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ESTATE PLANNING TECHNIQUES AND I.R.C. 2036(c)

JOHN L. NELSON†

INTRODUCTION

It is said that there are only two certainties in life: death and taxes. A third certainty is that there will always be people trying to avoid the other two certainties. In the case of the estate planner, there is an admission that death will occur. One of the estate planner's goals is to prevent the imposition of taxes from occurring simultaneously with death.¹ The Internal Revenue Service (IRS), acting pursuant to the Internal Revenue Code of 1986,² makes its last attempt at taxing an individual at that individual's death. As a result, there has been a constant struggle between the IRS and the estate planner.

Recent and significant action in this struggle has been taken on behalf of the IRS by Congress. Section 2036(c) of the Internal Revenue Code came into law with passage of the Omnibus Budget Reconciliation Act (OBRA) of 1987.³ The statute was significantly modified by the Technical and Miscellaneous Revenue Act (TAMRA) of 1988.⁴ The purpose of the statute is to prevent the use of an estate planning technique known as an "estate freeze."

Estate planners use an estate freeze to lock in the value of a client's asset at a certain point in time and to have any further appreciation in value of that asset escape estate tax upon the client's death. Typically, the asset will be a successful business or an interest in real property expected to have substantial future appreciation. While the client is giving up the future appreciation of the asset, it is usually the intent of the client to


¹ See D. FREEMAN, ESTATE TAX FREEZE § 1.02(1) (1989).
continue to receive income from and to keep control of the business or the real property.

Congress was quite successful in accomplishing its goal when it enacted I.R.C. section 2036(c). The traditional estate freeze transactions have clearly been eliminated by the statute. In fact, Congress may have been too successful. Many non-freezing transactions come within the general rule of I.R.C. section 2036(c). While several safe harbors have been created for certain non-abusive transactions, there remain several uncertainties about the scope of the new law.

Two basic uncertainties can best be understood by posing the following questions: First, what estate planning techniques are available that will successfully keep post-transfer appreciation from being taxed in the client's estate, while at the same time allowing the client to receive income from and/or control of the asset being transferred? Second, how can you structure nonfreezing asset transfer transactions so that I.R.C. section 2036(c) is avoided? These questions, and some possible answers, are the focus of this article.

The first part of this article will describe several of the estate planning techniques used by practitioners prior to the passage of I.R.C. section 2036(c). Next, the article will analyze I.R.C. section 2036(c), describing the terms of the statute and when they will apply. Unresolved questions about the meaning of certain terms will also be discussed. Finally, the article will analyze what types of asset transfer techniques may still be available in spite of I.R.C. section 2036(c).

I. EXAMPLES OF COMMON ESTATE FREEZES

Prior to passage of I.R.C. section 2036(c), there were several estate freezing techniques used by estate planners to keep appreciation of property out of their clients' estates. A review of these techniques will aid in understanding the new statute. What follows is a brief description of three estate freezing techniques.

A. Corporate Freezes

Prior to passage of I.R.C. section 2036(c), the freezing of the value of a corporation involved a nontaxable reorganization under I.R.C. section 368(a)(1). Specifically, the corporation would recapitalize its stock. The typical person who would benefit from a recapitalization was an individual who owned a corporation and who wanted to have subsequent generations continue the business. The individual intended to transfer control of the business to the next generation at death or at some other point in the future, and wanted to do so with a minimum of tax. In addition to remaining in control, the individual wanted to continue receiving income from the corporation. The business was successful, and was expected to substantially appreciate in value.

Upon learning of these facts, the estate planner could suggest a recapitalization to achieve the individual’s goals. An example of this recapitalization would be to create two classes of stock, preferred and common. The preferred stock would be issued to the present owner of the business. The preferred stock would have a value that approximated the value of the corporation at the time of the corporate recapitalization. It would be preferred as to dividends in an amount that would give the owner the desired income stream. The dividends would be noncumulative, giving the owner flexibility in determining how much income was to be distributed. The preferred stock would also possess a majority of the voting power of the corporation. Finally, the preferred stock would have a liquidation preference as to the amount of its value when issued.

The second class of stock would be common stock. This stock would be transferred to the children. It would have no


7. Proper valuation of the stock is essential to ensure that the recapitalization’s gift tax consequences will be minimized. See D. Freeman, supra note 1, § 2.10, at 2-30.

8. In fact, one of the problems the IRS had with the use of the estate freeze was that the nonpayment of dividends further increased the value of the common stock at essentially no transfer tax cost. See H.R. Rep. No. 795, 100th Cong., 2nd Sess., 422 (1988) [hereinafter TAMRA H. Rep.] (stating “section 2036(c) was directed at two concerns. The first is that the creation or transfer of disproportionate interests in a business or other property often allows the transfer of wealth outside the transfer tax system, . . . because of action or inaction of the transferor or transferee after that transfer”). Id.
dividend rights, or would have dividend rights secondary to the rights of the preferred stock. Its liquidation rights would be the entire value of the corporation, less the preferred stock preference.9

As a result of the recapitalization, the present owner's interest in the corporation would be frozen. The preferred stock was included in the owner's estate. However, the value of the preferred stock was the value of the corporation at the time of the recapitalization. Any increase in value of the corporation subsequent to the recapitalization would result in an increase in value of the common stock, and thus was not included in the present owner's estate.

The use of corporate recapitalization as an estate freezing technique was closely scrutinized by the IRS.10 The IRS made several arguments in an attempt to include the appreciated value of the corporation in the decedent's estate. It was generally unsuccessful with those arguments.11

The law prior to I.R.C. section 2036(c) was that with careful drafting of the recapitalization agreement, this estate freezing technique would be successful and would avoid causing any post-transfer appreciation to be taxed in the individual's estate.

B. Partnership Freezes

The concept of the partnership freeze is similar to that of a corporate recapitalization. With a partnership, the two interests created were a limited interest and a general interest. The limited interest was similar to the preferred stock. It was specially allocated a certain amount of income,12 which gave the owner the desired cash flow. It had a preference on with-

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9. As a result, all of the appreciation resulting after the recapitalization will belong to the owners of the common stock.
11. See, e.g., Estate of Boykin v. Commissioner, 53 TCM (CCH) 345 (1987). In Boykin, a corporation had two classes of stock, each of which was viewed separately for determining a retained interest. Decedent owned 100% of nonvoting stock, but 0% of the voting stock. Therefore, the court held that there was no retained interest in the voting stock and it was excluded from decedent's estate. Id. at 349.
12. I.R.C. § 704(b) allows taxpayers to specially allocate income, gain, loss, deductions and credits of the partnership. The laws regarding this special allocation are extremely complex. See W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners § 10.02 (1977).
drawal equal to the value of the partnership on the date the limited interest was created. The total value of the limited interest was equal to the value of the partnership when the two separate interests were created.

The general interest was similar to the common stock. It had a liquidation preference equal to the entire value of the partnership, less the limited interest preference.

As with the corporate recapitalization, it was necessary that the agreement be carefully drafted to avoid a successful attack by the IRS. For estate planners, this was a relatively new estate planning technique, with little guidance or reliable authority.13

C. Sale of a Remainder Interest

Estate freezes utilizing the sale of a remainder interest usually involved property such as real estate. Typically, the estate planner’s client owned real property which was expected to appreciate substantially. The client wanted to retain until death both the property and the income generated by the property. At death, the client desired that the property transfer to the next generation.

The estate planner could suggest that the client sell a remainder interest in the property to the children. The client would own the life estate. Once the entire value of the property was determined,14 the value of each interest was determined by using the appropriate valuation table.15 The table valued each interest based upon the age (and therefore the life expectancy) of the holder of the life estate.16

As the holder of the life estate, the client had full control over the property, subject to state law restrictions such as not committing waste.17 All income from the property belonged to

13. See D. Freeman, supra note 1, § 1.05, at 1–13.
15. Prior to passage of OBRA, the appropriate valuation table was found in Treas. Reg. § 20.2031-7(f) (1984). OBRA § 5031 enacted I.R.C. § 7520 which prescribes that valuation tables are to be updated monthly, based on life expectancy and the appropriate interest rate that is in effect for the month the valuation event occurs. See I.R.C. § 7520(a)–(c) (West 1989).
16. Note that the life estate can be a joint life estate. For example, the remainder interest can be set up to be transferred after the death of both the transferee and the transferee’s spouse.
17. See Beliveau v. Beliveau, 217 Minn. 235, 14 N.W.2d 360 (1944) (duties of life
the life tenant and all deductions, such as depreciation, were taken by the life tenant.

Upon the death of the client, the property passed to the holders of the remainder interest. As the client had no interest in the property at death, its value was not included in the client's estate.\textsuperscript{18} The money received by the client upon the original sale of the remainder interest, and any income from it, was included in the client's estate, unless it had been removed from the estate by spending it or giving it away.

As with business freezes, a sale of a remainder interest was subject to close scrutiny and challenge by the IRS. Careful planning was essential, and even then this was an aggressive estate planning technique.\textsuperscript{19} However, if successful, it could significantly reduce a client's taxable estate.

\section*{II. Code Section 2036(c)}

\textbf{A. A Brief History}

The original version of the estate freeze legislation was enacted by the House of Representatives in October 1987.\textsuperscript{20} The House Committee Report\textsuperscript{21} made it clear that the House was

\begin{itemize}
  \item \textsuperscript{18} In general, an individual's gross estate includes all property in which the decedent owned an interest at death. \textit{See} I.R.C. § 2033 (West 1989).
  \item \textsuperscript{19} \textit{See} Gradow v. United States, 11 Cl. Ct. 808 (1987) for a decision shedding considerable doubt on the usefulness of this estate planning technique.
  \item \textsuperscript{20} \textit{See} Budget Reconciliation Act of 1987, H.R. 3545, 100th Cong., 1st Sess. § 10108, 133 CONG. REC. H9185, 9332 (daily ed. Oct. 29, 1987). The estate freeze provisions would have been added as new I.R.C. § 2211(b), reading as follows:
    \begin{itemize}
      \item (b) Limitations on Valuation Freezes.—
        \begin{enumerate}
          \item (1) In General.—If—
            \begin{enumerate}
              \item (A) any person holds a substantial interest in an enterprise, and
              \item (B) such person in effect transfers a disproportionate share of the potential appreciation in the enterprise, then the transferred property shall be included in his gross estate.
            \end{enumerate}
          \end{enumerate}
        \end{enumerate}
    \end{itemize}
\end{itemize}
concerned with corporate and partnership valuation freezes when it passed this law. The Senate tax bill, on the other hand, did not include any provisions regarding estate freezes. The subsequent Conference compromise, which resulted in OBRA, significantly expanded the scope of I.R.C. section 2036(c).

I.R.C. section 2036(c) was then amended by TAMRA. This amendment made several major changes. First, it dealt with any post-transfer transfers of the enterprise. Second, it created certain statutory safe harbor exceptions to the application of I.R.C. section 2036(c). Third, it dealt with the payment of estate taxes due to the transferred interest. Finally, it provided a period in which any prior transfers could be undone to avoid the application of I.R.C. section 2036(c).

There have been no changes to I.R.C. section 2036(c) subsequent to TAMRA. However, in 1989, the Senate Finance Committee proposed a bill which would have repealed I.R.C. section 2036(c) in its entirety, retroactive to the original enactment of the statute. No such provision was passed by the Senate or the House, and the repeal never became law.

No regulations have been issued by the IRS in regard to I.R.C. section 2036(c). However, IRS Notice 89-99 has been issued which interprets the meaning of several ambiguous terms and provides safe harbors in addition to those statutorily prescribed.

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23. See supra note 4 and accompanying text.

24. See Senate Finance Committee's Explanation of Title VI, reprinted in Revenue Reconciliation Bill of 1989, CCH Special 4, Vol. 76, No. 42, pt. 3, at 281 (CCH Oct. 11, 1989). Among the reasons for the repeal the Senate Finance Committee noted, was concern that the statute's complexity, breadth, and vagueness posed an unreasonable impediment to the transfer of family businesses. Many taxpayers uncertain about the scope of these rules have refrained from legitimate intrafamily transactions. The committee is convinced that additional technical and substantive modifications to the current rules would exacerbate rather than solve the current problems with the statute.

B. Description of the Statute

1. In General

The purpose of I.R.C. section 2036(c) is to prevent the removal of appreciation of an asset from an individual's estate if that individual continues to retain control or receive income from the asset. Generally, the new law applies when the owner of a substantial interest in an enterprise transfers a part of that interest, along with a disproportionately large share of the potential appreciation in that interest, while retaining income and/or rights in the enterprise. If such a transfer is made, then the retention of the interest is treated as retention of the enjoyment of the transferred property. Therefore, pursuant to I.R.C. section 2036(a), the value of the entire enterprise is included in the individual's estate, provided the other elements of I.R.C. section 2036(a) are met.

2. Substantial Interest

The only term that the statute itself defines is "substantial interest." A person holds a substantial interest in an enterprise if that person owns, either directly or indirectly, ten percent or more of the voting power, or income stream, or both, in such enterprise.

There is a special rule of attribution in the statute. An individual is treated as owning any interest in an enterprise that is owned directly or indirectly by any member of such individual's family. The statute defines family to include an individ-

27. Id.
28. I.R.C. § 2036(a) (West 1989) reads as follows:

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 (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

1) the possession or enjoyment of, or the right to the income from, the property, or
2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Id.
30. Id.
31. Id.
ual's spouse, any lineal descendant of the individual or the individual's spouse, any parent or grandparent of such individual, and any spouse of any of the foregoing. A relationship by legal adoption shall be treated as one by blood.\(^{32}\)

There are special rules regarding spouses. The statute reads that "[e]xcept as provided in regulations, an individual and such individual's spouse shall be treated as 1 person."\(^{33}\) The Conference Report to TAMRA\(^{34}\) indicates that spouses are to be treated as one if interests in enterprises are transferred between them in a manner that is not taxable, such as transfers qualifying for the marital deduction.\(^{35}\) Similarly, if the transfer between the spouses is taxable, then the spousal unity rule will not apply.\(^{36}\) A significant portion of Notice 89-99 is devoted to interpreting the spousal unity rule.

In its essence, I.R.C section 2036(c)'s spousal unity rule is designed to cause inclusion in at least one spouse's estate, and only one spouse's estate, should all of its elements be met. In fact, Notice 89-99 says that the principal purpose of the spousal unity rule is to identify the transferor for purposes of I.R.C. section 2036(c).\(^{37}\)

The statute and the relevant congressional reports are silent on the use of double attribution.\(^{38}\) In addition, the Conference Report to OBRA\(^{39}\) does not fully clarify what is meant by "indirectly." The OBRA Conference Report does say that an interest held indirectly by a person includes interests held by an entity in which such person has an interest.\(^{40}\)

Notice 89-99 does indicate how the IRS will apply indirect entity attribution. Notice 89-99 gives four examples of indirect entity attribution. For all entities except for an estate or trust,

35. Id. at 5136.
36. Id.
37. See Notice 89-99, supra note 25, at 14.
38. For example, if a child owns stock, the attribution rules of I.R.C. § 2036(c)(3)(B) would attribute ownership of that stock to the child's parent. Would attribution be applied a second time to attribute ownership of that stock down to a brother or sister of the child? See I.R.C. § 318(a)(5) (1988) for an example of double attribution rules.
40. Id. at 1742.
any interest is considered as owned proportionately by the owners of the corresponding interest in the entity. \textsuperscript{41} With an estate, any interest owned by the estate is considered as being owned proportionately by the beneficiaries of the interest. \textsuperscript{42}

Two separate rules are applied to trusts. Any interest in the income stream of an enterprise owned by a trust is considered as owned by the beneficiaries to the extent they are eligible or entitled, presently or in the future, to receive trust income or principal. \textsuperscript{43} Any voting power exercisable with respect to property held in trust, other than voting power held in a fiduciary capacity, is considered as held by the transferor to the extent the transferor or a member of the transferor’s family is entitled to exercise such power. \textsuperscript{44}

In addition to these attribution rules, Notice 89-99 also indicates that the IRS is willing to provide safe harbors for situations in which the transferor owns more than ten percent of an enterprise, but a significant number of unrelated parties also own interests, which limits the potential for an abusive transfer to occur. \textsuperscript{45}

3. Enterprise

One of the most significant terms in the new law is “enterprise.” While this term is not defined in the statute, it has been indicated elsewhere that the term is to be given extremely broad scope. The OBRA Conference Report indicates that an enterprise includes a business or other property which may produce income or gain. \textsuperscript{46} The usual focus of an estate freeze is on income-producing property which has the potential for substantial appreciation. It is difficult, if not impossible, to

\textsuperscript{41} See Notice 89-99, supra note 25, at 8.
\textsuperscript{42} Id.
\textsuperscript{43} Id.
\textsuperscript{44} Id.
\textsuperscript{45} Id. Footnote 19 of Notice 89-99 says that the IRS is considering a safe harbor for those situations when more than 50% of the voting power and more than 50% of the value of the equity interests in the enterprise are held by parties that are not related to the transferor and do not hold a substantial interest in the enterprise. This safe harbor would apply only if the equity owners unrelated to the transferor receive the same treatment in the transaction as those equity owners who are related to the transferor.
\textsuperscript{46} OBRA CONF. REP., supra note 39, at 1742.
conceive of any property that could be used in a freeze that does not fit the definition of an enterprise.

In spite of the broad definition of enterprise found in the OBRA Conference Report, the IRS has chosen to create exceptions. Notice 89-99 defines an enterprise as any arrangement, relationship, or activity that has significant business or investment aspects. Arrangements treated as trades or businesses under I.R.C. section 162, or property held for the production of income within the meaning of I.R.C. section 212, are considered activities which have significant business or investment aspects.

In contrast, an arrangement with respect to personal use property, as defined in I.R.C. section 1275(b)(3), is presumed to lack significant business or investment aspects. If the arrangement involves an individual's personal residence or a life insurance contract, as defined in I.R.C. section 7702, that presumption is conclusive. In all other cases, the presumption may be rebutted by demonstrating that the arrangement's personal use aspects are subordinate to its business or investment aspects.

4. Rights in the Enterprise

The OBRA Conference Report defines the term "rights in the enterprise" as including voting rights, conversion rights, liquidation rights, warrants, options and other rights of value. Thus, if an individual owns any of these contract rights, then the individual is deemed to own the underlying property interest. Neither the OBRA Conference Report nor the statute offer guidance on how these rights are to be treated relative to actual equity interests. Another question that needs to be answered is how broad the language "other rights of value" will be interpreted.

47. See Notice 89-99, supra note 25, at 7.
48. Id.
49. Id.
50. Id.
51. Id.
52. OBRA CONF. REP., supra note 39, at 1742.
53. Would an option to acquire voting stock be treated the same as ownership of the voting stock itself? How would you compare an interest that has voting control to one that has a preferential right to income? What are other rights of value? These and many other questions remain unanswered even after Notice 89-99.
Notice 89-99 does provide some limited exceptions to what otherwise may be considered other rights of value. One example of a potential retained right is the right to serve as a trustee or other fiduciary. However, Notice 89-99 indicates that this is not a right within the meaning of I.R.C. section 2036(c).

Notice 89-99 indicates that other rights of value are limited to rights that are intrinsic to an equity interest in an enterprise and similar to the rights specifically mentioned in the legislative history.

5. Transfers

In order for the statute to apply, a person has to "in effect" make a transfer. The term "transfer" is defined in the OBRA Conference Report as including all transactions whereby property is passed to or conferred upon another, regardless of the means and device employed in its accomplishment. As with the term enterprise, Congress has chosen to define the term "transfer" broadly. It is difficult to conceive of any means to directly transfer property from one person to another without coming within the definition of a transfer.

While the term transfer is defined in the OBRA Conference Report, there is no guidance as to what is meant by the term "in effect." Perhaps it is meant to cover indirect transfers that may not come within the broad definition of transfer. An example of this would be where an individual owns one hundred percent of the common stock in a corporation. The corporation adopts a plan of recapitalization where the stockholder exchanges common shares for preferred. The stockholder's children receive from the corporation the new common stock at its current fair market value. The preferred stock has income and voting rights, while the common stock has rights to subsequent appreciation. While the stockholder has not made a direct transfer to the children of a disproportionately large
share of potential appreciation, an in effect transfer was made.\textsuperscript{57}

Another example of an in effect transfer may be where a parent buys a life interest in property and the child buys the remainder interest, and the source of the children's funds for the purchase is a gift from the parent. It may be argued that the parent has in effect made a transfer of the remainder interest to the child.

The new statute applies regardless of the identity of the transferee; it does not have to be a family member. However, for a transfer other than to family members, there is an exception to the applicability of I.R.C. section 2036(c) if the transfer is a bona fide sale for adequate and full consideration in money or money's worth.\textsuperscript{58} This relief provision does not apply to a transfer of property to a younger generation within the family, which is the usual object of an estate freeze. However, there are special rules applicable to transfers between family members.

The statute does have an adjustment for transfers to a family member where the family member provides consideration. In order for the adjustment to apply, two requirements must be met. First, the family member must provide consideration in money or money's worth for the interest in an enterprise.\textsuperscript{59} Second, the consideration must have originally belonged to the family member and must never have been received or acquired directly or indirectly from the transferor for less than full and adequate consideration.\textsuperscript{60}

If these requirements are met, then a portion of the enterprise is not included in the transferor's estate. This amount is called by the statute the applicable fraction. This fraction is defined as follows: \textsuperscript{61} The numerator is the amount of consideration paid by the family member; The denominator is the value of the portion of the enterprise which would have been included in the estate of the transferor, immediately after the

\textsuperscript{57.} See Blattmachr & Gans, \textit{supra} note 5, at 13.

\textsuperscript{58.} I.R.C. \$ 2036(a) (West 1989) as a general rule does not apply to bona fide sales for full and adequate consideration. I.R.C. \$ 2036(c)(2) (West 1989) says that by definition a sale to a family member is not a bona fide sale for full and adequate consideration.


\textsuperscript{60.} See I.R.C. \$ 2036(c)(2)(B)(i)(II) (West 1989).

\textsuperscript{61.} See I.R.C. \$ 2036(c)(2)(B)(ii) (West 1989).
transfer, had this exception not applied.\textsuperscript{62}

The TAMRA Conference Report directs the IRS to promulgate regulations appropriate to demonstrate that the consideration originally belonged to the family member and was not received from the transferor. The Report indicates that the regulations could provide an elevated standard of proof for making this demonstration or they could create a presumption that consideration was received from gifts made by the transferor to the transferee within a certain period of time.\textsuperscript{63}

In Notice 89-99, the IRS does address these issues. A presumption is made that consideration furnished by the transferee comes from the transferor. To rebut that presumption, it must be shown that:

1) The transferee received property from other sources in an amount sufficient, considering only a reasonable rate of growth, to enable the transferee to accumulate consideration for the transfer; and

2) The transferee's ability to furnish the consideration was not dependant on the acquisition or receipt of property from the transferor during the three years preceding the transfer.\textsuperscript{64}

The IRS has provided several guides for applying the above rules.\textsuperscript{65} One of the most notable is that amounts borrowed

\begin{center}
\begin{tabular}{|l|c|}
\hline
Total value & $600,000$\\
\hline
Applicable fraction & \\
\textbf{Numerator (consideration paid)} & 100,000 \\
\textbf{Denominator (total amount included)} & 200,000 \\
\textbf{Fraction amount} & \(\frac{1}{2}\) \\
\hline
\textbf{Total included} & $300,000$
\end{tabular}
\end{center}

As a result of the transfer, one-half of the post-transfer appreciation has been removed from the parent's estate.

\textsuperscript{62} For example, assume a parent owns all the common and preferred stock in a corporation. The parent sells to the child all of the common stock for $100,000, its fair market value. The entire fair market value of the corporation is $200,000 at the time of the transfer. The $100,000 consideration furnished by the child was never received or acquired from the parent for less than full and adequate consideration. Upon the death of the parent, the corporation is worth $600,000.

Based on these facts, the amount included in the parent's estate would be determined as follows:

\begin{center}
\begin{tabular}{|l|c|}
\hline
Total value & $600,000$\\
\hline
Applicable fraction & \\
\textbf{Numerator (consideration paid)} & 100,000 \\
\textbf{Denominator (total amount included)} & 200,000 \\
\textbf{Fraction amount} & \(\frac{1}{2}\) \\
\hline
\textbf{Total included} & $300,000$
\end{tabular}
\end{center}

As a result of the transfer, one-half of the post-transfer appreciation has been removed from the parent's estate.

\textsuperscript{63} See TAMRA CONF. REP., supra note 34, at 5136.

\textsuperscript{64} Notice 89-99, supra note 25, at 16.

\textsuperscript{65} See id. Notice 89-99 states that

1) property acquired or received from the transferor includes property acquired or received from the transferor's spouse;

2) proceeds, income, and gain from property are deemed to be from the same source as the property from which they issue;

3) amounts borrowed from the transferor are deemed to be acquired or
from the transferor are deemed to be acquired or received from the transferor if the loan is a "gift loan" as defined in I.R.C. section 7872(f)(3). This would apply in any situation where a child is buying the common stock of a business from a parent and the payments of the purchase price are to come out of the earnings of the business.

In such a situation, if the sale price is not at fair market value, there would be a partial gift at the time of the sale and the transfer would not be for full and adequate consideration. If the interest rate were less than a market rate, the transaction would similarly be for less than full and adequate consideration. In either event, the entire value of the corporation may be included in the transferor’s estate, even if the value of the consideration furnished by the transferee is significant.

6. Disproportionate

The OBRA Conference Report defines “disproportionately large share of potential appreciation” as any share of appreciation in the enterprise that is greater than the share of appreciation borne by the property retained by the transferor. The potential appreciation transferred and the potential appreciation retained may not always be easy to determine. For example, there could be a situation where the preferred stock was to have rights to the first $1 million of liquidation proceeds and rights to all proceeds in excess of $5 million. The common

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66. "Id. I.R.C. § 7872 (Supp. IV 1986) generally is concerned with the treatment of loans at below-market interest rates. I.R.C. § 7872(f)(3) defines a gift loan as any below-market loan where the foregoing of interest is in the nature of a gift."

67. See Notice 89-99, supra note 25, at 15-16. Rather than an all or nothing approach, it may be that the transfer would be considered part gift and part for adequate consideration. In the example in note 62, if the transferee paid $50,000 for the $100,000 valued interest, the numerator of the applicable fraction should be adjusted accordingly. In the case of a gift loan, the result would not be as easy to determine.

68. See OBRA CONF. REP., supra note 39, at 1742.
stock would have rights to the proceeds in excess of $1 million up to $5 million. In such a case, it may not be possible to determine if either class of stock has a disproportionately large share of potential appreciation.

To solve this problem, Notice 89-99 adopts a "heads" the IRS wins, "tails" the taxpayer loses solution. Notice 89-99 applies to any situation where the participation in future appreciation is subject to change based on the passage of time, the aggregate amount of appreciation, or any other factor. In any situation where the amount of appreciation is determined, the determination of the transferor’s share is made by assuming circumstances that maximize the share of potential appreciation attributable to the transferor’s interest before the transfer and minimizes the share of potential appreciation attributable to the transferor’s interest after the transfer.69 Thus, there would be a disproportionate transfer if, as of any time and under any reasonably foreseeable circumstance, the transferor’s ratio of appreciation to value before the transfer is greater than the transferor’s ratio of appreciation to value after the transfer.70

Another major issue dealt with in Notice 89-99 concerns capital contributions to an enterprise. Notice 89-99 considers the situation where two or more persons contribute consideration to a common enterprise. At the time of contribution, each person originates a proportionate share of the rights inherent in ownership of the enterprise. Notice 89-99 states that if the persons divide the ownership rights in the enterprise disproportionately, the nature of their ownership interests change and this may result in a disproportionate transfer covered by I.R.C. section 2036(c).71 The result of this is that an individual can make a disproportionate transfer of property that the person never owned.72

69. See Notice 89-99, supra note 25, at 9.
70. Id. In the situation where the transferor’s common stock has the rights to the appreciation in excess of $1,000,000 up to $5,000,000, Notice 89-99 would assume that the maximum value of the corporation would be $1,000,000. This would maximize the transferee’s share of appreciation and minimize the transferor’s. In fact, the transferor’s share of appreciation would be zero.
71. Id. at 9–10.
72. See infra notes 90–92 and accompanying text.
7. Deemed Gift

Once a transfer has been made that is covered by I.R.C. section 2036(c), what happens when there is a subsequent transfer of either the transferred or retained interest? The result in this circumstance was unclear under the original version of I.R.C. section 2036(c), but TAMRA added a specific provision to cover this situation.\(^\text{73}\) This is known as the deemed gift provision. It applies if either the original transferor transfers any part of the retained interest or the original transferee transfers any part of the transferred property to a person who is not a member of the original transferor's family.\(^\text{74}\) At the time of either of these transfers, a deemed gift is made. As a result, the gift tax provisions of the Internal Revenue Code may also be brought into play by I.R.C. section 2036(c).\(^\text{75}\)

In general, the amount of the deemed gift is equal to the amount that I.R.C. section 2036(c) would have included in the transferor's estate had the transferor died at the time of the subsequent transfer. If the transferor or transferee make a subsequent transfer of only a portion of their interest in the enterprise, the deemed gift is only a proportional amount.

As a result of this deemed gift provision, once a disproportionate transfer has been made, there will generally be I.R.C. section 2036(c) inclusion, either by way of a gift tax or an estate tax.

8. Right of Recovery

TAMRA creates I.R.C. section 2207B,\(^\text{76}\) which essentially provides for a right of recovery for estate and gift taxes from the transferee for property which was included in the estate of the transferor due to I.R.C. section 2036(c).\(^\text{77}\) In the case of

\(^\text{73}\) See I.R.C. § 2036(c)(4) (West 1989).
\(^\text{74}\) See I.R.C. § 2036(c)(4)(A) (West 1989).
\(^\text{76}\) See TAMRA, supra note 4, at § 3031(f)(1) (codified at I.R.C. § 2207B (West 1989)).
\(^\text{77}\) I.R.C. § 2207B(a)(1) reads as follows:

If any part of the gross estate on which tax has been paid consists of the value of property included in the gross estate by reason of section 2036, the decedent's estate shall be entitled to recover from the person receiving the property the amount which bears the same ratio to the total tax under this chapter which has been paid as-

A) the value of such property, bears to
B) the taxable estate.
estate taxes, the transferor may direct by will or by provisions in a revocable trust, by making specific reference to I.R.C. section 2207B, that the provisions of I.R.C. section 2207B will not apply. This section will not apply to give a right of recovery against a charitable remainder trust.

9. Effective Date

When originally enacted, I.R.C. section 2036(c) was effective for estates of decedents dying after December 31, 1987, but only in the case of property transferred after December 17, 1987. For example, if the two classes of stock in a corporate freeze have been issued, but not transferred prior to December 17, 1987, the statute will apply.

The TAMRA amendments generally have the same effective date as the original I.R.C. section 2036(c). There are a couple of exceptions. The rules relating to the deemed gift provisions are effective for original transfers made on or after June 21, 1988. The right of recovery (which applies to all I.R.C. section 2036 transfers), is applicable to non-I.R.C. section 2036(c) transfers only after the date of enactment of TAMRA.

TAMRA also provided a correction period where a transfer could be undone to avoid a possible I.R.C. section 2036(c) inclusion. There were two possible actions that could have been taken. First, action could have been taken to have I.R.C. section 2036(c) not apply to the transaction. Second, the original transferor and spouse could dispose of their entire interest in the enterprise. The action must have been taken prior to January 1, 1990.

Finally, TAMRA provides a safe harbor for freezes that were completed prior to the effective date of I.R.C. section 2036(c). The safe harbor arises in situations similar to this: The owner of preferred stock has a right to a noncumulative dividend and decides not to declare the dividend. Because the dividend is

80. See OBRA, supra note 3, at § 10402(b).
81. See OBRA CONF. REP., supra note 39, at 1743.
82. See TAMRA, supra note 4, at § 3031(h)(1).
83. See TAMRA, supra note 4, at § 3031(h)(2).
84. See TAMRA, supra note 4, at § 3031(h)(3).
85. See TAMRA, supra note 4, at § 3031(h)(4).
not declared, the corporation in effect is increased in value by the money not taken out of the corporation. This increases the value of the common stock owned by the younger generation. An argument could be made that the older generation has in effect made a transfer by not declaring a dividend.

TAMRA says that in the case of a failure to pay dividends, that failure to pay will not be treated as a subsequent transfer. This safe harbor also applies to any failure to exercise a right of conversion or any other rights that could cause I.R.C. section 2036(c) to apply.86

III. WHAT IS LEFT AFTER I.R.C. SECTION 2036(c)?

I.R.C. section 2036(c) has significantly limited the ability of an individual to transfer an interest in property and at the same time keep control of and/or an income interest in the property and have all post-transfer appreciation kept out of the individual's estate. In each of the three estate freezing techniques described above,87 the transferor gives up more potential appreciation than income interest. As a result, all of the post-transfer appreciation will be taxed in the transferor's estate.

With a corporate recapitalization, the transferor gave up the entire right to appreciation, while keeping a large portion of the income. The same is true of the partnership freeze. Both fall squarely within the parameters of the statute.

With a sale of a remainder interest, again the income interest is retained while the appreciation has been transferred. With the broad definition of enterprise, it is clear that it includes real estate. Sales of remainder interests are also covered by the statute.

As long as the proportion of the income interest kept is greater than the proportion of the potential appreciation kept, I.R.C. section 2036(c) will cause the entire interest to be included in the transferor's estate. Another example of where the statute will apply is where a parent owns a substantial interest in a corporation and makes a gift of $10,000 worth of preferred stock to a child and the transferred stock has more rights to appreciation and less of income than any other rights.

86. See TAMRA, supra note 4, at § 3031(h)(5).
87. See supra notes 6-19 and accompanying text.
in the corporation that the parent owns. Nothing in I.R.C. section 2036(c) excludes gifts that qualify for the annual exclusion.88

What follows is a discussion of other potential family transactions and the application of I.R.C. section 2036(c) to them.

A. Split Purchases

I.R.C. section 2036(c) applies when an individual has made a transfer of an interest in an enterprise. If there has been no transfer, then the statute does not apply. One area that may not involve a transfer is a split purchase, although Notice 89-99 does take a contrary view.89 With a split purchase, the older generation taxpayer buys a life estate in property and the younger generation purchases the remainder interest in the property. There is no transfer from one generation to the next; there is a simultaneous purchase by each generation from a third party.

Notice 89-99 gives an example of a split purchase90 and indicates that this constitutes a disproportionate transfer of potential appreciation. Based on reasoning previously discussed,91 Notice 89-99 compares the proportionate undivided share of ownership rights in the enterprise originating with the purchase with the share of each right actually allocated to the transferor. Each purchaser has the potential to purchase an equal share of the income and the appreciation. However, in a split purchase, the transferor is getting none of the appreciation rights in the property. As a result, Notice 89-99 holds that a disproportionate transfer occurs.92

This reasoning of the IRS may be improper. In the House version of TAMRA, the substantial interest test was amended

88. See I.R.C. § 253(b) (1982).
89. See Notice 89-99, supra note 25, at 10. An issue arises as to what authority Notice 89-99 has. The IRS considers notices to have the same authority as revenue rulings and revenue procedures. See Rev. Rul. 87-138, 1987-2 C.B. 287. Notice 89-99 indicates that the notice is an administrative pronouncement and that the notice may be relied upon in the same manner as a revenue ruling or a revenue procedure. A position taken in a notice would generally be binding upon the IRS, but not necessarily upon the taxpayer. See Banoff, Dealing with the "Authorities": Determining Valid Legal Authority in Advising Clients, Rendering Opinions, Preparing Tax Returns and Avoiding Penalties, 66 TAXES 1072, 1102 (Dec. 1988).
90. See Notice 89-99, supra note 25, at 10 (example 16).
91. See supra notes 71-72 and accompanying text.
92. See Notice 89-99, supra note 25, at 10.
to apply if the transferor held a substantial interest either before or after the disproportionate transfer. The TAMRA House Report gives two examples of the application of this amendment. The first example concerns a parent who contributes cash or publicly traded securities to a corporation in exchange for preferred stock. The child owns the common stock. If, after the transfer, the parent or a member of the parent’s family together own ten percent or more of the voting power or income stream of the corporation, the substantial interest test is met. The second example is an example of a split purchase.

The Senate version of TAMRA did not have this provision. TAMRA does not contain the House language and the TAMRA Conference Report specifically says it does not adopt the House language, but the “conferees understand that section 2036(c) applies if a parent transfers an existing enterprise or assets from such enterprise to another enterprise in which a child owns a disproportionately large share of potential appreciation and in which the parent retains an income interest or other rights.” The split purchase example is not mentioned.

Additionally, a split purchase should be viewed in light of the purposes of the statute. Notice 89-99 indicates that Congress had three concerns in enacting I.R.C. section 2036(c): the undervaluation of property for transfer tax purposes; the shift of wealth without the imposition of a transfer tax; and allowing a transferor to exclude appreciation from his or her estate without parting with the enjoyment of the property. The split purchase does not raise any of these concerns.

There is no undervaluation issue here. The property is purchased at arms-length from a third party. Each interest is valued according to the appropriate valuation tables. As long as the transaction is bona fide, there is no valuation issue.

There has been no shift of wealth in a split purchase. Assuming that the child did not receive the consideration from

93. See H.R. 4333, 100th Cong., 2d Sess., 134 Cong. Rec. H6333, 6407 (daily ed. Aug. 4, 1988). Section 204(s)(4)(A) of this bill would have amended I.R.C. § 2036(c)(3), the provision which defines substantial interest.
94. See TAMRA H. Rep., supra note 8, at 424.
95. Id.
98. See Notice 89-99, supra note 25, at 5.
the parent for the purchase of the remainder interest, no wealth has been transferred from the parent to the child. If the parent did furnish the money for the remainder purchase, then the parent has shifted wealth to the child; the substance of the transaction is similar to the parent purchasing the entire interest in the property and gifting the remainder interest to the child.\textsuperscript{99} Without the furnishing of consideration by the parent, both parties have paid fair value for their respective interests in the property.

Finally, there is no appreciation excluded from the parent's estate. Instead, the parent has elected to purchase an asset that does not appreciate. This is quite different than taking an asset the parent currently owns and making a transfer to keep appreciation of that asset out of the parent's estate. The child has simply bought an asset that produces no current income. There are any number of assets that a person could buy that generate no current income and have the potential to appreciate in value.

Even though arguments exist to exclude joint purchases from I.R.C. section 2036(c), the IRS obviously does not agree with those arguments. As a result, the use of a joint purchase would be an aggressive estate planning technique.

\textbf{B. Outright Sale}

One technique for limiting the size of a taxpayer's estate that is still available is an outright sale of a business or income producing property to the younger generation. A complete sale for cash leaves the transferor with no interest in the enterprise and I.R.C. section 2036(c) would not apply. The issue is not as clear if the sale is on terms other than all cash. However, there is a specific statutory safe harbor that excepts certain noncash purchases from I.R.C. section 2036(c).\textsuperscript{100} The safe harbor is known as the qualified debt exception.\textsuperscript{101}

\textsuperscript{99} This would likely then be an indirect transfer under I.R.C. § 2036(c). See Gordon v. Commissioner, 85 T.C. 309 (1985) (Substance of transaction was that taxpayer purchased the entire bond and transferred remainder interest to trust. Trust never had funds of its own to purchase remainder interest.).

\textsuperscript{100} See I.R.C. § 2036(c)(7)(A)(i) (West 1989).

\textsuperscript{101} I.R.C. § 2036(c)(7)(C) reads as follows:

\begin{quote}
Qualified Debt.–For purposes of this paragraph ... the term "qualified debt" means any indebtedness if—
(i) such indebtedness—
\end{quote}
The statute lists several requirements for debt to be qualified debt. To be qualified debt, the debt must unconditionally require the payment of a sum certain in money in one or more fixed payments on specified dates and be for a term no longer than fifteen years (thirty years in the case of indebtedness secured by real estate). The debt can be payable on demand if it is issued for cash used to meet the normal business needs of the enterprise. The only amount that can be paid under the loan is interest at a fixed rate or at a rate which bears a fixed relationship to a specified market interest rate. The interest payment dates must be fixed.

The debt cannot be subordinated to the claims of general creditors. However, the debt can be subordinated to the claims of one or more specified creditors. The holder of the debt cannot be granted voting rights and the terms of the debt cannot place limitations on the rights of others to vote, unless

(I) unconditionally requires the payment of a sum certain in money in 1 or more fixed payments on specified dates, and

(II) has a fixed maturity date not more than 15 years from the date of issue (or in the case of indebtedness secured by real property, not more than 30 years from the date of issue).

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

(I) a fixed rate; or

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

(iii) the interest payment dates are fixed,

(iv) such indebtedness is not by its terms subordinated to the claims of general creditors,

(v) except in a case where such indebtedness is in default as to interest or principal, such indebtedness does not grant voting rights to the person to whom the debt is owed or place any limitation on the exercise of voting rights by others, and

(vi) such indebtedness—

(I) is not (directly or indirectly) convertible into an interest in the enterprise which would not be qualified debt, and

(II) does not otherwise grant any right to acquire such an interest.

The requirement of clause (i)(I) that principal be payable on 1 or more specified dates and the requirement of clause (i)(II) shall not apply to indebtedness payable on demand if such indebtedness is issued in return for cash to be used to meet normal business needs of the enterprise.

Id.

103. See I.R.C. § 2036(c)(7)(C) (West 1989).
107. See TAMRA CONF. REP., supra note 34, at 5134; Notice 89-99, supra note 25, at 12.
the debt is in default.\textsuperscript{108} Finally, the debt cannot be convertible into or have any right to acquire an interest that is not qualified debt.\textsuperscript{109} In addition to the statutory requirements for qualified debt, the legislative history adds one other. The debt must constitute debt within the generally accepted meaning of that term.\textsuperscript{110}

The Senate Committee Report indicates that there were several reasons for the qualified debt exception. Qualified debt is easily valued, it presents limited opportunity for the subsequent transfer of wealth and does not constitute retained enjoyment of the enterprise.\textsuperscript{111} Notice 89-99 says that these factors from the Senate Report will be used to determine if debt not coming within the statutory safe harbor is still not a I.R.C. section 2036(c) retained interest.\textsuperscript{112} The issue for planners, then, is how can you structure a sale in a manner most favorable to your client, while avoiding I.R.C. section 2036(c). Several alternatives may be available.

As a means of transferring wealth to the younger generation through an installment sale, the transferor has the option of cancelling any installments as they come due. This would still be income to the transferor but the installments give the transferor opportunities on an annual basis to make use of the $10,000 exclusion for gift tax purposes. Another possible option the transferor has is to make any notes cancellable upon the transferor's death, in order to keep the value of the installment notes out of the transferor's estate. This, however, is an aggressive estate planning technique.\textsuperscript{113}

\section*{C. Start-up Debt and Working Capital Loans}

TAMRA created statutory exceptions for the loaning of capital to a business for use within the enterprise. One of the ex-

\begin{itemize}
\item \textsuperscript{108} See I.R.C. § 2036(c)(7)(C)(v) (West 1989).
\item \textsuperscript{109} See I.R.C. § 2036(c)(7)(C)(vi) (West 1989).
\item \textsuperscript{110} See TAMRA H. REP., supra note 8, at 424-25.
\item \textsuperscript{111} See id. at 424.
\item \textsuperscript{112} See Notice 89-99, supra note 25, at 12.
\item \textsuperscript{113} See, e.g., Estate of Moss, 74 T.C. 1239 (1980) (self-cancelling installment note not included in decedent's estate; was a nonfamily transaction and a premium was built into the purchase price for the self-cancelling feature). \textit{See also} Rev. Rul. 86-72, 1986-1 C.B. 253 (gain is recognized in decedent's estate on amount of obligation cancelled at death); Notice 89-99, supra note 25, at 12 (self-cancelling installment notes do not meet the definition of qualified debt).
\end{itemize}
exceptions is called start-up debt.\textsuperscript{114}

For this exception to apply, the debt must unconditionally require the payment of a sum certain in money and be received in exchange for cash to be used in any enterprise involving the active conduct of a trade or business.\textsuperscript{115} In addition, the person making the loan must not at any time have transferred any property which was not cash to the enterprise or transferred customers or other business opportunities to the enterprise and has not at any time held an interest in the enterprise that was not start-up debt.\textsuperscript{116} The person receiving the debt must participate in the active management of the enterprise. Finally, the same rules for qualified debt relating to voting rights and conversion rights apply to start-up debt.\textsuperscript{117}

The IRS has expanded the availability of the start-up debt exception. Notice 89-99 modifies some of the literal language of I.R.C. section 2036(c) and provides further safe harbors. For example, Notice 89-99 determines that previous incidental transfers to the enterprise and transfers occurring in the ordinary course of business are allowable.\textsuperscript{118} Notice 89-99 also clarifies the start-up debt exception by noting that the exception is not limited to an actual start-up situation and that transfers occurring more than three years prior to the acquisition of the start-up debt will not be a prohibited transfer under I.R.C. section 2036 (c)(7)(D)(ii)(III).

Notice 89-99 also creates a limited safe harbor for certain preferred interests received in exchange for debt transferred to a new enterprise. The rules for this exception give it limited applicability.\textsuperscript{119} Essentially, the preferred interest must be structured just like debt. Perhaps the only benefit of a pre-

\begin{itemize}
\item \textsuperscript{114} See I.R.C. § 2036(c)(7)(D) (West 1989).
\item \textsuperscript{115} See I.R.C. § 2036(c)(7)(D)(ii)(I),(II) (West 1989).
\item \textsuperscript{116} See I.R.C. § 2036(c)(7)(D)(ii)(III) (West 1989).
\item \textsuperscript{117} See supra notes 108-09 and accompanying text.
\item \textsuperscript{118} See Notice 89-99, supra note 25, at 12. Incidental transfers include a parent making an automobile available for occasional use in a child's personal service business. \textit{Id.} at 7 n.15. Transfers occurring in the ordinary course of business include a child's restaurant purchasing fruits and vegetables from parent's wholesale market among other sources and a child's gasoline service station acquiring petroleum products from parent's tank farm even if parent is the only provider of petroleum products in the area (assuming that the parent provides products to other service stations owned by unrelated parties on similar terms). \textit{Id.} at 7 n.16.
\item \textsuperscript{119} See, e.g., Mahon, Blitzkrieg on Family Business, \textit{TRUSTS \\& ESTATES}, Feb. 1989, at 10, 16 ("Qualified start-up debt appears to be a safe harbor to be avoided.").
\end{itemize}
ferred interest is that it can be subordinated to the interests of creditors.

The other statutory exception concerns debt issued in return for cash to be used to meet normal business needs of the enterprise and the debt is payable on demand. In such situations, the debt must meet the requirements of qualified debt, except that the requirements that the principal be payable on one or more specified dates and that the debt have a fixed maturity are excepted.\textsuperscript{120}

\section*{D. Buy-Sell Agreements}

A common means of transferring business interests between generations is the use of a buy-sell agreement. I.R.C. section 2036 (c)(7)(A)(iii) creates a safe harbor for the use of buy-sell agreements. The safe harbor applies only if fair market value is paid for the property as of the time the purchase is consummated.

One of the principal purposes of a buy-sell agreement is to fix the price for the sale at the time of the agreement to help achieve certainty and to avoid difficult valuation issues at the time the sale actually occurs. However, with this statutory exception, it appears that the purchase price of the property subject to the buy-sell agreement cannot be finally determined until the sale itself occurs.\textsuperscript{121}

Notice 89-99 does provide limited relief from the strictness of this rule. A buy-sell agreement will qualify for this safe harbor if the sales price is determined by a formula that is based on currently acceptable valuation techniques and is reasonably expected to produce a valuation that approximates the fair market value of the property at the time the sale is consummated.\textsuperscript{122} Notice 89-99 further states that "[a] good faith buy-sell agreement that adopts a formula generally recognized as suitable to the valuation of the type of property involved and acceptable in arm's-length negotiations taking place at the time the agreement is executed meets the requirements of the safe harbor."\textsuperscript{123}

\begin{footnotes}
\item[120.] See I.R.C. § 2036(c)(7)(C) (West 1989).
\item[121.] See generally Hale, Hintze & Salley, Buy-Sell Safe Harbor Under Section 2036(c) Limited in Scope, J. Tax'N, July 1989, at 20.
\item[122.] See Notice 89-99, supra note 25, at 13.
\item[123.] Id.
\end{footnotes}
Prior to the passage of I.R.C. section 2036(c), there were two basic requirements for the price in a buy-sell agreement to be respected for estate tax purposes:

1) The decedent was obligated to sell the stock during lifetime to the other parties to the agreement at the same price as the price to be paid upon death; and

2) The agreement was entered into for bona fide business reasons, and not as a device to pass the value of a business to the objects of the decedent’s bounty for less than an adequate and full consideration in money or money’s worth.124

With the expansion of the safe-harbor by Notice 89-99, it is uncertain what the differences are between the old buy-sell rules and the new buy-sell rules.

E. Private Annuities

An option for the transfer of property that may still be available is the private annuity. In a private annuity, the older generation would sell an asset to the younger generation. The younger generation would pay for the asset by agreeing to make payments either for the life of the transferor or the life of the transferor and the transferor’s spouse.

All the elements of an I.R.C. section 2036(c) transaction are clearly apparent, with one exception. Has the transferor retained an interest in the income of or rights in the enterprise?125 The legislative history is silent as to whether an unsecured liability of the transferee would be a right to the income of the enterprise. Notice 89-99 says that “an interest in the income of an enterprise may be embodied in any form of interest (present or future), agreement, or arrangement, including, without limitation, a preferred equity interest in the enterprise, a promissory note, a life or term interest, an employment agreement, a retirement arrangement, a sale agreement, and a lease agreement.”126 This passage does not clarify the status of a private annuity. The only reference to a private annuity in Notice 89-99 is that it may be covered by I.R.C. section 2036(c).127 However, a private annuity should probably

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126. Notice 89-99, supra note 25, at 10, 11.
127. Id. at 5.
not be covered by I.R.C. section 2036(c).

With a private annuity, the only interest retained by the transferor is an unsecured promise by the transferee to make payments pursuant to the terms of the annuity.128 If the transferee defaults, the only recourse the transferor has is to sue the transferee. Once a judgment has been obtained, then the transferor may have the ability to use the enterprise as a means of collecting the judgment.

There is minimal potential for abuse with an annuity. The value of the annuity is based on the life expectancy of the transferor, and I.R.C. section 7520 prescribes tables which give the appropriate value. The only potential for abuse exists on the value of underlying property sold, but the potential exists equally in any transfer of property, including the statutorily created exceptions.

F. First Death Freezes

There may still be planning opportunities available with estate freezing upon the first spouse's death. For example, assume one spouse owns all the preferred and common stock of a corporation. At that spouse's death, the preferred stock passes to the surviving spouse and the common stock passes to the children. Notice 89-99 indicates that the surviving spouse will not be a transferor for purposes of I.R.C. section 2036(c).129 As a result, while all of the stock is included in the estate of the first spouse to die, only the preferred (non-appreciating) stock is included in the surviving spouse's estate. This post-death freeze will not work if the surviving spouse is given a nonfiduciary power to allocate the assets between the two shares.130

In the situation where the common stock is passed to the children, it could potentially have a value in excess of $600,000. As a result, there may be estate taxes owing on the death of the first spouse. Traditional estate planning strategy attempts to limit estate tax payments to the death of the second spouse. However, with assets that have large appreciation

128. The annuity cannot be secured. If it is, the entire gain may be recognized in the year of sale. See, e.g., 212 Corp. v. Commissioner, 70 T.C. 788 (1978); Bell v. Commissioner, 60 T.C. 469 (1973).

129. See Notice 89-99, supra note 25, at 15 (example 39).

130. See Notice 89-99, supra note 25, at 15 (example 40).
potential, it may be better to pay some tax at the first death, thereby avoiding a potentially larger estate tax at the second death. This possibility should at least be considered in any comprehensive estate planning analysis.

As with any first death planning, it is not always possible to predict who will die first. There are two possible approaches to take. The estates could be divided equally between the spouses, so that at least one-half of the corporation could be frozen at the first death. Otherwise, if there is a strong possibility that one spouse will die first, it may be appropriate to transfer the corporate stock to that spouse.131

G. Grantor Retained Income Trusts

One estate planning technique that was specifically left viable by a statutory exception was the grantor retained income trust (GRIT). In a GRIT, the transferor places property into a trust and retains an income interest for a specific term of years, or until the transferor’s death, whichever comes first. At the end of the term, the trust terminates and the property passes to the remainder beneficiary.

A GRIT presents two ways to save transfer taxes. First, the amount subject to gift tax is only the value of the remainder interest. That value is determined by subtracting the entire value of the property transferred to the trust by the actuarial value of the transferor’s retained income interest. The second tax savings occurs only if the transferor outlives the term of the trust. If this happens, none of the appreciation in value of the property is taxed to the transferor.

TAMRA created a specific safe harbor for certain GRITs.132 In order for the safe harbor to apply, the income beneficiary must have a qualified trust income interest, which is “any right to receive an amount determined solely by reference to the income from property held in trust.”133 In addition, the term of the trust can be no greater than ten years, the transferor must be the person receiving the income interest, and the transferor

131. Unlimited gifts can be made between spouses at anytime prior to death, without incurring a gift tax liability. See I.R.C. § 2523 (1982). As long as the transfer to the deceased spouse occurs one year prior to that spouse’s death, the stock retransferred back to the surviving spouse will get a step-up in basis. See I.R.C. § 1014(e) (1982).
133. Id.
cannot be a trustee of the trust. This exception was added to TAMRA by the Conference Committee and the legislative history on this provision is limited.

One common planning technique used with a GRIT is to give the transferor a contingent right of reversion or a contingent general power of appointment if the transferor died before the term of the trust ended. This would increase the value of the transferor’s retained interest, thereby decreasing the value of the gift of the remainder interest. Read literally, I.R.C. section 2036(c) would not allow the transferor to retain either of these interests. However, Notice 89-99 provides that a contingent reversion or general power of appointment will be allowed if the value of the reversion or power does not exceed twenty-five percent of the value of the retained income interest, determined without regard to the value of the reversion or power.

Congress indicated that the statutory exceptions are safe harbors and transactions that fall out of the safe harbors will not necessarily come within the reach of I.R.C. section 2036(c). Notice 89-99 indicates that the IRS will determine if a transaction that is not specifically covered by a statutory safe harbor will be reached by I.R.C. section 2036(c) based on an examination of all relevant facts and circumstances. One area of interest is how the IRS will consider the fact and circumstance of a trust established for longer than ten years.

There is no direct authority on the use of a GRIT of more than ten years. However, Notice 89-99 indicates that a trust would be considered an enterprise because it is an arrangement to hold and manage property. For example, assume a parent transfers $10,000 of stock of a publicly traded company to a GRIT, retaining an income interest for a period of fifteen years. Assume also that the actuarial value of the income interest exceeds ten percent of the value of the trust. Since it is the trust in which the parent has an interest, the parent then has a substantial interest in an enterprise. There has also been a dis-
proportionate transfer of appreciation, and a retained interest in the income of the trust. As a result, I.R.C. section 2036(c) would literally apply.

H. Employment and Other Agreements

Under a statutory safe harbor, the existence of an agreement for the sale or lease of goods or other property to be used in an enterprise or the providing of services to the enterprise will not be a retained interest if:

1) the agreement is an arm's length agreement for fair market value;
2) the consideration for the agreement cannot be determined by reference to gross receipts, income, profits or similar items of the enterprise; and
3) the agreement does not otherwise involve any change in interests in the enterprise.\(^{140}\)

In addition, for compensation for services performed after a transfer of an enterprise, the agreement cannot be for a term longer than three years.\(^{141}\)

Read literally, the statute seems to say that a parent cannot have such an agreement in conjunction with a transfer of the enterprise by the parent. However, Notice 89-99 only applies this requirement to the issuance of preferred stock and similar equity interests as compensation for entering into the agreement or for services performed under the agreement.\(^{142}\) If an agreement otherwise complies with the requirements of this safe harbor, but is in excess of three years, it will not be a retained interest if the agreement is terminable by the employer at will or for reasonable cause.\(^{143}\)

Notice 89-99 indicates that a covenant not to compete will be considered an agreement for the performance of services.\(^{144}\) Therefore, if an agreement for the transfer of an enterprise contains a covenant not to compete in order to get the transferee a current income tax deduction, the agreement cannot be no longer than three years.


\(^{142}\) See Notice 89-99, supra note 25, at 13.

\(^{143}\) Id. It has also been noted that the "term of the agreement does not include a period for which the agreement is extended by mutual agreement." TAMRA H. Rep., supra note 8, at 427.

\(^{144}\) See Notice 89-99, supra note 25, at 13.
I. Transfers of NonEnterprises

Notice 89-99 has carved out an exception to the definition of enterprise that will allow a freeze of some assets. For example, a person’s residence is not an enterprise. As a result, any freezing type transaction with a personal residence will not come under I.R.C. section 2036(c).

Perhaps the most significant nonenterprise, from an estate planning perspective, is life insurance. Notice 89-99 conclusively presumes that life insurance is not an enterprise. As a result, there are still options available for the use of life insurance as an estate planning device.

One example of the continued use of life insurance is the irrevocable life insurance trust. While not used as an estate freezing device, the irrevocable life insurance trust still could be covered by the literal language of I.R.C. section 2036(c).

With an irrevocable life insurance trust, the grantor of the trust either transfers money to be used to purchase life insurance or transfers an existing life insurance policy to the trust. The trust is irrevocable, and the grantor makes sure that he or she retains no incidents of ownership in the life insurance.

The grantor may on an annual basis transfer money to the trust sufficient to pay the premiums on the life insurance. The trust may contain a “Crummey” provision, which will allow the annual contributions to the trust to qualify for the annual gift tax exclusion.

Upon the death of the grantor, the life insurance will not be included in his or her estate, while the proceeds are distributed as if the insurance was owned by the grantor at death. Depending on the amount of insurance and the size of the estate, the estate tax savings can be enormous.

The enactment of TAMRA left the issue of the applicability of I.R.C. section 2036(c) to life insurance trusts in doubt. However, Notice 89-99 specifically gives an example of a life insurance trust.

145. See id. at 7.
146. Id.
147. If the transferor retains any incidents of ownership, the life insurance will be included in the transferor’s estate by reason of I.R.C. § 2042 (1982).
148. Named after the case Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). A Crummey power is essentially a right to demand a withdrawal from a trust. The right is only in existence for a limited period of time, and if it is not exercised, it lapses. This right to demand may be sufficient to consider a contribution to a trust to be a gift of a present interest.
insurance trust and indicates that I.R.C. section 2036(c) does not apply.\textsuperscript{149}

Another estate planning technique using life insurance is the split dollar policy. The split dollar policy is a way of shifting both the benefits and costs of life insurance among two parties. For example, a corporation will buy a life insurance policy on the life of an employee. The corporation will pay the premiums due on the policy, while the employee is the party who names the beneficiary of the policy.

On the death of the employee, the policy proceeds are split between the corporation and the beneficiary, with the corporation getting an amount equal to the premiums it paid with the remainder going to the beneficiary. This allows the employee to get a fairly significant amount of insurance at a relatively low cost.

As with life insurance trusts, the use of split dollar is not an estate freezing device. However, because of the split ownership feature, there is a sort of transfer of disproportionate appreciation, and an argument could be made that I.R.C. section 2036(c) should apply. However, there is a specific example of split dollar insurance in Notice 89-99, and the Notice indicates that I.R.C. section 2036(c) is not applicable.\textsuperscript{150}

\textbf{J. Transfers That Are Not Disproportionate}

If a transfer is not disproportionate, I.R.C. section 2036(c) does not apply. For example, if the parent transfers fifty percent of the income and fifty percent of the appreciation, there has been no disproportionate transfer. As the parent gets older, the amount of income needed will presumably decrease, thereby allowing further proportionate transfers. If the business is increasing in value, the value of the transfers will also increase, using up a larger amount of the parent’s unified credit. However, with transfers made on an annual basis, there will be the continued use of the annual exclusion amount.

\textbf{K. Office Furniture Exception}

One area of concern for newly graduated law students is how to furnish their new offices. It has been common for parents

\begin{footnotes}
\item[149] See Notice 89-99, \textit{supra} note 25, at 7, 8 (example 7).
\item[150] Id. at 8 (example 8).
\end{footnotes}
either to loan or give children furniture to use in the child’s law practice. However, with the passage of I.R.C. section 2036(c), there was some concern that this practice would be covered by the statute. It appeared that the loaning of furniture to the law practice would make the parent a transferor with regard to the enterprise.151 With the rules of attribution and the lack of an exception for bona fide transfers between family members, there was a strong possibility that the entire value of the law practice would be included in the parent’s estate.152

Concern over this issue was so great that representatives from student bar associations throughout the country lobbied heavily with the IRS for a satisfactory resolution of this important issue. The IRS was originally planning to consider such furniture transfers to be within the ambit of I.R.C. section 2036(c), but this view was eventually tabled. The IRS finally resolved that “the fact that parent gives or loans office furniture to child for use in child’s law practice does not make parent a participant in child’s enterprise.” 153

**Conclusion**

I.R.C. section 2036(c) appears to have put an end to the traditional forms of estate freezes. How far it has gone beyond this is uncertain. Even with the legislative history and Notice 89-99, there is still considerable uncertainty regarding the scope of I.R.C. section 2036(c). Options are available that accomplish some, but not all of the goals of an estate freeze. However, until there is further clarification of the statute, the estate planner will be unable to predict the results of any transaction not falling precisely within one of the safe harbors.

151. It was always assumed that the graduating law student’s practice was property which may produce income or gain.
152. It was always assumed that this value would be significant.