the partnership after the transfer.[103] Specifically, if the parent retains an "applicable retained interest" [104] in the partnership after the transfer, the transferred interest may be subject to §2701. Application of that section will result in the use of special valuation rules to determine the value of the transferred interest.

To avoid applying the special valuation rules to nonabuse areas, certain types of transfers are expressly excluded from the application of §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 partnership.[105]

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Application of the Valuation Mandate

For those situations in which §2701 does apply, a multistep process is used to value the interests transferred to family members.[106] First, the aggregate value of all family held equity interests in the partnership is initially determined.[107] That valuation is pursuant to general principles, but assumes all interests are held by one individual.[108]

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) are subtracted.[109] 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." [110] Fair market value of these interests is determined in accordance with traditional valuation principles.[111]

Third, the value of all applicable retained interests held by the transferor or applicable family members, using the valuation rules in §2701, is subtracted from the fair market value of the above sum.[112] Under §2701, applicable retained interests held by the transferor which consist of extraordinary payment rights [113] are valued at zero.[114] 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." [115] A "qualified payment right," generally valued under traditional principles, includes 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.[116]

Accordingly, §2701 assumes that discretionary rights underlying applicable retained interests will not be exercised in the intrafamily situation. Only if the retained equity rights provide cumulative payment rights, at fixed amounts (or rates), 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.[117]

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.[118]

The following example illustrates the above-described methodology. P holds all 1,000 units in partnership X. The fair market value of P's family held interests in X is $1,500,000 (Step 1). P determines to engage in a leveraged gift transaction under §2701 and reconstitutes X, in a taxfree transaction,[119] to consist of 1,000 units of Class A partnership interests, which bear an annual preferred payment of $80 per unit, to the extent X has sufficient net income (and if net income is insufficient in any taxable year, the unpaid distribution rights carry over to the next succeeding year in which there is sufficient taxable income). The Class A interest also allows the holder to redeem the unit at any time for $1,500. X also consists of 1,000 units of Class B interests, which absorb any remaining rights. P transfers all of his Class B units to his children and retains only the 1,000 Class A units. Under §2701, the gift tax value of the Class B units is determined by subtracting from the value of the family held interests, $1,500,000, the value of P's retained Class A units (Step 2). The Class A units consist of two applicable retained interests, the annual preferred payment (which is cumulative if not paid) and the redemption right; accordingly, the units are valued pursuant to the special valuation rules set forth in §2701 (Step 3). The redemption right is valued at zero because it is an extraordinary payment right.[120] In contrast, because the preferred payments under the Class A units are cumulative distribution rights, the Class A units are ascribed a value for these purposes.[121] The value of the distribution rights (and therefore the retained Class A units) could approximate $800,000.[122] The gift tax value of the Class B units is thus $1,500,000 less $800,000, or $700,000 (Steps 3 and 4). Because 100% of the Class B units have been transferred, no minority discount is applicable (Step 5) and the value of the Class B units is not reduced.

PHASE TWO: TRANSFER TAX SAVINGS

Transfer tax savings versus an outright gift (outside of the partnership context) will be achieved in the §2701 partnership setting if the transferred, residual partnership asset increases in value at a sufficient rate.[123] The necessary rate is a variable and depends on the discount rate used in valuing the retained interest. Specifically, to the extent the partnership's rate of earnings exceeds the discount rate used in valuing the retained preferred interest, that excess rate will inure to the benefit of the holders of the transferred residual interest. Hence, in that instance transfer tax gain will have been achieved.

This conclusion follows from the methodology used in valuing the qualified payment right. That right is no more than a string of constant payments. 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.[124] 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 annuity.[125]

The Code and regulations provide no guidance as to what discount rate to use in valuing the retained qualified payment right. The §7520 rate,[126] used in other gift and estate tax contexts, is not necessarily reflective of the most realistic discount rate. Nor is a discount rate tied to a public market rate; distribution

rights in a family partnership context are more uncertain than those in a publicly traded corporation.[127] Conceptually, the starting point for choosing the discount rate could be public market rates, but that number should be increased to account for the uncertainty of whether the partnership will be able to make its payments.[128]

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, transfer tax gain will be achieved only if the value of the gifted interest is greater than its calculated gift tax value. This will occur if the discount rate used for gift tax valuation purposes exceeds the partnership's rate of earnings.

Assume that partnership P is created to have (1) 1,000 units of a Class A interest which bears an annual preferred payment right of $80 per unit and a liquidation preference of $800,000, and (2) 1,000 units of a Class B partnership interest which carries with it the residual value. The value of the company is $1,500,000. The Class A units are valued at $800,000 under section 2701.[129] The value of the Class B interest equals the residue, or $700,000, and these units are 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 growth of 12% of the partnership's value at the beginning of the year.[130] Therefore, assuming the payment each year of the Class A distribution, the value of P is $2,135,285 at the end of five years, illustrated as follows:

Beginning of Year	Value of Partnership At Beginning of Year	Increase in Partnership's Value at 12%	Payout to Class A Partner	Value of Partnership at End of Year
1	$1,500,000	$180,000	$80,000	$1,600,000
2	1,570,000	192,000	80,000	1,712,000
3	1,647,000	205,440	80,000	1,837,440
4	1,731,700	220,993	80,000	1,977,933
5	1,824,870	237,352	80,000	2,135,285

Based on the above, one may be inclined to conclude that there has been effective a gift taxfree transfer of $1,335,285 to the children. This appears to be so because the value of the Class A interest, using the same valuation methodology that was used during the partner'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 partnership, which is $2,135,285 less $800,000, or $1,335,285, is not included in the taxpayer's gross estate.

Despite the transaction resulting in transfer tax savings, that specific conclusion is incorrect. if $700,000 had been gifted outright in year one, that amount theoretically would also have grown by 12% over the next five years, to $1,233,639.[131] Accordingly, only the difference between $1,335,285 and $1,233,639 (the value of $700,000, the initial gift, increased at a 12% annual rate) is the true transfer tax savings. As a result, $101,646 [132] has passed to the donees free of transfer tax.

This conclusion can be arrived at in an alternative fashion. By the end of year five, the preferred holder has received $400,000 in payments, plus income and appreciation at 12% on the amounts received each year, which totals $108,228, and also has a retained interest valued at $800,000.[133] 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, to $1,308,228. At a 12% growth rate, the $800,000 would have equaled $1,409,873 at the end of five years.[134] This is $101,646 greater than the amount actually received by the preferred interest holder. The difference occurs because the annuity right was valued assuming the payments would yield 10% per year. The additional 2% per year in actual yield, $101,646 in the aggregate, has inured to the benefit of the residual interest.

Conversely, if the partnership's earnings are at a rate less than the discount rate used in valuing the retained preferred interest, then there will actually be negative leverage, or 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 partnership interests in a one-tier partnership with a gift tax value (assuming no minority discounts) equal to the gift tax value of the transferred interest in the two-tier partnership, less property would have been included in the transferor's gross estate.

If, in the previous example, P increased at a 8% rate instead of a 10% rate, P would equal $2,203,992 at the end of five years.[135] The retained interest would consist of $400,000 in payments, $59,328 in interest on those payments,[136] 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. $934,664 is less than

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the value of $700,000, the initial gift, increased at an annual 8% rate ($1,028,530).[137] As a result, $93,866 [138] less has passed to the donees than if P had only one class of partnership interests and the transferor made an outright gift of $700,000 of those partnership interests.

CONCLUSION

The retained interest family partnership — a sophisticated and rate-of-return oriented strategy — is a viable strategy to avoid the archaic and punitive application of §2036(a)(1). The partnership can be structured to allow the transferor of gifted property to retain, in effect, an interest in the gifted property. That interest will be a fixed dollar amount. Transfer tax benefits will be superior to that of an outright gift outside of the §2701 partnership area if the partnership grows at a rate in excess of the discount rate used in valuing the retained interest. If that occurs, the gifted interest may receive a substantial amount of the increase in value of the assets transferred to the partnership.

FOOTNOTES

 The author gratefully acknowledges the assistance of his colleague, John Hughes, for his insights on this article.

[1] For example, in 1987 Congress enacted §2036(c) (now repealed) which imposed estate tax on various lifetime transfers of property. But Congress did not address at that time how the estate tax was to be paid. Because the property had been transferred during life, the decedent did not own it at death and therefore could not use it to pay estate tax. Thereafter, Congress, realizing this omission, enacted §2207B, allowing that property to be reached to pay the estate tax.

[2] Technical corrections necessitated by the Tax Reform Act of 1986, P.L. 99-514, were still being incorporated two years later into the Code by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647.

[3] For example, §2035(d) was enacted into the code in 1981 to prevent gifts made within three years of death from being included in the gross estate. One exception that was carved out related to gifts of retained interests in trusts within three years of death, which were still includible. §2035(d)(2). However, the exception language was broad enough to cover even $10,000 per donee gifts from living trusts, of which there was no policy reason for inclusion. All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified. *See generally*, "IRS Rulings Demand More Careful Use of Revocable Trusts to Make Gifts," 17 *Est. Plan.* 332 (1990).

[4] The legislative history to this Act contains no references to §2036(a)(1).

[5] If the original transfer resulted in a taxable gift, inclusion of the asset in the transferor's gross estate under §2036(a)(1) will allow the transferor to receive a credit for the prior gift tax payable. §2001 (b)(2).

[6] For a general discussion of §2036(a)(1) and its raison d'etre, see Pedrick, "Grantor Powers and the Estate Tax: End of an Era?," 71 *N.W.U. L. Rev.* 704 (1977).

[7] A credit equal to the gift tax payable for a gift of $50,000 will be applied to the estate tax owed. §2001(b)(2).

[8] *See generally U.S. v. O'Malley*, 383 U.S. 627 (1966) (§2036(a)(1) reflects "legislative policy of subjecting to tax all property which has been the subject of an incomplete *inter vivos* transfer"); *Comr. v. Church Est.*, 335 U.S. 632 (1949).

[9] Tax Reform Act of 1976, P.L. 94-455, which unified the estate and gift tax rate structure. After that law, gifts during life are subject to the same tax rate structure as gifts at death. *See* §2001(b). Further, an individual is entitled to only one trip through the gift and estate tax brackets. *Id.* Congress intended to eliminate 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 1 976-3 C.B. 735, 741. *See generally* Isenbergh, "Simplifying Retained Life Interests, Revocable Transfers and the Marital Deduction," 51 *U. Chi. L. Rev.* 1 (1984).

[10] *See generally* "IRS Rulings Demand More Careful Use of Revocable Trusts to Make Gifts," 17 *Est. Plan.* 332 (1990).

[11] Retained interest trusts and purchased life estate, remainder interests, statutorily sanctioned by §2702, provide one alternative. For a discussion of these topics, see Blattmachr, "When Should Planners Consider Using Split Interest Transfers," 21 *Est. Plan.* 20 (1993). A §2036(a)(1) transaction is desirable for both tax and nontax reasons. On the nontax front, the transferor is to receive a stream of payments, *i.e.*, the income. On the tax side, the transaction may result in transfer tax savings. If the gifted property increases in value, that increase inures to the benefit of the donees, without any additional payment of gift tax. Nevertheless, that is not an abusive result because an equivalent result occurs with gifted property (with no retained interest). Moreover, a gift with a retained income interest perhaps may not be as desirable in saving transfer taxes as an outright gift. For example, if the gift tax value of the property is the full value of the property transferred, and the donor retains the right to income from the property, then the donor would have been better off from a transfer tax perspective by not retaining an income interest. By receiving income, the donor's gross estate is increased and the value of the gifted property is decreased.

The analysis as to the potential for transfer tax savings becomes more involved if, for gift tax purposes, the value of the transferred property is discounted because the donor retains the right to income. In that instance, whether the increase in value that inures to the benefit of the gifted interest will be greater than that associated with an outright gift with no retained interest will depend on two variables, the discount rate used in valuing the interest and the rate of growth (dividends plus capital appreciation) of the gifted interest. If the rate of growth is less than the discount rate, an outright gift would have generated a greater increase in value and would have been preferable from a transfer tax perspective; if the rate of growth is greater than the chosen discount rate, then the retained interest strategy will result in more transfer tax savings than an outright gift.

[12] PL. 101-508.

[13] The rules operate "by adopting valuation assumptions that take into account the likelihood that related parties will not exercise rights in an arm's length manner." *Fed. Est. & Gift Tax Rep.* (CCH) ¶11,860 (Mar. 24, 1990).

[14] For a discussion of the precursor to the retained interest partnership, what was often referred to as the partnership freeze, see Petrie, "Partnership Freezes: Determining When & How This Estate Planning Technique Should Be Used," 34 *Tax'n for Accts.* 226 (1985).

[15] The terms "transfer tax" and "transfer taxes" are hereinafter used to refer to estate taxes and gift taxes. The terms are not used herein to refer to the generation-skipping transfer tax.

[16] Allowing growth in the gifted asset to inure to the benefit of the donee is consistent with the 1976 transfer tax unification. 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 dies. The following example illustrates this concept. Donor A gratuitously transfers assets currently worth $600,000 to her daughter, D. Over the next 20-year period the value of these assets in D's hands grows from $600,000 to $3,000,000. At the end of this 20-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, 20 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 20 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.

In enacting a unified gift and estate tax system, Congress was no doubt aware of this disparity and concluded that the disadvantages associated with a lifetime gift outweighed, or at least equalled, the benefit of the freeze. House Ways and Means Committee Hearings on Estate and Gift Taxes, 94th Congress, 2d Sess. (1976). *See also* Surrey, "Reflections on the Tax Reform Act of 1976," 25 *Cleveland State L. Rev.* 303 (1976). 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.

[17] The discount rate used to value remainder interests is 120% of the federal midterm rate in effect for the month of the transfer. §7520.

[18] 6.655 shares times $10,000 per share = $66,550. At a 10% discount rate, the right to receive $66,550 three years in the future is $50,000 ($66,550 × $1/(1 + .10)^3$).

[19] The formula is dividends received plus earnings on these dividends plus face amount, or $50,000 + 5,000 + 5,000 + 5,000 + 1,550 = $66,550.

[20] *See* fns. 123 through 138, below, and accompanying text.

[21] The concept is reflected by a retiree's goal of retaining income to live on while transferring the underlying capital.

[22] As hereinafter discussed, if the individual's objective can be shifted from a retained "income interest" to a retained "annual fixed dollar amount," the retained interest partnership provides a workable strategy to avoid §2036(a)(1) concerns. Depending on the partnership's rate of earnings, that strategy may also result in greater transfer tax savings than an outright gift of an equivalent amount outside of the partnership setting. In that instance, the transferor's desire to shift future appreciation to the transferees may succeed, at least to an extent. This result occurs because there is no guaranty that valuation assumptions—even those mandated by §2701 of Chapter 14—will turn out to equal actual investment return rates. *See* fns. 123 through 138, below, and accompanying text.

[23] The transferors will hereinafter occasionally be referred to for illustration purposes as "the parents" and the transferees as "the children."

[24] Effective generally for transfers after October 8, 1990.

[25] *See* fns. 123 through 138, below, and accompanying text.

[26] The goal is to have the gift tax value of the transferred interest turn out to be lower than its actual future value. In that instance, there will be an inherent transfer of appreciation from the retained interest — valued for gift tax purposes by using assumed discount rates — to the transferred interest — whose value is represented by actual partnership return rates. This requires two influences: first, that economic changes to the partnership affect the retained and transferred interest differently, and second, that there be a disparity between the partnership's assumed rate of return for gift tax purposes, which has meaning in valuing the retained interest, and the partnership's actual rate of return, which will impact on the value of the transferred interest.

[27] The value of the transferred interest, regardless of the earnings of the partnership, will not be increased because of a gift tax valuation of the retained interest that, in actuality, turns out to be too low. For example, partnership P is worth $10,000 and has 100 units, 60 of which are owned by parent D and 40 of which D transferred to child C. The gift tax value of the transfer is 40% (40/100) times $10,000, or $4,000. The units are equal in all respects. Accordingly, C will receive 40% of all distributions (40 units C owns divided by 100 total units) and 40% of P on liquidation. In this regard, any growth in the value of P will inure 40% to the benefit of C. The gift tax value of the units owned by C will be at 40% of the total value of P. At any point in the future, C's interest will represent 40% of the then value of P, regardless of P's earnings. Accordingly, for gift tax purposes C's interest accurately represents current and future value.

Conversely, assume that 60 units of P allow D to receive preferred payments of $300 per unit per year (and a preference to the first $6,000 in liquidation). P is still worth $10,000. Assume the other 40 units entitle C to all other residual benefits from P. If a 5% discount rate is used to value D's units, then D's units are arguably worth $6,000 ($300/.05). *See* fn. 125, below. But if P earns 10%, then D's units were overvalued. Those units should have been valued assuming a 10% discount rate, or $3,000 ($300/.10). What happens, then, to the 5% (10% less 5%) disparity? In effect, that 5% is transferred from the retained interest to the transferred interest. *See* fns. 123 through 138, below, and accompanying text.

[28] *See* fns. 32 through 39, below, and accompanying text as to whether the preferred interest should be structured as guaranteed payments or limited by partnership net income.

[29] PLR 7824005 (value of 40% interest in farm land originally owned by decedent and transferred to a limited partnership includible in gross estate of decedent because "decedent intended to retain possession of the property until her death" and the limited partnership was not done for a business reason); PLR 7837003.

[30] In that instance, there is no transfer in which there can be a retained interest. Section 2036(a)(1) should be inapplicable on its face.

[31] Section 2701 is addressed at transfers in family owned partnerships or corporations where the parent transfers an interest to his or her children while retaining another, preferred interest in the same entity.

[32] §707(c). The term guaranteed payment is a misnomer. To qualify as a guaranteed payment under §707(c), the actual payment of cash is not required to be made with an accrual basis partnership contemporaneously with the income tax deduction by the partnership and income inclusion by the guaranteed partner.

[33] *Id.* A distribution by the partnership of appreciated property, rather than money, to satisfy its guaranteed payment obligation could result in gain recognition by the partnership, which, however, should then be offset by a deduction in the amount of the fair market value of the property. *See* McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶13.03[5].

[34] *See* Banoff, "Guaranteed Payments for the Use of Capital: Schizophrenia in Sub-chapter K," 70 *TAXES* 820 (12/92) in which it is argued that if the partnership invests entirely in tax-exempt bonds, §265 may preclude any deduction relating to guaranteed payments. *See also* Dees, "Now That The Monster Is Dead, Can You Avoid The Hotseat? The Cold Facts of Partnership Freezes under Chapter 14," 71 *TAXES* 902 (12/94), in which the author suggests that in an investment partnership, the deduction might arise under §212 and not §162. A deduction arising under §212 is subject to the 2% floor on deductibility.

[35] If the guaranteed payment exceeds taxable income, the resulting loss at the partnership level will be allocated to the partners (including the guaranteed partner) pursuant to the allocation provisions of the partnership agreement (assuming such provisions are respected as having substantial economic effect under §704(b)). Utilization of this loss by a partner may

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be delayed if a partner has insufficient basis in his interest, or if the passive loss or at-risk rules of §469 or §465 apply.

[36] This will depend on the allocation provisions in the partnership, which should in a §2701 partnership with guaranteed payments allocate taxable income and losses pro rata. The burden or benefit of taxable income or losses will then fall on the residual interest.

[37] See fns. 72 through 73, below, and accompanying text.

[38] See fns. 4 through 11, above, and accompanying text.

[39] If preferred payments are used, the tax provisions of the partnership agreement should allocate taxable income first to these payments and thereafter taxable income should be allocated pro rata among other partnership interests. In addition, the distribution provisions of the partnership should provide that the preferred partner receives a distribution of cash equal to his or her preferred income allocation (with make-up provisions if cash flow is insufficient).

If guaranteed payments are used, the making of that payment, if it constitutes a useable deduction, will operate to reduce partnership income. That result, in effect (though not in actual operation), allocates partnership income first to these guaranteed payments. *But see* fn. 36, above.

[40] If the retained preferred interest is treated as having no value for gift tax purposes, the transferred interest will carry with it the full value of the transferor's pretransfer interest in the partnership. *See* fns. 100 through 121, below, and accompanying text. From a transfer tax perspective, this will be deleterious and an outright gift transfer would be preferable to the §2701 partnership. For example, analogizing to the retained interest trust (GRIT) transaction under Chapter 14, assume a grantor transfers $1 million to a GRIT and retains the right to the income for ten years. The gift tax value of the transfer would be $1 million, the full value of the gift under §2702. In the best case scenario from a transfer tax perspective, assume the GRIT produced no income but only growth and at the end of ten years the $1 million doubled, to $2 million. This $2 million passes to the remainder beneficiaries at the end of the ten-year period free of additional gift or estate tax cost. That would be the same result if the $1 million were transferred outright (or in a nonretained interest trust) to the beneficiaries in year one, rather than establishing the GRIT. 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 ten years only $1 million passes to the remainder beneficiaries. In that situation, had the $1 million been transferred outright to the transfer beneficiaries in year one rather than via a GRIT, the remainder beneficiaries would have received the benefit of the $1 million plus all of the income from that amount during the ten-year period, at the same gift tax cost as establishing a GRIT under §2702.

[41] §2701(a)(3)(B).

[42] *Id.*

[43] §2701(c)(3)(A).

[44] §2701(c)(1).

[45] Regs. §25.2701-2(b)(4)(iii). This means that guaranteed payments, to be outside of the valuation rules of §2701, must provide for mandatory payments. A guaranteed payment that allows deferral will be an applicable retained interest. But in that instance, the guaranteed payment will constitute a qualified payment right.

[46] See fns. 100 through 121, below, and accompanying text. However, structuring the partnership with guaranteed payments may result in income tax disadvantages depending on the income generated by the partnership and the availability of a corresponding income tax deduction to the partnership of the guaranteed payment. See fns. 35 through 37, above, and accompanying text.

[47] §2701(a)(3)(A). This result follows because there is no assurance that the pertinent interest will be paid in any year; that determination is dependent on partnership earnings. Therefore, Congress felt that this type of retained interest was too subject to manipulation to be given a value for gift tax purposes. 1990 Senate Report on Proposed Revision of Estate Freeze Rules, 136 Cong. Rec. S515679 (reprinted in 835 T.M., *Estate Freezes (Chapter 14)*).

[48] See fns. 100 through 121, below, and accompanying text.

[49] This structure is analogous to preferred stock, which can only be paid to the extent of the corporation's earned surplus. Cumulative preferred stock constitutes a qualified payment right. *See, e.g.,* Regs. §25.2701-3(d), Ex. 1.

[50] If the distributions are ignored, ultimately this will be taxable in the gross estate (or as a taxable gift) of the preferred interest holder. *See* Regs. §25.2701-4(b).

[51] That interest would entitle the holder to both the preferred return and management control. There are variations on this theme. For example, the general partnership interest could be more limited in nature, entitling the holder to only an inconsequential equity interest, such as 1%, and management responsibility. The limited partnership interests could then be divided into two classes, one fixing distribution amounts and retained by the parents and one representing residual growth and transferred to the children. Alternatively, the general partnership interest could be structured as two classes, one with management responsibility and one representing the preferred return.

[52] In a limited partnership, responsibility for the management of the partnership's affairs is vested in the general partner. *See, e.g.*, §403 of the Illinois Revised Uniform Limited Partnership Act of 1986. *See generally* Dees, fn. 34, above, at 918, in which the author discusses the desirability of a limited partnership format over a general partnership when undertaking §2701 transactions. To the extent liability is a concern, a limited partnership offers advantages. A limited liability company offers even greater protection in that regard. *See* "What, me worry? Limited Liability for the Operation of Family Businesses Without Extra Tax Costs," 28 *Univ. Miami Inst. Est. Plan.* (1994) (hereafter "Limited Liability"). From a strict §2701 transfer tax standpoint, a limited partnership and general partnership should be equivalent.

[53] A partnership agreement can provide any method as to management. *See* Uniform Partnership Act §205/18. For administrative convenience, a general partnership typically provides that the affairs of the partnership are vested in one or more managing partners. A general partner still has the power (as opposed to the right) to bind the partnership. *Id.* §205/9. Also, absent a provision in the partnership agreement on management, all partners must participate in management decisions. *See, e.g., id.* §205/18.

[54] Typically, the general partnership will not have §2704(a) concerns, nor will there be an issue that the partnership is taxed as an association. *See* fns. 73 and 61 through 70, below, and accompanying text.

[55] §2036(a)(2). Section 2038 is also applicable. Section 2038 provides, "The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer. where the enjoyment thereof was subject the date of his death to any change through the exercise of a power ... to alter, amend, revoke, or terminate."

[56] Any management power which is not governed by a fiduciary standard, such as those set forth in the text, is subject to §2036(a)(2) or §2038 inclusion. *See, e.g., U.S. v. Byrum*, 408 U.S. 125 (1971); *Cohen Est. v. Comr.*, 79 T.C. 1015 (1982).

[57] *See Old Colony Trust Co. v. U.S.*, 423 F.2d 601 (1st Cir. 1970) (no inclusion in gross estate of trust property over which the grantor trustee had administrative powers over trust investment and power to allocate receipts and expenditures between income and principal); *Budd Est. v. Comr.*, 49 T.C. 468 (1968) (no inclusion even where administrative power to retain or invest in improper state law investments or to permit grantor to buy or sell from trust).

[58] *See, e.g., U.S. v. O'Malley*, 383 U.S. 627 (1966).

[59] *See Byrum v. U.S.*, 408 U.S. 125 (1972) (retained voting power not equivalent to a right to designate under §2036(a)(2)); PLR 9332006 (management authority over the partnership, including authority to control partnership distribu-

tions, did not constitute retained control since general partner occupied "a fiduciary position with respect to the limited partners"); PLR 9310039 (transferor, as general partner, retained right to make discretionary distributions to the partners at any time, thereby controlling the timing and amount of distributions, not a retained interest because general partner under a fiduciary duty to act in the best interest of all partners); PLR 9026021 (control over income receivable by transferee partners by transferor not a §2036(a)(2) power because under state law, "a partner owes a fiduciary duty to each of the other partners and must exercise good faith in matters involving the partnership"). *See also* Regs. §1.704-1(e)(ii), which provides that a donee will be treated as a partner for income tax purposes only if the donor has no retained control over the donee's interest (*i.e.*, the transfer vests "dominion and control of the partnership interest in the transferee"). Satisfaction of this test arguably precludes application of §2036(a)(2) or §2038. See fns. 79 through 80, below, and accompanying text. Nevertheless, the most conservative approach is for the preferred interest holder not to retain control over discretionary partnership distributions. Accumulating or distributing net partnership income should be at levels specifically set forth in the partnership agreement. Alternatively, those determinations should be vested in someone other than the parent.

[60] Section 2704(a) addresses the problem attacked by the Service in *Harrison Est. v. Comr.*, T.C. Memo 1987-8, and legislatively overrules the holding in that case. In *Harrison*, the decedent obtained during his life partnership interests with an aggregate value of $59,476,523. This amount represented the decedent's share of the partnership if the partnership was liquidated, and the decedent had the right during life to dissolve and liquidate the partnership. At the decedent's death, the right to dissolve and liquidate the partnership effectively ceased as to the decedent's interest in the partnership. As a result, the value of the decedent's partnership interests decreased from approximately $60,312,136, the value immediately before death, to $33,757,116. In effect, the 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. The Tax Court in *Harrison* refused to accept the Service's argument and held that for estate tax purposes, the value of the decedent's partnership interests was $33,757,116.

The problem identified 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. To address this problem, Congress in §2704 adopted the argument propounded by the Service—the same argument that was rejected by the *Harrison* court—that a right that lapses is given a value and treated as a taxable transfer at the time of the lapse.

[61] Regs. 25.2704-1(a)(2)(iv).

[62] *Id.*

[63] Regs. §25.2704-1(d). For example, if the facts of *Harrison*, fn. 60, above, had occurred after the enactment of §2704(a), the decedent's interest that lapsed at death (*i.e.*, the right to dissolve and liquidate the partnership) would be treated as a transfer and given a value for estate tax purposes. This value would be the value of all interests held by the decedent immediately prior to death (approximately $60,312,136) over the value of such interests after the lapse (approximately $33,757,116). As a result, the lapse would be treated as a transfer of $26,555,020, and that additional amount would be included in the decedent's gross estate.

[64] For example, analogizing to the corporate context, a parent who owns 51% of the common stock and transfers 2% of his stock to his children, so that they became 51% owners, effectively has transferred control, an event that could invoke the statute. Arguably, this situation represents a lapse of a voting right in that "voting control" is eliminated by the transfer of the stock. The Preamble to the Proposed Regulations, clarified that this is not the case: "Generally, a transfer of an interest conferring a right is not a lapse of that right because the right is not reduced or eliminated. For example, the transfer of a minority interest by the controlling shareholder is not a lapse of voting rights even though the transfer results in a transferor's loss of voting control."

[65] Regs. §25.2704-1(c).

[66] Regs. §25.2704-1(f), Ex. 5.

[67] What is the value of the decrease? The interest rate used to value the preferred, limited partnership units will increase by the uncertainly that these payments will be made. For example, the management right can direct that the partnership change a course of investments so that net profits are sufficient in any year to make the distribution of the preferred payment evidenced by the preferred class of the limited partnership units. The interest rate, see fns. 126 through 128, below, and accompanying text, can be correspondingly decreased by the ability to control the preferred payment.

[68] See fn. 63, below, and accompanying text.

[69] For a general discussion of this issue, see Caudill and Budyak, "New IRS Position on Valuation May Result in Reduced Marital and Charitable Deductions," 79 *J. of Tax'n* 176 (1993).

[70] If the preferred interest is represented by both general and limited partnership interests, then the general partnership interest, if it carries with it management rights, should be structured to avoid a lapse at death. If the state limited partnership act requires the transferee of a general partnership interest be admitted as a general partner, *i.e.*, allowing for the possibility of a lapse, the general partnership interest could be held by a corporation or trust so it does not become transferred at the preferred interest holder's death. Revised Uniform Limited Partnership Act (RULPA) §17-702(a)(2). Alternatively, the agreement could provide for the redemption at death of the entire preferred interest at fair market value.

[71] For example, the transaction becomes reduced to the contribution by the transferors of property to one or more transferees with the retention by the transferors of an equity interest in the actual property transferred, as compared to the retention of a separate interest in the partnership. Even if the transferees pay consideration for their partnership interest, the consideration must be "adequate and full" to remove the §2036(a)(1) problem. Under the reasoning of the Court of Claims in *Gradow v. U.S.*, 87-1 USTC, ¶13, 711(1990), consideration not equal to all partnership assets may not be adequate and full consideration.

[72] The Service could argue that the guaranteed payment evidences no more than straightforward debt, and that the interest holder has no rights in the partnership. *See, e.g.*, Rev. Rul. 75-35, 1975-1 C.B. 131.

[73] Even a 1% residual interest should be sufficient. *See* Rev. Proc. 89-12, 1981-1 C.B. 798; Rev. Proc. 74-17, 1974-1 C.B. 438. From a transfer tax perspective, those other retained equity interests should be as minimal as possible. Moreover, the partnership should be sure to have significant partnership attributes to avoid classification as an association, taxable as a corporation. Classification as a corporation could result in double taxation. The corporate attributes include, most importantly, free transferability, centralization of management, limited liability, and continuity of life. For a thorough discussion of these topics, see Limited Liability, fn. 52, above. Failure to meet at least two of these criteria will result in partnership classification. Regs. §301.7701-2(a)(3). This can occur in a limited partnership if the general partner is an individual and if the partnership does not deviate from the Uniform Partnership Act. *See* Regs. §301.7701-2(b), (c). Inability to have at least two of these attributes is basically always achieved in a general partnership.

[74] §704(e)(1); Regs. §1.704-1(e)(ii). Capital will be a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business. If capital is not a material income-producing factor, then recognition of a partnership interest for income tax purposes is pursuant to the more stringent, subjec-

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tive standard of *Culbertson v. U.S.*, 337 U.S. 733 (1949), which considered whether the parties in good faith and acting with a business purpose intended to join together in the conduct of an enterprise.

As a family partnership will most often own investment-type assets, such as a business, real estate, or a stock portfolio, and the revenues will not consist principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership, capital will most likely be a material income-producing factor. *See generally* Zaritsky, *Family Wealth Transfers*, ¶9.08.

[75] This concept had relevance before the Tax Reform Act of 1986. That Act introduced the so-called "kiddie tax," which taxes the income of a child under age 14 at the parents' highest marginal income tax rate. §1(i)(1986).

[76] *Cf.* "The Intentional Use of Tax Defective Trusts," *Univ. Miami Inst. Est. Plan.* (1992).

[77] Regs. §1.704-1(e)(2)(i) ("Isolated facts are not determinative; the reality of the donee's ownership is to be determined in the light of the transaction as a whole").

[78] Regs. §1.704-1(e)(2)(ii-vi). If a person is a donee or minor, additional tests are imposed. *See* Regs. §1.704-1(e)(2)(vii-viii). For a general discussion of this area, see *Zaritskv*, fn. 74, above. Further, the holder of the partnership interest needs to be the owner of a capital interest upon withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership. Regs. §1.704-1(e)(1)(v) (a donee owns an interest in the partnership capital if the donee will receive a portion of the partnership assets upon liquidation of the partnership).

In a limited partnership, fewer tests must be satisfied. Regs. §1.704-1(e)(2)(ix). The primary factor in the limited partnership is whether the partner's right to transfer or liquidate his or her interest is subject to substantial restrictions, such as where the interest is not assignable in a real sense or where such interest may be required to be left in the partnership for a long term of years.

[79] Regs. §1.704-1(e)(2)(ii)(a). The regulation does not prohibit the managing partner or partners from retaining income in the partnership in amounts that are reasonable for the needs of the business.

[80] *Id.* Further, in a §2701 partnership, the parent may not want to control the discretionary distribution of income from the partnership to avoid any §§2036(a)(2) and 2038 argument. See fns. 58 through 59, above, and accompanying text.

[81] Regs. §1.704-1(e)(2)(ii)(b).

[82] Regs. §1.704-1(e)(2)(ii)(d).

[83] *Id.*

[84] See fn. 56, above.

[85] See fns. 56 through 57, above, and accompanying text. Other tests of retained control include whether there is a retention of control of assets essential to the operation of the partnership, such as through a lease of assets to the partnership. Regs. §1.704-1(e)(2)(ii)(c). This retention presents analogous §§2036(a)(2) and 2038 concerns as a retained power to determine partnership distributions.

[86] Regs. §1.704-1 (3)(2)(iv). Retained management powers present no concern in the limited partnership setting. There, the limited partner may have no control over the partnership's management and this is permissible. Regs. §1.704-1(e)(2)(ix).

[87] Under the Illinois Uniform General Partnership Act, the agreement can spell out the management rights of the general partners or, absent any express partnership provision, all partners have equal rights in the management and conduct of the partnership business. §205/18

[88] See fn. 39, above.

[89] Regs. §1.704-1(e)(2)(ii)(a).

[90] Regs. §1.704-1(e)(2)(vi).

[91] Section 2701 requires strict adherence to preferred distribution requirements to avoid the application of transfer tax add-ons. Regs. §25.2701-4(a). The equity rights of all partners need to be specified and followed to achieve the potential transfer tax gain.

[92] See fns. 124 through 134, below, and accompanying text. Note also that encumbering property prior to its transfer will lower the eventual gift or sales value of the nonpreferred interest.

[93] §721(a). As cash has no inherent capital gain potential, a contribution of cash to the partnership will also not result in a taxable event. If the contribution is of appreciated property (for example, closely held stock, real estate, or securities), the subsequent sale of the property or distribution of the property to other partners can cause the contributing partner to recognize gain. *See* §§704(c)(1)(A)-(B); 707(a)(2)(B); and 737.

[94] *See* §§752(b) and 731. Gain results because the contribution of encumbered property is treated as a distribution of cash under §752(b) while the portion of such liability included in the contributing partner's basis is treated as an offsetting contribution of cash under §752(a). To the extent the net deemed distribution exceeds the remainder of the partner's basis, gain results.

[95] *See* §351.

[96] Regs. §1.351-1(c)(1).

[97] While not recognized upon contribution, built-in gain (*i.e.*, the appreciation inherent in the property at the time of contribution) will be allocated to the contributing partner at the time the property is sold by the partnership. §704(c)(1)(A). If the property is depreciable, a portion of the depreciation deductions generally is allocated to the noncontributing partners, until the contributing partner has, in effect, recognized the gain. In addition, §§704(c)(1)(B), 707(a)(2)(B), and 737 can cause gain recognition to the contributing partner in certain other cases.

[98] *See* PLR 9045064.

[99] Regs. §1.351-1(c)(5). *See also* PLR 9014030.

[100] That section contemplates a subtraction method, meaning that the value of the partnership as a whole less the value of the retained, preferred interest (valued pursuant to §2701 rules) yields the value of the residual partnership interest.

As the parents will retain a fixed amount from the partnership each year, the parents have achieved the first of their objectives. The parents should also retain an insubstantial additional equity interest to ensure qualification as a partnership. See fns. 72 through 73, above, and accompanying text. In order to understand whether the second objective can be achieved — transfer of future appreciation to the children — the §2701 valuation process must be understood.

[101] §2701.

[102] §2701(e)(1).

[103] The following discussion focuses on §2701's application to the partnership area. Section 2701 applies to the corporate area as well. The general operation of the statute to the corporate area 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 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 gift 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 (*i.e.*, the gift tax on $600,000 is $192,800, §2501, which is the amount shielded from the payment of gift tax by the unified credit, §2505). In this situation, the valuation rules under §2701 would apply and, because the noncumulative preferred stock is ascribed no value for gift tax purposes pursuant to §2701(a)(3)(A), the common stock carries with it the full value of the corporation, or $1,000,000.

[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"). §2701(b)(1)(B); Regs. §25.2701-2(b)(1)(i). 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. §§2701(b)(1)(A), 2701(c)(1)(A), 2701(b)(2); Regs. §§25.2701-2(b)(1), 25.2701-2(b)(2).

A right which is a (1) mandatory payment right (a right to receive payments required to be made at a specific time for a specific amount), (2) liquidation participation right provided the family does not have the ability to compel liquidation, or (3) 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. Regs. §25.2701-2(b)(4). Also, voting rights are not applicable retained interests.

[105] *See, e.g.*, Regs. §25.2701-(1)(c)(3). With 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 leverage potential and §2701 need not apply. See discussion immediately following text accompanying fn. 26, above. 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 interest in a partnership, the statute will not apply. *Id.* As with the above, there is no abusive leveraging potential with this type of transfer.

[106] Regs. §25.2701-3(b).

[107] 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" includes 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).

[108] *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 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).

[109] Regs. §25.2701-3(b)(2)(i).

[110] Regs. §25.2701-3(a)(2)(ii). An example of a senior equity interest (which is not an applicable retained interest) is a preferred partnership interest which requires a payment at a specific time in the future for a specific price.

[111] *See, e.g.*, Regs. §25.2701-3(d). Section 2701(c)(1)(B)(iii) specifically provides that in the partnership setting, a guaranteed payment, defined in §707(c), is not an applicable retained interest. Accordingly, a guaranteed payment which is structured so that it requires a payment of a specific amount at a specific time, should be subject to traditional fair market value principles and outside of the valuation rules of §2701. Interestingly, even if a guaranteed payment were governed by §2701, it would constitute a qualified payment right and therefore be subject to the same fair market value principles as a guaranteed payment not subject to §2701, with a few exceptions. First, a guaranteed payment that is a qualified payment right would, if not paid, be required to carry with it imputed interest for transfer tax purposes, *see* Regs. §25.2701-4, and second, a guaranteed payment would be subject to the ancillary valuation rules of §2701 such as the reduction in the value of the qualified payment right if an extraordinary right could be exercised in a manner to produce a lesser amount of property to the transferor. See fn. 116, below.

Rather than structuring the Class A interest as a guaranteed payment, the textual discussions that follow structure the Class A interest as being entitled out of partnership net income to a percentage preference of distributions, computed on a cumulative basis. To illustrate the transfer tax feasibility of §2701 partnerships, the discussion will assume that net income is sufficient each year to make the preferred distributions. For example, in the study accompanying fn. 129, below, the Class A interest has an 8% (of original capital) preference, cumulative. The distributions will be made only if net income is sufficient each year to make the distribution; however, for illustration purposes, net income will be assumed to be sufficient to make all distributions.

[112] 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.*

[113] See fn. 104, above, and accompanying text for a definition of "extraordinary payment rights."

[114] §2701(a)(3)(A); Regs. §25.2701-2(a)(1).

[115] §2701(a)(3)(A); Regs. §25.2701-2(a)(2). That zero valuation assumption will most often apply to noncumulative preferred stock or to nonguaranteed payments of income or principal from a partnership.

[116] 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. §2701(a)(3)(B); Regs. §27.2701-2(a)(3). This rule is intended to preserve the integrity of the arrived at valuation of the qualified payment right.

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 fn. 125, below, 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 residual partnership interests) 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. §2701(a)(4), Regs. §25.2701-3c.

[117] Regs. §25.2701-(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 §2701 at zero did not exist (or would be exercised in a manner consistent with the assumption of the rule of Regs. §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.*

[118] 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 §2701 and without applying a family attribution rule. *Id.* For a general discussion of minority discounts in the family control context, see Janiga, fn. 108, above.

[119] §708(b)(2)(A).

[120] See fn. 33, above.

[121] *See* §2701(a)(3)(A); Regs. §25.2701-2(a)(2).

[122] The statute provides no explicit methodology on how to value the Class A units in this scenario. The regulations contemplate that this asset will be valued by multiplying the

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expected stream of payments by a discount rate. *See, e.g.*, Regs. §§25.2701-2(a)(5), 25.2701-4(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 Class A units (*i.e.*, taking into account the risk that X may not be able to pay to P $80 per unit per year, as well as present and projected economic conditions, 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 Class A units is then $80 × 1,000 units × (1/.10) (the discount rate), or $800,000. See fn. 125, below.

[123] The discussion of transfer tax benefits focuses on the tax savings versus an outright gift or sale equal in value to the value of the residuary partnership interest. An equity interest that is transferred has the potential for appreciation and that appreciation will not be in the transferor's gross estate. Accordingly, the transfer tax savings discussed in this section are those savings above those experienced by appreciation. See fns. 129 through 134, below, and accompanying text.

[124] *See, e.g.*, Regs. §25.2701-2(a)(5). Despite grumblings by estate planning practitioners that the valuation methodology will be extremely complex and possible only with the aid of a computer, the valuation methodology appears straightforward. The only variable is the discount rate to be chosen.

[125] This is an author-derived formula pursuant to common algebraic principles. The formula for the value of an annuity for a term of years is the amount of the annual annuity (A) multiplied by:

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

Since "t" is assumed to 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 becomes A multiplied by:

$$\frac{1-0}{i}, \text{ or } 1/i$$

Generally, the lower the discount rate, the greater the value of the retained interest, and therefore the lower the value of the transferred interest. For example, 1/8% is greater than 1/10% (1/.08 equals 12.50, which is greater than 1/.10 which equals 10). 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.

[126] Section 7520, which requires 120% of the federal midterm rate then in effect as the rate to value various estate and gift tax interests. *Cf.* PLR 9324018 ("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.")

[127] *See, e.g.*, Rev. Rul. 83-120, fn. 122, above.

[128] *Id.* Also, there is a four-year grace period (*i.e.*, no interest) with regard to the making of qualified payments. §2701(d)(2)(C); Regs. §25.2701-4(c)(3). If the partnership agreement allows the partnership to defer making an annual preferred or guaranteed payment, without interest, during this four-year grace period, or if the earning potential of the partnership indicates that the four-year grace period may be necessary because net income may be insufficient to make a preferred payout, then clearly the discount rate needs to be adjusted, upwards, to account for the possibility that each guaranteed or preferred payment may be up to 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.

[129] See fn. 122, above. The liquidation preference is intended to preserve the integrity of the arrived at $800,000 valuation. The preference ensures that the Class A units will always be worth $800,000, even at liquidation.

[130] Note that a 10% rate was used in valuing the Class A units for gift tax purposes. See fn. 122, above. Accordingly, a 12% rate of growth exceeds the expected rate used for gift tax purposes of 10%.

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

[132] The difference between the amount that should have passed to the Class B interest holders ($1,233,639) and the amount that actually inured to the benefit of the Class B interest holders because of the §2701 transaction ($1,335,285).

[133] The $400,000 consists of $80,000 annually for five years. The $108,228 is arrived at mathematically by the following formula: $(80{,}000 (1 + 12)^4 = 80{,}000 (1 + .12)^3 + 80{,}000 (1 + .12)^2 + 80{,}000 (1 + .12) - 320{,}000)$.

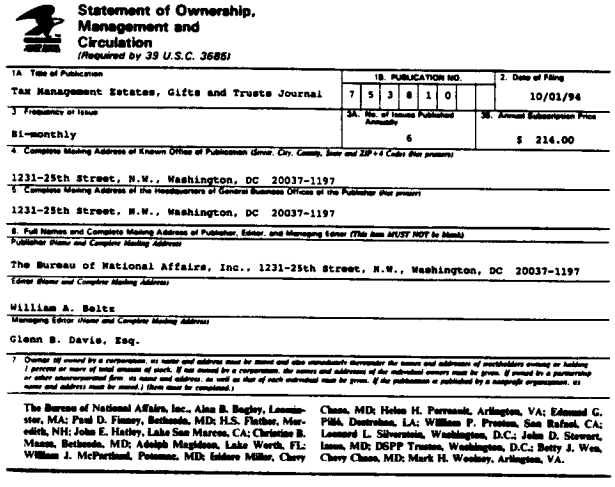
[134] Calculated by multiplying $800,000 × $(1 + .12)^5$

[135] Calculated by multiplying $1,500,000 × $(1 + .08)^5$.

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

[137] Calculated by multiplying $700,000 × $(1 + .08)^5$.

[138] $1,028,530 less $934,664 is $93,866.



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TRENDS AND TECHNIQUES

Significant Recent Trends and Innovations in Estate Planning

TAM Ignores Identity of Legatee in Valuing Closely Held Stock

In TAM 9432001, the decedent owned approximately 49% of the stock in a closely held corporation, and his son owned the remaining approximate 51%. The decedent's will left his 49% interest to his son. The Service ruled that the 49% block would be valued without taking into account the identity of the person inheriting the stock. The Service's analysis looked to Rev. Rul. 93-12, which ruled that the possibility of family control would not affect the valuation of minority-interest gifts in a closely held corporation.

Gifts Out of Revocable Trust Within Three Years of Death

Taxpayers and their advisors do not seem to be paying attention to the IRS' position, repeatedly stated and confirmed, that gifts made directly from a revocable trust within three years of the grantor's death will be included in the grantor's estate under §2035(d)(1).

In *Kisling Est. v. Comr.*, T.C. Memo 1993-262, *rev'd* 94-2 USTC ¶60,176 (8th Cir. 1994), the IRS sought to include in the grantor's estate transfers of irrevocable fractional interests in the trust effected by the grantor within the three years before death which were all within the $10,000 annual gift tax exclusion. The Tax Court agreed with the IRS; the Eighth Circuit recently reversed, justifying the result on the basis that the grantor had the power to make withdrawals from the trust without revoking it in its entirety and holding that when she assigned fractional interests in the trust she had created new, distinct trusts and therefore has, in effect, made a withdrawal followed by creation of trusts. The Eighth Circuit, citing its recent decision in *McNeely v. U.S.*, 16 F.3d 303 (8th Cir. 1994), noted that although the withdrawals in this case did not occur in the same manner as those in *McNeely*, the design of the decedent's trust accomplished the same result. Declining to draw a line that is "overly formalistic," the court concluded that the decedent's trust and transaction did not differ in substance from those in *McNeely*.

The IRS is going to attack distributions from revocable trusts to others besides the grantor that are made within three years of death and include the distributions in the grantor's gross estate. A discussion of the Eighth Circuit's opinion in *McNeely* and the IRS' positions in a variety of circumstances appears at *19 Tax Mgmt. Est., Gifts and Tr. J.* 109 (May-June 1994).

Whether or not the trust instrument authorizes the trustee to make distributions of corpus and income to persons other than the grantor, until the dust settles on this issue, prudence dictates that the trustee distribute cash or assets first and only to the grantor, who then can make the gifts. If the grantor is incapacitated, this still can be accomplished if the grantor has executed a general durable power of attorney that authorizes the agent to make annual exclusion gifts, or if the grantor's court-appointed guardian is granted authority to make the gifts. Until Congress addresses this problem, taxpayers will continue to encounter problems with the IRS, especially in today's atmosphere where it appears more and more clients are opting for and insisting upon the use of living revocable trusts in their estate plans.

Trust Advisory Fees — Fully Deductible?

The Sixth Circuit noted that individual investors are not required to consult investment advisors, are not required to diversify assets, and are not subject to liability if they fail to do so or act negligently. Since investment advisory fees would not have been incurred had the property not been in trust, the court held that the fees were deductible in full by the trust and were not subject to the §67(e)(1) 2% of adjusted gross income floor. *William J. O'Neill Jr. Irrevocable Trust v. Comr.*, 93-1 USTC ¶50,332 (6th Cir. 1993). (See Langstraat, "A Victory for Estates and Trusts: The Sixth Circuit Reins in the Tax Court," 19 *Tax Mgmt. Est., Gifts and Tr. J.* 106 (May-June 1994)).

The IRS recently has announced that it will not follow the Sixth Circuit's holding, so if fees are fully deducted, the IRS will challenge the trustee. *Non acq.*, 1994-38 I.R.B. 4.

Taxpayer May Recover Administrative Costs — But There Are Rules

Under §7430 of the Code, a taxpayer may recover from the IRS administrative costs on or after the earlier of the date of the taxpayer's receipt of a notice of decision from the IRS Appeals Office or the date of the deficiency notice, if the IRS' position is unreasonable. An executor recently tried an innovative

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argument: that the 30-day letter prompted the administrative costs provisions. However, the Tax Court disagreed, holding that where the case reached settlement before going to Appeals, the estate was not eligible for administrative costs. *Gillespie Est. v. Comr.*, 103 T.C. No. 20 (1994).

Editor's Note: John Grigsby, the author of the article "Supporting Foundations: An Alternative to Private Foundations for Achieving Charitable Goals," 19 *Tax Mgmt. Est., Gifts and Tr. J.* 162 (Sept.-Oct. 1994), inadvertently omitted acknowledgment of his significant reliance on Bjorklund, Victoria B., "When is a Private Foundation The Best Option?" 132 *Tr. & Est.*, No. 8, 12 (Aug. 1994), in the preparation of his article. The author regrets the omission.

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SELECTED RECENT DEVELOPMENTS

Legal Analysis of Current Legislative, Regulatory, and Judicial Developments

Fourth Circuit Applies "Relation-Back" Doctrine to Noncharitable Gifts by Check

In *Metzger v. Comr.*, affirmed by the Fourth Circuit, 1994-2 USTC ¶60,179 (4th Cir. 1994), the decedent's attorney-in-fact wrote four checks, each in the amount of $10,000, on December 14, 1985. Two of the checks were deposited on December 31, 1985, and cleared the drawee bank on January 2, 1986. In 1986, the decedent's attorney-in-fact wrote four checks in the amount of $10,000 each to the same four donees, and these checks were cashed in 1986. The decedent died in 1987, and the estate tax return reported no taxable gifts.

The Service took the position that, with respect to the two donees whose 1985 checks cleared in 1986, the checks dated in 1985 and the checks dated in 1986 all constituted completed gifts in 1986. Thus, according to the Service, the gifts by the decedent in 1986 to each of these two donees totalled $20,000, resulting in a $10,000 taxable gift per donee.

Before ultimately holding for the taxpayer, the Fourth Circuit (like the Tax Court) examined two issues. First, did the checks that were deposited in 1985 and cleared in 1986 result in completed gifts in 1985 or in 1986? Second, if the gifts were completed in 1986, would they be deemed to be made in 1985 under the "relation-back" doctrine?

The Fourth Circuit agreed with the Tax Court's determination that the gifts were completed in 1986. Although the checks were deposited on December 31, 1985, under state law, the delivery of the check is regarded as a conditional payment.

The Fourth Circuit then examined the second issue—whether the payment of the checks in 1986 "relates back" to the delivery and deposit of the checks in 1985. The relation-back doctrine has been applied in several charitable cases, and rejected in several noncharitable cases. In the charitable area, there is case law allowing an income tax charitable deduction in the year of deposit (although the check cleared in the following year). Similarly, there is case law holding that there would be no inclusion in a decedent's gross estate with respect to checks mailed to charitable donees prior to the decedent's death but not paid until after the decedent's death. On the other hand, there are several cases that have rejected the relation-back doctrine in the noncharitable context.

The Fourth Circuit agreed with the Tax Court's application of the relation-back doctrine to the noncharitable gifts made by the decedent in *Metzger*. The Court emphasized the circumstances in which the relation-back doctrine would be appropriate with respect to noncharitable gifts. The relevant factors were: (1) the decedent did not die until after the checks were honored; (2) the checks were deposited shortly after receipt; and (3) the delay in honoring the checks was beyond the control of the donees. Affirming the Tax Court, the Fourth Circuit stated:

> In such a limited circumstance, where noncharitable gifts are deposited at the end of December and presented for payment shortly after their delivery but are not honored by the drawee bank until after the New Year's holiday, we agree with the Tax Court that the gifts should relate back to the date of deposit.

Metzger is a helpful extension of the relation-back doctrine to year-end gifts designed to qualify for the annual exclusion. Notwithstanding the *Metzger* decision, if it is important that a gift be completed immediately, it is prudent to make the gift by bank check or wire transfer.

Gift Tax Lien — Collections and Liability

Section 6901(a) provides that when a gift tax is being assessed against the donee that this tax shall be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as would be the case for gift taxes being assessed against the donor. The taxpayer would assume, therefore, that the IRS could not collect a deficiency in gift taxes until and unless it has mailed a notice of deficiency and the time for filing a petition with the Tax Court has expired.

In *Ripley v. Comr.*, 102 T.C. 654 (1994), the Tax Court agreed with the IRS that it has independent and cumulative options for pursuing a deficiency in gift taxes: (1) it may seek to establish a general lien against the donee and then collect on that lien and this option requires the mailing of a statutory notice of deficiency; (2) it may simply levy against the donee, after the liability of the donor has been established, under the special 10-year gift tax lien of §6324; or (3) it may seek to collect under the general and special lien provisions at the same time.

Mrs. Ripley gave real estate to her son in 1983. Although she filed a gift tax return, the IRS disa-

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greed with her valuation and issued a notice of deficiency to her. In 1992, the Tax Court entered a stipulated order which established Mrs. Ripley's gift tax liability.

Nearly seven months later, the IRS mailed a notice of intention to levy to the son, for taxes and interest of approximately $655,000. The son petitioned the Tax Court for a redetermination; the IRS sought to enforce its lien; the son sought to restrain collection.

The Tax Court refused to restrain the IRS. In support of its decision, the Tax Court noted that the IRS does not need to send a deficiency notice to the transferee of estate property before collecting estate tax from the transferee, citing *U.S. v. Geniviva*, 16 F.3d 522 (3d Cir. 1994) (where no assessment had been mailed and, in fact, the time for making an assessment had now run; however, the executor had not filed an estate tax return until January 1985 for a woman who had died in 1981 and additional taxes, interest, and fraud penalties of approximately $275,000 had been assessed against the estate in 1987; by February 1993 this had grown to approximately $421,000; in April 1992 the United States filed suit seeking to hold the two children liable for the full $110,000 each had received from the estate; the children argued that the statute of limitations for assessing taxes against them had run; the Third Circuit upheld the government.)

A federal district court in North Dakota held in 1992 that an assessment must be made before the IRS can collect; however, the Third Circuit found that court's reasoning "unpersuasive." *U.S. v. Schneider*, 92-2 USTC ¶60,119 (D.N.D. 1992).

Be aware as well that the Eleventh Circuit has held that the donee's liability for interest on estate taxes can, when added to the underlying unpaid estate taxes, exceed the value of the property received by the donee, and that the donee is personally liable for the excess interest. *U.S. v. R. Baptiste*, 94-2 USTC ¶60,178 (11th Cir. 1994). The brother of that donee lives in the Eighth Circuit and his liability, including interest, is limited to the value of the property received from the estate. *U.S. v. G. Baptiste, Jr.*, 94-1 USTC ¶60,173 (8th Cir. 1994). There is now a dispute between circuits and the Supreme Court may be asked to resolve it. Such different results in the same family based upon exactly the same facts is quite disturbing to taxpayers and their representatives.

REVIEW OF ESTATES, GIFTS, AND TRUSTS LITERATURE

Books, Treatises, Studies and Periodicals

PERIODICALS

• "Proper Disposition of IRD Items Can Produce Tax Savings," by Ann C. Harris, 21 *Estate Planning* 276 (Sept.-Oct. 1994)

Income in respect of a decedent can create difficulties in estate administration. This article provides a basic review of income in respect of a decedent, focusing on a case study. Through the case study, the author identifies the items constituting IRD and analyzes the impact of those IRD items in funding the various trusts in the client's estate plan. This article will be a helpful introduction to, or review of, the fundamentals of planning for IRD.

• "Deductibility of Estate Planning Fees: An Old Strategy Revisited," by Louis S. Harrison and John M. Janiga, 8 *Probate & Property* 32 (Sept.-Oct.1994)

Billing is a necessary part of the estate planning process. To the extent that estate planning fees are deductible to the client for income tax purposes, the client's "pain" may be reduced. This article discusses the issue of the deductibility of estate planning fees. The article first discusses the impact of the limitations on "miscellaneous itemized deductions" (assuming the fees are otherwise deductible), and then distinguishes between those portions of the estate planning services that generate deductible fees and those portions that generate nondeductible fees. Most helpful, the article includes both a sample bill and a case study establishing a reasonable allocation between deductible and nondeductible fees.

• "Long-Term Care Insurance: Selecting the Right Policy," by Ann J. Pinciss, Stephen C. Harmelin and Margaret H. Kreiner, 8 *Probate & Property* 50 (Sept.-Oct. 1994)

Practitioners must sometimes advise their clients on long-term care insurance, an area with which many practitioners have little experience. After describing the limitations of Medicare benefits in this area, the authors describe eligibility for long-term care insurance, choosing the right insurance company, and the provisions the applicant should demand in a policy for long-term care. This article provided a helpful checklist which may be useful in analyzing and comparing long-term care insurance policies.

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