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An Analysis of the TAMRA Changes to the Valuation Freeze Rules (Pt. I)

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

Significant changes to Section 2036(c) include new exceptions, a GRIT rule, and one less prerequisite, but its scope remains uncertain.

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The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) makes significant changes to Section 2036(c). Although part of the legislative history to RA '87 indicated that the section was aimed at certain limited transactions involving closely held businesses,[1] statements in the Conference Report[2] and subsequent developments signal that the scope and impact of Section 2036(c) may be far-reaching. Although TAMRA provides some guidance in this respect, it leaves so many areas open that it continues to be difficult to state with assurance how and when the section is intended to apply.

Background

As originally enacted, Section 2036(c) provided, effective for estates of decedents dying after 1987 and with respect to transactions after 12/17/87, that if a property owner held a "substantial interest" in an "enterprise" and "in effect" transferred property representing a "disproportionately large share" of the "potential appreciation" of the transferor's interest in the enterprise while retaining a disproportionately large share of 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) would be the retention of the enjoyment of the transferred interest. Hence, the transferred property would be includable in the transferor's estate.

As indicated, Section 2036(c) applies not just to transfers but to "in effect"[3] transfers as well. Although transfers made prior to death usually are not includable in the transferor's estate if the pre-death transfer is for full and adequate consideration in money or money's worth, Section 2036(c) applies even to a full-value transfer if it is to a family member. An "appropriate adjustment" is to be made on account of the value of the interest retained by the transferor. (See Sections 2036(c)(2) and (5).)

Section 2036(c) originally contained no gift tax counterpart, and Section 2035(d) generally provides that no transfer made within three years of death is includable in the transferor's estate. However, a special rule governing transfers within three years of death was contained in Section 2036(c)(4) prior to the enactment of TAMRA.

Perhaps the most troubling aspect was that Section 2036(c) itself contained no definition of "enterprise," and the Conference Report stated that it applied not only to businesses but also to other property that may produce income or gain.[4]

TAMRA makes changes to Section 2036(c) that are both substantive and technical in nature. However, even the technical changes, in large measure, have significant and substantive impact. Unfortunately, neither the substantive nor technical changes adequately clarify the scope of the section and, in many ways, add to the uncertainty.

TAMRA also fails to provide any guidance as to whether Section 2036(c) could apply on the basis of transfers of minority interests in the enterprise that are valued at a discount (where the transferor retains a majority interest), transfers of voting stock where the transferor retains nonvoting stock (or vice versa), or certain other transfers such as private annuities (where, however, the consideration-offset rule, discussed in detail in the second part of this article, would apparently preclude the effective application of the section). It would seem consistent with the original Congressional intent in enacting Section 2036(c) that the section not apply to transfers of minority discount assets or nonvoting stock where the transferor retains voting stock (or vice versa), but the law is not clear. Overall, however, the TAMRA changes suggest that Section 2036(c) is extremely broad.

Scope of the Section

Although TAMRA simplified Section 2036(c) by eliminating the disproportionate retention test, problems remain in determining what is a substantial interest and the definition of an enterprise.

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Disproportionate retention test. Although Section 2036(c) originally applied only if the transferor retained a disproportionately large share of income of, or voting rights in, the enterprise, TAMRA has eliminated this requirement. Thus, Section 2036(c) may apply to the retention of any income or voting rights in the enterprise. According to the legislative history, no separate retention of a disproportionately large share of income or rights test is necessary because the granting of a disproportionately large share of potential appreciation is deemed as necessarily entailing the retention of a disproportionately large share of income or other rights in the enterprise.[5]

Also, whether the disproportionately large share of potential appreciation test is met is determined by comparing two proportions.[6] The first is the potential appreciation attributable to the transferred property divided by the value of the transferred property. The second is the potential appreciation attributable to the retained interest divided by the value of that interest. If the first proportion exceeds the second, the disproportionate appreciation test is met and Section 2036(c) may apply. In other words, if the percentage of potential appreciation of the transferred interest is greater than the percentage of potential appreciation of the retained interest, the section applies.

EXAMPLE: A mother owns all of the preferred and common stock in a company. The potential appreciation attributable to the common, which she gives to her son, is $100, and the value of the common is $500. The proportion of potential appreciation with respect to the transferred property (the common stock) is 20%. The potential appreciation attributable to the preferred is $150, and the preferred has a current worth of $1,000. The potential appreciation attributable to the retained property (the preferred stock) is 15%. Because the percentage of potential appreciation with respect to the common shares given away (20%) is greater than the percentage of potential appreciation attributable to the preferred stock that she kept (15%), the disproportionate appreciation test is met.

Although it is not certain, this change indicates that *any* disparity in potential appreciation causes the application of Section 2036(c). For instance, if the percentage of potential appreciation is only a percentage point greater for the transferred interest (*e.g.*, common stock) than for the retained interest (*e.g.*, preferred stock), the section applies in full.[7] The relative values of the retained and transferred interests also appear to be irrelevant.

Moreover, there is no indication in either Section 2036(c) or the legislative history that the amount includable depends upon relative values of the amount transferred and the interest retained.

EXAMPLE: A father capitalized a corporation in 1960 with $1,000, receiving $500 in preferred stock and $500 in common stock. In 1990, the common stock has grown to $500,000 and the preferred continues to be worth $500. The shareholder gives the common stock to his daughter and retains the preferred. Literally read, it would appear that Section 2036(c) applies to the full value of the common stock, so that if the father later sells the $500 of preferred stock, he will be deemed to make a gift at the time of sale to his daughter equal, basically, to all the appreciation in the common stock after the date of the original gift. If, instead, the father holds the preferred stock until his death, the full value of the common stock will be includable in his estate, assuming the daughter has not transferred it outside her father's family.

Substantial interest test. As noted above, Section 2036(c) applies only if a person holds a substantial interest in an enterprise. The substantial interest test is met if the transferor and the transferor's family hold, directly or indirectly, at least 10% of the voting power or income stream from the enterprise (Section 2036(c)(3)(A)). The time to determine whether the substantial interest test is met is not set forth in the section. Under the House version of TAMRA, the substantial interest test would have been met if the transferor (and the transferor's family) holds a substantial interest in the enterprise either before or after the effective transfer.[8] The Conference did not adopt that provision from the House bill.

The Conference Agreement does provide that the Conferees understand that Section 2036(c) applies if a parent transfers an existing enterprise or assets from an enterprise to another enterprise in which the child owns a disproportionately large share of potential appreciation and in which the parent retains an income interest or other rights. However, the failure to adopt the House version of the substantial interest test does not clarify when the test will apply. Although one might infer from the failure to adopt the House provision that Section 2036(c) cannot apply to a new "venture," such as a joint purchase, it is unclear whether such exceptions will be

1 Preferred stock recapitalizations and partnership freezes. See, e.g., H. Rep't No. 100-391, 100th Cong., 1st Sess. 1044 (1987). See also Bettigole, "Use of Estate Freeze Severely Restricted by Revenue Act of 1987," 68 JTAX 132 (March 1988).

2 H. Rep't No. 100-495, 100th Cong., 1st Sess. 995 *et seq.* (1987).

3 See Blattmachr and Gans, "Putting the Heat on Freezes," 2 Probate and Property 12 (May-June 1988), for a discussion of the concept of "in effect" transfer.

4 H. Rep't No. 100-495, *supra* note 2, at 996.

5 H. Rep't No. 100-795, 100th Cong., 2d Sess. 423 (1988).

6 *Id.*

7 No clue is provided as to how the potential appreciation is determined. Presumably, the current FMV of any asset reflects its potential for appreciation. No definition of potential appreciation is available although it seems to be contrasted with income, which is also not defined. The denominators (the values of the transferred and retained interests) are apparently determined as of the original transfer.

8 The House version was intended to clarify that Section 2036(c) would apply to a joint purchase where the parent purchases an income interest in property that may produce income or gain and the child purchases a remainder in the same property, provided that after the purchase the parent or a member of the parent's family together own 10% or more of the voting power or income stream of the property. See H. Rep't No. 100-795, *supra* note 5, at 424. See also Fuller and Strauss, "Split Purchases May Still Be Viable After RA '87 and TAMRA," page 22, this issue.

deemed to exist. A logical argument can be made that Section 2036(c) should not apply to an enterprise when previously the transferor[9] had no interest in it—he or she then could not make a transfer representing a disproportionately large share of his or her potential interest in the enterprise. It is not certain that this argument will ultimately prevail in Regulations or the courts. The determination of this issue may be dependent, in part, on the meaning of "enterprise."

Enterprise. As noted above, Section 2036(c) applies only to the transfer and retention of interests in an "enterprise." The section both as originally enacted and as revised by TAMRA does not define that critically important term. The RA '87 House Report defined it as a business in any form whether conducted through a corporation, partnership or proprietorship, but the Conference Report stated that it includes a business "or other property which may produce income or gain."[10] Of course, virtually all property may produce income or gain. Indeed, some statements contained in the TAMRA House Report further indicate that it may cover any property.[11] Inasmuch as some of these statements relate to provisions in the House bill not adopted by the Conference, it still is not clear whether all property (*e.g.*, cash or life insurance) is included within the meaning of enterprise.

Regardless of how broad a reading is given to enterprise, Section 2036(c) applies only if the transferor and his or her family own 10% or more of its income or rights. Since no one owns 10% of all cash, transfers and retentions of cash should not be covered. However, at least part of the legislative history may indicate that certain GRITs funded with cash are covered.[12] This suggests that the GRIT itself is the enterprise. If that is correct, then virtually any arrangement between family members or any transfer gratuitously made to others is an enterprise and Section 2036(c) may apply.

Exceptions

Under TAMRA, several safe harbor exceptions are provided in Section 2036(c)(7). Both the House and Senate Reports provide that no inferences are to be drawn as to the application of Section 2036(c) to transactions falling outside the safe harbors.[13] However, falling *within* the safe harbors will *not* prevent the application of the section if some other aspect of the transfer would cause it to apply.

Qualified debt. Section 2036(c) will not apply solely because the transferor retains qualified debt in the enterprise, or receives such debt in connection with a transfer of an interest in the enterprise. For debt to constitute qualified debt:

1. It must unconditionally require the payment of a sum certain in money in one or more fixed payments on specified dates.

2. It must have a fixed maturity date not more than 15 years from the date of issue (30 years in the case of debt secured by real property).

3. Only principal and interest can be payable under the debt obligation. Hence, a payment of part of the profits, liquidation proceeds, etc., will cause the interest not to constitute qualified debt.

Indebtedness may not, by its terms, be subordinate to the claims of general creditors and, except where the indebtedness is in default, may not grant voting rights to the creditor or place any limitations on the exercise of voting rights of others. Also, the indebtedness cannot, directly or indirectly, be converted into an interest in the enterprise that would not be qualified debt and may not otherwise grant any right to acquire such an interest.

The requirement of the payment of a sum certain in one or more fixed payments at specified dates does not apply to cash used to meet the "normal business needs" of the enterprise. The term "normal business needs" is not defined, and might not cover, for example, a borrowing to construct a facility. Presumably, it would cover borrowing to meet payroll expenses, rent, etc. It is uncertain whether tracing rules will be developed to establish the purpose for which the cash borrowing occurred.

The interest must be at a fixed rate, or a rate that bears a fixed relationship to a specified market interest rate (such as the prime rate of a certain bank, or the applicable Federal rate under Section 7872).

Startup debt. Somewhat different rules apply to startup debt (a type of qualified debt), the retention or receipt of which will not alone trigger application of Section 2036(c). To be startup debt, the indebtedness must unconditionally require the payment of a sum certain of money. It must have been received in exchange for cash to be used in an enterprise involving the active conduct of a trade or business.[14] The person to whom the indebtedness is owed must not at *any* time have transferred any noncash property, including goodwill, to the enterprise, or transferred customers or other business opportunities to the enterprise.

There are several potential problems here. The presence of goodwill (which is not defined) could prove troublesome.

EXAMPLE: A father has owned a number of car dealerships in a cer-

[9] As indicated above, for purposes of the substantial interest test the original transferor is treated under Section 2036(c)(3)(A) as owning any interest owned (directly or indirectly) by a family member. The section does not say, however, that the original transferor is treated as owning another family member's potential appreciation in the enterprise for purposes of determining whether the original transferor is treated as having made a transfer representing a disproportionately large share of the original transferor's interest in the enterprise. Indeed, the section seems to be to the contrary.

[10] H. Rep't No. 100-495, *supra* note 2, at 996.

[11] See, e.g., H. Rep't No. 100-795, *supra* note 5, at 420, 422, and 424.

[12] The House Report states that Section 2036(c) applies if a person gives away a remainder interest in a trust "the assets of which consist of property capable of producing income or gain" while retaining an income interest in the trust for a term of years. *Id.* at 420.

[13] *Id.* at 424; S. Rep't No. 100-445, 100th Cong., 2d Sess. 627 (1988). The exception in Section 2036(c)(6) for certain grantor retained interest trusts (GRITs) was added in Conference, and it is uncertain whether the "no inference" statement applies to them as well as the exceptions listed in Section 2036(c)(7). Although the GRITs act as exceptions they are not listed as such. See the discussion in the text, *infra*.

tain state. He loans his son money in exchange for a note, which otherwise would constitute startup debt, for his son to start a car dealership. The father's pre-eminence in the car dealership industry in the state may benefit the son. Possibly, that "goodwill" could prevent the indebtedness from constituting startup debt.

Equally troubling are concepts of the transfer of customers or business opportunities to the enterprise. Although in some circumstances obligations under a contract may be delegated, customers often have the right to refuse to deal with any person other than the one with whom the contract was made. Indeed, the startup debt rules may be suggesting the following as the kind of transfer that will cause the safe harbor to be missed: A mother who sells life insurance recommends to her customers that they acquire insurance from her daughter, who now has her own insurance brokerage started with a loan from the mother. Similarly, the safe harbor provision might not apply if a father "steers" an opportunity to make an arm's-length investment to his son's enterprise that was started with a loan from the father.

In addition, in order for the indebtedness to constitute startup debt, the person to whom the indebtedness is owed must not at any time (again, whether before, after or when lending the cash) hold any interest in the enterprise, including an interest as an officer, director or employee. Also, the person who would be the transferee (*e.g.*, the child) must participate in the active management of the enterprise. Active management for this purpose is the same as that provided for special-use valuation of real estate under Section 2032A (e)(12).

Finally, as with qualified debt, to be startup debt the indebtedness must not grant voting rights to a person to whom the debt is owed or place any limitation on the exercise of voting rights by others except in the case where the indebtedness is in default as to interest or principal. Also, the indebtedness must not, directly or indirectly, be convertible into an interest in an enterprise which would not be qualified debt[15] and must not otherwise grant any right to acquire such an interest.

Goods and services at full value. Section 2036(c)(7)(A)(ii) states that, except as may be provided in Regulations, an agreement for the sale or lease of goods or other property to be used in the enterprise or the providing of services will not trigger Section 2036(c) if the agreement is an arm's-length agreement for FMV and does not otherwise involve any interest in the enterprise.

Falling within the safe harbors will not prevent the application of Section 2036(c) due to another aspect of the transfer.

The qualification that these exceptions apply only to the extent not provided otherwise in Regulations may cause problems. Also, the exception does not apply in any event if any payment for the goods, property or services is determined by gross receipts, income, profits, or similar items of the enterprise. Sales on consignment, where the consignor's payment is equal to a percentage of the amount for which the consignee sells the item, may cause the transaction to be outside of the safe harbor. However, since this payment would not be based on the total gross receipts of the enterprise, it still might be within the safe harbor.

Furthermore, the providing-of-services exception does not apply if the agreement is for more than three years, including any period for which the service may be extended at the option of the service provider. The section seems to include both employees and independent contractors.

Options. Under Section 2036(c)(7)(A)(iii), an exception is created for options or other agreements to buy or sell property. In order for this exception to apply, the price for the property that is subject of the agreement or option must be the fair market value at the time of exercise of the option.

Under existing Reg. 20.2031-2(h), buy-sell agreements will be given some deference by the Service for estate tax valuation purposes where the agreement can be viewed as a bona fide arrangement and not as a device to pass assets to a family member (or another) for less than full consideration. Generally, in determining whether an agreement is sufficiently bona fide within the meaning of the Regulations, the focus will be on the adequacy of the price at the time the agreement is executed. If the price established in an agreement turns out to be less than FMV (as of the date the rights under the agreement are exercised), the Section 2036(c)(7)(A)(iii) exception will not apply. Is one to infer from this that Reg. 20.2031-2(h) is no longer valid if the price contained in the buy-sell agreement is less than FMV at the time of exercise?[16] The failure to satisfy the requirements of the exception (*i.e.*, the price in the agreement is less than FMV at the time of exercise) strongly suggests that Section 2036(c) could apply and thereby require transfer-tax inclusion of the FMV of the stock or interest in question. Nevertheless, it should be recalled that the House and Senate Reports instruct that no inference is to be drawn about the scope of Section 2036(c) from the failure to come within an exception.

Effective dates. If the exception does not apply to a particular agreement or option it may become necessary to consider the effective date of Section 2036(c) as applied to such agreements or options. The Senate Report indicates that the section does not apply solely because of an agreement to buy or sell property entered into before 12/18/87. Thus, it would appear that a pre-12/18/87 agreement cannot be subject to the new provision. If, however, an amendment to the agreement is made after 12/17/87, Section 2036(c) may become applicable. Although the legislative history does not clearly indicate all of the circumstances in which an amendment to an agreement will trigger application of the section, it does provide that an amendment that changes the amount potentially includable in the transferor's estate or a change in the parties to the agreement after 12/17/87 could cause the section to apply. Perhaps, therefore, it would be advisable not to update a pre-12/18/87 agreement to reflect a change in value even though this might result in a Service argument that the agreement is not bona fide in nature.

GRITs

A special rule for certain grantor retained income trusts (GRITs) effectively provides an additional exception. Although the term is used in the heading of Section 2036(c)(6), it is not defined.

A GRIT is an estate planning tool which has become popular in recent years: an irrevocable trust under which the grantor retains an income interest for a fixed period, after which the remainder passes to or for other persons. The gift made at the time of the creation of the GRIT is the value of the trust property reduced by the actuarial value of the income interest and any other actuarially computable interest the grantor has retained in the trust. No further gift is made when the grantor's interest in the trust terminates and the property passes to or is held in further trust for other persons. However, if the grantor dies prior to the expiration of the retained income interest, the trust will be includable in the grantor's estate under Section 2036(a).

The House Report to TAMRA specified that the termination-or-lapse rule would apply to GRITs; that is, a gift would be deemed to be made at the time the grantor's income interest terminated. Under Section 2036(c)(6) as enacted, however, certain GRITs are excepted from the termination-or-lapse rule. In order for this special exception to apply, the grantor may not retain the income for a term exceeding ten years. The person holding the rights to the income must be the person who transferred the property to the trust (*i.e.,* the grantor).

Moreover, the grantor may not be trustee of the trust.[17] According to the Conference Report, the grantor may retain only a qualified trust income interest (QTII). The Conference Report specifies that, for example, the exception will not apply if the transferor retains an annuity interest. Also, the retention of a reverter may prevent the exception from applying. However, it is not clear whether the retention of a power of appointment[18] (general or special) would prevent the GRIT exception from applying. It would seem that the GRIT could be structured so that the grantor's QTII would terminate on the earlier of the end of the stated term (not in excess of ten years) or the grantor's death. Hence, it might be possible to have the GRIT terminate in favor of a QTIP trust (or other interest qualifying for the marital deduction) if the grantor died before the end of the stated term so as to attempt to secure a marital deduction for the assets in the GRIT. However, Section 2036(c) does not specify whether this arrangement would be within the GRIT exception since, *e.g.,* the income interest of the surviving spouse (who perhaps will be treated as the grantor) could extend beyond ten years.

The Conference Report indicates that the ten-year GRIT could be funded with common stock in the enterprise and Section 2036(c) would not apply. (Again, it is important to emphasize that, as under prior law, if the grantor dies during the time that he or she has the income interest in the trust, the trust will be includable in the grantor's estate under Section 2036(a).) However, it appears that if at the termination of the GRIT the common stock is transferred to the grantor's daughter, and the grantor has retained preferred stock, then Section 2036(c) would apply upon the death of the grantor, the grantor's disposition of the preferred, or the daughter's disposition (outside of the family) of the common. Since the retention of the preferred would trigger a later deemed gift or an inclusion in the grantor's estate and thereby defeat the planning objective underlying the GRIT, it would not be advisable to use the GRIT exception where preferred stock is to be retained. Also, the Conference Report indicates that if the grantor gives away common stock to his child and places the preferred stock in the GRIT, the exception will not apply; hence, when the GRIT terminates (or, presumably, the preferred stock is sold by the trustee or the common stock is transferred by the daughter outside of the family), the grantor will be deemed to have made a gift under the new deemed gift rules of Section 2036(c)(4)(A) (discussed in detail in the second part of this article).

Spousal Rule

Under TAMRA a husband and wife are treated as one person for purposes of Section 2036(c), except as may otherwise be provided in Regulations. As originally enacted, Section 2036(c)(3)(C) provided that a husband and wife are one, without any exception. According to the TAMRA legislative history, the spousal rule is to be applied so as to prevent inclusion of the same property in both spouses' estates. The indication is that it will be includable in the estate of the last

14 Active trade or business is not defined for this purpose, although the Service has developed some rules as to what will be an active trade or business under Sections 355 and 6166. See, e.g., Rev. Rul. 75-365, 1975-2 CB 471.

15 This requirement, in Section 2036(c)(7)(D)(ii)(VI), arises by cross-reference to the qualified debt rule in Section 2036(c)(7)(C)(vi). What was probably meant was qualified or startup debt.

16 According to the RA '87 legislative history, Section 2036(c) "only makes certain property includable in the estate; it does not affect the valuation of such property for estate tax purposes." H. Rep't No. 100-495, *supra* note 2, at 996.

17 As discussed in more detail below, as a general rule a husband and wife are one person for Section 2036(c) purposes. It is unclear whether this spousal rule would prevent the grantor's spouse from serving as trustee of the GRIT or whether the grantor's spouse could be (or become) an income beneficiary of the GRIT.

18 Presumably, if this power alone would cause Section 2036(c) to apply the GRIT safe harbor would in any event be lost.

19 H. Rep't No. 100-795, *supra* note 5, at 427-28.

20 The scope of the TAMRA effective date exception is unclear. For example, it is unclear if Act Section 3031(h)(4)(B) (relating to husbands and wives) is necessary on account of the apparent breadth of Act Section 3031(h)(4)(A).

21 It also would prevent Section 2036(c) from applying if the transferred property is "transmitted" into a safe harbor arrangement, e.g., common stock into qualified debt.

spouse to die if one spouse is the transferor of the interest representing a disproportionately large share of the potential appreciation in an enterprise and the other spouse holds the retained income or voting interest which would cause Section 2036(c) to apply. For example, Section 2036(c) would apply where a father leaves common stock to his son and his preferred stock to his wife. When the wife later dies, the common stock owned by the son would be includable in her estate (unless disposed of prior to her death).[19]

The House and Senate Reports also specify that Regulations should prescribe rules governing the application of the spousal rule to interests in trusts, particularly those having as the sole asset term insurance on the spouse's life. Although it has been suggested that irrevocable life insurance trusts (in which the spouse has an income interest directly or through powers to withdraw property from the trust) are not intended to be covered by Section 2036(c), none of the Committee Reports specifies that result or states what the result would be if the irrevocable life insurance trust is funded with a cash-value insurance policy rather than a term insurance policy.

The Conference Report provides that spouses generally are to be treated as one if the retained interest in the enterprise is transferred to the spouse in a transaction qualifying for the marital deduction or the annual exclusion with respect to the spouse. Likewise, the Conference Report provides that spouses generally would not be treated as one if the transferred interest is not so transferred. In many (if not most) irrevocable life insurance trusts drafted prior to the enactment of TAMRA, the insured-grantor's spouse is given a right to withdraw property from the irrevocable life insurance trust to obtain the benefit of a gift tax annual exclusion with respect to the spouse for transfers made to the trust.

Although such trusts may have been created before 12/18/87 (the original effective date of Section 2036(c)), each subsequent transfer to the trustee to pay a premium, or the direct payment of premiums by the grantor, will be treated as a subsequent transfer for purposes of Section 2036(c) and, therefore, the irrevocable life insurance trust could be covered unless an exception for such trust is provided in Regulations. Also, as is discussed more fully below, if the term "enterprise" is limited to the businesses (as was originally indicated in the RA '87 legislative history), life insurance trusts presumably would be excluded as not constituting enterprises. At the present time, however,the result with respect to irrevocable life insurance trusts is not certain. However, creating an irrevocable life insurance trust in which the spouse received no power of withdrawal (thereby preventing the allowance of an annual exclusion with respect to the spouse for transfers to the trust) would appear to prevent the application of Section 2036(c).

A special rule for certain GRITs effectively provides an additional exception to the application of Section 2036(c).

Effective Dates

Generally, all of the changes apply retroactively to the effective date of enactment of Section 2036(c). However, the deemed gift provision applies only to "in effect" transfers made after 6/20/88. Furthermore, the right of contribution under Section 2207B (discussed in the second part of this article) applies only as of 11/10/88 (the date of enactment of TAMRA) if the amount is includable in the gross estate of a decedent under Section 2036 other than solely by reason of Section 2036(c).

TAMRA clarifies that any failure to exercise the right of conversion, any failure to pay dividends, and any failure to exercise other rights specified in Regulations which would constitute transfers, will not be treated as a later transfer with respect to property transferred before 12/18/87.

The new law appears to allow a certain "freeze" transaction to be "undone" before 1990 without the application of Section 2036(c).[20] For example, although it is not entirely free from doubt, if a child retransfers common stock back to the parent before 1990, Section 2036(c) will not apply. Presumably, however, the "transfer back" of common stock from the child to the parent is itself subject to gift tax (regardless of whether the original transfer from the parent to the child was subject to gift tax).

The provision seems simply to eliminate the retransferred property from falling under Section 2036(c) if the transaction is accomplished before 1990.[21] This, in effect, seems to provide an opportunity for a type of short-term freeze. It appears that a parent could transfer, for example, the common stock to the child while retaining the preferred stock; provided the parent eliminated the ownership of the preferred stock (or possibly if the child transferred the ownership of the common stock to someone other than to a member of the parent's family), Section 2036(c) would not apply. It will be important for practitioners to consider what, if any, steps should be taken before 1990 in order to avoid the application of Section 2036(c).

EXAMPLE: A woman created a GRIT in August 1988, naming herself as trustee. Except for her serving as trustee, this trust would qualify for the GRIT exception under Section 2036(c)(6). However, if she resigns her trusteeship before 1990, the section should not apply. (Regardless of whether she resigns as trustee, however, the trust will be includable in her estate under Section 2036(a) if she dies before her income interest terminates.)

Similarly, because it is not certain whether the retention of a reverter (or certain powers of appointment) will prevent the GRIT exception from applying, it may be appropriate to consider having a grantor who has retained a reverter or a power of appointment to renounce those interests before the end of 1989, although that renunciation probably will result in another gift being made. □