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An Analysis of the TAMRA Changes to the Valuation Freeze Rules: Part II

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A deemed gift provision now applies, adjustments are now made for consideration received, and a right of contribution has been enacted.

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As indicated in the first part of this article,[1] the significant changes to Section 2036(c) made by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) do not resolve all doubts concerning its application. However, under TAMRA, several new provisions come into play once the section does apply. These include a deemed gift provision and adjustments in the amount includable in the gross estate on account of the retained interest and the consideration received. In addition, TAMRA has also provided for a right of contribution for estate or gift tax.

Deemed Gift Provision

Section 2036(c) was originally an estate tax inclusion provision only. Hence, if the original transferor disposed of the retained interest (at least three years prior to death), Section 2036(c) would not operate on the originally transferred interest. The section was unclear in its application if the original transferee disposed of the transferred interest. In any event, TAMRA adds a type of gift tax provision. Under Section 2036(c)(4)(A), if either the original transferee (*e.g.*, the child) transfers the transferred property to a person other than a member of the family of the original transferor,[2] or the original transferor (*e.g.*, the parent) transfers the retained interest, then the original transferor (*e.g.*, the parent) is treated as making a gift to the original transferee. It seems that even the original transferor's transfer of the retained interest to a family member triggers the deemed gift. Although Section 2036(c) applies to "in effect" transfers, the subsequent dispositions by the original transferor or transferee which are deemed to be gifts under Sections 2036(c)(4)(A)(i) and (ii) seem to include only "transfers," not "in effect" transfers.

A change that restores proportionality with respect to the appreciation of both the transferred and retained interests also seems to be treated as a transfer for this purpose under the "termination or lapse" rule (discussed below).[3] The gift is the amount that would have been includable under Section 2036(c) had the transferor died immediately prior to the "gift." However, neither alternate valuation nor special-use valuation applies. The deemed gift is reduced by any taxable gift previously made with respect to the original transfer (Section 2036(c)(4)(D)(iii)). Also, as discussed more fully below, a type of consideration offset (which is adjusted) is taken into account in determining the amount that would have been includable in the transferor's estate if the interest had been retained until death.

The deemed gift is treated as made to the original transferee, although if the member of the family who initially received the interest transferred it in turn to another family member, this second (or more subsequent) family member is treated as the original transferee.

EXAMPLE: A father makes a transfer described in Section 2036(c) to his daughter, who in turn transfers it to her brother (her father's son). The father will be deemed to have made a gift to his son if the son transfers the interest to someone outside the family.[4]

It seems that the deemed gift will be treated as occurring whether the subsequent transfer by the original transferor or transferee is gratuitous or for full value. If it is gratuitous, a double "gift" or a "gift plus estate tax" transfer occurs.

EXAMPLE: The original transferor's son dies and leaves the transferred interest to a person who is not a member of the original transferor's family. The transferred interest will be includable in the son's estate and simultaneously be treated as a "gift" to the son by the original transferor.

Under newly enacted Section 2207B (discussed below), the father would be entitled to recover from the son, or presumably the son's estate, the gift tax attributable to the deemed transfer. It would appear that the son's estate would be entitled to a deduction under Section 2053 with respect to the father's claim against the estate. If the father

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were to waive his right of recovery after the death of his son, the estate might not be entitled to a Section 2053 deduction[5] and the father would presumably be viewed as having made a gift to the beneficiaries of the son's estate. It would seem preferable for the father to enforce the right of recovery, thereby securing the Section 2053 deduction for the son's estate; the father could then give the amount recovered from the estate to the beneficiaries. Although this approach does result in a taxable gift by the father equal to the amount he would be entitled to recover under Section 2207B, it does avoid forfeiture of the Section 2053 deduction for the son's estate that a waiver might entail. Finally, the payment by the son's estate to the father should not affect the estate's basis, which should be determined under Section 1014 without regard to the estate's Section 2207B obligation.

EXAMPLE: After 12/17/87 a parent gave away all the common stock in a corporation, while retaining all the preferred stock. If the parent were to later sell the preferred stock, the parent would be treated as having made a gift of the common stock at that time. The amount of the gift equals the FMV of the common stock at the time of the deemed gift reduced by the FMV of the common stock at the time of the original transfer. The common stock is not thereafter includable under Section 2036(c) in the transferor's estate.

Where the original transferor transfers a portion of the retained interest or the original transferee transfers (outside the family) a portion of the transferred property, a proportionate amount of the originally transferred property is treated as transferred by gift. The remaining part is still subject to Section 2036(c).[6]

Generally, the termination, lapse or other change in any interest in the property of the transferor or transferee is treated as a transfer under the deemed gift rule. Hence, if the parent retains preferred stock which by its term expires in ten years, there will be a deemed gift with respect to the common stock given to the child at the end of the ten years when the preferred stock expires.[7]

However, because (as is discussed in the first part of this article) Section 2036(c) does not apply with respect to certain so-called grantor retained income trusts (GRITs), the termination or lapse of an interest in (or the transfer of an income interest in) such a trust generally will not constitute a deemed gift under Section 2036(c), provided the trust satisfies the requirements of Section 2036(c)(6).

Even the original transferor's transfer of the retained interest to a family member triggers the deemed gift.

Under TAMRA, the Treasury is required to prescribe Regulations to carry out the purposes of Section 2036(c), including those to prevent avoidance of the section through distributions or otherwise. A distribution that is substantially equivalent to a liquidation might be treated as a deemed gift of the entire amount which would have been included in the transferor's estate had he died immediately before the transfer.[8] Such a gift might be deemed to occur if a distribution leaves the enterprise with virtually no assets.

The House Report suggests that Section 2035(d)(2) does not apply with respect to the transferred interest where the retained interest is transferred within three years of death. However, if Section 2036(c) applies both with respect to the transferred and the retained interests, Section 2035(d)(2) would seem to be applicable.

Adjustments in the Amount Includable

Section 2036(c) originally provided that an appropriate adjustment would be made for the value of the retained interest. TAMRA also provides for an adjustment for the consideration received by the original transferor, in some cases, in Section 2036(c)(2)(B). Subject to showing (as discussed below) that this consideration was not provided by the original transferor, if a member of the transferor's family[9] provides consideration in money or money's worth for an interest in the enterprise, then a part of the enterprise may not be included under Section 2036(c). The part which may be excluded is the portion of the enterprise which otherwise would have been included in the gross estate times a fraction. The numerator is the consideration received and the denominator is the portion of the enterprise which would have been includable in the gross estate immediately after the disproportionate transfer (without any adjustment under Section 2036 (c)(5) for the value of the retained interest). As drafted, Section 2036 (c)(2)(B) seems to have a technical flaw. Read literally, it would appear that the section would not effectively apply to any full value sale of an interest in an enterprise to a family member. The legislative history strongly suggests, however, that it results in only a partial limitation to the operation of the section. According to the Conference Report, only that proportionate part of the transferor's entire interest in the enterprise (both the part sold and the part retained) which the family member buys is excluded.[10] Hence, if the transferor retains any interest in the enterprise while selling an interest representing a disproportionately large share of potential appreciation, Section 2036(c) appears to apply to at least a part of the transferred interest even if the sale is for full value.

Also, appropriate adjustments are to be made for the value of the retained interest, extraordinary distributions, and changes in the capital structure of the enterprise of the original transfer (Section 2036(c)(5)). No guidance as to the operation of these adjustments is provided by TAMRA. The legislative history suggests that the appropriate adjustments rule is, in part, intended to prevent double inclusion of the retained interest (*e.g.*, under both Sections 2036(c) and 2033).

Although the legislative history does not state when or how extraordinary distributions and changes in capital structure will affect the amount included, it states that Regulations may be promulgated on these matters and indicates that they may cover, for example, contributions to the enterprise by the transferor or transferee or distributions to them. For instance, to the extent that the original transferee makes a contribution to the capital of the enterprise which increases the value of the original transferor's retained interest, this contribution may be treated as consideration paid by the original transferee to the original transferor for the transferred interest and an adjustment similar to that for consideration paid by a family member to the original transferor, as discussed above, may apply.

EXAMPLE: A parent owns all the common and preferred stock in a corporation worth $2 million. The common and preferred stock are each worth $1 million. After 12/17/87 the parent sells the common stock to his daughter for $1 million. At the parent's death, the preferred stock is still worth $1 million but the whole enterprise is worth $3 million. Under these circumstances, and without the adjustment for the consideration received from his daughter, the entire value of the enterprise (both the preferred stock that he continued to own and the common stock, on account of Section 2036(c)) would be includable in his estate. The amount excluded for the consideration is determined as follows:

> $1,000,000 (consideration received from the daughter) divided by $2,000,000 (the amount that would have been includable under Section 2036(c) immediately after the original transfer, unreduced for any adjustment under Section 2036(c)(5)), multiplied by $3,000,000 (the value of the enterprise at death) equals $1,500,000.

Accordingly, $1.5 million of the total amount that would be includable (*i.e.*, $3 million) is excluded. In this example, of the $1.5 million amount includable in the transferor's estate, $1 million is attributable to the preferred stock (presumably is includable under Section 2033 as an asset owned at death) and $500,000 of the common stock is includable under Section 2036(c).

This example is derived from the Conference Report. It reflects that the denominator includes the full value of the retained interest, as stated in the Report. However, Sections 2036(c)(2)(B)(ii)(II) and (i) provide for the denominator to be the portion includable under Section 2036(c) "determined without regard to any reduction . . . for the value of the retained interest" under Section 2036(c)(5). In most cases, Section 2036(c) does not seem to include the value of the *retained* interest; Section 2036(c)(5) provides for appropriate adjustment on account of it. However, as explained, the legislative history suggests that the denominator does include the full value of the retained interest. It is unclear whether this retained interest includes only the retained interest which causes the potential appreciation to be included, or also interests which represent the same potential appreciation as that transferred.

EXAMPLE: The facts are the same as in the above example, except the parent sells only $500,000 of the common stock to his daughter for $500,000 and keeps the other half plus all the preferred stock. It seems certain that the numerator is $500,000, but it is not certain what comprises the denominator. The new provision indicates that the denominator is the value that would be includable immediately after the original transfer in the gross estate of the transferor by reason of Section 2036 (c) determined without regard for any reduction on account of the value of the interest retained by the transferor. If the common stock retained by the parent is considered, then the applicable fraction is:

$$\frac{\text{\$500,000 (the consideration paid by the daughter for one half of the common stock)}}{\text{\$2,000,000 (the value of the preferred and common stock retained by the parent plus the value of the common stock sold to the daughter)}} = \frac{1}{4}$$

Accordingly, when the parent later dies and the common and preferred stocks are worth $3 million, the amount excluded is $750,000 (¼ × $3,000,000). Hence, the total amount includable is $2,250,000, of which apparently $1 million is is attributable to the preferred stock (directly owned), $1 million is attributable to the common stock directly owned, and $250,000 is attributable to the common stock includable under Section 2036 (c).

However, as mentioned above, the interest retained that causes the daughter's common stock to be includable in the parent's estate is not the parent's common stock but the preferred stock.[11] Hence, it appears logical to consider only the value of the retained preferred stock, and not the retained common stock, for purposes of determining the denominator and the amount against which the fraction will be multiplied. In that case, the applicable fraction would be:

$$\frac{\text{\$500,000 (the consideration paid by the daughter for one half of the common stock)}}{\text{\$1,500,000 (the value of the daughter's common stock that would be includable under Section 2036(c) plus the value of the preferred stock retained by the parent)}} = \frac{1}{3}$$

When the parent dies, the applicable fraction of one-third will be applied against $2 million (the $1 million current value of the preferred stock plus the $1 million current value of the daughter's common stock). Therefore, the amount excluded from Section 2036(c) would be $666,667. The amount includable under Section 2036(c) then would be $333,333 ($1 million, the current value of the daughter's common stock at the parent's death, less the consideration offset of $666,667). In addition to the $333,333 includable under Section 2036(c), the $1 million value of the preferred stock owned by the parent also will be in his estate, as will the $1 million of common he owned directly. Hence, the determination of the denominator (and the amount against which the applicable fraction shall be applied) may significantly affect the amount subject to estate tax when the parent dies. This determination currently is uncertain.

Source of Consideration

In order for the consideration offset under Section 2036(c)(2)(B) to apply, it must be established to the Service's satisfaction that the consideration originally belonged to the transferee and was never received or acquired, directly or indirectly, from the transferor for less than full and adequate consideration in money or money's worth. This provision appears to be derived from the rules in Section 2040 relating to the inclusion in the gross estate with respect to jointly owned property with rights of survivorship. Except in the case of spouses, the portion of such jointly held property includable in the estate of the first joint tenant to die is based upon the proportionate part of the consideration provided by that joint tenant. The surviving tenant must establish what part he or she provided and also must establish that the consideration was never received, directly or indirectly, from the first tenant to die for less than full and adequate consideration.

It is uncertain whether a husband and wife will be considered one person for purposes of this "proof of origin of consideration" rule. Perhaps, as suggested in the Conference Report generally (and as discussed in the first part of this article), a husband and wife may be considered as one person only with respect to assets received from each other under the protection of the marital deduction or the gift tax annual exclusion. In any event, many of the difficulties experienced with respect to establishing the proper amount includable under Section 2040 will certainly arise in cases involving Section 2036(c) where a family member provides consideration for the acquisition of the asset that is includable in the estate of another member under that section.

The consideration offset rule contained in Section 2036(c)(2) applies only if the member of the transferor's family "provides consideration in money or money's worth for [the original transferor's] interest in the enterprise," and is in lieu of application of Section 2043 (the general estate tax consideration offset rule). A circumstance involving a bargain sale is not expressly covered. However, the lack of the words "full and adequate" to modify consideration (compare Section 2036(a)) suggests that the consideration offset rule will apply to the extent of the consideration even if it is only for part of the value. No provision is contained for consideration involving nonfamily members. For example, if an uncle sells his common stock to his niece (not a family member under Section 2036(c)(3)(B)) for $80,000, knowing it is then worth $100,000, Section 2036(c) would apply without any adjustment under Section 2036(c)(2) for the consideration provided by the niece. However, Section 2043 presumably would control and provide an offset.

Section 2036(c) may be somewhat illogical. To illustrate, two situations should be contrasted. In the first, the parent gives common stock having a value of $1 million to his daughter, retaining all of the preferred stock with the value of $1 million. Assuming no changes in value, the $1 million in common stock will be includable in the parent's estate by virtue of Section 2036(c), together with the $1 million in preferred by virtue of Section 2033 (the taxable gift of $1 million which occurred at the time the common was transferred to the daughter will not constitute an adjusted taxable gift by virtue of the fact that it is otherwise includable in the gross estate under Section 2036 (c)).

In the second situation, the facts are the same except that the parent sells the common to the daughter for $1 million. It is impossible to establish that the funds used by the daughter to effect the purchase were not derived from the parent. Here, no gift is deemed to occur at the time of the transfer of the common to the daughter. The $1 million of preferred is, of course, includable in his estate under Section 2033. The $1 million in common is included in his estate under Section 2036(c). Thus, the tax effect in the second situation appears to be the same as in the first. There is, however, one important difference: in the second situation, the $1 million of purchase price must be included in the father's estate under Section 2033.

Thus, it would appear that Section 2036 would create a harsher result in

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1 Blattmachr and Gans, "An Analysis of the TAMRA Changes to the Valuation Freeze Rules: Part I," 70 JTAX 14 (January 1989).

2 Section 2036(c)(4)(A)(ii) and the Conference Report speak only in terms of members of the original transferor's family, and not of the original transferor. See H. Rep't No. 100-1104 (Vol. 2), 100th Cong., 2d Sess. 73 (1988) (Conference Report). However, the House Bill included the original transferor as a person to whom the original transferee could transfer the transferred interest without the deemed gift occurring. Because Section 2036 (c)(4)(C) provides for the amount covered by Section 2036(c)(4)(A) to be reduced by the value of the property "retransferred" back to the original transferor, it seems quite apparent that such retransfers are subject to the deemed gift rule. Where the original transferee retransfers the property back to the original transferor, the amount of the gift is reduced by the excess of the FMV of the property so transferred over the consideration paid by the original transferor for it. See Section 2036 (c)(4)(C).

3 See H. Rep't No. 100-795, 100th Cong., 2d Sess. 421 (1988).

4 "Family" is defined in Section 2036 (c)(3)(B). It is unclear under what circumstances a transfer to a trust for the benefit of one or more family members prevents the deemed gift from occurring. Section 2036(c) (4)(E) provides that no transfer is taken into account if the original transferor or transferee retains a direct or indirect interest. The legislative history provides an example of a transfer to a wholly owned holding company. *Id.*

5 See, e.g., Estate of Sachs, CA-8, 9/15/88, *rev'g* 88 TC 769 (1987). See also "Estate Cannot Deduct Claims That Are Later Forgiven," page 82, this issue.

6 See H. Rep't No. 100-795, *supra* note 3, at 421.

7 *Id.*

8 *Id.*

9 This exception does not apply to transfers to persons who are not members of the original transferor's family. However, Section 2043 should apply in those situations.

10 Conference Report, *supra* note 2, at 76.

11 If there were no preferred stock (or similar interest) retained, the disproportionate appreciation test discussed above would not be met. In that case, Section 2036(c) could not apply.

12 Conference Report, *supra* note 2, at 75.

13 *Id.*

14 See Diedrich, 457 U.S. 191 (1982).

15 See Reg. 1.1015-4.

the context of a sale (where it cannot be established that the transferor did not supply the funds used by the purchaser to effect the transaction) than in the context of a straight gift.

Right of Contribution

New Section 2207B provides, in effect, that if any part of the gross estate consists of property includable by reason of Section 2036 (not just Section 2036(c)), the estate may recover a part of the estate tax from the person receiving the property. The estate tax is based upon the "average" rate, rather than the marginal increase in estate tax which applies under Section 2207A (relating to QTIP includable in the estate of a beneficiary-spouse under Section 2044).

A similar right is created with respect to deemed gifts occurring under Section 2036(c). A decedent may override Section 2207B by a provision in the will or revocable trust specifically referring to Section 2207B. Hence, a general "pay all death taxes by reason of my death out of my residuary estate" will not override the right of contribution under Section 2207B. If more than one person receives the property to which the right of recovery applies, the right is against each of them, apparently in the total amount of tax generated under Section 2036 and not on a proportionate basis. Right of contribution extends to penalties and interest, but does not apply to state death or state gift tax. Also, the rule does not apply with respect to charitable remainder trusts described in Section 664.

In the case of the deemed gift under Section 2036(c)(4), the transferor is entitled under Section 2207B (b) to recover from the original transferee the portion of the transferor's gift tax attributable to the deemed transfer. In addition, Section 2036(c)(4)(A) provides that proper adjustment is to be made in determining the amount of the deemed gift with respect to the right of recovery provided for in Section 2207B. In effect, as the Conference Report indicates, the amount of the deemed gift is reduced by the amount of the recovery to which the transferor is entitled.[12] Thus it would appear necessary to do the kind of "interrelated" computation that is made with respect to a net gift in order to compute the taxable gift and the amount of gift tax attributable to the deemed transferor.

The Conference Report indicates that an additional gift is deemed to occur when the transferor fails to collect upon the right of recovery, even if collection is impossible. This additional gift, according to the Conference Report, is treated as made when the transferor's right to recover the gift tax is no longer enforceable.[13]

Apparently, the Conferees anticipate that a statute of limitations will be applicable to the right of recovery. However, the appropriate time period for the statute of limitations is not clear. There is also no indication whether the statute of limitations is to be determined by Federal or state law.

Thus, the deemed transfer under Section 2036(c)(4) may well be treated as occurring in one year while the additional gift triggered by a failure to collect upon the right of recovery is treated as occurring in some subsequent year. Though this treatment may be somewhat complex, it does perhaps offer the opportunity to enjoy an additional annual exclusion.

Inasmuch as the right of recovery is analogous to a net gift, it would appear that the income tax consequences associated with the right of recovery may be the same as they are for the net gift. Thus, it may be appropriate to view the transferor as having gain to the extent that the right of recovery exceeds the transferor's basis.[14] Similarly, the transferee may be able to take the payment into account in computing basis.[15] Perhaps, the tax consequences ordinarily associated with a net gift could be avoided if the transferor waives the right of recovery, but such a waiver would produce additional gift tax.

It is arguable that, even in the absence of a waiver, the net-gift treatment should not apply to Section 2036(c)(4) deemed gifts. In the net gift context, the right to have the donee bear the gift tax is imposed by a voluntary agreement. On the other hand, the Section 2207B right of recovery is created by statute. It should be emphasized, however, that this distinction may not be significant.

The right of recovery applies only with respect to the gift tax payable by the transferor. It does not apply with respect to any increase in estate tax attributable to a deemed gift. For example, if a transferor has not previously used the unified credit and is deemed to have made a gift of $600,000 under Section 2036(c)(4), no gift tax will be payable and, therefore, there will be no right of recovery. Yet, upon the death of the transferor, the deemed gift of $600,000 will be treated as an adjusted taxable gift, thereby increasing the estate tax imposed on the transferor's estate. In this context the deemed gift produces additional transfer tax (*i.e.*, estate tax); nevertheless, under Section 2207B(b) the transferee has no obligation to contribute.

Finally, the use of gift splitting under Section 2513 may affect the right of recovery. For example, where a husband splits his gifts in order to use his wife's heretofore untouched unified credit and thereby avoid paying tax, he in effect forfeits his right of recovery.

Summary

The second part of this article has examined the new deemed gift provisions, the effects of adjustments to the amount includable due to the retained interest or consideration received, and the new right of recovery for gift tax. Practitioners undoubtedly will find the amendments to Section 2036(c) complicated, ambiguous, and difficult to work with. □