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TAX THOUGHTS

By John McGown, Jr.
Hawley Troxell Ennis & Hawley

This month's column again has two parts. The general interest item is a discussion of new Section 2036(c) of the Internal Revenue Code dealing with disproportionate transfers. It is written by John A. Miller, tax professor at the University of Idaho Law School.

This discussion is followed by Tax Forum, an exchange of ideas of particular interest to Idaho attorneys practicing in the tax area.

The Latest Turn Of The Screw In Estate Planning: The Legislative Attack On Disproportionate Transfers

By John A. Miller

In 1987 and again in 1988 Congress took shots at closing perceived loopholes in the estate and gift taxes in the valuation freeze area.¹ The end result was the addition of an elaborate subsection to Section 2036 of the Internal Revenue Code. This new provision, Section 2036(c), is designed to prevent estate and gift tax avoidance through the use of the planning mechanism commonly known as the estate freeze.²

In general, an estate freeze involved division of ownership of a business into two parts, a frozen interest and a growth interest. Ideally, the frozen interest was worth the present value of the business and the growth interest held only the potential for becoming valuable if the business prospered. By selling or giving away (at a low gift tax cost) the growth interest, a taxpayer could maintain control of the business and continue to enjoy the income from the business while excluding any further appreciation in its value from her gross estate. The classic estate freeze is the corporate recapitalization in which the taxpayer

takes back preferred stock with dividend and liquidation preferences approximating the business' present income stream and present fair market value. The taxpayer also receives common stock which will only have value if the business grows. By giving away the common stock to her children, the taxpayer excludes (before enactment of Section 2036(c)) any appreciation in the value of the business from her gross estate.³

This transfer of the growth interest is referred to as a *disproportionate* transfer because the growth interest possesses disproportionately greater potential for appreciation than the retained frozen interest.⁴ Section 2036(c) attacks all forms of disproportionate transfers of an interest in an "enterprise" (a term not defined in the statute but which presumably will be defined in the regulations). This means the provision holds the potential for application to many circumstances beyond the stereotypical estate freeze. For instance, option and buy-sell agreements may be within its ambit unless the agreements provide that the purchase price will be fair market value on the date of exercise of the

option or the rights under the buy-sell.⁵ Depending on the course Treasury takes in drafting the regulations implementing Section 2036(c), even such innocuous devices as minority discounts may be within its reach.

The Section's mechanism for eliminating the estate tax benefits of freezes is to treat a retained frozen interest in an estate freeze as the equivalent of a retained life estate in the given up growth interest for purposes of the application of Section 2036(a).⁶ Section 2036(a) draws into the gross estate remainders given away prior to death by decedents who retained a life interest in the property. Thus, Section 2036(c) draws into the gross estate (via Section 2036(a)) transferred growth interests in estate freezes.

Prior to the 1988 changes, one might have avoided an adverse tax result by giving away the frozen interest more than three years before dying. But the current version of the statute creates a deemed gift (for gift tax purposes) of the post-freeze appreciation in the value of the growth interest by the original transferor upon the post-freeze transfer of either the frozen or growth interests.⁷ This means that

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any maneuver designed to avoid the estate tax consequences of the provision leads to similar gift tax consequences under the subsection's other prong.

The amounts of the estate tax inclusion and the deemed gift are both adjusted in cases where full and adequate consideration not traceable to the original transferor was provided by a family member who was the original transferee in the disproportionate transfer. The effect of the adjustment in each case is to realign the transfer as though it had been proportionate (e.g., as though the transferor had simply transferred common stock in an enterprise with no other classes of stock).⁸ In this way some, but not all, of the appreciation in the value of the growth interest is still drawn into the gross estate or is the subject of a deemed gift. A bona fide sale to a nonfamily member will remove the entire growth interest from the ambit of Section 2036.

The 1988 amendments to Section 2036(c) included some safe harbor provisions. Certain forms of Grantor Retained Interest Trusts (GRITs) are excluded from its application.⁹ But perhaps the most significant safe harbor is for certain installment sales of enterprises.¹⁰ The fact that a safe harbor rule for installment sales was considered necessary is indicative of how broadly Section 2036(c) may be applied. The full breadth of the provision will not be known until Treasury promulgates regulations under the authority granted it by Section 2036(c)(8). Until that time, estate planners will need to be particularly careful in shaping inter vivos and, in some cases, testamentary transfers which involve bifurcation of interests in property. □

¹ Omnibus Budget Reconciliation Act (OBRA), Pub. L. No. 100-203, § 10402(a), 101 Stat. 1431 (1987) (Titles IX and X of the Act are referred to as the Revenue Act of

1987); Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, H.R. 4333, § 3031(a), 102 Stat. 3634 (1988).

² H. Rep. No. 391, 100th Cong., 1st Sess., 1043 (1987). Earlier that same year the Tax Court had rejected the Service's argument that the gifted growth stock in a corporate recapitalization freeze was includable in a decedent's gross estate under Section 2036(a). *Boykin Est. v. Comm'r*, 53 T.C.M. 345 (1987).

³ For descriptions of the various forms of estate freezes, see Abbin, "The Value Capping Cafeteria — Selecting the Appropriate Freeze Technique," 15 U. Miami Inst. Est. Plan. Ch. 20 (1981).

⁴ As originally enacted, Section 2036(c) was activated by a transfer of a disproportionately large share of the potential appreciation of an enterprise while retaining a disproportionately large share of income or rights in the enterprise. See the 1987 version of Section 2036(c)(1)(B).

⁵ The statute provides a safe harbor for options and buy/sells which meet this condition. I.R.C. § 2036(c)(7)(A)(iii).

⁶ I.R.C. § 2036(c)(1).

⁷ I.R.C. § 2036(c)(4).

⁸ I.R.C. § 2036(c)(2). There may be a technical error in the drafting of this provision but the legislative history makes clear the Congressional intent behind its enactment.

⁹ I.R.C. § 2036(c)(6).

¹⁰ I.R.C. § 2036(c)(7).

Tax Forum

By John McGown

Taxation, Probate and Trust Section of the Idaho State Bar.

A new Taxation, Probate and Trust Section of the Idaho State Bar is being formed. The organizational meeting will take place at the Idaho State Bar offices, 204 W. State Street in Boise at 4:30 p.m. on July 26 (Wednesday).

Interested parties should contact Steven E. Alkire or Joseph H. Uberuaga II, c/o Eberle, Berlin, Kading, Turnbow & Gillespie, P.O.

Box 1368, Boise, Idaho 83701, by July 24. Their telephone number is 344-8535. Many thanks to Steve and Joe for their work in helping organize the section.

Idaho Inheritance Tax Issue

The "tentative" estate tax is computed by multiplying the applicable rate under Section 2001(c) times the sum of the taxable estate and the amount of adjusted taxable gifts. The state death tax credit is based on the applicable rate times the adjusted taxable estate (which is the taxable estate less \$60,000).

An interesting issue arises when the taxable estate is below \$600,000, but the adjusted taxable gifts result in a sum in excess of \$600,000. The Idaho State Tax Commission takes the position that the state death tax credit is payable in such situations (both for decedents dying before 1989 (under the "old" law) and for decedents dying after 1988 (under the "new" law)). The Internal Revenue Service appears to have some question whether it will grant the credit in such cases, especially for decedents dying before 1989.

New Idaho Inheritance Tax Form

The Idaho State Tax Commission has issued a new Form 33 for decedents dying after 1988 (under the "new" law). It may be obtained by writing the State Tax Commission, P.O. Box 36, Boise, Idaho 83722. □



John McGown