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### To Share or Not to Share: The Inadvertent Reach of the New Estate Freeze Statutes

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# TO SHARE OR NOT TO SHARE: THE INADVERTENT REACH OF THE NEW ESTATE FREEZE STATUTES

## I. INTRODUCTION

The transfer of family wealth is an underlying theme in Shakespeare's play, *Hamlet*.<sup>1</sup> After Hamlet's father met an unexpected death in the garden, his father's estate, the entire country of Denmark, passed to Hamlet's mother. Perhaps, since there is no mention of an estate tax, this was an early version of the unlimited marital deduction.<sup>2</sup>

When Hamlet's mother decided to marry Hamlet's deceased father's brother, Hamlet saw his position as chief executive officer of Denmark snatched away. Needless to say, Hamlet was distraught. In fact, he believed that he had seen his deceased father walking the towers and speaking to him. In order to maintain his sanity, Hamlet looked deep within his soul and reduced his problem: "to be or not to be, that is the question."<sup>3</sup> Interestingly, if Hamlet had been a scholar of Chapter 14 of the Internal Revenue Code,<sup>4</sup> he may have rephrased his dilemma: "to share or not to share in the growth or profits of the business, that is the question."

Section 2701 of Chapter 14<sup>5</sup> establishes the estate and gift tax consequences<sup>6</sup> of a transfer of all or part of a business from a parent to the next

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1. WILLIAM SHAKESPEARE, *THE TRAGEDY OF HAMLET, PRINCE OF DENMARK* (John D. Wilson ed., Cambridge University Press 1948) (1605).

2. I.R.C. § 2056 (West Supp. 1992). Essentially, § 2056 allows transfers of assets between spouses without any gift or estate transfer taxes. This makes the husband and wife one economic unit for transfer tax purposes.

3. SHAKESPEARE, *supra* note 1, at 60.

4. I.R.C. § 2036(c) was repealed retroactively to transfers after December 17, 1987 by the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11601, 104 Stat. 1383 and was replaced with Chapter 14 of the Internal Revenue Code, which included I.R.C. §§ 2701-2704 (West Supp. 1992). All transactions that occurred between December 17, 1987 and October 8, 1990 will be treated under the law as it existed prior to § 2036(c). *Id.*

5. See *supra* note 4.

6. I.R.C. §§ 2001, 2501 (West Supp. 1992). A federal gift tax is imposed on transfers by gift during life, and the federal estate tax is imposed on the taxable estate at death. The estate tax and the gift tax are unified so that a single progressive rate schedule is applied to an individual's lifetime and death transfers. The unified transfer tax rates, which currently reach a top rate of 55%, encourage the use of estate planning techniques to reduce the estate taxes and to preserve wealth within a family unit. One widely used approach attempts to minimize the transfer tax value of

generation. However, section 2701<sup>7</sup> is so broad that many routine transactions, such as the redemption of a corporation's stock, the formation of a new business,<sup>8</sup> or transactions between a parent and a child that utilize debt rather than equity--if the debt is recharacterized as equity--may find themselves ensnared within the scope of section 2701.<sup>9</sup> Section 2701 treats these transactions as preferred stock recapitalizations.<sup>10</sup> Thus, transactions falling within the sweep of section 2701 result in unexpected gift or estate taxes.<sup>11</sup> The broad<sup>12</sup> and inadvertent<sup>13</sup> impact of these statutes must therefore, be understood not just from an estate planning standpoint, but also from a general business planning perspective.

Recapitalization<sup>14</sup> of a corporation was a method commonly used by parents to transfer their business to their children while allowing the parents to maintain some degree of control over the business. Until 1987, recapitalization was a popular technique.<sup>15</sup> The parent recapitalized the business into common stock<sup>16</sup> and preferred stock<sup>17</sup> and then exchanged the old common stock for

certain assets, which are typically business interests, by shifting the future appreciation in the value of those assets to the owner's descendants and other family members.

7. See *supra* note 6. This note will deal primarily with § 2701. See *infra* note 100 (providing a brief discussion of §§ 2702, 2703 and 2704).

8. See *infra* notes 218-48 and accompanying text (discussing certain common business transactions covered by § 2701).

9. For example, when a parent lends money to a new corporation that is owned by his child, the loan could be recharacterized as equity by the Internal Revenue Service [hereinafter IRS] (discussed *infra* at notes 241-48 and accompanying text). The transaction now falls within the scope of § 2701 because the parent has made a taxable gift to his child.

10. See Appendix A (describing a typical recapitalization). For further discussion of recapitalizations, see *infra* notes 55-66 and accompanying text.

11. See *supra* note 6.

12. See *infra* notes 218-48 and accompanying text.

13. See *infra* notes 218-48 and accompanying text.

14. See *supra* note 10; see also I.R.C. § 368 (West Supp. 1992) (defining various corporate reorganizations).

15. In 1987, Congress passed I.R.C. § 2036(c) (1988), which required that the transferred interest be included and taxed in a decedent's estate if the transferred interest represented a disproportionate share of the potential appreciation (i.e. common stock) of an enterprise while retaining an income interest (i.e. preferred stock). Thus, § 2036(c) disregarded the recapitalization and taxed the decedent as if the transaction had never occurred. *Id.*

16. The United States Supreme Court, in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), identified the characteristics usually associated with common stock as (i) the right to receive dividends contingent upon an apportionment of profits, (ii) negotiability, (iii) the ability to be pledged or hypothecated, (iv) the conferral of voting rights in proportion to the number of shares owned, and (v) the capacity to increase in value. *Id.* at 847-57.

17. Preferred stock is defined as shares that are entitled to a specified dividend or liquidation distribution before any payments can be made to common shareholders. See *infra* notes 59-60 and accompanying text. See ROBERT W. HAMILTON, CORPORATIONS 253-57 (3d ed. 1986) for a discussion of preferred stock attributes. See *infra* note 58 and accompanying text.

the preferred stock and gifted the new common stock to the children. The value attributed to the preferred stock represented a significant portion of the value of the entire business; the parent, as the preferred shareholder, retained voting control of the business. The common stock represented only a small portion of the value of the business and provided little if any voting control to the holder of the common stock. For estate tax purposes, this corporate recapitalization froze the value of the corporation in the preferred stock owned by the parent. Any future increase in the value of the business was attributable to the common stock now owned by the children. The future increase in the value of the business escaped transfer tax.<sup>18</sup> This transaction was commonly referred to as an estate freeze.<sup>19</sup>

Congress perceived abuses in the use of the estate freeze technique.<sup>20</sup> Because of the difficulties involved in accurately valuing corporate securities<sup>21</sup> that are not publicly traded, the estate freeze does lend itself to abuses. In 1987, in response to those perceived abuses, Congress passed section 2036(c) that effectively eliminated estate freezes.<sup>22</sup> The business community viewed the

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18. See *supra* note 6.

19. Estate of Boykin v. Commissioner, 53 T.C.M. (CCH) 345 (1987), illustrates the effect and operation of a corporate recapitalization. In *Boykin*, the decedent owned 7,000 shares of the stock of a land and timber company. His brother and other family members owned the remaining shares. In 1969, the corporation was recapitalized, and each of the stockholders received a proportionate number of shares of nonvoting preferred stock to go with their voting common stock. The nonvoting stock had a preference in liquidation of up to \$100 per share, before anything could be paid to the common stockholders, and a right to receive 10 times the dividends per share paid to the common stockholders. Each of the shareholders then executed trusts for their children and descendants, and assigned their voting common stock to the trusts. When Mr. Boykin died, the IRS contended that his control of the corporation through the dividend and liquidation preferences constituted a retained right to control the beneficial enjoyment of the stock held by his descendants' trusts. The IRS assessed a deficiency of \$5,496,674, but the Tax Court disagreed. *Id.* at 345-47. The court held that the voting common stock and the nonvoting preferred stock were separate classes of corporate stock, and the mere retention of one class of stock did not "taint" or affect the enjoyment of the other class. *Id.* at 348-49. See generally *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982).

20. The *Boykin* case appears to have been quite important in prompting Congress' attempt to curtail estate freezes by enactment of § 2036(c). See H. R. REP. NO. 391, 100th Cong., 1st Sess. 1044 (1987) reprinted in 1987 U.S.C.A.N. 2313-660, which discusses the perceived abuses that led to the enactment of § 2036(c). See *infra* notes 75-85 and accompanying text.

21. A high value placed on the retained preferred stock and a low value placed on the gifted common stock will lead to a disproportionate amount of any future appreciation in the business to escape transfer tax. For a discussion of valuation factors and struggles with the valuation issue, see *infra* note 153 and accompanying text.

22. See *supra* note 15.

new statutes as unnecessarily complex and overreaching.<sup>23</sup> The estate planning bar criticized section 2036(c) as an impediment to legitimate family transactions.<sup>24</sup> Furthermore, the 1990 Senate Report indicates that the Senate was also concerned that section 2036(c) posed an unreasonable impediment to the transfer of family businesses and that many taxpayers might refrain from legitimate intrafamily transactions because of its complex rules.<sup>25</sup> In response, Congress repealed section 2036(c) and enacted section 2701 of the Internal Revenue Code in October, 1990.<sup>26</sup>

This Note advocates that a compelling need exists to better understand the new mechanisms that must be utilized to pass small businesses from one generation to the next, in order to avoid ensnaring innocent business transactions that are not intended to bypass the transfer tax system. This Note will first present a brief overview of estate and gift taxation as it applies to the transfer of business interests.<sup>27</sup> Second, this Note will examine the history and trends in the taxation of business transfers from one generation to the next,<sup>28</sup> including the evolution of case law and the congressional response to the case law.<sup>29</sup> Third, this Note will explain the current statutes and treasury regulations interpreting these statutes.<sup>30</sup> Fourth, this Note will examine the interplay of debt, recharacterized as equity, on the new statutes and regulations.<sup>31</sup> In addition, it will identify several common business transactions that have been ensnared by these statutes and regulations.<sup>32</sup> Finally, this Note will advocate revisions to section 2701 that would accomplish congressional objectives without subjecting legitimate intrafamily business transactions to unwarranted restrictions.<sup>33</sup>

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23. See Michael D. Mulligan, *Estate Freeze Rules Eased By New Tax Law But Other Restrictions Are Imposed*, 18 EST. PLAN. 2 (1991).

24. Karen C. Burke, *Valuation Freezes After the 1988 Act: The Impact of Section 2036(c) On Closely Held Businesses*, 31 WM. & MARY L. REV. 67, 69 (1989); (in particular, see footnote 10, which discusses the American Bar Association's urging of Congress to repeal § 2036(c) because it is overbroad, vague and ambiguous).

25. 101st Cong., 2d Sess., SENATE REPORT reprinted in 136 CONG. REC. S15679-81 (daily ed. Oct. 18, 1990) (hereinafter SENATE REPORT).

26. See *supra* note 4.

27. See *infra* notes 34-54 and accompanying text.

28. See *infra* notes 55-73 and accompanying text.

29. See *infra* notes 74-98 and accompanying text.

30. See *infra* notes 99-185 and accompanying text.

31. See *infra* notes 186-217 and accompanying text.

32. See *infra* notes 218-51 and accompanying text.

33. See *infra* notes 252-69 and accompanying text.

**II. THE HISTORY OF ESTATE FREEZE TRANSACTIONS:  
USES, ABUSES AND EVOLUTION**

***A. Overview of Estate and Gift Taxation of Business Interest Transfers***

All estate freezing techniques adhere to two basic principles of taxation. First, tax consequences follow, or attach to, the ownership of capital.<sup>34</sup> Second, ownership and management of capital can be separated without adverse tax consequences.<sup>35</sup> A parent should, therefore, be able to transfer non-voting common stock<sup>36</sup> to a child and have the tax consequences of the common stock flow to that child. Furthermore, the parent should be able to retain control with preferred stock that has voting rights.<sup>37</sup>

Numerous statutes support the position that the individual or entity that earns the income should be taxed on it.<sup>38</sup> The Supreme Court established this doctrine<sup>39</sup> in its landmark decision, *Lucas v. Earl*.<sup>40</sup> In *Lucas*, the Supreme Court taxed a husband on his earnings, even though he had agreed with his wife that each would own one half of the other's earnings. The Court held that "the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it."<sup>41</sup> The Court also held that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."<sup>42</sup> In other words, the tax consequences follow the person who earns the income or owns the capital that generates the income. Moreover, the taxpayer cannot artificially attribute income to someone else. The courts have consistently upheld this principle.<sup>43</sup>

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34. DOUGLAS K. FREEMAN, *ESTATE TAX FREEZE: TOOLS AND TECHNIQUES* §1.03 (1992). See also *Lucas v. Earl*, 281 U.S. 111 (1930); see *infra* note 40 and accompanying text.

35. FREEMAN, *supra* note 34, at § 1.03. See also *United States v. Byrum*, 408 U.S. 125 (1972) *infra* note 44.

36. See *supra* note 16.

37. See *supra* note 17.

38. I.R.C. §§ 61, 267, 382, 704(e) (West Supp. 1992); I.R.C. § 269A (1988).

39. This doctrine is commonly referred to as the fruit of the tree doctrine. See *infra* note 40 and accompanying text.

40. 281 U.S. 111 (1930). The tax statutes and rates, at the time, provided for reduced taxes to a husband and wife who had separate earnings and reported taxable income separately.

41. *Id.* at 114-15.

42. *Id.* at 115.

43. *Helvering v. Horst*, 311 U.S. 112 (1940) (principle applied to assignment of investment income); *Johnson v. Commissioner*, 78 T.C. 882 (1982) (principle applied to taxation of shareholders instead of to the corporation); *Carriage Square Inc. v. Commissioner*, 69 T.C. 119 (1977) (principle applied to allocation of partnership income).

The courts have held that the ownership of capital and management of a business can be separated without adverse tax consequences.<sup>44</sup> In *United States v. Byrum*,<sup>45</sup> the court required that the retained enjoyment or control must relate directly to the transferred property.<sup>46</sup> Indirect control in the form of retained voting stock did not trigger estate tax inclusion.<sup>47</sup> Thus, separating ownership of capital and management simultaneously capped the value of the business in the business owner's estate, and yet allowed the business owner to retain control of the business.<sup>48</sup>

The federal transfer tax system taxes the value of property transferred by a person during his life or upon his death.<sup>49</sup> Therefore, minimizing the value of the property is an essential element in an estate freeze transaction, since decreasing the value of the property correspondingly reduces the transfer tax. The value of business interests that are transferred by gift or included in the decedent's gross estate is generally the business's fair market value at the time of the gift or the date of death.<sup>50</sup> Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under the compulsion to buy nor sell and both having reasonable knowledge of relevant facts.<sup>51</sup> This standard reflects the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer.<sup>52</sup> Accordingly, courts have refused to consider familial relationships among co-owners in valuing property.<sup>53</sup> In addition, a transfer that is made in the ordinary course of business will be deemed to have been for full and adequate consideration, and will not result in a gift.<sup>54</sup>

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44. *United States v. Byrum*, 408 U.S. 125, 150 (1972). The government contended that the decedent continued to control corporate dividend policy and thus possessed the power to shift or to defer beneficial enjoyment of income on the transferred stock. The Court rejected the government's arguments largely because of the economic and legal constraints (fiduciary responsibilities) that are imposed on a controlling shareholder's power. *Id.* at 144.

45. *Id.* at 150.

46. *Id.*

47. *Id.*

48. *Id.* This was a primary tenet of an estate freeze until 1987. In 1987, § 2036(c) and its replacement, § 2701, statutorily overrode this principle.

49. See *supra* note 6 and accompanying text.

50. I.R.C. § 2031(b) (1988); Treas. Reg. § 20.2031 (as amended in 1992) (providing guidelines for the valuation of unlisted securities for estate tax purposes).

51. Treas. Reg. § 20.2031-1(b) (as amended in 1965).

52. Rev. Rul. 59-60, 1959-1 C.B. 237.

53. In *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the court allowed corporate stock to be discounted (reduced) to reflect minority ownership in the block of stock being valued even when the related persons together comprised a majority ownership in the underlying stock. *Id.* at 1007.

54. The transaction must be a bona fide arm's length transaction and without any donative intent. See Treas. Reg. § 25.2512-8 (as amended in 1992).

*B. The Perceived Problem with Estate Freeze Recapitalizations*

In the typical recapitalization,<sup>55</sup> two or more classes of stock<sup>56</sup> are created to separate the various rights represented by a share of stock. These rights include the right to share in the earnings of the enterprise, the right to share in the liquidation capital, the right to vote and assert control over the management of the enterprise, and the right to future appreciation in the enterprise.<sup>57</sup> Preferred stock gives the holder a priority right to a fixed amount of corporate earnings and liquidation capital and may also confer voting rights.<sup>58</sup> Common stock gives the holder a right to corporate earnings and liquidation capital above the amounts assured to the preferred stockholders.<sup>59</sup> Common stock is sometimes accompanied by voting rights and always includes the right to future appreciation in the corporation's net value.<sup>60</sup>

Estate freezing recapitalizations divide the two classes of stock between members of different generations and allocate the different rights associated with stock ownership.<sup>61</sup> For example, the older generation stockholders exchange their common stock for preferred stock.<sup>62</sup> This exchange gives the older generation a fixed dividend rate, a fixed redemption value, a preference on both dividends and liquidation proceeds, and, in many cases, voting control.<sup>63</sup> The younger generation exchanges their common stock for a new class of common stock or receives the common stock as a gift from the older generation.<sup>64</sup> This transfer provides the younger generation shareholders with a subordinate right to dividends and liquidation values, and the rights to all future appreciation in the corporation.<sup>65</sup> The older generation retains control of the corporation through its voting rights, while shifting the future appreciation of the corporation

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55. See Appendix A (describing a typical recapitalization).

56. A partnership capital freeze operates in a similar conceptual manner, and therefore, will not be separately described.

57. See generally ROBERT W. HAMILTON, CORPORATIONS 251-74 (3d ed. 1986) for a discussion of common and preferred stock characteristics.

58. *Id.* at 253-57.

59. *Id.* at 252-53.

60. HOWARD M. ZARITSKY & RONALD D. AUCUTT, STRUCTURING ESTATE FREEZES UNDER CHAPTER 14, 5 (1991). See *supra* note 16 (discussing common stock characteristics identified by the United States Supreme Court).

61. See Appendix A, which illustrates a typical estate freeze recapitalization based on ZARITSKY & AUCUTT *supra* note 60, at 5-6.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*



and growth in earnings to the younger generation.<sup>66</sup>

Theoretically, the estate freeze described above and in Appendix A is not innately abusive.<sup>67</sup> When the preferred and common stock are properly valued, transfer taxes are not avoided.<sup>68</sup> A gift tax is imposed on the value of the new common stock at the time of the transfer.<sup>69</sup> An estate tax is imposed on the value of the preferred stock in the older generation shareholder's estate.<sup>70</sup> The older generation shareholder could just as easily remove the future appreciation from his estate by gifting the common stock and not retaining any preferred stock.<sup>71</sup> By retaining the preferred stock, the older generation shareholder, in effect, retains a degree of control over the value of the common stock subsequent to the initial gift.<sup>72</sup> The retention of control over a gift of stock arguably has value.<sup>73</sup>

The potential for abuse in the preceding example arises from the possible undervaluation of the common stock for gift tax purposes.<sup>74</sup> *Estate of Boykin v. Commissioner*<sup>75</sup> illustrates a situation that is considered abusive according to the Internal Revenue Service. At the time of the recapitalization, the liquidation value of the preferred stock was \$15,000,000, while the net worth of the company was approximately \$4,000,000. High liquidation value<sup>76</sup> and dividend preferences<sup>77</sup> were intended to offset a discount in the value of the preferred stock because the preferred stock lacked cumulative dividend rights.<sup>78</sup>

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66. Estate freeze recapitalizations, however, are not a panacea. The value of the corporation could decrease in the future rather than increase. If the corporation is worth less at the older generation shareholder's death, his estate may pay an artificially inflated estate tax based on the frozen value of his preferred stock. The possibility that transfer taxes are artificially increased under these circumstances seems to have been ignored by Congress in its members' discussions leading to the statutory reform of estate freeze recapitalizations. See *infra* notes 83-85 and accompanying text. This author's research did not disclose any studies that indicate how often companies decrease in value subsequent to an estate freeze recapitalization. The courts would not be asked to address this situation because the Internal Revenue Service will not challenge an estate freeze that increases the taxpayer's tax burden.

67. Burke, *supra* note 24, at 71.

68. *Id.*

69. *Id.*

70. Burke, *supra* note 24, at 71.

71. *Id.*

72. *Id.*

73. See *infra* note 167.

74. Burke, *supra* note 24, at 72.

75. 53 T.C.M. (CCH) 345 (1987).

76. See *supra* note 59 and accompanying text.

77. See *supra* note 59 and accompanying text.

78. Rights, attached to preferred stock such as a preference to other shareholders at the time of liquidation, generally increase the value of the preferred stock. A preferred stock without the right to cumulative dividends is generally worth less than a preferred stock with this right. See Rev.

The government asserted that the company never intended to pay a market rate of return on the preferred stock because the company actually paid only minimal dividends.<sup>79</sup> However, the Tax Court rejected the government's argument and held that the voting common stock and the nonvoting preferred stock were separate classes of stock, and that the mere retention of one class of stock did not taint or affect the enjoyment of the other class of stock.<sup>80</sup> In effect, the recapitalization in *Boykin* allowed the older generation shareholders to dispose of the potential appreciation of the common stock at a minimal gift tax while retaining control over the dividends that were actually paid on the preferred stock.<sup>81</sup>

Congress began to view recapitalizations as deceptive methods of reducing estate taxes<sup>82</sup> because recapitalizations artificially shifted future appreciation to the next generation, while the present generation retained the income generated by the corporation.<sup>83</sup> The House Ways and Means Committee, for example, perceived that estate freeze recapitalizations were primarily substitutes for testamentary dispositions that escaped substantial transfer taxes because of undervaluation of the securities at the time of the transfer.<sup>84</sup> Another concern was that the transferor effectively retained enjoyment of the entire enterprise<sup>85</sup> by retaining a disproportionate share of the income or rights of the businesses.

In response to *Boykin*<sup>86</sup> and similar cases,<sup>87</sup> Congress passed I.R.C.

Rul. 83-120, 1983-2 C.B. 170.

79. *Boykin*, 53 T.C.M. (CCH) at 347-48.

80. *Id.* at 348. The IRS also argued that Mr. Boykin's control of the corporation through the dividend and liquidation preferences constituted a retained right to control the beneficial enjoyment of the stock held by his descendant's trusts. *Id.*

81. *Burke*, *supra* note 24, at 78.

82. See ZARITSKY & AUCUTT, *supra* note 60, at 11 (presenting arguments for allowing the traditional estate freeze recapitalization).

83. See H. R. REP. NO. 391, 100th Cong., 1st Sess. 1044 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-660.

84. See H. R. REP. NO. 795, 100th Cong., 2d Sess. 422-423 (1988); see also S. REP. NO. 445, 100th Cong., 2d Sess. 526-27 (1988), reprinted in 1988 U.S.C.C.A.N. 5028-29.

85. *Id.*

86. *Estate of Boykin v. Commissioner*, 53 T.C.M. (CCH) 345 (1987).

87. For example, in *Snyder v. Commissioner*, 93 T.C. 529 (1989), Snyder created a personal holding company to hold \$2.5 million of marketable securities. The holding company issued both common stock and two classes of preferred stock. The common stock was the only voting stock, and it was empowered to force redemption of the preferred stock for its par value at any time. Snyder gave the common stock to trusts for her great-grandchildren, retaining both classes of the preferred stock. She valued the common stock at a nominal value, \$1,000, contending that the entire value of the company was reflected in the preferred stock. The IRS contended that the common stock given to the trusts was worth \$2,412,000. *Id.* at 535-38. The Tax Court agreed with Snyder's appraisers, who had computed the value of the common stock by reducing the value of the total corporation by the value of the preferred stock (the subtraction method). *Id.* at 545. The court

section 2036(c) in 1987.<sup>88</sup> Section 2036(c) treated a transferor (older generation shareholder) as having retained a transferred interest when he transferred a disproportionately large share of stock with potential appreciation and retained an interest in the income or rights of the entity.<sup>89</sup> Therefore, the transferred interest was included in the transferor's gross estate and subjected to estate tax. Section 2036(c) required that the transferred interest be included and taxed in a decedent's estate if the transferred interest represented a disproportionate share of the potential appreciation (i.e., common stock) of an enterprise while retaining an income interest (i.e., preferred stock).<sup>90</sup> Thus, section 2036(c) disregarded the estate freeze recapitalization and taxed the decedent as if the transaction never occurred.<sup>91</sup>

The business community, however, viewed the new statutes as unnecessarily complex and overreaching.<sup>92</sup> The estate planning bar criticized section 2036(c) as an impediment to legitimate family transactions.<sup>93</sup> The Senate Committee Report indicates that the Senate was also concerned that section 2036(c) posed an unreasonable impediment to the transfer of family businesses and caused many taxpayers to refrain from legitimate intrafamily transactions.<sup>94</sup> Furthermore, in 1990, when Congress repealed section 2036(c),<sup>95</sup> it believed that the statute was an "inappropriate and unnecessary approach to the valuation problems associated with estate freezes."<sup>96</sup>

In developing the replacement statutes, the Committee attempted to provide a well-defined and administrable set of rules that would allow business owners who were not abusing the transfer tax system to freely exchange business interests in standard intrafamily transactions, without being subject to severe transfer tax consequences.<sup>97</sup> Concurrently, the Committee also desired to develop statutes that would deter abusive transactions that avoided transfer taxes.<sup>98</sup>

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valued the preferred stock on the basis of its redemption price, because that is all any buyer could be sure of obtaining for it on the date of the gift. *Id.* at 544-45.

88. *See supra* note 4.

89. *See Burke, supra* note 24, at 91.

90. ZARITSKY & AUCUTT, *supra* note 60, at 15.

91. *Id.*

92. Mulligan, *supra* note 23, at 2.

93. Burke, *supra* note 24, at 69.

94. SENATE REPORT, *supra* note 25, at S15680.

95. *See supra* note 4.

96. SENATE REPORT, *supra* note 25, at S15680.

97. *Id.*

98. *Id.* at S15681. Chapter 14 approaches the problem from a different perspective than § 2036(c), which it replaces. Rather than adopting an estate tax solution to the problem, the new statutes adopt a gift-tax solution. *Id.*

## III. EXPLANATION OF INTERNAL REVENUE CODE SECTION 2701

A. *Explanation and Scope of Section 2701*

To replace the repealed section 2036(c), Congress added Chapter 14 to the Internal Revenue Code,<sup>99</sup> thereby adding four new statutes, sections 2701-2704.<sup>100</sup> The new statutes focus on the value of the interests<sup>101</sup> that are actually retained by the transferor. Chapter 14 is primarily a valuation and gift tax provision that deals with estate freeze transactions at the time of the initial transfer.<sup>102</sup> If the retained interest does not satisfy certain requirements, the retained interest is deemed to have no value.<sup>103</sup> Moreover, retention of a non-qualified interest does not reduce the value of the transfer.<sup>104</sup> This results in a taxable gift of the entire property at the time of the estate freeze

99. See *supra* note 4.

100. This note focuses on § 2701. A brief outline of §§ 2702-2704 follows to add some perspective as to how these statutes interrelate with § 2701. Section 2702 attempts to limit the use of estate freezing transactions not related to corporations or partnerships, providing that the gift tax value of certain remainder interests will be determined without regard to the intervening retained term interest, thus eliminating or severely limiting the use of several traditional estate planning techniques. Under § 2702, the value of a gift in a trust in which the transferor retains an interest will be determined as if the retained interest had no value, unless the retained interest takes certain special forms (an annuity, a unitrust interest, a remainder interest following one of these interests, or an interest in certain trusts holding residences or nondepreciable tangible property).

Section 2703 addresses the use of buy-sell agreements and similar arrangements to freeze the value of interests in family corporations and partnerships. Under § 2703 the value of a decedent's interest in a corporation or partnership will be determined without regard to any option, agreements, or other right to acquire or use the property at less than its fair market value, or any other restriction on the sale or disposition of such property, unless two requirements (in addition to the traditional requirements observed by the IRS and the courts) are met. First, the agreement must both have a bona fide business purpose and not be a tax-avoidance device. Second, its terms must be comparable to similar arrangements entered into by persons in arm's length transactions.

Section 2704 addresses specifically the problem raised in recent Tax Court decisions by providing that a lapse of any voting or liquidation right created on or after October 9, 1990, in an entity controlled by the holder's family constitutes a taxable gift, or an increase in the value of the holder's gross estate if it occurs at death.

Finally, to aid the IRS in its auditing function with respect to transactions under Chapter 14, § 6501(c)(9) provides that if a transfer results in a gift or an increase in gift tax value because of the new rules of §§ 2701 and 2702, the usual three-year statute of limitations for gift tax purposes will not begin to run with respect to that transfer until the transfer is adequately disclosed on a gift tax return. In other words, it will not be enough to file a gift tax return reporting other gifts for that year; specific reference must be made on the tax return to the § 2701 or § 2702 transaction.

101. Interests retained by the transferor are usually a type of preferred stock. See *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990).

102. I.R.C. § 2701 (West Supp. 1992); Treas. Reg. § 25.2701 (1992).

103. I.R.C. § 2701(a)(3) (West Supp. 1992).

104. See generally Mulligan, *supra* note 23, at 2.

recapitalization.<sup>105</sup>

At first reading, section 2701 is very difficult to understand because the transactions that fall within its scope are not actually defined until the end of the statute.<sup>106</sup> Furthermore, other definitions, which must be understood before the statute can be properly interpreted, are interwoven throughout the statute.<sup>107</sup> Appendices B and C provide an overview of section 2701. In fact, the reader may find it helpful to refer to the appendices at this time to obtain an overall understanding of section 2701. Appendix B illustrates the various types of transactions and equity interests to which section 2701 applies.<sup>108</sup> Appendix C illustrates how section 2701 requires the interests to be valued.<sup>109</sup>

Section 2701(a) provides the general rule for determining whether a transfer<sup>110</sup> of a junior equity interest<sup>111</sup> in a corporation or partnership,<sup>112</sup>

105. If § 2701 applies, it requires a departure from traditional valuation theory. Specifically, traditional valuation theory requires that the value be the amount at which a willing buyer will buy and a willing seller will sell the interest, neither being under a compulsion to buy nor sell, and both having knowledge of all relevant facts. *See generally*, Treas. Reg. § 25.2512-1 (as amended in 1992); Treas. Reg. § 20.2031-2(f) (as amended in 1992); Rev. Rul. 83-120, 1983-2 C.B. 170 (amplifying Rev. Rul. 59-60, 1959-1 C.B. 237).

106. I.R.C. § 2701(e) (West Supp. 1992).

107. *E.g.* I.R.C. §§ 2701(a)(4)(B), 2701(c)(1)(A)(i), 2701(c)(1)(A)(ii), 2701(e)(1), and 2701(e)(2) (West Supp. 1992).

108. *See infra* notes 110-36 and accompanying text.

109. *See infra* notes 137-75 and accompanying text.

110. I.R.C. § 2701(e)(5) (West Supp. 1992), and Treas. Reg. § 25.2701-1(b) (1992), require that there be a transfer of an interest in a corporation or partnership. The regulation states that a transfer for this purpose can occur whether or not the transfer would otherwise be a taxable gift under chapter 12 of the Internal Revenue Code. For example, § 2701 applies to a transfer for full and adequate consideration where X sells his common stock to his son for its fair market value of \$1,000,000 but retains noncumulative preferred stock. A transfer includes a redemption, recapitalization, or other change in the capital structure of a corporation or partnership if the taxpayer or an applicable family member either receives an applicable retained interest or "under regulations" holds such an interest immediately after the transaction. Treas. Reg. § 25.2701-1(b) (1992) defines a transfer to include 1) a redemption, recapitalization, or other change in the capital structure of the entity if the transferor or applicable family member, holding an applicable retained interest, receives property other than such an interest or the value of the applicable retained interest is increased (i.e. common stock received in recapitalization), or 2) a termination of an indirect holding in an entity. *See* Treas. Reg. §§ 25.2701-1(a)(3), 25.2701-1(e) (1992) for illustrations.

111. Section 2701(a)(4)(B)(i) defines a junior equity interest as common stock or, in the case of a partnership, any partnership interest where the rights to income and capital are junior to the rights of all other classes of equity interests. Section 2701(a)(4)(B)(ii) defines an equity interest as stock or any partnership interest.

112. I.R.C. §§ 7701(a)(2) and 7701(a)(3) (West Supp. 1992) define a partnership and a corporation respectively. There is nothing in § 2701 or the regulations to suggest that these are not the definitions to use. It appears that § 2701 would apply to an entity that is not formally organized as a corporation. For attributes of an entity not formally organized as a corporation but taxed as a corporation, *see generally*, *Morrissey v. Commissioner*, 296 U.S. 344 (1935); *Elm Street Realty*

controlled<sup>113</sup> by the transferor, to a member of the transferor's family<sup>114</sup> is a gift; and--if so--determines the value of the gift.<sup>115</sup> The general rule is that the value of certain rights<sup>116</sup> attributable to any applicable retained interest<sup>117</sup> held by the transferor or an applicable family member<sup>118</sup> will be determined as stipulated by section 2701(a)(3). Section 2701(a)(3) provides that (i) the value of any such rights,<sup>119</sup> other than a distribution right<sup>120</sup> that consists of

Trust v. Commissioner, 76 T.C. 803 (1981); Hynes v. Commissioner, 74 T.C. 1266 (1980); and Larson v. Commissioner, 66 T.C. 159 (1976).

113. I.R.C. §§ 2701(b)(2) and 2701(e)(3)(B) (West Supp. 1992); Treas. Reg. § 25.2701-2(b)(5)(i) (1992). The regulations define a controlled entity covered by § 2701 as a corporation or partnership controlled (at least 50% of the voting control) immediately before a transfer, by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse. See Treas. Reg. § 25.2701-6 (1992) for discussion of indirect holding of interests.

114. A member of the transferor's family is defined in I.R.C. § 2701(e)(1) (West Supp. 1992) and Treas. Reg. § 25.2701-1(d)(1) (1992) as the transferor's spouse, a lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant. In order for § 2701 to apply, the junior equity interest must be transferred to the transferor's spouse or a lower generation family member. A transfer to an ancestor of the transferor is outside the operation of § 2701.

115. See *infra* notes 137-75 and accompanying text.

116. See *infra* note 117 for discussion of various rights.

117. In the case of a controlled entity, an applicable retained interest is defined in I.R.C. § 2701(b)(1) (West Supp. 1992) and Treas. Reg. § 25.2701-2(b)(1) (1992) as a distribution right. An extraordinary payment right is an applicable retained interest whether or not it was a controlled entity. An extraordinary payment right is defined in I.R.C. § 2701(c)(2) (West Supp. 1992) and Treas. Reg. § 25.2701-2(b)(2) (1992) as any liquidation, put, call or conversion right (or similar right), the exercise or nonexercise of which will affect the value of the transferred interest. It excludes any right that must be exercised at a specific time and for a specific amount. It also excludes any nonlapsing right to convert into a fixed number or percentage of the same class of stock as the transferred interest.

118. An applicable family member is defined in I.R.C. § 2701(e)(2) (West Supp. 1992) and Treas. Reg. § 25.2701-1(d)(2) (1992) as the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor. The retained interest must, therefore, be held by the transferor, the transferor's spouse, or senior generation family members in order for the statute to apply.

119. See *supra* note 117 for discussion of various rights.

120. A distribution right is defined in I.R.C. § 2701(c)(1) (West Supp. 1992) and Treas. Reg. § 25.2701-2(b)(3) (1992) as the right to receive distributions with respect to an equity interest. The following distributions are not considered distribution rights: 1) any right to receive distributions with respect to an interest in the same class or a class subordinate to the transferred interest; 2) any extraordinary payment right; 3) any right of a partner to receive guaranteed payments of a fixed amount described in I.R.C. § 707(c) (1988); and 4) any mandatory payment right, liquidation participation right or non-lapsing conversion right. The significance of these exclusions is that these rights (not including extraordinary payment rights) are valued at fair market value outside of the scope of § 2701. Note that a right to interest payments is not a distribution right. Section 2701 will not apply if the transferor gives away common stock and retains only debt and common stock. See *infra* notes 194-217 and accompanying text for a discussion of debt recharacterized by the courts as equity.

a right to receive a qualified payment,<sup>121</sup> shall be zero;<sup>122</sup> and (ii) if a right to a qualified payment<sup>123</sup> is combined with a liquidation, put, call, or conversion right,<sup>124</sup> then the value of all such extraordinary payment rights shall be determined in a manner that results in the lowest value.<sup>125</sup>

If the corporation does not make payments for four years,<sup>126</sup> section 2701(d) treats the transaction as if a gift<sup>127</sup> has been made by the transferor of his and other family member's preferred stock. This "taxable event"<sup>128</sup> is the earliest of the following: a lifetime transfer of the preferred stock; the death of the owner of the preferred stock; or the time when the late dividends are paid

121. A qualified payment right is defined in I.R.C. § 2701 (c)(3) (West Supp. 1992), Treas. Reg. § 25.2701-2(b)(6) (1992) and Treas. Reg. § 25.2701-4 (c)(3) (1992) as a dividend payable on a periodic basis on a cumulative preferred stock (or comparable partnership interest) at a fixed rate or a rate which bears a fixed relationship to a specified market rate. An election may be made to treat a payment, which would qualify as a qualified payment, as not qualifying (an election out). An election may be made to treat a payment that does not qualify as a qualified payment right (an election in). The payment may not be in the form of an equity interest such as a stock dividend.

122. I.R.C. § 2701(a)(3)(A) (West Supp. 1992).

123. See *supra* note 121 for a discussion of qualified payments.

124. Put, call, liquidation and conversion rights generally allow the holder of the right to either acquire or dispose of the security at a predetermined price. See *Hamilton, supra* note 17.

125. In the event that a qualified payment right is combined with an extraordinary payment right the value of these rights is determined under § 2701(a)(3) in such a manner as to result in the lowest total value for all such rights. Treas. Reg. § 25.2701-2(a)(5) (1992) illustrates the rule:

P, an individual, holds all 1,000 shares of x Corporation's \$1,000 par value preferred stock bearing an annual cumulative dividend of \$100 per share and holds all 1000 shares of x's voting common stock. P has the right to put all the preferred stock to x at any time for \$900,000. P transfers the common stock to P's child and immediately thereafter holds the preferred stock. Assume that at the time of the transfer, the fair market of x is \$1,500,000, and the fair market value of P's annual cumulative dividend right is \$1,000,000. Because P has both an extraordinary payment right (the put right) and the qualified payment right (i.e., the right to receive cumulative dividends), the special rule of paragraph (a)(3) of this section applies, and the value of these rights is determined as if the put right will be exercised in a manner that results in the lowest total value being determined for the rights (in this case, by assuming that the put will be exercised immediately). The value of P's preferred stock is \$900,000 (the lower of \$1,000,000 or \$900,000). The amount of the gift is \$600,000 (\$1,500,000 minus \$900,000).

126. I.R.C. § 2701(d) (West Supp. 1992); Treas. Reg. § 25.2701-4 (1992).

127. The value of the deemed gift is the excess of (i) the value of qualified payments payable during the period beginning on the date of transfer and ending on the date of the taxable event, calculated as if all such payments were paid when due and reinvested at a yield equal to the discount rate used in determining the value of the applicable retained interest, over (ii) the value of such payments actually paid during such period assuming the same reinvestment. I.R.C. § 2701(d) (West Supp. 1992); Treas. Reg. § 25.2701-4 (1992). The result of this approach is to compound unpaid distributions in determining their value. Such compounding fails to take into account any income taxes that would be payable on the dividends received, and therefore overstates the compound value.

128. I.R.C. § 2701(d) (West Supp. 1992); Treas. Reg. § 25.2701-4(b) (1992).

and the taxpayer elects to treat the payment as a taxable event.<sup>129</sup>

Section 2701 provides exceptions to certain transfers that, by their nature, would not avoid transfer taxes.<sup>130</sup> For example, if market quotations are readily available on an established securities market for the transferred interest<sup>131</sup> or the retained interest,<sup>132</sup> section 2701 does not apply. In addition, section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest;<sup>133</sup> for example, if both the retained and the transferred interest are both common stock. When the retained interest is of a class that is proportionally the same<sup>134</sup> as the class of the transferred interest,<sup>135</sup> section 2701 does not apply. Finally, section 2701 does not apply if the transfer results in a proportionate reduction of each class of equity interest held by the transferor and all applicable family members in the aggregate immediately before the transfer.<sup>136</sup>

### B. Valuation of Business Interests Under Section 2701

Once a determination is made that section 2701 applies to a transaction, the valuation mechanics must be deciphered.<sup>137</sup> The section 2701 regulations<sup>138</sup> clarify the Internal Revenue Service's interpretation of the valuation mechanics. Appendix C illustrates the valuation<sup>139</sup> process required by section 2701 and

129. I.R.C. § 2701(d) (West Supp. 1992); Treas. Reg. § 25.2701-4(b) (1992).

130. See *infra* notes 131-136.

131. I.R.C. § 2701(a)(1) (West Supp. 1992); Treas. Reg. § 25.2701-1(c) (1992). The transferred interest is usually common stock.

132. I.R.C. § 2701(a)(2)(A) (West Supp. 1992); Treas. Reg. § 25.2701-1(c) (1992). The retained interest is usually preferred stock.

133. I.R.C. § 2701(a)(2)(B) (West Supp. 1992); Treas. Reg. § 25.2701-1(c) (1992).

134. This is determined without regard to nonlapsing differences in voting power. I.R.C. § 2701(a)(2)(B) (West Supp. 1992); Treas. Reg. § 25.2701-1(c) (1992).

135. I.R.C. § 2701(a)(2)(C) (West Supp. 1992); Treas. Reg. § 25.2701-1(c) (1992).

136. This exception is not specifically provided for in the statute, but the regulations provide for this exception. Treas. Reg. § 25.2701-1(c)(4) (1992).

137. Section 2701(a)(3) provides rules for valuing the retained interests. Section 2701(a)(4) establishes a minimum value for the junior equity interest. However, the specific application of these statutes with economic valuation principles is not addressed. Treas. Reg. § 25.2701-3 (1992) provides some guidance in the mechanics of valuing the retained interests and the interplay with economic valuation principles.

138. Treas. Reg. § 25.2701-3 (1992).

139. The values determined under § 2701 may not be the fair market value in terms of the normal willing buyer and willing seller test (see *infra* note 153 and accompanying text). As a result, the values determined under the section 2701 rules may not apply for basic purposes. I.R.C. § 1015 (1988) (relating the basis of property acquired by gift) and I.R.C. § 1014 (1988) (relating to property acquired for a decedent) appear to be unaffected by § 2701. Section 2701 valuation rules apply for purposes of determining whether there is a gift and the amount of the gift. Normal valuation rules apply in determining fair market value for basis purposes.



its regulations.

The Senate Report<sup>140</sup> states that the rules for section 2701 rely on present law valuation principles that use a subtraction method<sup>141</sup> in valuing transferred interests, with an adjustment to reflect actual fragmented ownership.<sup>142</sup> However, the plain language of section 2701 does not refer to the subtraction method of valuing the business. Furthermore, the Senate Report's reference to the present legal principles that use the subtraction method is not entirely clear.<sup>143</sup> Neither income tax nor transfer tax statutes refer to the subtraction method of valuation.<sup>144</sup>

The Tax Court does not appear to either endorse or refute the subtraction method of valuation.<sup>145</sup> In a 1989 decision, the Tax Court upheld the use of the subtraction method in the valuation of a personal holding company.<sup>146</sup> However, in 1990, the same Tax Court specifically rejected the use of the subtraction method in the estate tax valuations of publishing corporations, but left open its use under different circumstances.<sup>147</sup> These two decisions<sup>148</sup>

140. See generally SENATE REPORT, *supra* note 25.

141. The premise of the subtraction method is that all of the various interests being valued must equal the value of the entire business. Conversely, from the value of the entire business, subtract the value of the interest retained to determine the amount of the gift. From an economic perspective the subtraction method may not be theoretically correct. For example, if 100 shareholders each own one percent of a business that is not publicly traded, the value of each shareholders interest will be reduced by minority and lack of marketability discounts. Therefore, the cumulative values of the 100 shareholders' interests would be worth less than the value of the business to one shareholder owning 100%. The subtraction method is also discussed *infra* notes 146-149. Minority and marketability discounts are discussed *infra* note 167.

142. See generally *supra* note 25.

143. See generally SENATE REPORT, *supra* note 25, at S15681.

144. See *supra* note 141 and accompanying text for a discussion of the subtraction method of valuation; see *infra* notes 146-149 and accompanying text.

145. See *infra* notes 146-147 and accompanying text.

146. *Snyder v. Commissioner*, 93 T.C. 529 (1989).

147. The tax court states in *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 247 (1990):

Not only is there no support in the record for the subtraction method in this case, but we conclude that it is far too simplistic a method for the valuation of the Advance common stock. An underlying fallacy in this theory of valuation is the assumption that the sum of the fair market values of the preferred stock and the common stock, each sold independently to separate buyers, must equal the net value of the entire company as a going concern. Massive amounts of credible evidence in this case indicate that this assumption is not supportable.

If all the common and preferred stock in the company were sold at one time to a single buyer, we have little doubt that the price would approach the values that the experts on both sides determined for the business as a whole. But if either class of stock is sold separately, a buyer cannot be reasonably certain of his ability to eliminate or control the other shareholders, and the price will be less than its proportionate share of the total value. Although the subtraction method may be suitable for other situations,

appear to base the appropriateness of the use of the subtraction method on the facts and circumstances of each case. Nevertheless, the present case law governing the use of the subtraction method in valuing a business is inconclusive.

The regulations<sup>149</sup> provide a four step methodology for the application of the subtraction method in the context of a section 2701 valuation. The regulations generally determine the amount of a gift by subtracting the values of all family-held<sup>150</sup> equity interests that are senior<sup>151</sup> to the transferred interest<sup>152</sup> from the value of the family-held interests<sup>153</sup> that are determined

its use is inappropriate for Advance.

*Id.*

148. See *supra* notes 146-47 and accompanying text.

149. Treas. Reg. § 25.2701-3 (1992). Since the courts do not provide clear guidance in the application of the subtraction method, the regulations provide the only guidance in § 25.2701-3. Congressional intent appears to be that it did not intend to change current valuation practices (see SENATE REPORT, *supra* note 25). There could possibly be future litigation to determine whether the regulation methodology prescribed to implement the subtraction method is representative of present legal principles.

150. Treas. Reg. § 25.2701-3(a)(2)(i) (1992). Family-held means held, directly or indirectly, held by an applicable family member and any lineal descendants of the parents of the transferor or the transferor's spouse. Treas. Reg. § 25.2701-2(b)(5)(i) (1992).

151. This usually means preferred stock. See *supra* notes 57-59 and accompanying text (discussing equity interests).

152. See Mulligan, *supra* note 23, at 2.

153. While there are numerous approaches available to the appraiser in the valuation of closely held business interests, the value of the interest is generally a function of either its return or its claim on the underlying assets of the entity. The value of an entity based on a function of its return is usually expressed as a function of its earning capacity. The earnings are then capitalized at appropriate risk-adjusted rates. This theory is based on the premise that the investment in the closely held business will yield a return sufficient to recover the initial cost and compensate the investor for the inherent risks of ownership. The capitalization rate is generally derived from an analysis of various investment alternatives and the risk associated with these investments. In some cases, the earnings are relatively insignificant in establishing the value of the entity. This situation occurs where the earnings are low relative to the value of the underlying assets. For example, a farmer operating an unprofitable farm on the edge of a growing city may have land worth far more than the farm income it generates. In such cases, it is appropriate to value the entity based on the value of the underlying assets.

Rev. Rul. 59-60, 1959-1 C.B. 237 sets forth the following factors to be considered in determining fair market value:

- 1) the nature of the business and the history of the enterprise from its inception;
- 2) the economic outlook in general and the condition and outlook of the specific industry in particular;
- 3) the book value of the stock and the financial condition of the business;
- 4) the earning capacity of the company;
- 5) the dividend-paying capacity of the company;
- 6) Whether or not the enterprise has goodwill or other intangible value; and the market price of corporations engaged in the same or similar line of business having their shares actively traded in a free and open market, either on a national exchange or over the

immediately before the transfer. Then, the balance is allocated among the transferred interests and other interests of the same class and subordinate classes.<sup>154</sup>

The balance that is allocated among the transferred interests is the amount of the gift. The value of the retained interest is, therefore, kept low,<sup>155</sup> while the corresponding value of the transferred interest is kept high. Thus, section 2701 prevents taxpayers from abusing the valuation process by making certain that the retained interest is valued as low as possible so that the transferred interest is valued as high as possible.<sup>156</sup>

The following is a summary of the four-step valuation process that is required under the regulations:<sup>157</sup>

*Step One:* Determine the fair market value of the family-held equity interests in the entity immediately after the transfer under the normal valuation methodology.<sup>158</sup> The fair market value is determined by assuming that the family-held interests<sup>159</sup> are held by one individual.<sup>160</sup>

*Step Two:* Subtract the value of the senior equity interest<sup>161</sup> from the value determined in step one. This is a two step process. First, from the value determined in step one, subtract the fair market value<sup>162</sup> of all senior equity

counter.

Revenue Ruling 59-60 also discusses the selection of capitalization rates and the process of reconciling various indications of value. *See generally*, Treas. Reg. § 25.2512-1 (as amended in 1981); Treas. Reg. § 20.2031-2(f) (as amended in 1974); Rev. Rul. 83-120, 1983-2 C.B. 170, (amplifying Rev. Rul. 59-60, 1959-1 C.B. 237); Estate of Newhouse v. Commissioner, 94 T.C. 193, 247 (1990); SHANNON PRATT, VALUING A BUSINESS (1981).

154. Treas. Reg. § 25.2701-3 (a) (1992).

155. *See infra* notes 176-85 and accompanying text for an example of this application.

156. A valuation of the transferred interest based on generally accepted valuation methods which would reflect the value based on financial and economic considerations, and not on tax considerations, could yield a lower value. The result is that the transferor is paying a higher transfer (gift) tax. *See supra* note 153 for a discussion of business valuation methodology.

157. Treas. Reg. § 25.2701-3 (b) (1992).

158. Treas. Reg. § 25.2701-3(b)(1) (1992); *See supra* note 153 for discussion of normal valuation methodology.

159. *See supra* note 150 for the definition of family-held interests.

160. Treas. Reg. § 25.2701-3(b)(1) (1992). Since fair market value is determined as if one person holds all of the stock interests, no minority or other discounts are allowed for fragmented ownership.

161. I.R.C. § 2701(a)(3)(A) (West Supp. 1992).

162. Treas. Reg. § 25.2701-3(b)(2)(A) (1992). The fair market value of an interest is its pro rata share of the fair market value of all family-held senior equity interests of the same class. Fair market value of senior equity interests (usually preferred stock) is based on economic valuation methods, rather than section 2701.

interests,<sup>163</sup> other than the applicable retained interests, that are held by the transferor or applicable family members. Next, subtract the value of all applicable retained interests<sup>164</sup> that were not subtracted in the first part of step two.<sup>165</sup>

**Step Three:** Allocate the remaining value among the transferred interests and other family-held subordinate equity interests.<sup>166</sup>

**Step Four:** Reduce the amount determined in step three by any minority discounts<sup>167</sup> or other similar discounts<sup>168</sup> in addition to any proceeds that were received by the transferor.<sup>169</sup>

Congress, however, failed to completely address the valuation issues in section 2701. Clearly, valuation is the area in which Congress perceived the abuses that led to the enactment of the original restrictions of estate freeze recapitalizations.<sup>170</sup> However, because it failed to specifically address the

163. Rev. Rul. 83-120, 1983-2 C.B. 170, provides guidelines for valuing preferred stock (senior equity interest). These factors include the entity's dividend paying capacity, dividend paying intent, and adequacy of the stated dividend rate based on a risk-return comparison with high-grade publicly traded preferred stock.

164. In general, the value of these rights in the hands of the transferor or applicable family member is zero, except for distribution rights (*see supra* note 120) that are qualified payments. Qualified payment rights are valued as preferred stock. *See supra* note 121.

165. Treas. Reg. § 25.2701-3(b)(2) (1992).

166. Treas. Reg. § 25.2701-3(b)(3) (1992).

167. Fragmented ownership is commonly referred to as a minority interest. A minority shareholder does not have the power to change by-laws, force a liquidation, determine salaries or dividend policies, or affect any other significant corporate policy. A discount from the value of the entity as a whole is appropriate. PRATT, *supra* note 153, at 74-76. In *Cravens v. Welch*, 10 F.Supp. 94 (D. Cal. 1935), the court stated that "minority stock interests in a closed corporation are usually worth much less than the proportionate share of the assets to which they attach." *Id.* at 95. The Internal Revenue Service has continuously taken the position that minority discounts do not apply in family business situations. Rev. Rul. 81-253, 1981-2 CB 187. The courts have consistently upheld minority discounts in family businesses. *See e.g.* *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982). For the purposes of applying a minority discount, the family-held interests of the same class are treated as one shareholder. Treas. Reg. § 25.2701-3(b)(4)(ii)(A) (1992). Rev. Rul. 77-287, 1977-2 C.B. 319 sets forth the factors to consider in determining the magnitude of the discount.

Minority discounts are applied to reflect that an interest that has control of a business is more valuable than a minority interest that has little or no control. By treating all family-held interests as a single shareholder the regulations take the position that the minority discount should be applied in step 4. *See also* the court's discussion of minority discounts in *Central Trust Co. v. United States*, 305 F.2d 393, 405 (Ct. Cl. 1962).

168. *See* PRATT, *supra* note 153, at 74-76.

169. Treas. Reg. § 25.2701-3(b)(4) (1992).

170. *See supra* notes 19-20.

application of the subtraction method of valuation which was mentioned in the Senate Committee Report,<sup>171</sup> and because of its treatment of fragmented ownership, Congress has again left the taxpayer unsure of the consequences of an estate freeze recapitalization.

### C. Minimum Value Rule

Section 2701 establishes a minimum value rule that applies to transfers that are subject to section 2701.<sup>172</sup> Under this rule, the aggregate value of all junior equity interests<sup>173</sup> in the entity cannot be less than ten percent of the sum of 1) the value of all equity interests in the entity, and 2) all indebtedness<sup>174</sup> of the entity that is owed to the transferor or an applicable family member. If dividends related to qualified payment rights are left unpaid, the general rule requires an increase in the taxable estate of a decedent-transferor who holds property with cumulative, but unpaid, dividends at death. The taxable gifts of a transferor who makes a lifetime transfer of such property are likewise increased.<sup>175</sup>

### D. Valuation Example

The following example, as adapted from the regulations,<sup>176</sup> illustrates the subtraction method both with and without the valuation adjustment.

Example: Corporation X has outstanding:

- 1) 1,000 shares of \$1,000 par value 8% cumulative voting preferred stock, each share of which carried a right to put<sup>177</sup> the stock to Corporation X for par value at any time, and
- 2) 1,000 shares of nonvoting common stock.

Suppose that A owned 60% of the preferred stock and 75% of the common stock. The balance of the stock was held by B, a person unrelated to A. The fair market value of each share of preferred stock (without regard to section

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171. See SENATE REPORT, *supra* note 25, at §15681.

172. I.R.C. § 2701(a)(4)(A) (West Supp. 1992); Treas. Reg. § 25.2701-3(c) (1992).

173. See *supra* note 111 and accompanying text for a discussion of junior equity interests.

174. Treas. Reg. § 25.2701-3(c)(2) (1992) excludes from the definition of indebtedness: 1) short term debt incurred with respect to the current conduct of the business, and 2) a lease payment representing full and adequate consideration for use of the property.

175. I.R.C. § 2701(d) (West Supp. 1992) and Treas. Reg. § 25.2701-4 (1992) deal with the specific mechanics of applying this adjustment.

176. Treas. Reg. § 25.2701-3(d) (1992).

177. See *supra* note 124 for a discussion of puts.

2701) was \$1,000. A's put right<sup>178</sup> is an extraordinary payment right<sup>179</sup> that is valued at zero. Assume that A's cumulative dividend right,<sup>180</sup> which is a qualified payment right,<sup>181</sup> is valued<sup>182</sup> at \$800 per share. Subsequently, A transferred all of his common stock to his child. The method to use in valuing A's gift is as follows:

*Step One:* Assume the fair market value of all of A's family-held interests is \$1,000,000.<sup>183</sup>

*Step Two:* From the \$1,000,000 value determined in *step one*, subtract \$480,000.<sup>184</sup> Thus, the aggregate value of the common stock is \$520,000 (\$1,000,000 minus \$480,000).

*Step Three:* The \$520,000 value of the common stock from *step two* is fully allocated to the 750 shares of family-held common stock.

*Step Four:* Since A did not receive any consideration for the common stock, the only adjustment applicable in *step four* is for minority discounts or other similar discounts.<sup>185</sup>

#### E. Treatment of Debt Under Section 2701

Debt,<sup>186</sup> as it is defined in section 2701,<sup>187</sup> does not constitute an

178. See *supra* note 124.

179. Treas. Reg. § 25.2701-2 (1992); see also *supra* note 117.

180. See HAMILTON, *supra* note 17, at 251-274. A cumulative dividend right requires that the corporation catch up on any unpaid dividends accrued from prior years before making any other dividend distributions to other classes of stock.

181. See *supra* note 121 and accompanying text for a discussion of qualified payment rights.

182. The valuation takes into account A's voting rights, but disregards A's put right.

183. The fair market value would include a factor to reflect the control A has on Corporation X. See *supra* note 167 for a discussion of minority shareholders and control of a corporation.

184. Six hundred preferred shares multiplied by \$800, the assumed per share fair market value in *step one*. Under § 2701(a)(3)(B), the put is treated as if exercised in a way resulting in the lowest value.

185. See *supra* note 167 and accompanying text. A minority discount would not be appropriate in this example because A has voting control over Corporation X.

186. In *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957), the court defined debt as an unqualified obligation to pay a sum certain, at a reasonably close fixed maturity date along with a fixed percentage in interest, payable regardless of the corporation's income or loss.

187. Debt presents a planning opportunity to avoid falling within § 2701. By substituting debt for preferred stock in the estate freeze recapitalization, the older generation shareholder can receive similar cash flow in the form of interest and principal payments. A holder of debt, however, cannot exert voting control over the corporation. Thus, by using debt, the older generation sacrifices voting control. Voting control was an important right associated with the preferred stock used in the typical estate freeze recapitalization.

applicable retained interest.<sup>188</sup> Rather, an applicable retained interest must be an equity interest.<sup>189</sup> Consider what happens, however, if the I.R.S. recharacterizes debt as equity:<sup>190</sup> the debt would fall within the definition of an applicable retained interest<sup>191</sup> and would, therefore, be subject to the gift tax provisions of section 2701. To complicate matters, the I.R.S. has refused to issue advance rulings on whether it would treat debt in a proposed transaction as equity.<sup>192</sup> Thus, in planning for family-owned corporate transactions, the possibility that debt will be recharacterized as equity and thereby pull the transaction within the broad scope of section 2701<sup>193</sup> is a possibility that is worthy of consideration.

#### IV. IS IT DEBT OR IS IT EQUITY?

The recharacterization of debt as equity, in some situations, will lead to an unforeseen gift tax under section 2701.<sup>194</sup> The manner in which the courts and Congress have treated the debt-equity issue<sup>195</sup> must, therefore, be considered. Generally, the shareholder assumes the risks associated with the business and reaps profits if the business succeeds.<sup>196</sup> On the other hand, a creditor does not share in the profits of the business, but rather receives his compensation independent of any risks associated with the business and has a right to the return of his capital.<sup>197</sup>

In 1946, the Supreme Court addressed the debt-equity issue in *John Kelley*

188. See *supra* note 117 for a discussion of applicable retained interests.

189. See *supra* note 117 and accompanying text.

190. See *infra* notes 194-217 and accompanying text.

191. See *supra* note 117 and accompanying text for a discussion of applicable retained interests. Once the debt is recharacterized as equity, the interest payments would be distribution rights as defined in § 2701 and the corresponding regulations. If the debt has any payment preferences, these may fall within the scope of extraordinary payment rights.

192. Rev. Proc. 91-3, C.B. 314.

193. See *infra* notes 218-48 and accompanying text for examples.

194. Treas. Reg. § 25.2701 (1992). The recharacterization of debt to equity would not automatically result in a transfer tax. The other aspects of § 2701 discussed *supra* at notes 99-136 would also need to be present. See also *infra* notes 218-48 and accompanying text for examples.

195. The tax treatment of debt and equity is a central issue in the pattern of corporate taxation. A corporation can deduct interest payments pursuant to § 163, while dividends are not deductible by the corporation. *Westin v. Commissioner*, 53 T.C.M. (CCH) 797, 805 (1987) held that if advances from an investor to a corporation are considered capital contributions the investor may not subsequently claim a bad debt deduction. For additional tax treatment differences see generally BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (4th ed. 1979).

196. *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935).

197. *Id.*

*Co. v. Commissioner.*<sup>198</sup> In *Kelley*, the Court emphasized the fact that a substantial amount of capital had been invested into the stock of the corporation so that the corporation would not be thinly capitalized. The Court then stated, "as material amounts were invested in stock, we need not consider the effects of extreme situations such as normal stock investment and obviously excessive debt structure."<sup>199</sup> This observation has led some lower courts to consider the ratio between debt and equity as the determinative factor in distinguishing between the two forms of corporate investment.<sup>200</sup>

The courts subsequently began to use multiple factors<sup>201</sup> to distinguish a

198. 326 U.S. 521 (1946). The investment in question involved an eight percent noncumulative interest that was to be paid if earnings were sufficient. The investment had a twenty year maturity, and was subordinate to all creditors, but had priority over stockholders, and could not participate in management.

199. *Id.* at 526.

200. *E.g.*, *Rowan v. United States*, 219 F.2d 51 (5th Cir. 1955); *Dobkin v. Commissioner*, 15 T.C. 31 (1950), *aff'd per curiam*, 192 F.2d 392 (2d Cir. 1951).

201. Some of the factors the courts have considered as they weighed the debt versus equity issue:

*Byerlite Corp. v. Williams*, 286 F.2d 285, 290 (6th Cir. 1960); *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 376-77 (1973) (reporting the manner in which the parties to the transaction reported the advances on their books may be indicative of whether the parties intended to treat the transaction as debt or equity); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697-98 (3d Cir. 1968) (stating identity of interest—the court considered the identity of interest between the transfer of funds and the shareholders); *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972); *Wood Preserving Corp. of Baltimore v. United States*, 347 F.2d 117, 119-20 (4th Cir. 1967) (defining use of funds—to meet daily operating expenditures of the corporation, rather than capital assets, would indicate the likelihood of a loan); *Byerlite v. Williams*, 286 F.2d 285, 291 (6th Cir. 1960) (defining length of transaction terms—the length of the transaction is important, i.e., the longer the period over which advances and repayments are made the more it looks like equity); *Estate of Mixon v. United States*, 464 F.2d 394, 410-11 (5th Cir. 1972); *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159, 165-66 (6th Cir. 1956) (defining repayments—actual repayments of the advances pursuant to the terms of the transactions indicate debt); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 630 (6th Cir. 1986); *Bauer v. Commissioner*, 748 F.2d 1365, 1368-70 (9th Cir. 1984); *Post Corp. v. United States*, 640 F.2d 1296, 1307-08 (Cl. Ct. 1981) (defining debt to equity ratio—the higher the ratio of debt to equity within the corporation's capital structure (commonly referred to as thin capitalization) the more likely the advances were equity; thin capitalization is a strong indication that advances are capital contributions rather than equity); *A.R. Lantz Co. v. United States*, 424 F.2d 1330, 1334 (9th Cir. 1970); *Wood Preserving Corp. of Baltimore v. United States*, 347 F.2d 117, 119-20 (4th Cir. 1967) (pledging security—security provided for the repayment of the advances is indicative of debt); *In re Lane v. United States*, 742 F.2d 1311, 1317-18 (11th Cir. 1984); *C.M. Gooch Lumber Sales Co. v. Commissioner*, 49 T.C. 649, 659 (1968) (defining ability to repay—the corporation's ability to repay the advances without relying on profits is indicative of debt. If the expectation of repayment depends solely on the success of the borrower's business, the transaction has the appearance of a capital contribution. An expectation of repayment solely from corporate earnings is not indicative of bona fide indebtedness regardless of its reasonableness); *In re Lane v. United States*, 742 F.2d 1311, 1317-18 (11th Cir. 1984); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 632 (6th Cir. 1986) (defining sinking fund—the establishment of a sinking fund is indicative of debt); *Stinnett's Pontiac Service Inc. v.*



corporation's obligation to repay from an equity investment. Section 385<sup>202</sup> was enacted in 1969 as an attempt to establish uniform rules to define debt and equity.<sup>203</sup> The statute<sup>204</sup> authorized the Secretary of the Treasury to issue regulations governing the classification of debt and equity and provided guidelines to be considered in the regulations.<sup>205</sup> Regulations were issued in 1980, but were subsequently withdrawn in 1983.<sup>206</sup> Thus, case law<sup>207</sup> remains the primary guide for an inquiry into the debt-equity issue.<sup>208</sup>

In determining whether advances of funds to an individual corporation are considered a capital contribution or debt, the courts have expanded upon the five

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Commissioner, 730 F.2d 634, 640 (11th Cir. 1984); *Smith v. Commissioner*, 370 F.2d 178, 180 (6th Cir. 1966); *Georgia Pacific Corp. v. Commissioner*, 63 T.C. 790, 797-98 (1975) (stating ability to obtain outside financing—the corporation's ability to obtain financing from an independent outside lender is indicative of debt. Where no reasonable creditor would have acted in the same manner there is strong evidence that the transaction is a capital contribution); *Stinnett's Pontiac Service Inc. v. Commissioner*, 730 F.2d 634, 640 (11th Cir. 1984); *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 496 (1980) (defining provision to pay interest—where the corporation has made provisions for the payment of interest there is indication of debt); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 631-32 (6th Cir. 1986); *Stinnett's Pontiac Service Inc. v. Commissioner*, 730 F.2d 634, 639 (11th Cir. 1984); *Charter Wire, Inc. v. United States*, 309 F.2d 878, 881 (7th Cir. 1962); *Litton Business Systems Inc. v. Commissioner*, 61 T.C. 367, 378 (1973) (discussing repayment subordination—subordination of the right to repayment of the shareholder to other creditors of the corporation is indicative of a capital contribution); *In re Lane v. United States*, 742 F.2d 1311, 1315 (11th Cir. 1984); *Stinnett's Pontiac Service Inc. v. Commissioner*, 730 F.2d 634, 638 (11th Cir. 1984); *Post Corp. v. United States*, 640 F.2d 1296, 1304-05 (Ct. Cl. 1981) (discussing absence of a note—the absence of a note or other instrument of indebtedness indicated a capital contribution and not debt).

202. I.R.C. § 385 (West Supp. 1992).

203. I.R.C. § 385 (West Supp. 1992).

204. *Segel v. Commissioner*, 89 T.C. 816, 826-27 (1987) (discussing the history of § 385 and the issuance and withdrawal of the regulations thereunder).

205. I.R.C. § 385 (West Supp. 1992) provides five factors that could be considered in the § 385 regulations. The guidelines set out in § 385(b)(1)-(5) in full are:

- (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
- (2) whether there is subordination to or preference over any indebtedness of the corporation;
- (3) the ratio of debt to equity of the corporation;
- (4) whether there is convertibility into the stock of the corporation, and
- (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

206. Prop. Treas. Reg. §§ 1.385-1 to 1.385-12, 45 Fed. Reg. 18957 (1980) (proposed Mar. 24, 1980), revised, 45 Fed. Reg. 18957 (1980), revised and reported as Prop. Treas. Reg. §§ 1.385-0 to 1.385-8, 47 Fed. Reg. 164 (1982), withdrawn, 48 Fed. Reg. 31053-54 (1983).

207. See *supra* note 201 for a summary of factors considered by the courts.

208. *Segel v. Commissioner*, 89 T.C. 816 (1987) (discussing the history of § 385 and the issuance and withdrawal of the regulations thereunder, which were withdrawn in 1983).

factors listed in section 385.<sup>209</sup> The factors considered by the courts<sup>210</sup> can be broken down into four broad, yet, interrelated standards: 1) the intent of the parties; 2) the formal characteristics of the debt; 3) the economic realities of the transaction; and 4) the business purposes of the transaction. Each factor must be considered based on the circumstances in each case.<sup>211</sup> No one factor, moreover, is decisive, nor can it be weighed more heavily than the others in determining whether the character of an advance is debt or equity.<sup>212</sup> The factors discussed *infra* are used by the courts in answering the ultimately determinative questions: was there a genuine intention to create debt,<sup>213</sup> with a reasonable expectation of repayment,<sup>214</sup> and did that intention conform with the economic reality of creating a debtor-creditor relationship?<sup>215</sup> In weighing the numerous factors, the court will not elevate the form of a transaction over its substance.<sup>216</sup> Thus, all the formalities may point to the treatment of advances as debt, but the court, nonetheless, may find that the advance is equity if the reality of the transaction weighs against treating it as indebtedness.<sup>217</sup>

## V. IMPACT OF CURRENT STATUTES ON CERTAIN BUSINESS TRANSACTIONS

### A. *Impact of Section 2701 on a Stock Redemption.*

Section 2701 applies to stock redemptions<sup>218</sup> and other changes to the capital structure of a corporation,<sup>219</sup> provided that the transaction meets all of the other provisions of section 2701.<sup>220</sup> The following is an example that illustrates the impact of section 2701 on a stock redemption.

Assume that a business that is worth \$4,000,000 is owned by parents who wish to retire and let their children take over control of the company. The parents, however, need to sell the company to fund their retirement. One route that they could take is a corporate redemption of their stock. Further, assume that the children of the parents do not have the necessary funds to buy all of the

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209. See *supra* note 201 for a summary of factors considered by the courts.

210. See *supra* note 201 for a summary of factors considered by the courts.

211. *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).

212. *John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 630 (6th Cir. 1986).

213. *Lundgren v. Commissioner*, 376 F.2d 623, 626 (9th Cir. 1967).

214. See *supra* note 201.

215. *Byerlite Corp. v. Williams*, 286 F.2d 285, 290-91 (6th Cir. 1960).

216. *Id.*

217. *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980).

218. I.R.C. § 2701(e)(5) (West Supp. 1992). The term redemption is defined in § 317(b) as a corporation's acquisition of its own stock from a shareholder in exchange for property.

219. *Id.*

220. See *supra* notes 99-136 and accompanying text for a discussion of § 2701's equivalents.

stock from the parents, so the children buy only five percent of the stock. The corporation buys the other ninety-five percent. Assume that the children and the corporation each pay fair market value.

The corporation does not have the \$3,800,000<sup>221</sup> in cash necessary to pay for the stock, so it gives the parents an installment note at a fair market interest rate as payment for the redemption of the parent's stock. This appears to be a very straightforward transaction without any gimmicks, freezes, or tax avoidance motivations. Indeed, the parents are not trying to retain control while transferring future appreciation to the children. Rather, the parents are merely selling their interests and allowing the children to run the company. Thus, the children can make the company grow and appreciate in value; ideally, any appreciation should belong to them.

As clean as this transaction appears to be, it may fall into the web of section 2701. Debt does not constitute an applicable retained interest,<sup>222</sup> which is necessary in order to find that a section 2701 transfer<sup>223</sup> has occurred. Applicable retained interests must be equity interests.<sup>224</sup> However, the debt versus equity rules<sup>225</sup> may recharacterize the debt in this example as equity.<sup>226</sup> In this situation, the debt is unusually large in relation to the total value of the corporation. Thus, the debt alone could trigger the recharacterization.<sup>227</sup> In general, if the debt has equity-like characteristics, the debt is in danger of being recharacterized as equity.<sup>228</sup> Furthermore, the IRS will refuse to rule on whether the debt in a proposed transaction is really equity.<sup>229</sup>

If the debt, as in this example, is recharacterized as equity, it will likely be treated as preferred stock. Under section 2701, whenever a senior family member transfers common stock to a junior family member—even if it is transferred for full market value—the value of the common stock is treated as a gift.<sup>230</sup> Since the value of the gift is determined by the subtraction method<sup>231</sup>

221. \$4,000,000 multiplied by 95%.

222. See *supra* note 117 for a definition of retained interest.

223. See *supra* note 110 for a discussion of transfers subject to § 2701.

224. See *supra* note 117 for a discussion of retained interests.

225. See *supra* notes 186-193 and accompanying text.

226. See *supra* notes 194-217 and accompanying text.

227. See *supra* note 201 for a list of factors courts use to distinguish debt from equity, one of which relates to the debt to equity ratio.

228. See *supra* note 201 for characteristics that courts have found to be equity-like characteristics.

229. The IRS announced in Rev. Proc. 91-3 that it will no longer issue rulings on whether debt is equity.

230. See *supra* notes 110-125 and accompanying text.

(the value of the preferred is subtracted from the total value of the entity), the value of the gift depends upon the value ascribed to the preferred stock by section 2701. Section 2701 values the preferred stock as zero unless it carries a qualified payment right and the qualified payments are actually made.<sup>232</sup>

It is likely that the installment note is a qualified payment.<sup>233</sup> The installment note has a periodic payment determined at a fixed rate.<sup>234</sup> Because it is a qualified payment, it will not automatically be valued at zero.<sup>235</sup> The value of the installment note (the retained interest in this example) will depend on its investment value.<sup>236</sup> If the note does not carry a market rate of interest, the note is likely to be valued at a discounted amount, because it does not have good investment value.<sup>237</sup> To the extent that the note is discounted, the value of the gift increases. For the purposes of section 2701, the installment note, characterized as preferred stock, itself is not subject to special valuation rules. The distribution right (the interest payment) is what affects the value of the transferred interest.

Even if the corporation can meet the payments and the debt sustains full value under scrutiny, the ten percent minimum value rule<sup>238</sup> would result in a taxable gift.<sup>239</sup> This would be true even though the dividends were qualified payments, the distribution rights held their full value of \$3,800,000, and the children paid fair market value for the common stock. The result is an unexpected taxable gift, even though no gift was intended to be made.

### B. New Business Start-Up

Another disturbing impact of section 2701 can be seen in a common business start-up scenario. If the children--who own one hundred percent of the common stock of a new corporation--ask their parents for a loan, the parents have the same potential problems as in the redemption situation previously discussed.<sup>240</sup> The regulations in section 2701 treat a contribution to capital, whether to an existing entity or to a new start-up entity,<sup>241</sup> as a transfer if the transferor, or other family members, receive an applicable retained interest or,

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231. See *supra* notes 140-171 and accompanying text.

232. See *supra* note 121 and accompanying text for a definition of a qualified payment right.

233. See *supra* note 121 and accompanying text.

234. See *supra* note 121 and accompanying text.

235. I.R.C. § 2701(a)(3)(A) (West Supp. 1992).

236. See *supra* note 163 and accompanying text.

237. See *supra* note 163 and accompanying text.

238. See *supra* note 172-75 and accompanying text.

239. I.R.C. § 2701(a)(4)(A) (West Supp. 1992); Treas. Reg. § 25.2701-3(c) (1992).

240. See *supra* notes 218-39 and accompanying text.

241. Treas. Reg. § 25.2701-1(b)(2)(i) (1992).

immediately after the transfer, hold an applicable retained interest in the entity.<sup>242</sup> For purposes of a contribution to capital, it does not matter whether the interests held by the transferor and transferee before and after the transaction are substantially identical.<sup>243</sup> With respect to other capital transactions, however, the substantially identical before and after rule would cause this subsection to not apply.

Assume, for example, that the children capitalize the business with \$200,000 for one hundred percent of the common stock of the new corporation. Then, rather than going to a bank, the children borrow \$3,800,000 from their parents at the prevailing market rate of interest under terms calling for repayment of the principal over fifteen years. Just as in the redemption example previously discussed,<sup>244</sup> if the debt in our example is recharacterized as equity,<sup>245</sup> it will probably be treated as preferred stock. Even if the corporation can meet the payments and the debt sustains a full value under scrutiny, the ten percent minimum value rule<sup>246</sup> would cause a reportable gift.<sup>247</sup> This would be true even though the dividends were qualified payments, the distribution rights held their full value of \$3,800,000, and the children paid fair market value for the common stock at incorporation.<sup>248</sup> The result is an unexpected taxable gift where no gift was intended to be made.

### C. The Problem With Section 2701

Congress intended section 2701 to provide a well-defined and administrable set of rules, which would allow those business owners who are not abusing the transfer tax system to freely exchange business interests in standard intrafamily transactions, without being subject to severe transfer tax consequences while, at

242. See *supra* note 117 for a definition of retained interests.

243. See *supra* notes 133-36 and accompanying text.

244. See *supra* notes 218-39 and accompanying text.

245. See *supra* notes 186-93 and accompanying text.

246. See *supra* notes 172-75 and accompanying text.

247. I.R.C. § 2701(a)(4)(A) (West Supp. 1992); Treas. Reg. § 25.2701-3(c) (1992).

248. I.R.C. § 6501(c) (West Supp. 1992). The statute of limitations is unlimited with respect to any Chapter 14 gift unless:

1. The gift is shown on a gift tax return, or
2. If not shown as a gift, it is disclosed in such a return in a manner adequate to apprise the IRS of the nature of the item.

In addition to the gift tax unlimited statute of limitations under Chapter 14, there also is the case of *Estate of Frederick R. Smith*, 94 T.C. 872 (1990). The court in *Smith* held that there is no time limit on the right of the IRS to revalue prior taxable gifts in computing adjusted taxable gifts for federal estate tax purposes. *Id.* at 878. In other words, even if the taxpayer files a gift tax return and pays some gift tax, while he may be safe from gift tax challenge after three years, the taxpayer is never safe from federal estate tax challenge with respect to the value of the gift reported on that gift tax return.

the same time, deterring abusive transactions in the transfer tax system.<sup>249</sup> The result--as illustrated in previous examples<sup>250</sup>--appears to be that section 2701, coupled with the power of the IRS to recharacterize debt as equity, has added uncertainty to several common transactions between stockholders and their closely held corporations.

Unless changes are made to section 2701, the capital structure of closely held businesses must be carefully scrutinized to determine whether debt may be recharacterized as equity, thereby creating unintended taxable gifts. This cloud of uncertainty may inhibit business formations and force family members to obtain financing from outside third parties rather than other family members. Furthermore, the potential chilling effect on legitimate business transactions between a parent and child is contrary to the stated Congressional objectives.<sup>251</sup>

## VI. PROPOSED REVISIONS

### A. Safe Harbor for Debt

Section 2036(c)<sup>252</sup> was repealed because its application posed an unreasonable impediment to the transfer of family businesses and caused many taxpayers to refrain from legitimate intrafamily transactions.<sup>253</sup> One objective of section 2701 is to allow business owners who are not abusing the transfer tax system to exchange their business interests in legitimate intrafamily transactions, without subjecting them to severe transfer tax consequences.<sup>254</sup> The uncertainty and potentially adverse transfer tax impact that is created by the combination of section 2701 with the debt-equity issue,<sup>255</sup> contrary to the objectives behind section 2701,<sup>256</sup> will likely inhibit legitimate intrafamily business transactions.

To achieve the stated legislative intent,<sup>257</sup> a safe harbor<sup>258</sup> should be provided in section 2701 for legitimate intrafamily transactions that use debt, but

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249. SENATE REPORT, *supra* note 25, at S15680-1.

250. See *supra* notes 218-248 and accompanying text.

251. SENATE REPORT, *supra* note 25, at S15680.

252. See *supra* note 4 and accompanying text.

253. SENATE REPORT, *supra* note 25, at S15680; Burke, *supra* note 24, at 69.

254. SENATE REPORT, *supra* note 25, at S15680; Burke, *supra* note 24, at 69.

255. See *supra* notes 186-193 and accompanying text for discussion of the debt-equity issue.

256. SENATE REPORT, *supra* note 25, at S15680; Burke, *supra* note 24, at 69.

257. SENATE REPORT, *supra* note 25, at S15680; Burke, *supra* note 24, at 69.

258. Transactions falling within specific guidelines are excluded from the scope of the general statute. This is commonly referred to as a safe harbor. BLACK'S LAW DICTIONARY 1336 (6th ed. 1990).

fall within the combined scope of section 2701 and the debt-equity rules.<sup>259</sup> Section 2036(c), the predecessor to section 2701, provided a safe harbor for qualifying debt.<sup>260</sup> The legislative history behind the safe harbor for qualified debt provision indicates that the exception may be appropriate, since qualified debt is easily valued, provides limited opportunities for disguised wealth transfers,<sup>261</sup> and does not constitute retained enjoyment of the enterprise.<sup>262</sup>

The rationale expressed by Congress toward debt is still applicable to transactions under section 2701. In the absence of a safe harbor for qualified debt provision in section 2701, business owners may restrict legitimate intrafamily transactions due to the uncertainties of the potentially adverse tax consequences. To achieve the legislative intent of section 2701,<sup>263</sup> and allow for legitimate intrafamily transactions that do not abuse the transfer tax system, a statutorily qualified debt safe harbor provision similar to the repealed section 2036(c)(7)(C)<sup>264</sup> should be added to section 2701.

259. See *supra* notes 186-193 and accompanying text.

260. *Burke*, *supra* note 24, at 111-116 for an analysis of the qualified debt safe harbor under § 2036(c)(7)(C). Section 2036 (c)(7)(c), *supra* note 4, defined qualified debt as:

The term "qualified debt" means any indebtedness if:

(i) such indebtedness-

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

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

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

(I) a fixed rate, or

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

(iii) the interest payment dates are fixed,

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

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

(vi) such indebtedness-

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

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

The requirement of clause (i)(I) that the 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.

261. I.R.C. § 7872 (West Supp. 1992), generally requires below-market interest rates to be imputed at prevailing rates among the parties who are then taxed as if market interest was charged and paid.

262. See *Burke*, *supra* note 24, at 112; S. REP. NO. 445, 526-29, 100th Cong., 2d Sess. 6 (1988), *reprinted in* 1988 U.S.C.C.A.N. 5028-31.

263. See *supra* note 25 and accompanying text.

264. See *supra* note 260.

*B. Safe Harbor for Start-Up Debt*

Presumably, in the case of start-up debt, an appreciation in the value of a business will result chiefly from the efforts of the younger generation shareholder.<sup>265</sup> Therefore, no transfer or gift occurs when a parent makes a legitimate loan to a child's start-up business. Under the repealed section 2036(c), a separate safe harbor existed for this start-up debt.<sup>266</sup> Even though section 2701 does not specifically include start-up debt, the Treasury added this interpretation when it promulgated the regulations<sup>267</sup> for section 2701.

Contrary to the stated objectives for section 2701,<sup>268</sup> without a safe harbor for start-up debt in section 2701, younger generation shareholders may be inhibited from legitimately borrowing funds from family members for business start-ups. Therefore, Congress should carve out a safe harbor for start-up debt in section 2701 similar to the repealed I.R.C. section 2036(c)(7)(D).<sup>269</sup>

## VII. CONCLUSION

Section 2701 is complex and seems to impact certain transactions that appear to be beyond the legislature's intent.<sup>270</sup> An understanding of section

265. Cf. S. REP. NO. 445, *supra* note 262, at 528, *reprinted in* 1988 U.S.C.C.A.N. at 5038-39.

266. See generally Burke, *supra* note 24, at 114-115 (for an analysis of the qualified start-up debt safe harbor under former § 2036(c)(7)(D)).

267. See *supra* note 241 and accompanying text.

268. See *supra* note 25 and accompanying text.

269. Section 2036(c)(7)(D) (1988) (*supra* note 4) defined qualified start-up debt as:

(i)(I) such indebtedness unconditionally requires the payment of a sum certain in money,

(II) such indebtedness was received in exchange for cash to be used in any enterprise involving the active conduct of a trade or business,

(III) the person to whom the indebtedness is owed has not at any time (whether before, on, or after the exchange referred to in subclause (II)) transferred any property (including goodwill) which was not cash to the enterprise or transferred customers or other business opportunities to the enterprise,

(IV) the person to whom the indebtedness is owed has not at any time (whether before, on, or after the exchange referred to in subclause (II)) held any interest in the enterprise (including an interest as an officer, director, or employee) which was not qualified start-up debt,

(V) any person who (but for subparagraph (A)(i)) would have been an original transferee (as defined in paragraph (4)(C)) participates in the active management (as defined in section 2032A (e)(12)) of the enterprise, and

(VI) such indebtedness meets the requirements of clauses (v) and (vi) of subparagraph (C).

270. See *supra* note 25 and accompanying text.



2701 is imperative not only for the estate planning practitioner, but for all attorneys who handle corporate formations or advise family owned corporations issuing debt or capital among family members. Section 2701 is so broad that many routine transactions, such as the redemption of a corporation's stock or the formation of a new business,<sup>271</sup> could become ensnared in its provisions. Transactions that use debt rather than equity may find themselves within the scope of section 2701, if the debt is recharacterized as equity.<sup>272</sup> The transactions ensnared in the web of the new statutes will be treated as preferred stock recapitalizations, thereby creating unexpected gift or estate taxes. Thus, the impact of these statutes must be understood not just from an estate planning standpoint, but also from a general business planning perspective.

Unless Congress enacts statutory revisions that provide safe harbor exceptions for qualified debt and qualified start-up debt, similar to those provided under the repealed section 2036(c), family business transactions will continue to be clouded in uncertainty. Business owners will continue to be confused as to whether they are inadvertently providing taxable gifts to their children. Hopefully, Congress will provide additional guidance to family business owners to avert the chilling effect of section 2701 on legitimate business transactions between family members.

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271. See *supra* notes 218-41 (discussing the transfers covered by § 2701).

272. See *supra* notes 188-93 and accompanying text.

APPENDIX B  
Steps to Determine Whether  
Section 2701 Applies

Step 1. Is the transaction a transfer?<sup>273</sup>

- \*contribution to capital
- \*redemption
- \*recapitalization
- \*other change in capital

If not, then section 2701 is inapplicable.

Step 2. If the transaction is a transfer (Step 1), does the transferor or applicable family member<sup>274</sup> receive an applicable retained interest?<sup>275</sup>

If not, then section 2701 is inapplicable.

Step 3. If the transferor or applicable family member receives an applicable retained interest (Step 2), are the interests held before and after the transaction substantially identical?<sup>276</sup>

If so, then section 2701 is inapplicable.

Step 4. If the interests are not substantially identical (Step 3), is the interest one for which there are market quotations from established securities markets?<sup>277</sup>

If so, then section 2701 is inapplicable.

Step 5. If market quotations from established securities markets are unavailable (Step 4), is the new interest the same class as the transferred interest?<sup>278</sup>

If so, then section 2701 is inapplicable.

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273. See *supra* note 110 and accompanying text.

274. See *supra* note 114 and accompanying text.

275. See *supra* note 117 and accompanying text.

276. See *supra* note 136 and accompanying text.

277. See *supra* notes 130-31 and accompanying text.

278. See *supra* note 133 and accompanying text.

## APPENDIX A

Example of Preferred Stock Recapitalization  
Prior to Sections 2036(c) and 2701

Assume that a parent owns 100 percent of the common stock of Z Corporation, valued at \$10,000,000.

Step 1. The parent recapitalizes the equity into:

\*Common stock worth \$1,000,000

\*Preferred stock worth \$9,000,000, with an eight percent non-cumulative dividend.

Step 2. The parent gifts common stock to the child and keeps the preferred stock. The parent then pays the gift tax on \$1,000,000.

Assume that ten years later the business is worth \$20,000,000. The parent then owns preferred stock worth \$9,000,000. The child owns common stock worth \$11,000,000.

Step 3. When the parent dies, the parent's estate pays tax on \$9,000,000, the value of his preferred stock. In step two, the parent paid gift tax on \$1,000,000. Therefore, total transfer taxes are paid on \$10,000,000.

Step 4. Without the recapitalization and gift tax, the parent's estate would pay tax on the full value of the corporation at his death of \$20,000,000.

Step 5. Transfer tax savings:

Corporate Value at Death . . . . .	\$20,000,000
Tax Paid on . . . . .	\$10,000,000
	-----
Savings: equal to the transfer tax on . . . . .	\$10,000,000

- Step 6. If the new interest is not the same class as the transferred interest (Step 5), is the new interest proportionally the same as the transferred interest?<sup>279</sup>**

**If so, then section 2701 is inapplicable.**

- Step 7. If the new interest is not proportionally the same as the transferred interest (Step 6), then section 2701 applies, and the interest must be valued according to section 2701.**

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**279. See *supra* note 134 and accompanying text.**

## APPENDIX C

## Section 2701 Valuation of Retained Interest

Step 1. Is the interest a qualified payment right?<sup>280</sup>

If not, the value of the right is zero (value of retained interest is zero)<sup>281</sup>

Step 2. If the interest is a qualified payment right (Step 1), does it have any of the following rights:

- \*Liquidation Right
- \*Put
- \*Call
- \*Conversion Right<sup>282</sup>

Step 3. If the qualified payment right does contain any of these rights (Step 2), the value of the retained interest is computed as if the right is exercised in a manner resulting in the lowest value for all rights.<sup>283</sup>

If the qualified payment right does not contain any of these rights (Step 2), the value of the retained interest is based on the fair market value.<sup>284</sup>

Step 4. The value of the gift using the subtraction method<sup>285</sup> is then determined using the value of the retained interest determined in Step 1 or Step 3.

- a. Determine the fair market value of the family-held equity interest after the transfer.<sup>286</sup>
- b. Subtract from the value of the family held-equity interest after the transfer (Step 4a) the value of the retained interest determined in Step 1 or Step 3 above.<sup>287</sup>

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280. See *supra* notes 120-21 and accompanying text.

281. See *supra* note 122 and accompanying text.

282. See *supra* note 124 and accompanying text.

283. See *supra* note 125 and accompanying text.

284. See *supra* notes 161-165 and accompanying text.

285. See *supra* notes 141, 149 and accompanying text.

286. See *supra* notes 158-60 and accompanying text.

287. See *supra* notes 161-65 and accompanying text.

- c. Allocate the remaining value to the transferred interests, junior equity (usually the common stock).<sup>288</sup>
- d. Reduce the Step 4c amount by any discounts.<sup>289</sup>

The minimum value of a junior interest is ten percent of all equity interests in the entity plus the total indebtedness of the entity to the transferor or applicable family member.<sup>290</sup>

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288. See *supra* note 166 and accompanying text.

289. See *supra* notes 167-69 and accompanying text.

290. See *supra* notes 172-75 and accompanying text.

