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Putting the Heat On Freezes

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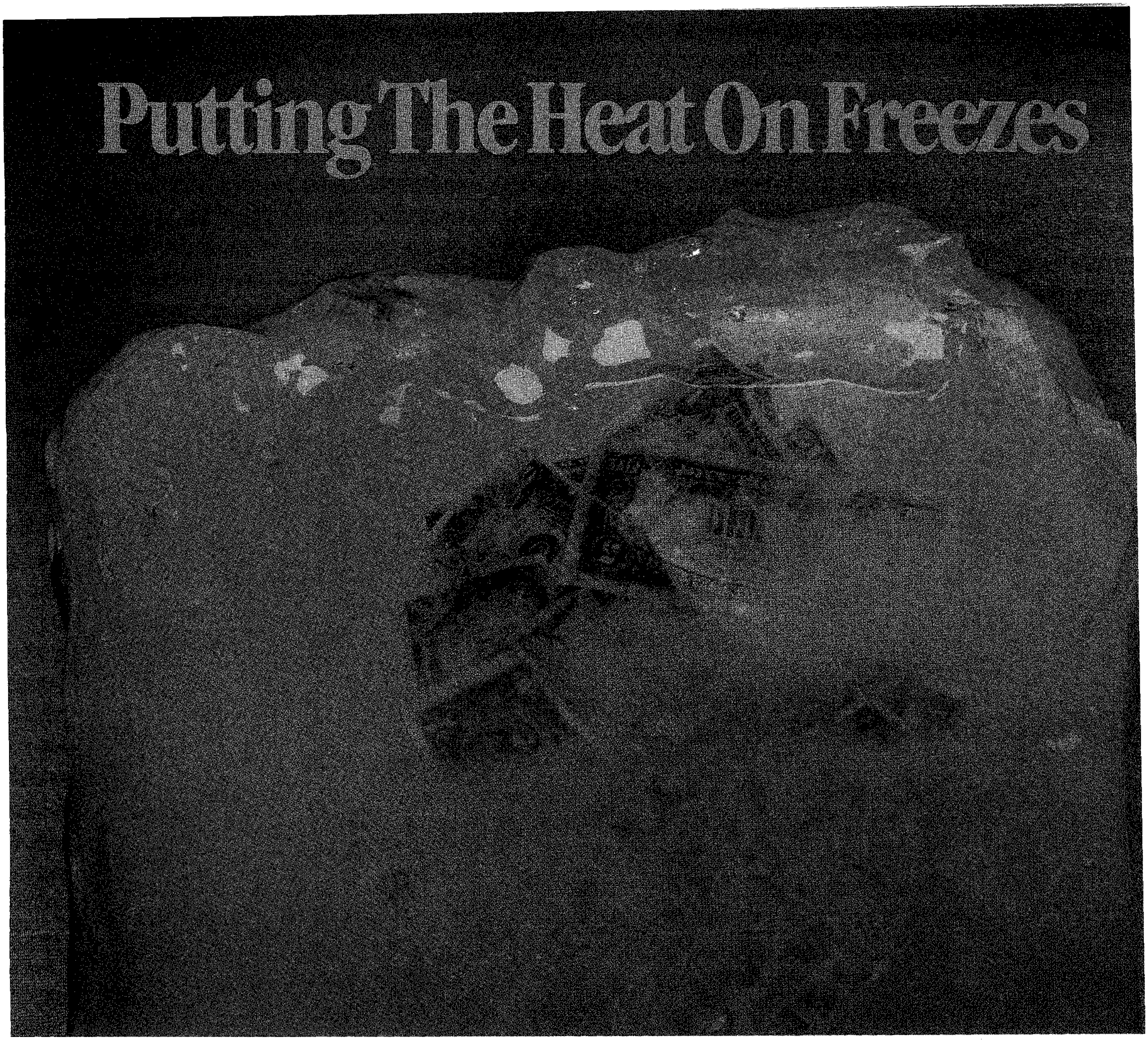

By Jonathan G. Blattmachr and Mitchell M. Gans

One popular estate planning technique, particularly for owners of closely held businesses, has been the recapitalization of a business so that the previous business owner holds interests which tend to be stabilized or frozen over time (such as preferred stock or equivalent interest in a partnership) and other family members (typically those in younger generations or entities on their behalf) hold interests in the enterprise which tend to capture its future appreciation (such as common stock or equivalent interest in a partnership). These transactions are typically called "freezes."

Over the past several years, the Internal Revenue Service has attempted to spoil the effects of those freezes. Even before the enactment of the Omnibus Budget Reconciliation Act of 1987, P.L. 100-203 ("OBRA"), Section 2036 of the Internal Revenue Code (the "Code") required inclusion in a decedent's estate of property transferred prior to death in which the decedent retained an income interest or enjoyment, but the Service has not been successful in being able to have freeze transactions treated as falling under that section. Now OBRA amends Section 2036 by adding new Section 2036(c) to provide the Service with some "antifreeze."

Effective for estates of decedents dying after 1987 and with respect to transactions after December 17, 1987, Section 2036(c) provides that if the decedent holds a substantial interest in an enterprise and had previously in effect transferred property having a disproportionately large share of the potential appreciation of his or her interest in the enterprise while retaining a disproportionately large share in the income of, or rights in, the enterprise, then the retention of the retained interest (i.e., the disproportionately large share of income or rights) is considered to be retention of

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the enjoyment of the transferred property. Hence, the transferred property is included in the transferor's estate.

Examples may help to clarify how the provision is supposed to work. A man who owns all outstanding preferred and common shares in a corporation gives 50% of the common and 50% of the preferred stock to his son. Because the owner did not transfer a disproportionately large share of the appreciation, the new provision does not apply and none of the transferred stock is includable in his estate. See example in House Report No. 100-391, at p. 1044. However, if he transferred 80% of the common and only 20% of the preferred stock, the new provision would apply. The Conference Report (House Report 100-495) states that only 60 of the 80 common shares are includable under the new provision.

"In Effect" Transfers

In contrast to other provisions of Section 2036, new Section 2036(c) applies not just to "transfers" but also where the decedent "in effect" transfers the interest. Although the statute does not provide a definition of transfer, one is set forth in the Conference Report. According to the report, it encompasses but is not limited to all transactions where property is passed to or conferred upon another, regardless of the means or device employed. Hence, "transfer" would appear to include all gifts, sales and exchanges, whether or not tax-free for income tax purposes. "In effect," however, is not defined or explained in either the statute or any report. The phrase may suggest that it is used to cover what might be treated as indirect transfers such as through an intermediary entity.

For example, a woman owns 100% of the common shares (the only type outstanding) in a corporation. It adopts a plan of recapitalization under which the woman exchanges her common shares for preferred ones having a value equal to the exchanged common shares. Her children subscribe for the "new" common shares, at their current fair market value. The preferred stock has a preference for dividends and payment upon liquidation of the corporation compared to the common stock. If the woman holds the preferred shares until her death, the common shares, owned by her children, will be included in her estate. Even though she did not directly sell or give shares to her children, she probably will be regarded as "in effect" making a transfer triggering the new provision.

In the example, it may be appropriate to conclude that the woman "in effect" made the transfer because she alone controlled the corporation which was recapitalized. However, if she alone did not control sufficient interests to cause the corporation to be recapitalized, it would be difficult to contend that she in effect made the transfer of stock to her children. Moreover, if she did have control but owned less than 100% of the common shares, she should be treated as the "in effect transferor" only over a proportionate part of the common shares her children acquired from the corporation.

The retention of the income interest apparently need not occur through the ownership of preferred stock. It would appear to cover also a debt instrument. If the statute is interpreted to be applicable to debt instruments, it might create difficulties for a fairly typical situation where a parent provides a child with financing for a new business venture in which the child owns the common stock and from which the parent receives a debt instrument. In such circumstances, it might be prudent to either charge a low interest rate or to forego interest in order to avoid a possible argument by the Service that the father retained the enterprise's income. Of course, it could be argued that the interest should be imputed but Section 7872 presumably would be applicable for income and gift tax purposes in any event.

Possibly even an employment contract under which a former common shareholder is entitled to salary payments or other forms of compensation (whether they are deferred arrangements or otherwise) might constitute a retained income interest in the enterprise. But if such compensation is reasonable in relation to the services rendered, the existence of the employment contract should not trigger application of the new provision. Note also that the mere retention of income is not sufficient; the substantial interest in the enterprise and transfer of a disproportionately large share of potential appreciation elements of the new section also must be present.

No "Regular" Bona Fide Sale Exception for Family

Prior to OBRA, Section 2036(a) provided that pre-death transfers for full and adequate consideration in money or money's worth were beyond the scope of estate tax inclusion under Section 2036 even if the transferor retained an income interest in or enjoyment from the property until death. But OBRA eliminates this bona fide transfer exception under the new rule for a transfer to a family member. Hence, in the example above, even though the woman received preferred stock equal in value to her common shares and even though her children paid full fair market value for the common shares after the recapitalization, the children's common shares apparently should be included in her estate.

New Section 2036(c)(5) provides, however, that in lieu of applying Section 2043, "appropriate adjustments" are to be made for the value of the retained interest. The Conference Report suggests that this means that "the amount included in the estate will be reduced by the value of the consideration received by the decedent." Although that presumably means that the decedent's estate will be reduced by the amount the decedent received for an asset, it is not certain if it will allow an offset for "in effect" transfers, such as where family members pay value to the business for the interests they acquire.

For example, a father and his daughter own 50% each of the common shares (50 each) in a business. In a recapitalization, the father exchanges 10 of his common shares for 10 preferred shares of equal value from the company. Under the "in effect" language of Section 2036(c), apparently this exchange may be treated as a transaction falling under the new provision. As a consequence, the increase in the daughter's ownership of common stock (increasing from 50% to 56%) will be includable in her father's estate. It does not appear that all of the common shares of the daughter are includable in the father's estate but only those which, through the transaction with the corporation, increased the percentage ownership of common shares of the daughter.

If the same transaction had been with a non-family member, it would have been exempted from the provision because it was for full and adequate consideration in money or money's worth. It is important, however, to note that Section 2036(c) does apply if a sale to a non-family member is made for less than full and adequate consideration in money or money's worth. Where a sale is, or is treated as being, made for less than the full and adequate consideration in money or money's worth, the amount included in the estate should be reduced, in any event, by the value of the consideration received by the decedent.

The Part Included—An Overview

The part of the transferred interest included in the estate apparently is based on the relationship of the retained interest held at death compared to the interest transferred. For instance, in one of the examples above, a man transferred 80 of his 100 common and 20 of his 100 preferred shares to his son. The Conference Report concludes that only 60 of the transferred common shares are includable in the estate.

Suppose that more than three years prior to death the man transfers 30 more of the preferred shares to his son—owning 20 common and 50 preferred at death. This should mean that only 30 shares of the common stock transferred to the child should be included in the estate even though, as explained below, for purposes of determining whether he holds a 10% or greater interest at death he is treated as holding the income stream and voting rights of his children under Section 2036(c)(3)(A). Similarly, if he transferred 60 of the retained 80 preferred shares after the initial transfer but more than three years before death, none of his son's common shares should be in his estate, because at death he does not hold interests having a disproportionately large share of income in the enterprise.

It is unfortunate that the statute is not based on relative values. For example, a man in 1968 formed a corporation capitalizing it with $2,000—$1,000 paid for preferred stock and $1,000 for common stock. In 1988 the preferred stock is still worth $1,000 but the common stock is worth $10 million. In that year he gives away the common stock to his family but keeps the preferred stock until he dies. Assuming that the preferred stock represents a disproportionately large share of income, Section 2036(c), as literally written, may operate to cause all the common shares to be included in his gross estate. However, as discussed below, perhaps the result should turn on what percentage of income the preferred stock is entitled to.

> ***"It is unfortunate that the statute is not based on relative values."***

Unanswered Questions

Neither the new statute nor the committee reports deal in any detail with the situation where the retained income (or rights) constitute less than 100% of the enterprise's income stream. As noted above, the Conference Report does posit a hypothetical where the transferor retained some (80 shares) of the preferred and some (20 shares) of the common, and the conclusion reached is that the transferor would be required to include 60 shares of common in her gross estate. But no guidance is provided for the situations where the transferor has retained a portion of the preferred and no common or where the transferor has retained all of the preferred but where the preferred is entitled to less than 100% of the enterprise's income stream.

The first such situation should be easy to resolve. To illustrate, assume that a father has transferred all of his common and 50% of his preferred to his daughter. It would seem that the retention of 50% of the preferred should trigger an inclusion in his estate of 50% of the common. He has divided or "split" the income from the appreciation with respect to 50% of the shares. The other 50% of the common (the potential appreciation) is not split from the income (the preferred) but is in fact owned by the daughter, who also owns 50% of the preferred. This analysis is consistent with, if not dictated by, the 80/20 hypothetical set forth in the Conference Report.

In the second situation, where the transferor has retained all of the preferred but not all of the enterprise's income stream, one can only infer the result Congress contemplated. Consider, for example, a mother who transfers all of the common, having a value of $9 million, to her son while retaining all of the preferred, which has a par value of $1 million and provides a dividend of 10%. Assume further that the enterprise earns $1 million per year, which represents a rate of return of 10% on the value of its assets. It would seem that the mother has retained a "substantial interest," within the meaning of subsection (c)(3)(A), in that she is entitled to receive 10% of the enterprise's income (she will be entitled to a dividend of $100,000, which is 10% of the enterprise's income of $1 million). Should all of the common stock be included in the mother's estate at her death by virtue of her retention of the preferred? Probably not. Only 10% of the appreciation component, i.e., the common, should be included in her estate, inasmuch as she retained a 10% income interest in the enterprise. In effect, she split the appreciation component from the income component only with respect to that 10% interest.

A similar issue could arise with respect to voting rights. Where, for example, a parent retains all of the preferred stock (which represents 10% of all voting rights in the enterprise) and none of the common (having transferred it to some member of his family), it would seem, by a parity of logic, that 10% of the common should be included in the parent's estate.

In those situations where the retaining preferred is entitled to, for example, 20% of the enterprise's income and 30% of the vote, how much should be included—20% or 30% of the common? It would seem that 30% should be included. After all, if the transferor had simply retained 30% of the vote, 30% of the common would be includable; the retention of the additional right to 20% of the income certainly should not produce a lesser amount to include.

Another issue that is very likely to arise concerns a change in the value of the preferred and the common. More specifically, what portion of the appreciation component (the common) will be included where the transferor has retained 100% of the enterprise's income through ownership of all of the preferred if, at the time of death, the income inherent in the preferred represents only a portion of the enterprise's income?

To illustrate, assume that at the time of the recapitalization the transferor retains all of the preferred with a value of $1 million and a non-participating dividend of 10%, having transferred all of the common to a family member. Assume further that the enterprise generates an annual income of $100,000. As a consequence, the transferor has retained the right to all of the enterprise's income through the ownership of the preferred. Were the transferor to die before the value of the common or preferred changed, the statute would clearly require that value of all of the common be included in the estate. But if, at the time of the transferor's death, the annual income of the enterprise has risen to $1 million and consequently the value of the common has increased to $9 million, what portion of the common should be included in the transferor's estate?

"Another issue that is very likely to arise concerns a change in the value of the preferred and the common."

Though it is arguable that the statute would require that all of the common be included, this result seems anomalous. After all, at the time of the transferor's death she only had the right to 10% of the enterprise's income. As suggested above, if she had retained 10% of the income at the outset and if the value had remained constant until her death, only 10% of the common should be included. In short, it would seem more appropriate to determine the percentage of the appreciation (the common) to be included based upon the percentage of income "controlled" as of death, rather than to make this determination at the inception of the recapitalization and to completely disregard the subsequent changes in income, value and the percentage of enterprise income controlled by the transferor.

The argument that the determination should be made at death can be buttressed by a hypothetical involving the retention of voting stock. Assume that a transferor retains, immediately after the recapitalization, all of the preferred, which represents 100% of the voting rights in the enterprise. Assume further that he or she transfers all of the common to a family member. If the transferor were to die, it would seem that all of the common should be included in the estate. If, however, the transferor were to consent to an amendment to the corporate documents whereby 75% of the vote with respect to the enterprise passed over to the owners of the common, it would seem that only 25% of the common should be includable in the transferor's estate. It is not likely that the Service could successfully argue that, by virtue of the fact that the transferor retrained 100% of the vote at inception, all of the common must be included. It would seem, however, that if the amendment to the corporate documents occurred within three years of the transferor's death, all of the common would be includable.

This would suggest that the portion of the enterprise's income or vote controlled by the transferor at the time of death should be determinative of the portion of the common to be included. Where, however, the percentage of the vote controlled by the transferor decreases during the last three years of the transferor's life, it would perhaps be appropriate to make the determination as of the date (during the last three years) on which he owned the highest percentage of the vote.

Should this construction of the three year rule in the voting rights context similarly apply in the context of retained income? Probably not. The three year rule is only triggered where there has been a "transfer of the retained interest" within the three year period. While in the voting context it may be appropriate to view the amendment to the corporate documents as such a transfer, the mere fluctuation in the percentage of retained income that occurs by reason of a change in the total income of the enterprise should not be viewed as a transfer. Thus it would seem logical to determine the portion of common to be included in the context of retained income on the basis of the percentage of enterprise income held at the time of transferor's death.

Transfers Within Three Years of Death

Since 1982, Section 2035(d)(2) has provided that if a property interest which otherwise would cause inclusion of an asset in the estate under Section 2036 is transferred within three years of death, the asset is included in the estate. New Section 2036(c)(4) expressly provides that any transfer of the *retained* interest (which would cause the *transferred* interest holding the disproportionately large share of appreciation to be includable in the estate under Section 2036(c)) within three years of death is treated as a transfer causing the transferred interest to be includable under Section 2035.

It is uncertain whether or how the new rule may apply where the *transferred* interest (having the disproportionately large share of potential appreciation) is sold or otherwise disposed of, whether outside or inside the three year period. Suppose, for instance, that in the example above where the father exchanges some of his common shares for preferred ones (thereby increasing the percentage of common shares owned by his fellow shareholder daughter), the daughter sold all or a part of her shares. No guidelines are provided as to whether the shares she sold or the proceeds she received in the sale are includable in her father's estate. The Internal Revenue Service has taken the position that the actual assets transferred within three years of death, whether held at death by the transferee or not, was the property includable in the decedent's estate where Section 2035 applies. Rev. Rul. 72-282, 1972-1 C.B. 306.

No Delay in Timing of Gift

The new provision has no gift tax analogue. As a consequence, whether the transfer is for full and adequate consideration (to a family member) or by gift, transactions occurring later (such as selling the retained interest more than three years prior to death in order to avoid application of the new rule) would not appear to postpone the timing of the initial "gift" nor result in a later gift when that sale occurs. That means that the new provision may not necessarily stop freezes. It only causes the family to take an additional risk of insuring, that all appropriate steps (such as a sale of the retained interest) are taken well before death.

Indeed, it would seem that taxpayers who were inclined to effect the freeze in the past will be just as willing to do so in the future, except that they will probably do so in two steps. The first step, as under the old law, would be to recapitalize the corporation in order to create common and preferred. The second step would be to gift the preferred away many years after effecting the first step. If this is done and if the gift of the preferred is made more than three years prior to the donor's death, the new provision will not apply to the common. Consequently, all of the appreciation accruing to the common after the adoption of the recapitalization would be excluded from the donor's gift tax and estate tax base. In short, taxpayers would be well advised to do this kind of recapitalization as early as possible, recognizing that a gift of the preferred, if made timely vis-a-vis the three year rule, would have the effect, as under the old law, of excluding all post-recapitalization appreciation accruing to the common. Even if the three year rule is not avoided, there is no real down side in that the new provision would apply and all post-recapitalization appreciation would be included, just as if the freeze had not been attempted.

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Meaning of "Potential Appreciation" and "Income" Uncertain

Although potential appreciation and income are not defined in the Act or reports, the Conference Report defines "disproportionately large share of potential appreciation" as any share of appreciation in the enterprise bigger than the share of appreciation borne by the property retained by the transferor.

It seems that the Section is aimed at *potential* appreciation rather than *actual* appreciation. On the other hand, the words of the statute suggest that it is retention of a disproportionately large share of *actual* (as opposed to *potential*) income which is covered by Section 2036(c). Unfortunately, the provision does not specify when the determination is made as to whether or not the transferor has retained a disproportionately large share of income or rights.

Although it might appear relatively simple to determine which interests in the enterprise are the ones holding a disproportionately large share of potential appreciation, that may not be so in all cases. Suppose, for example, that the preferred stock received in a recapitalization contains a special feature such as the right to receive all appreciation once the new common shareholders receive a certain multiple of current value. The common shares prior to recapitalization are worth \$1 million. In the recapitalization, the former common shareholder receives preferred shares having a fair market value of \$1 million and that shareholder's children subscribe for and pay the corporation full fair market value for the new common shares, now worth \$500,000. The preferred stock is entitled to the first \$1 million of liquidation proceeds, the common stock is entitled to the next \$5 million of proceeds and the preferred stock is entitled to all proceeds above \$6 million. In that case it is uncertain which type of stock holds the disproportionately large share of *potential* appreciation.

Neither "income" nor "disproportionately large share of income" is defined or explained in the statute or reports. Income may cover the regular distribution of earnings or profits of the enterprise and, perhaps, stock dividends. It might also cover the use of an asset which does not produce current "income." It may not cover liquidation proceeds whether or not treated as taxable dividends under Section 302.

Family

Section 2036(c)(3)(B) defines "family" as the spouse, any lineal descendant, parent or grandparent of the decedent (or the decedent's spouse) and the spouse of any of the foregoing. Relationship by legal adoption is treated as a relationship by blood. Also, an individual and the individual's spouse are treated as one person under Section 2036(c)(3)(C). This latter provision means, for example, that the statute apparently cannot be avoided by recapitalizing the company and having the former common shareholder's spouse receive preferred stock while the former shareholder's children subscribe for the common stock.

Note that siblings and their descendants are not included in the definition of family. Hence, transfers to them will not cause the property to be included in the decedent's estate if the transfers are for full and adequate consideration in money or money's worth.

In order for the new provision to apply, the decedent must hold at death a substantial interest in an enterprise. Substantial interest is a 10% or greater income interest in or right in the enterprise. It seems, although it is by no means certain, that this condition may be determined as of the decedent's death as opposed to the time of the transfer. However, if the 10% or greater income or rights interest is the same as the *retained* interest, then the specific transfer within three years of death rule would appear as a practical matter to apply to the substantial interest requirements of the statute too. For purposes of the substantial interest at death test, income stream and rights or interests include those indirectly held by the decedent and those directly and indirectly held by the family.

Rights

Although the statute does not define the term "rights"—which, like income, if held in a disproportionate manner in the enterprise, can cause inclusion in the estate—it is defined in the Conference Report as including voting rights, conversion rights, liquidation rights, warrants, options and other rights of value. Neither the Committee Reports nor the statute makes it clear whether the retention of voting rights in a fiduciary capacity will trigger that provision. Compare Section 2036(b), where Congress has made clear its intent that the statute should apply to voting rights even if held in a fiduciary capacity. The absence of a similar statement with respect to Subsection (c) suggests that, perhaps, voting rights held in a fiduciary capacity will not trigger application of Subsection (c).

Enterprise

The legislative development of the statute and the words used in new Section 2036(c) suggest that "enterprise" covers an interest in a business only, even though the statute contains no definition. Indeed, the House Report defined it as a business in any form whether it be through a corporation, partnership or proprietorship. However, the Conference Report states that it includes "a business or other property which may produce income or gain." The Conference Report definition could be read as covering every type of property interest—as every property *may* produce income or gain. It seems as though this definition probably was expanded to cover intermediate entities, such as where all interests in a business are placed in a trust and then the interests in the trust are sliced up into income and appreciation parts or to cover the use of holding companies even though they are not businesses for certain purposes, such as Section 6166. Indeed, if "enterprise" were construed to cover all interests in property of all kinds, then a person might never be able to give property away to a family member—because under the new rule the transferor is treated as holding the income and voting power of family members. In other words, Section 2036(c) would swallow, in large measure, Section 2036(a).

It seems relatively certain that income and voting interests transferred to family members (other than a spouse) are treated as interests retained by the decedent under Section 2036(c)(1)(B) only for purposes of determining if the transferor holds at death a 10% or greater income or voting power interest. The result apparently is different for transfers to a spouse. As explained above, an individual and the individual's spouse are treated as one person. If enterprise were construed to mean all property interests, one spouse might never be able to create a lifetime trust, or possibly make any gift at all, for the other without having it included in the spouse's estate.

For example, a woman creates a lifetime trust to pay the income to her husband for life with remainder to charity and funds it with treasury bonds. If this arrangement is treated as an "enterprise," the trust assets may be included in the woman's estate because she will be deemed, through her husband's income interest, to hold a greater than 10% income interest in the enterprise, and treated as having transferred a disproportionately large share of the potential appreciation (the remainder for charity) while retaining (by reason of her husband's income interest) a disproportionately large share of the income. The result would apply whether the trust qualified for the gift tax marital deduction or not and possibly would apply to outright transfers to a spouse. It should be concluded that the result is too extreme and, except for business interests, the new provision will not apply.

Overall Scope of Provision

It is important to note that in order for the anti-freeze provision to apply, three conditions must be met. First, the decedent must hold, or be treated through family ownership as holding, a substantial interest in the enterprise although it is not certain whether this is determined at the time of transfer or at death. Second, the decedent must have made a transfer of property having a disproportionately large share of potential appreciation in his or her interest in the enterprise while, third, retaining (or apparently transferring to his or her spouse) a disproportionately large share of the income of or rights in the enterprise. Where, for example, the common shares held by one person (even a family member) participate in income and voting rights proportionately with the preferred shares, the statute should not apply even if the preferred shares do not share ratably or proportionately with potential appreciation in the common shares. Hence, if the stock "retained" by the former common shareholder only has a preference upon liquidation but not the dividends, the new provision should not apply. Although recapitalizations involving such "hybrid" securities may not achieve all of the benefits which other forms of freezes have achieved in the past, the new transactions should provide a way to shift significant appreciation while allowing the former shareholder to participate in income.

New Enterprises, Joint Purchases and GRITs

It appears that the statute is aimed only at a circumstance where the decedent has been stripped of potential appreciation that he once held. As a result, it should not apply to new enterprises as where a new business is formed and one person buys common stock and another buys preferred. Where, however, the decedent purchases the preferred and as part of the same transaction makes a gift of money to enable the donee to purchase the common, it would seem arguable that the decedent has "in effect" made a transfer of the common and that therefore the new provision could apply.

Likewise, the statute should not apply to "joint purchases" in which one person purchases the remainder interest and another person purchases a life estate or a term of years in the property. However, it probably would cover the sale of a remainder interest in an enterprise even if the remainder were purchased for the current value of the entire asset.

The provision should have no new impact on grantor retained income trusts (GRIT's), even if funded with interests in an enterprise, under which the grantor retains the right to income for a term with remainder over to others. Such a trust would have been includable under the previous version of Section 2036 if the income interest is held by the grantor until death.

Summary

In summary, the new "anti-freeze" rule probably will not stop all freezing transactions but expose them to greater tax risks and cause new techniques to be used instead.

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