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# Congressional Diversions: Legislative Responses to the Estate Valuation Freeze

By WAYNE M. GAZUR\*

"Law is a spider's web; big flies break through, but the little ones are caught."

Hungarian Proverb<sup>1</sup>

## Introduction

WHILE THE HISTORY of the United States federal wealth transfer taxation system has been largely tranquil, it has nonetheless been punctuated with bouts of fundamental change.<sup>2</sup> The most sweeping reforms were those introduced with the Tax Reform Act of 1976.<sup>3</sup> A countering legislative upheaval arrived five years later in the Economic Recovery Tax Act of 1981 ("ERTA"),<sup>4</sup> which could be considered a repeal of the system for all but a relatively small number of taxpayers.<sup>5</sup>

The future of the taxes has generated a great debate, at least among members of the academic community.<sup>6</sup> One viewpoint maintains that

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1. Reprinted in W. MIEDER, *THE PRENTICE-HALL ENCYCLOPEDIA OF WORLD PROVERBS* 268 (1986).

2. See S. SURREY, P. MCDANIEL & H. GUTMAN, *FEDERAL WEALTH TRANSFER TAXATION* 4-12 (succ. ed. 1987) for a historical account of American wealth transfer taxation. See also Hudson, *Tax Policy and the Federal Taxation of the Transfer of Wealth*, 19 WILLAMETTE L. REV. 1 (1983).

3. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

4. ERTA, Pub. L. No. 97-34, 95 Stat. 172.

5. Prior to the 1981 amendments, only 2.8% of resident decedents incurred an estate tax liability. While that relatively small percentage reflects the concentration of wealth in the United States, it was estimated that only 0.3% of resident decedents would incur estate tax liability under the post-ERTA law. See Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183, 1207-08 (1983).

6. The American public, however, does not seem to be particularly interested in the debate. See *infra* notes 54-58 and accompanying text.

the system has failed to achieve its stated objectives and should therefore be eliminated.<sup>7</sup> Others reject the basic premise that a government should tax gifts and inheritances, and urge repeal on that basis.<sup>8</sup> Influential groups such as the American Bar Association have apparently accepted the continued existence of the wealth transfer taxation system, but have argued for stability in this area of the law through selective technical refinements.<sup>9</sup> Some scholarly commentators would address perceived inadequacies, particularly those exacerbated by the ERTA amendments, through more fundamental changes to the current system.<sup>10</sup> Others have proposed entirely new systems, such as an accessions tax<sup>11</sup> or a periodic wealth tax.<sup>12</sup>

The purpose of this article is to examine recent congressional efforts with respect to wealth transfer taxation as demonstrated by the Revenue Act of 1987<sup>13</sup> and Technical and Miscellaneous Revenue Act of 1988 ("TAMRA")<sup>14</sup> restrictions on the so-called "estate valuation freeze." This article suggests that the new legislation, which will likely be unsuccessful in a reform sense and insignificant as an additional source of revenue, serves only to divert the attention of Congress from effective reform of the wealth transfer taxation system.

"Reform" does not have to be a prescription for complexity. Integration of necessary reforms with the income tax, or its ultimate replacement, consistent with revenue base broadening, for example, could be one way to introduce more fundamental fairness to the income tax, with overall simplification and increased revenues as added dividends. Reform, however, will require a change in congressional behavior toward the taxation of wealth transfers. This article, therefore, will first discuss the wealth transfer taxation environment and the possibilities for reform.

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7. See, e.g., Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 SYRACUSE L. REV. 1215 (1984).

8. See generally R. WAGNER, *INHERITANCE AND THE STATE* (1977); G. GILDER, *WEALTH AND POVERTY* (1981).

9. See Task Force on Transfer Tax Restructuring, *Report on Transfer Tax Restructuring*, A.B.A. Sec. Taxation, reprinted in 41 TAX LAW. 395 (1988) [hereinafter ABA Proposals].

10. See, e.g., Gutman, *supra* note 5. See also Gutman, *A Comment On The ABA Tax Section Task Force Report on Transfer Tax Restructuring*, 41 TAX LAW. 653 (1988).

11. See *infra* note 67.

12. See Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

13. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, §§ 10000-10714, 101 Stat. 1330, 1330-430 - 1330-472.

14. TAMRA, Pub. L. No. 100-647, 102 Stat. 3342.

## I. Reforming the Wealth Transfer Taxation System

### A. Patterns of Congressional Behavior

The enactment of broad technical reform legislation followed in close order by more definitive amending legislation has marked past congressional behavior in the wealth transfer taxation area. For example, the Supreme Court's decision in *United States v. Byrum*<sup>15</sup> resulted in a poorly drafted, sweeping legislative response in the Tax Reform Act of 1976.<sup>16</sup> Congress responded to criticism of the statute with an amendment in 1978.<sup>17</sup> Although the current anti-*Byrum* provision may no longer suffer from overbreadth or complexity, one might question if it accomplishes anything of significance.<sup>18</sup>

The provisions for gifts in contemplation of death also followed a pattern of well-intentioned beginnings, only to have repeated amendments reduce the statute to one of limited application.<sup>19</sup> The generation-

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15. 408 U.S. 125 (1972). The Court held that closely held corporate stock owned by an irrevocable trust was not includable in the estate of the settlor despite his retention of the power to: (1) vote the stock, (2) veto the transfer by the trustee of any of the stock, (3) remove the trustee and appoint a successor, and (4) veto investments and reinvestments. *Id.* at 150. The decision presented new estate tax avoidance possibilities for the owners of closely held corporations. See, e.g., Tankskerley, *Estate Tax and the Closely Held Corporation — A Nearly Fatal Blow to Section 2036*, 51 N.C.L. REV. 325 (1972).

16. Section 2009(a), (e)(1) of the Tax Reform Act of 1976, amended I.R.C. § 2036(a) with the following language referring to the I.R.C. § 2036(a)(1) "retained string" arising from retained "possession or enjoyment of" transferred property: "For purposes of paragraph (1), the retention of voting rights in retained stock shall be considered to be a retention of the enjoyment of such stock." *Id.* The statute was perceived as overbroad because it was not limited to the closely held corporation scenario presented in *Byrum*. On the other hand, the technical retention of voting rights could possibly be circumvented by a settlor's transfer of cash to a trust with the trust (of which the settlor was a trustee) in turn acquiring the closely held stock. See, e.g., Newman & Kalter, *Retention of Corporate Voting Rights: Some Comments on the Tax Reform Act Amendment*, 55 TAXES 263 (1977).

17. In the Revenue Act of 1978, Pub. L. No. 95-600, § 702(i)(2) 92 Stat. 2763, 2931, Congress deleted the language added to I.R.C. § 2036(a) by the Tax Reform Act of 1976, and enacted the current I.R.C. § 2036(b) (Supp. V 1987).

18. If the perceived evil of *Byrum* was the retention of voting rights in the transferred shares, this could still be accomplished under I.R.C. § 2036(b) by recapitalizing the corporation, retaining voting preferred or common stock, and transferring only non-voting common. Even before the Revenue Act of 1978 amendments, which were accompanied by legislative history permitting use of voting and non-voting stock, commentators discussed the use of voting and non-voting stock as an avoidance device. See Note, *The Applicability of Section 2036(a) To Retained Voting Rights Devices After The Tax Reform Act of 1976*, 19 B.C.L. REV. 597 (1978). Moreover, I.R.C. § 2036(b) by its terms applies only to corporations. A partnership might be utilized to accomplish the same result proscribed for corporations by the amendments. See McCord, *The 1978 Anti-Byrum Amendment: A Cruel Hoax*, 14 INST. ON EST. PLAN. ¶ 1200 (1980).

19. The slow death of I.R.C. § 2035 should not be mourned by many in view of the legacy of litigation that it fostered. However, it took the Tax Reform Act of 1976, the Reve-

skipping transfer tax appears to have risen above its complex but loophole-ridden childhood by its transformation into a complex, refined statute prospectively touching only the very wealthy or ill-advised.<sup>20</sup> "Prospectively" should be emphasized; the generation-skipping transfer tax may never really have an effect on anyone. When originally enacted in 1976, the law grandfathered existing generation-skipping trusts, such that the Joint Staff estimated that the provisions would not be fully effective for fifty years.<sup>21</sup> One could add more years to that estimate; when the generation-skipping transfer tax was amended by the Tax Reform Act of 1986, the prior statute was repealed retroactively, with the new statute applying only prospectively to transfers after the new date of enactment, with few exceptions.<sup>22</sup>

The estate marital tax deduction is for general public consumption, that is if one can even consider the small number of potential taxable estates as representative of the general public.<sup>23</sup> Nevertheless, it is a complex and technical statute which has drawn the ire of even the legal scriveners.<sup>24</sup>

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nue Act of 1978, ERTA, and the Technical Corrections Act of 1982 to accomplish the mission, leaving a statute which is drafted in a manner best described as highly confusing. See S. SURREY, P. MCDANIEL & H. GUTMAN, *supra* note 2, at 260-75, for a detailed account of the tortured history of the section.

20. I.R.C. §§ 2601-2663. The generation-skipping transfer tax provisions were introduced by the Tax Reform Act of 1976. Criticized as overly broad and complex on one hand, the tax scheme suffered from broad gaps, such as the failure to address outright intergenerational transfers. See, e.g., Belknap, *Planning Under the Generation-Skipping Tax*, 19 B.C.L. REV. 433 (1978). The Tax Reform Act of 1986 retroactively repealed I.R.C. §§ 2601-2663, replacing it with a more comprehensive, yet still complex statute. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)-(d), 100 Stat. 2731-32. Due to a number of exemptions, the new statute is definitely targeted at only very significant transactions. For example, until January 1, 1990, transfers to a grandchild, which do not in the aggregate exceed \$2 million for such grandchild, are exempt. Moreover, I.R.C. § 2631 gives each individual a lifetime generation-skipping tax exemption as a transferor in the amount of \$1 million.

21. Surrey, *Reflections on the Tax Reform Act of 1976*, 25 CLEV. ST. L. REV. 303, 326 n.43 (1976).

22. The Tax Reform Act of 1986 retroactively repealed the prior generation-skipping tax and substituted a new statute. The new statute generally applies to any generation-skipping transfer made after the date of enactment, October 22, 1986. The statute contains certain special exceptions. Tax Reform Act of 1986, § 1433(b)-(d).

23. See *supra* note 5.

24. In the American Bar Association Report on Transfer Tax Restructuring, the Task Force on Transfer Tax Restructuring included as an example of complexity a typical marital deduction will clause, stating: "We submit that a testator, even if above average intelligence, is unlikely to understand, or if he was once told, to remember, all that such a will clause is intended to accomplish." See ABA PROPOSALS, *supra* note 9, at 396. In commenting on the practicing bars complaints concerning the complexity of the generation-skipping transfer provisions of the Tax Reform Act of 1976, Professor Surrey noted, "The various bar groups were of no assistance, for their input was a pious urging of caution and really no action lest the

If a pattern is discernible, it is one of patchwork amendments. With respect to complexity, the result is one of uneven application with no apparent regard for the sophistication of the affected taxpayer or the importance of the intended result. Some of the confusion in the wealth transfer taxation provisions has been attributed to undue legislative haste.<sup>25</sup> As discussed later in this article, the recent efforts of Congress in the wealth transfer taxation area have suffered from such haste. The frequent but largely technical tinkering with the statutory language may, in part, also be reflective of the legislative "incrementalism" best demonstrated by the income tax.<sup>26</sup>

Incrementalism would also explain the tax reduction bias in recent legislation.<sup>27</sup> For example, substantial revenue losses were created by the

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statute become too complex, though why lawyers capable of producing the complex provisions of these trusts were worried about complexity, must remain a mystery." Surrey, *supra* note 21, at 325.

25. "The law cannot, in ex-President Hoover's analogy, be made 'as clear as the Ten Commandments.' So it is hardly strange that these provisions of the statute are no better than they are. They have been moulded out of conflict and in emergencies." R. PAUL, *FEDERAL ESTATE AND GIFT TAXATION* 283 (1942). It has been noted that:

The 1976 legislation was the product of an unusual legislative procedure and this resulted in a number of technical difficulties surviving in the statutory language . . . . The result of this procedure was that the technical refinement in the statutory language that typically occurs as the result of Senate Finance Committee Hearings on a House-passed bill did not take place with respect to the estate and gift tax changes enacted in 1976. Nor did the Senate get its usual opportunity to amend the bill during floor debate. The statutory changes reflected both the detriments and benefits of this unusual procedure.

S. SURREY, P. MCDANIEL & H. GUTMAN, *supra* note 2, at 9.

26. J. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* (1985). Professor Witte's treatise tracks the development of the income tax, finding a consistent pattern. The foremost pattern is incrementalism, that the legislative process works slowly in steps and radical changes are filtered out. The changes, rather than sweeping, are often directed at specific abuses. He states:

Thus, at any point in time, decisions on tax policy fulfill most of the conditions of the incremental model. They lead to primarily marginal variations in existing structures, with little time spent in consideration of radical proposals; they are remedial in nature, responding to general or particular needs or problems, either within the tax system or without; innovations are often based on or are direct copies of old proposals; and there appears to be an ongoing process of adjustment as new values and objectives are introduced or unforeseen consequences emerge. In all of these respects the structure of the tax code is well suited to the incremental process.

*Id.* at 247.

Some have asserted that the level of technical complexity and loophole closing behavior exhibited by recent legislation is due to the abdication of tax-writing to young staff members, some of whom "have personal tax 'reform' agendas that they intend to see Congress adopt." Pennell, *Is Legislative Change Inevitable?*, 128 Tr. & Est. 26 (1989).

27. Professor Witte has stated that:

At any given time the equilibrium position, represented by the current status of tax laws is under constant pressure toward less rather than more taxes. This is

Tax Reform Act of 1976 and ERTA wealth transfer taxation changes,<sup>28</sup> followed by smaller revenue gains generated by the Revenue Act of 1987 and TAMRA amendments.<sup>29</sup>

If legislative incrementalism is a factor in wealth transfer taxation, fundamental changes to the wealth transfer taxation system may be too radical at this time.<sup>30</sup> One does not have to be much of a cynic to conclude that most citizens do not care about this type of reform.<sup>31</sup> Unlike the income tax, application of the wealth transfer tax is reserved for a few<sup>32</sup> and, except for inter vivos gifts and multiple generation skips, it is somewhat more inconspicuous by being imposed only once. If the wealth transfer system is to be reformed by anything short of a Great Depression, which would, for example, stir wealth redistribution rhetoric,<sup>33</sup> any reform movement would probably be subdued. The commen-

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hardly a startling conclusion: The United States has always been a 'tight' tax country, and if the present conservative trend is any indication, the idea that large-scale government is a permanent feature in modern society has not yet been accepted.

J. WITTE, *supra* note 26, at 249.

An exception to the general tax reduction bias is found in periods of war or other emergencies which force Congress to raise revenues. *Id.* at 248-49.

28. The revenue losses of the Tax Reform Act of 1976 wealth transfer tax provisions were estimated as increasing from \$728 million in 1978 to \$1.449 billion in 1981. JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE, H.R. CONF. REP. NO. 94-1515, 94th Cong., 2d Sess. 399, 626, *reprinted in* 1976 U.S. CODE CONG. & ADMIN. NEWS 4118, 4264. This probably was understated overall because the revenue gains provided by the carry-over basis provisions were lost upon its repeal, and the generation-skipping transfer taxes were ultimately repealed retroactively. *See supra* note 22. The revenue loss estimates for the wealth transfer tax provisions of ERTA increased from \$204 million in 1982 to \$5.568 billion in 1986. JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE, H.R. CONF. REP. NO. 97-215, 97th Cong., 1st Sess. 195, 289, *reprinted in* 1981 U.S. CODE CONG. & ADMIN. NEWS 285, 377.

29. *See infra* note 131.

30. As discussed in the textual material that follows, fundamental reforms to the system of wealth transfer taxation may not be a practical possibility due to the apathy of the American electorate, coupled with the Treasury Department's apparent recognition of the relative insignificance of the revenue generating capabilities of any such changes. The introduction to the American Bar Association Report on Transfer Tax Restructuring Proposals reflects a careful, studied approach in its summary of the comments received by the Task Force. Some comments considered complexity to be the worst feature of the system. Others observed that any change is complexity, and found more need for repose in the transfer taxes than in the income tax. This latter position was summarized by the Task Force: "At a minimum, if transfer tax revision must be attempted, it should be done carefully and with adequate opportunity for outside study and comment before enactment." ABA PROPOSALS, *supra* note 9, at 395.

31. *See infra* notes 54-58 and accompanying text. Law school administrations apparently reflect this apathy in the reported shrinkage of the ranks of full-time estate planning faculty. *See Pennell, Finding Future Estate Planners*, 127 TR. & EST. 20 (1988).

32. *See supra* note 5.

33. Even the Great Depression era debates might have been largely rhetoric, obscuring objectives based on fiscal exigency. *See infra* notes 54-58 and accompanying text.



tators who advocate incremental changes to the current system, an example being the American Bar Association proposals,<sup>34</sup> have perhaps correctly appraised the political realities.

## **B. Reform and the Unique Wealth Transfer Taxation Environment: Why Such a Tax?**

Professor Surrey listed the three ingredients necessary for genuine tax reform as "a public interested in tax reform, a moderate-liberal Congress willing to respond to that interest, and an executive branch really concerned to achieve tax reform and provide leadership."<sup>35</sup> With respect to the latter factor, the recent Republican National Platforms have consistently promised limits on the application of the estate and gift taxes.<sup>36</sup> With respect to the first factor, upon which the second and third factors ultimately turn, the American public, as discussed below, is apparently apathetic to the issue of wealth transfer tax reform.

### **1. Revenue Significance**

Despite the deceptive complexity of the operative estate and gift tax provisions and the resources spent by the government and taxpayers alike in planning for, complying with, administering, and litigating these provisions and resulting issues, these taxes are not significant sources of revenue. In 1986, for example, the estate and gift tax receipts were \$7.2 billion, less than one percent of all federal revenues.<sup>37</sup> By comparison, in

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34. See *supra* note 9.

35. Surrey, *supra* note 21, at 330.

36. The 1980 platform attacked "[t]he heavy estate tax burden imposed on the American people [which] is threatening the life savings of millions of our families, forcing spouses and children to sell their homes, businesses, and family farms to pay the estate taxes. To encourage continuity of family ownership, we will seek to ease this tax burden on all Americans and abolish excessive inheritance taxes to allow families to retain and pass on their small businesses and family farms." Republican National Convention, 1980 Republican National Convention Platform 18 (July 15, 1980).

This promise was fulfilled with the tax reductions enacted with ERTA. See Gutman, *supra* note 5. The theme continued with the 1984 platform. "We oppose any scheme to roll back the estate tax cuts and will seek further reductions for family businesses." Republican National Convention, 1984 Republican National Convention Platform 5 (Aug. 20, 1984).

The 1988 message was more general. "We oppose any attempts to increase taxes." Republican National Convention, Republican Platform 10 (Aug. 16, 1988). "We will not allow liberal Democrats to imperil the other gains the elderly have made during the Reagan-Bush Administration: . . . We dramatically cut estate taxes so surviving spouses will not have to sell off the property they worked a lifetime to enjoy just to pay the IRS." *Id.* at 28-29. The restrictions on the estate valuation freeze were not driven by the Reagan Administration or Treasury, who reportedly opposed the measures. See *infra* note 132 and accompanying text.

37. The exact figure is 0.9%. U.S. INTERNAL REVENUE SERVICE, ANNUAL REPORT OF THE COMMISSIONER AND CHIEF COUNSEL OF THE INTERNAL REVENUE SERVICE, *reprinted*

the same year, the corporate and individual income taxes raised \$497 billion.<sup>38</sup> It has been noted that an amount equal to the wealth transfer tax yield could be generated by a one percent increase in the federal individual income tax rates.<sup>39</sup> Moreover, based on the reported gross estates for estate tax returns filed in 1983, a 100 percent tax would yield approximately \$50 billion,<sup>40</sup> which in terms of 1986 tax revenues, would constitute only six percent of the total.

Because the estate tax return amounts omit personal wealth, such as interests in trusts and life insurance that easily avoid inclusion, the potential revenue base is understated. The value of privately held wealth in 1976 was estimated at \$5 trillion.<sup>41</sup> Coupling this with an estimated annual turnover of three percent through deaths, the potential annual tax base has been estimated at about \$150 billion,<sup>42</sup> three times the 1983 tax return amounts. However, even with tax base broadening one may be inclined to agree with Professors Richard and Peggy Musgrave, who state, "even drastic efforts in this direction [base broadening] would hardly render the estate tax a major revenue producer relative to other sources, such as the income, property, or sales tax. The reason is that death is too infrequent an event."<sup>43</sup>

## 2. Social Redistribution Goals

The stated purpose of federal estate and gift taxes is not limited to revenue collection. The primary purpose originally advanced by its proponents was one of wealth leveling and wealth redistribution.<sup>44</sup> In that regard, although the distribution of wealth has reportedly become less

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in U.S. DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, No. 487 (108th ed. 1988).

38. *Id.* If one excludes excise and employment taxes from the computation, the estate and gift taxes are still only 1.4% of the total.

39. Jatscher, *The Aims of Death Taxation*, in DEATH, TAXES, AND FAMILY PROPERTY 41 (E. Halbach ed. 1977) [hereinafter DEATH AND TAXES]. The revenue yields of the taxes were greatest during the Great Depression years of 1935-1940. The percentages for the years 1935-1940 were 6.49, 10.84, 6.59, 7.39, 6.99, and 6.76, respectively. The 10.84% amount was somewhat of an aberration. See Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223, 239 n. 94 (1956). The revenue yield has never exceeded 3% of total internal revenue receipts since that time. S. SURREY, P. MCDANIEL & H. GUTMAN, *supra* note 2, at 42, fig. 1.

40. *Id.* at fig. 2.

41. R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 489-90 (4th ed. 1984).

42. *Id.*

43. *Id.*

44. President Theodore Roosevelt and industrialist Andrew Carnegie were early advocates of estate and gift taxes as tools of social policy to discourage excessive concentrations of wealth. See R. PAUL, *supra* note 25, at 31-33 for a historical of this aspect of the taxes.

concentrated in the last fifty years, there is some question as to whether the estate and gift tax system can take any credit for this development.<sup>45</sup> Other evidence suggests that the distribution of wealth is becoming even more unequal.<sup>46</sup> As discussed below, significant redistribution of wealth may not be realized through the wealth transfer taxes, or any taxes for that matter, because public sentiment does not support such a goal. Ironically, although the taxes seem to be ineffective or have little effect, the critics of wealth transfer taxes continue to attack the system as a legalized manifestation of envy by the general public, which stifles initiative and ignores the dynamic nature of American wealth and the economic need for a wealthy investor group.<sup>47</sup>

### 3. Added Progressivity

Another justification expressed for the estate tax is that it lends further progressivity to the income tax.<sup>48</sup> This argument sees the estate tax as the final "backstop" for the income tax system with its various loopholes and tax incentives.<sup>49</sup> All other factors being equal, a more direct approach to income tax progressivity and loopholes would seem more desirable than a one-time, one-shot, upon death treatment. Also, with the withering of wealth transfer tax influence produced by the ERTA, this perceived increased progressivity is claimed to have been reduced

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45. According to Professor James D. Smith, "Wealth in the United States has become less concentrated in the last half century. Both the diminution is not great, and it all occurred in periods when the market system was functioning under duress or was in administration abeyance, specifically the Great Depression and World War II." *The Distribution and Composition of Wealth Holdings and Their Implications for Estate Tax Reform: Hearings on Federal Estate and Gift Taxes*, 94th Cong., 2d Sess. 1314-1318 (1976), reprinted in S. SURREY, P. MCDANIEL & H. GUTMAN, *supra* note 2, at 50. See also Verbit, *Do Estate and Gift Taxes Affect Wealth Distribution?*, 117 TR. & EST. 598 (1978), in which the author concludes that the estate and gift taxes have had no discernible impact on personal wealth distribution or concentration since 1949. The author, however, noted: "The most that can be said, therefore, is that *but for* the present transfer tax system, the percentage of wealth in the hands of the top five percent of the population would be increasing at an additional rate of less than 0.5 percent per year." Verbit, *supra*, at 607.

46. More recent statistics indicate that "[t]he top 0.5 percent of the U.S. population owned 35 percent of the country's wealth and 43 percent if personal homes are excluded." Kornhäuser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465, 482 n. 69 (1987).

47. See generally R. WAGNER and G. GILDER, *supra* note 8.

48. See generally Gutman, *Federal Wealth Transfer Taxes After the Economic Recovery Tax Act of 1981*, 35 NAT'L TAX J. 253 (1982).

49. "If the income tax fails to do its job, only the estate tax can assure an eventual day of reckoning." Eisenstein, *supra* note 39, at 257. See also E. SELIGMAN, *ESSAYS IN TAXATION* 135 (10th ed. 1925).

from twelve percent for years prior to the 1981 amendments to four percent for years thereafter.<sup>50</sup>

#### 4. Minimized Inhibition of Economic Incentives

The preservation of private economic incentives has been a long-standing issue in taxation. Former Treasury Secretary Mellon's statements of the early 1920's could be used in the supply-side economics debates of the 1980's:

Taxpayers subject to the higher rates cannot afford, for example, to invest in American railroads or industries or embark upon new enterprises in the face of taxes that will take 50 percent or more of any return that may be realized. These taxpayers are withdrawing their capital from productive business and investing it instead in tax exempt securities and adopting other lawful methods of avoiding the realization of taxable income. The result is to stop business transactions that would normally go through, and to discourage men of wealth from taking the risks which are incidental to the development of new business.<sup>51</sup>

Assuming that a given level of tax revenues is required, an estate tax may be less of a burden on incentives and savings than an income tax,<sup>52</sup> although "[n]o conclusion as to the effects of estate and gift taxation on incentives can be more than a guess."<sup>53</sup>

#### 5. Public Sentiment

One commentator has asserted that the wealth redistribution debate of the Great Depression years "was more verbal than actual,"<sup>54</sup> and concludes that the changes to the estate tax produced by that period, were

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50. See Gutman, *supra* note 48, at 261-62.

51. Quoted in R. PAUL, *TAXATION IN THE UNITED STATES* 134-35 (1954).

52. One articulation of such a theory is as follows:

Opinions about death taxes vary greatly in a society relying on private incentives for economic growth. Some believe that these taxes hurt economic incentives, reduce saving, and undermine the economic system. But even they would concede that death taxes have less adverse effects on incentives than do income taxes of equal yield. Income taxes reduce the return from effort and risk taking as income is earned, whereas death taxes are paid only after a lifetime of work and accumulation and are likely to be given less weight by individuals in their work, saving, and investment decisions.

J. PECHMAN, *FEDERAL TAX POLICY* 234-235 (5th ed. 1987).

See also C. SHOUP, *FEDERAL ESTATE AND GIFT TAXES* 234-236 (1966); A. TAIT, *THE TAXATION OF PERSONAL WEALTH* 173-190 (1967); Jatscher, *supra* note 39, at 40-46; H. SIMONS, *PERSONAL INCOME TAXATION* 144 (1938). But see Boskin, *An Economist's Perspective on Estate Taxation*, in *DEATH AND TAXES*, *supra* note 39, at 56.

53. B. BITTKER & E. CLARK, *FEDERAL ESTATE AND GIFT TAXATION* xxviii (5th ed. 1984).

54. Eisenstein, *supra* note 39, at 237.

primarily imposed for revenue.<sup>55</sup> With respect to the income tax, Professor Witte has concluded that "there is no evidence either that the income tax significantly redistributes income or that there was ever any sustained intention that income taxes should redistribute income."<sup>56</sup> It should therefore come as no surprise that the sentiment of the public toward wealth redistribution through the tax system seems to be one of apathy.<sup>57</sup> Some have attributed this to the "with pluck and luck" optimism of the American public that considers everyone a potential subject of the tax.<sup>58</sup> If these observations are accurate, an avenue may exist for wealth transfer tax changes based on pragmatic, revenue raising and simplification considerations, rather than through a broad-based call for reform.

### C. The Direction of Reform

#### 1. Abolition

In view of the unmet objectives of the estate and gift tax, some have suggested that it be abolished.<sup>59</sup> In that regard, it has been suggested that the ineffective and insignificant system has been permitted to muddle along merely to maintain an illusion of wealth redistribution.<sup>60</sup> Main-

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55. *Id.* at 238.

56. J. WITTE, *supra* note 26, at 257-59.

57. Professor Witte describes the results of a number of public opinion surveys concerning progressive taxation and wealth redistribution. A 1976 Harris Poll asked for agreement or disagreement with the statement that "the federal government try to make a fairer distribution of wealth in the country." Although admittedly not directed at wealth transfer taxation as such, 47% of the respondents opposed the measure, 37% supported it, and 16% offered no opinion. WITTE, *supra* note 26, at 353. Although there may be apathy with respect to eliminating loopholes, certain groups such as the farm and small business lobbies can be incredibly vocal in attacking wealth transfer taxes. This was particularly true in the 1981 legislative process where Congress was moved to act on the basis of apparently very little hard evidence that a real problem existed. See Gutman, *supra* note 5, at 1197-1202 & 1209-12.

58. This phenomenon is discussed below:

The most puzzling political obstacle to estate tax revision, however, is that the American people do not seem to like heavy taxes on bequests. George McGovern's proposal in 1972 to confiscate inheritances above a certain amount was not well received, and a recent California initiative to repeal the state's inheritance tax garnered a sixty-four percent positive vote . . . . The only convincing explanation that has occurred to me for this phenomenon lies in the optimism of the American people. In California, at least, sixty-four percent of the people must believe that they will be in the wealthiest five to ten percent when they die.

Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 285 (1983).

59. See, e.g., Dobris, *supra* note 7.

60. Such an illusion is noted below:

The poor are often delighted to see the wealth and income of the rich reduced even if they are not thereby monetarily benefitted. The total sum of happiness in this country might conceivably be increased if the wealth of the rich were simply destroyed rather than shifted (a possible motivation for the excesses of the French

taining appearances aside, abolition of the system without offering a substitute would be a mistake. First, the \$7.2 billion revenue yield of the taxes is not a trivial amount in any sense, even when viewed in the context of the United States federal budget.<sup>61</sup> In addition, with certain reforms that yield could almost be doubled or tripled.<sup>62</sup> Second, if one is choosing between the wealth transfer taxes and the income tax in raising revenues, a death tax is less of a disincentive to saving and investment. Third, the incidence of the wealth transfer taxes falls upon the recipient of the gift or bequest, and it is probably indefensible, from the standpoint

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Revolution). Of course, happiness should also be increased if most people had the *illusion* of destruction, which may be a good argument for retaining stiff wealth transfer taxes while simultaneously riddling the tax structure with such loopholes as the (now repealed) orphan's deduction.

Robinson, *The Federal Wealth Transfer Taxes — A Requiem?*, 1 AM. J. TAX POL'Y 25, 39-40 (1982).

"Abolition would be seen as a giveaway; therefore, something must be left in place." Dobris, *supra* note 7, at 1231. Professor Cooper has stated that:

In sum, because estate tax avoidance is such a successful and yet wasteful process, one suspects that the present estate and gift tax serves no purpose other than to give reassurance to the millions of unwealthy that entrenched wealth is being attacked. The attack is, however, more cosmetic than real and the economy is paying the price of fettered capital and distorted property ownership for this tax cosmetology.

Cooper, *supra* note 12, at 223.

61. The following are examples of estimated 1987 federal outlays that could be paid for by the "trifling" \$7 to 20 billion potential of the wealth transfer taxation system.

(1) International development and humanitarian assistance — \$4.3 billion; (2) Foreign information and exchange — \$1.0 billion; (3) Health research — \$5.6 billion; (4) Consumer and occupational health and safety — \$1.2 billion; (5) Elementary, secondary, and vocational education — \$7.9 billion; (6) Higher education — \$7.4 billion; (7) Pollution control and abatement — \$4.9 billion; (8) Energy conservation — \$0.3 billion; (9) Federal judicial activities — \$2.6 billion; (10) Federal law enforcement — \$4.6 billion; (11) Federal correctional activities — \$0.8 billion.

U.S. OFFICE OF MANAGEMENT AND BUDGET, HISTORICAL TABLES, BUDGET OF THE UNITED STATES GOVERNMENT, ANNUAL, *reprinted in* U.S. DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, No. 471 (108th ed. 1988).

62. Reconsidering the proposals for carryover basis or a tax at death on unrealized appreciation would reopen the debate concerning the I.R.C. § 1014 basis adjustment at death. That debate needs to be reopened. See Osgood, *Carryover Basis Repeal and Reform of the Transfer Tax System*, 66 CORNELL L. REV. 297 (1981). The revenue loss from this inconsistent and unsupportable loophole was estimated as \$5.7 billion in 1987 alone. See, U.S. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT, ANNUAL, *reprinted in* U.S. DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, No. 475 (108th ed. 1988). Based on 1966 levels of gifts and inheritances and income tax rates (which were much higher), Professor McNulty noted that the revenue from the taxation of estates and gifts could almost be tripled by taxing such amounts as income. See McNulty, *Fundamental Alternatives to Present Transfer Tax Systems*, in DEATH AND TAXES, *supra* note 39, at 98.

of economic theory<sup>63</sup> or the simple notion of an unearned windfall,<sup>64</sup> that the recipient should avoid any tax on such a receipt, regardless of what the tax is called.

Many would still add enhanced wealth redistribution to the list of justifications for taxing wealth transfers in seeking a remedy for perceived social ills.<sup>65</sup> This justification has been the principal one traditionally advanced in support of such taxes, but it has apparently never been embraced by the American public or been implemented in the wealth transfer taxation system in a meaningful way. However, even if such social changes were never to occur, taxation of wealth transfers would be desirable both on economic terms and from the standpoint of revenue raising. Today's goal, therefore, should be to enhance the fairness of application, efficiency and revenue raising potential of the taxes.<sup>66</sup>

## 2. Alternatives

A number of scholarly articles that go beyond technical refinements of the present system, have been devoted to proposals for new systems of wealth transfer taxation. A summary of the main issues surrounding these proposals follows below:

### a. The Accessions Tax

An accessions tax<sup>67</sup> on cumulative lifetime gifts and inheritances would essentially operate like an inheritance tax, with the amount of the

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63. H. SIMONS, *supra* note 52, at 125-47. R. MUSGRAVE & P. MUSGRAVE, *supra* note 41, at 334-35.

64. E. SELIGMAN, *supra* note 49, at 134-35; Jatscher, *supra* note 39, at 49-51.

65. "Excessive unearned wealth, however, may arouse deep-seated resentment, and possibly alienation from society, over someone's 'getting something for nothing.'" FINAL REPORT OF THE AMERICAN ASSEMBLY ON DEATH, TAXES AND FAMILY PROPERTY, in DEATH AND TAXES, *supra* note 39, at 184. A correlation has been drawn between property crime and feelings of relative deprivation by others. The argument is that a more level wealth distribution would reduce the perceived inequalities and anti-social feelings. See R. CHESTER, INHERITANCE, WEALTH, AND SOCIETY (1982). "I think we should accept the idea that revenue raising is not an important job of the transfer tax and focus exclusively on the societal aspects of the tax." Dobris, *supra* note 7, at 1232. "Do not accepted moral principles call for continuing and strengthening the death tax system?" PEDRICK, 19 INST. ON EST. PLAN. ¶ 1900 (1985).

66. Even in focusing on revenue raising and consistent application of a tax, complete neutrality is difficult to attain, and the social issues creep in. If the rates of tax are progressive, for example, that reflects wealth redistribution policies. See, e.g., W. BLUM & H. KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953). The level and type of exemptions and exclusions will unavoidably reflect such social policy judgments.

67. See, e.g., Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967). With an accessions tax, the question of determining when a gift has occurred, or if property is included in a decedent's estate, is avoided by simply looking to the amount of cash or other

tax being determined with reference to the circumstances of the recipient. This system can have strong appeal, because it provides a separate and progressive rate structure, such that gifts and inheritances are taxed on a cumulative basis and at rates greater than those for other types of income. Another claimed benefit of the accessions tax proposal is that it should encourage wider dispersion of wealth to a greater number of people due to its emphasis on taxation at the recipient's level. Moreover, a degree of simplification is obtained with respect to property placed in trust, likely the most complex issue of wealth transfer taxation, because the donee is not taxed until cash or property is actually received.<sup>68</sup>

A major drawback of the proposal, however, is that it would require the creation and maintenance of a new and separate accessions tax system. Consequently, one must question whether the attendant compliance and administrative costs of implementing and maintaining such a system are justified.

#### b. Wealth Tax

A wealth tax has been advocated by some writers,<sup>69</sup> and, as typically proposed, it would periodically levy a relatively low rate of tax on a taxpayer's total wealth after limited exemptions. Of all the proposals, the wealth tax would most effectively counter estate valuation freezes because both the transferor and transferee would be taxed on their accretions of wealth. A wealth tax suffers from a number of practical drawbacks,<sup>70</sup> however, not the least of which would be a lack of political palatability and almost certain constitutional objections.<sup>71</sup>

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property or benefits in the hands of the recipient. This is the long-standing question of the multiple meanings of "gift" as used in the context of the gift, estate, and income tax. *Commissioner v. Beck's Estate*, 129 F.2d 243, 246 (2d Cir. 1942) ("Gift . . . gaft . . . or geft"). Andrews' proposal recognizes that accumulation trusts could pose an abuse to this system, so an additional special tax would be levied on transfers into trust, for which a distributee could receive a partial credit as distributions were actually made. Such a tax injects some complexity into the system in differentiating between revocable trusts (what will be considered "revocable"?), for which a tax would not be payable, and all other trusts. See also Rudick, *A Proposal For an Accessions Tax*, 1 TAX L. REV. 25 (1945); Rudick, *What Alternative to the Estate and Gift Taxes?*, 38 CALIF. L. REV. 150 (1950); Halbach, *An Accessions Tax*, 23 REAL PROP., PROB. & TR. J. 211 (1988). But see Kirshberg, *The Accessions Tax: Administrative Bramblebush or Instrument of Social Policy?*, 14 UCLA L. REV. 135 (1966).

68. Andrews, *supra* note 67, at 591-92. The trust issue aside, the accessions tax would still need to wrestle with the estate valuation limiting devices discussed later in this article. Those techniques could be used to defer the accessions tax liability.

69. See, e.g., Cooper, *supra* note 12, at 244-46.

70. An annual wealth tax raises valuation, privacy, and liquidity concerns, among others.

71. A wealth tax would probably require a constitutional amendment to exempt it from the requirement that direct taxes be apportioned. See *infra* note 176.



### c. Integrated Income or Consumption Tax

Repeal of the estate and gift tax system, followed by its integration into the individual income tax system or a consumption tax system, is another alternative.<sup>72</sup> In the income tax proposal integration would be effected by repealing the present income tax exclusion provided by Internal Revenue Code section 102, and the income tax basis adjustment upon death provided by Internal Revenue Code section 1014. The income tax exclusion for life insurance proceeds would need to be addressed as part of the process. Additionally, some exclusions for transfers, such as small gifts and inheritances, marital transfers,<sup>73</sup> and support payments would be required.

The income/consumption tax integration proposals appear to offer more simplicity than the accessions tax because no separate system and rate schedule is required. Not all difficulties will disappear, however. For example, in dealing with property transferred in trust, rules will be required to determine when a taxable inter vivos gift has occurred and when a taxable inheritance has been received. Adoption of the tax upon receipt concept of the accessions tax would tend to mitigate this problem, however.<sup>74</sup>

One psychological hurdle that must be overcome in adopting an integrated system is a desire for a wealth transfer system with steeply progressive rates, such as an accessions tax, computed on a cumulative basis.<sup>75</sup> In an integrated system, it may be viewed as objectionable to tax "unearned" income from gifts and inheritances on an equal footing with other sources of income.<sup>76</sup> In addition, due to the flat tax nature of the

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72. See, e.g., Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980); R. MUSGRAVE & P. MUSGRAVE, *supra* note 41, 237-238; Dodge, *The Taxation of Wealth and Wealth Transfers: Where Do We Go After ERTA?*, 34 RUTGERS L. REV. 738 (1982); Gac & Brougham, *A Proposal for Restructuring the Taxation of Wealth Transfers: Tax Reform Redux?*, 5 AKRON TAX J. 75 (1988); H. AARON & H. GALPER, *ASSESSING TAX REFORM* (1975).

73. Under one proposal, spouses would be treated as a single taxable unit, simplifying the marital deduction concerns. See Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177, 1192-93 (1978).

74. See *supra* note 67 and accompanying text.

75. One recent accessions tax proposal, however, has suggested that a flat rate of tax be used. See Halbach, *supra* note, 67.

76. The bias against unearned income as opposed to earned income has been noted by commentators for years. See, e.g., E. SELIGMAN, *supra* note 49, at 134 ("It is now commonly recognized that incomes from property should pay a higher rate than incomes from labor."). The income tax rate differential between earned and unearned income was discarded with ERTA's enactment of a single maximum 50% marginal rate, as compared with the prior law that taxed unearned income at a maximum marginal rate of 70%, and earned income at a

current individual income tax rates, any added measure of progressivity for gifts and inheritances would require increasing the general income tax rate brackets, potentially presenting more complex and political issues. This would be unacceptable from an incentive standpoint because all other income would be subject to the increased rates. A compromise could take the form of a separate, highly progressive cumulative income tax rate schedule limited to gifts and inheritances. This would essentially incorporate that aspect of the accessions tax into the income tax vehicle. On the other hand, such a tax rate schedule could unnecessarily complicate matters, thereby diminishing much of the desired simplification.<sup>77</sup>

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maximum marginal rate of 50%. It was hoped that the tax cut, as applied to unearned income, would stimulate saving and investment. According to the Senate committee:

The committee also believes that the increase, resulting from marginal rate reductions, in the after-tax return to saving will significantly increase personal saving, thus insuring adequate financing for the additional investment encouraged by other provisions of this bill . . . . Because the law already provides a special maximum tax rate on earned income, this change is intended to eliminate a substantial disincentive to investment.

S. REP. NO. 97-144, 97th Cong., 1st Sess., 25 *reprinted in* 1981 U.S. CODE CONG. & ADMIN. NEWS 105, 132.

77. It can be suggested that a highly progressive wealth transfer tax rate schedule is an illusion as applied under the current system and could be unnecessary or counter-productive.

First, for decedents dying in 1983, the highest marginal estate tax rate was 60%, payable on taxable estates in excess of \$3,500,000. I.R.C. § 2001(c)(2)(C) (1982). The average rate of tax reported on estate tax returns filed in 1983, however, could be roughly estimated as 20% of the reported taxable estates. For the 1983 filing period, the taxable estates totaled \$26,235,000,000. The tax paid thereon was \$5,170,000,000. S. SURREY, P. MCDANIEL & H. GUTMAN, *supra* note 2, at 42, fig. 2. Grouping the smaller estates with the larger estates might underestimate the effective rate on larger estates. However, due to tax avoidance opportunities, Professor Cooper computed the average wealth transfer tax rate for certain DuPont family members as 6%. See Cooper, *supra* note 12, at 215. Based on estate tax returns filed in 1985, the average tax rate (after state death tax credit) paid on gross estates in excess of \$10 million was 13 percent. See U.S. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, *reprinted in* J. PECHMAN, FEDERAL TAX POLICY 390 (5th ed. 1987) [hereinafter STATISTICS OF INCOME].

Second, the current flat tax rate structure of the income tax might be modified to further increase rates for upper income taxpayers, who would typically be the recipients of large gifts or inheritances. That would add to progressivity.

Third, the flat tax rates could be somewhat of a blessing, because they simplify integration of the wealth transfer tax without requiring a special averaging computation for substantial one-time receipts.

Fourth, the integrated system considers other sources of income. Thus, if the emphasis is on the recipient, the integrated system best determines the recipient's ability to pay the tax. See Dodge, *supra* note 73.

Fifth, consideration of the recipient's other circumstances will deflect attempts to create standard exemptions at such a level as to make the tax useless, thereby repeating the excesses of ERTA. A very modest \$30,000 lifetime gift and inheritance exemption, will be easier to justify if the truly needy citizen, with little other income, will pay little or no income/consumption tax on the gift or inheritance. On the other hand, it is difficult to justify any exemption for

The integrated income/consumption tax would also need to grapple with the problem of generation-skipping transfers. One response calls for a separate tax levied on all trust property every thirty years.<sup>78</sup> Moreover, a consumption tax proposal has already recognized the necessity of addressing the estate valuation freeze, which is discussed later in this article.<sup>79</sup> Nevertheless, integration could still offer some degree of simplification,<sup>80</sup> improved equity, and additional revenues. One remaining impediment to full integration with the income or consumption tax base is the constitutionality of taxing gifts as income. One commentator has argued that this issue can be resolved favorably.<sup>81</sup>

Any change from the present, albeit cumbersome, system will be viewed, at least initially, as a source of new complexity and administration problems. The administrative costs of the present system have not been concretely quantified,<sup>82</sup> but some have speculated that the costs exceed the revenue yield.<sup>83</sup> Integration with the income tax would offer an incremental political alternative to reform. Some benefits should accrue

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a citizen with large amounts of other taxable income. By taking other income into account, the call for extreme, debilitating exemptions broadly available to everyone can be avoided.

Sixth, added progressivity, coupled with deference for income sources other than gifts or inheritances, could be enhanced through elimination of any gift or inheritance exemptions once a certain level of gifts or inheritances is attained, coupled with a separate surtax computed with respect to only the level of gifts and inheritances. The surtax, which is a contradiction of the concept of considering other income, would be effective only at very substantial levels, for example, receipts in excess of \$500,000.

78. H. AARON & H. GALPER, *supra* note 72, at 95.

79. *Id.* at 96-97.

80. Simplification of the law has been expressed as one of the goals of recent proposals in the income tax area. Complexity is seen as creating administrative burdens, undue reliance on professional tax advice, and a perception of unfairness. See *infra* note 117. Professor Witte echoes the same points:

[A] complex tax system has costs associated with it apart from the administration ones. Complicated systems require tax experts to compute and plan strategies for individuals and organizations, thus reducing taxpayer understanding and diverting resources to activities some consider unproductive. More important, complexity, and the public's perception of that complexity, may affect the legitimacy of the tax system. These consequences may extend to general attitudes toward the rule of law and government actions and institutions.

J. WITTE, *supra* note 26, at 31.

81. See Dodge, *supra* note 73, at 1185 n.37.

82. The cost of administration of the overall tax system was determined as 48¢ for each \$100 collected. No separate costs were presented for the estate and gift tax. However, in 1985, only 77,000 estate tax returns and 95,000 gift tax returns were filed. This is to be compared with 99,425,795 individual returns and 3,302,627 corporate returns. 1985 IRS COMMISSIONER AND CHIEF COUNSEL, ANN. REP. [hereinafter 1985 ANNUAL REPORT].

83. Professor Gerald P. Moran estimated that the total cost of compliance with the wealth transfer taxes "probably exceeds the yield that Uncle Sam receives." See Hudson, *supra* note 2, at 32 n.174 (1983).

due to use of an existing system; a system that the public may not completely understand, but one with which there is at least some familiarity.<sup>84</sup>

The current dominance of the individual income tax as a revenue source suggests where the future of wealth transfer taxation lies. Although the income tax may evolve into a consumption tax or be supplemented by a value added tax, it presently provides the most logical avenue for reforming the wealth transfer tax system. Nonetheless, as the following discussion suggests, recent congressional efforts with respect to the estate valuation freeze indicate a continued willingness to grapple only with the insignificant issues, leaving the important work to another day.

## II. Evolution of the Estate Valuation Freeze and the Legislative Response

### A. A Concept Attracts Attention

The use of different classes of corporate stock to accomplish estate tax deferrals was discussed in the popular estate planning literature over thirty-five years ago.<sup>85</sup> The main concept underlying simple corporate

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84. One loss of administrative efficiency may arise in the conversion to a recipient reporting system from the present donor/estate reporting system. In 1984, only 500 returns were filed with gross estates in excess of \$5 million, and 108.60% of these returns were audited. Returns with gross estates under \$1 million were audited 15.91% of the time, and those in the \$1 million to \$5 million range were audited 73.09% of the time. The 1984 overall audit percentage for individual tax returns was only 1.31%. 1985 ANNUAL REPORT, *supra* note 82. If the focus of the estate tax is shifted to the donee/recipient, the wealth transfers will be spread among the almost 100 million individual returns and the associated low rate of audits, recognizing that the audit rate is higher for higher incomes. Carl Shoup has made the argument that donors may be more sophisticated and fewer in number than donees, and may have a greater degree of compliance. The administrative aspect would therefore seem to favor reporting by the donor. C. SHOUP, *supra* note 52, at 29. If the administrative concern is met by donor filing of a simplified Form 1099 informational return to supplement donee reporting, then some of the simplicity and reduced paper flow advantages are reduced.

85. One of the first articles addressing corporate estate valuation freezes was published in 1953, Foosaner, *Stockholder Estate Problems*, 92 TR. & EST. 908 (1953), in which the author described the use of different classes of stock, whether on formation or in a subsequent recapitalization, to facilitate inter vivos gifting and testamentary dispositions to family members. The article, and the related articles that followed in quick succession, focused primarily on the practical estate planning advantages of recapitalizations, but also touched upon some of the estate and gift tax considerations. See also Tremayne, *Estate Planning for the Man with a Business*, 1955 WASH. U.L.Q. 40; Wormser, *Preserving the Family Enterprise for the Family*, 2 PRAC. LAW. 44 (1956); McKenney, *Estate Planning for Business Interests*, 95 TR. & EST. 212 (1956); Teschner, *How to Use Recapitalizations to Effect Tax Planning Objectives*, 6 J. TAX'N 322 (1957); Bogert & Chanan, *The Family Business: Recapitalization for Estate Planning Purposes*, 40 CHI. B. REC. 347 (1959). Although these articles appear to be some of the first to address the ability to transfer value and/or control in a family business with the effect of

restructuring blossomed to include a number of other arrangements, all serving to effect tax avoidance; a phenomenon that became known as the "estate valuation freeze."<sup>86</sup> The topic captured the attention of the practicing bar and scholars alike, generating a blizzard of legal discourse.<sup>87</sup> The explosive inflation in values experienced by the holders of hard assets during the 1970's undoubtedly contributed to the flurry of planning activity and discussion.<sup>88</sup> Most of the literature enthusiastically touted the various planning opportunities while cautioning readers of their technical pitfalls.<sup>89</sup> Some of the scholarly discussion, however, sounded a

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limiting both income and wealth transfer taxes; it appears that practitioners were employing this estate planning technique as early as 1946. Professor Cooper, for example, discussed the estate planning background of the decision in *Estate of Salsbury v. Commissioner*, 34 T.C.M. (CCH) 1441 (1975), in which a preferred stock recapitalization was accomplished in 1946 as the preparatory step in a plan of lifetime gifting of stock ownership. See Cooper, *supra* note 12, at 171-74.

86. A number of very different structures can result in limiting or "freezing" the amount of taxable future appreciation in an estate. One writer identified at least 12 different value capping or freeze methods. See Abbin, *The Value-Capping Cafeteria — Selecting the Appropriate Freeze Technique*, 15 INST. ON EST. PLAN. ¶ 2000 (1981).

87. Based on the author's survey, the number of published articles in the area which expressly mention estate freezing in their titles well exceeds 150. That number does not include other numerous articles on general estate planning which would direct some attention to estate valuation freezes. See *infra* notes 88, 89, and 96-104, for citations to some of the literature.

88. As discussed in the text which follows, the goal of the estate valuation freeze is to place a ceiling on the estate tax value of property, shifting future appreciation to other individuals, typically the natural objects of the taxpayer's bounty. From 1967-1987, the Consumer Price Index increased from 33.4 to 113.6, for all items, and the cost of shelter, for example, increased from 28.8 to 121.3. See U.S. BUREAU OF LABOR STATISTICS, MONTHLY LABOR REVIEW AND HANDBOOK OF LABOR STATISTICS PERIODIC, reprinted in U.S. DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, No. 758 (109th ed. 1989). The estate valuation freeze concept assumes that the underlying assets will significantly appreciate over the long term. See Burch & Hemmerling, *Estate Planning in an Inflation Economy*, 27 S. CAL. TAX INST. 489 (1975); Abbin & Harrill, *Using Tax Strategies To Fight Inflation*, 58 TAXES 839 (1980); but see Harl, *Estate Planning in an Era of Declining Asset Values*, 20 GONZ. L. REV. 637 (1984/85).

89. See, e.g., Abbin, *Gift, Estate, and Income Tax Exposure from Recapitalizing Closely Held Companies*, 10 INST. ON EST. PLAN. ¶ 1200 (1976); Abbin, *The Partnership Capital Freeze — An Alternative to Corporate Recapitalization*, 13 INST. ON EST. PLAN. ¶ 1800 (1979); Wallace, *An Overview of Estate Freezing Techniques and Attendant Estate and Gift Tax Problems*, 15 REAL PROP., PROB. & TR. J. 71 (1980); Cohan, *Outline on Recapitalizations and Holding Companies*, 15 REAL PROP., PROB. & TR. J. 81 (1980); Nelson, *The Partnership Capital Freeze: A Prclis*, 15 REAL PROP., PROB. & TR. J. 99 (1980); Meyers, *Outline on Valuation Problems in Estate Freezing Techniques*, 15 REAL PROP., PROB. & TR. J. 112 (1980); Kopple, *Corporate Recapitalizations and Partnership Freezes*, 17 INST. ON EST. PLAN. ¶ 1100 (1983); Petrie, *Partnership Freezes: Determining When and How This Estate Planning Technique Should Be Used*, 14 TAX'N LAW. 50 (1985); Wallace, *Recapitalizing the Closely Held Corporation: New Problems for an Old Technique*, 19 INST. ON EST. PLAN. ¶ 400 (1985); Abbin & Zukin, *Have They Nuked the Freeze? Evaluating the Impact of Recent Decisions, Regulations and Rulings*, 19 INST. ON EST. PLAN. ¶ 500 (1985); Elias, *The Partnership Capital Freeze: A*

note of caution, arguing that the estate valuation freeze techniques had the potential of diminishing the role of the estate tax to that of a "voluntary tax,"<sup>90</sup> paid only by taxpayers who, for whatever reasons, chose not to avoid the levy.<sup>91</sup>

## B. The Estate Valuation Freeze Concept

The estate tax is computed with reference to the value of a decedent's taxable estate upon death.<sup>92</sup> The estate tax can therefore be decreased with reductions in the value of property included in the taxable estate of the decedent. One could reduce or eliminate the estate subject to taxation through contributions to charity,<sup>93</sup> extensive lifetime gifts,<sup>94</sup>

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*Path Through the Maze*, 40 TAX LAW. 45 (1986); Trebby, *Handling Estate Planning Problems of Valuation of Closely Held Corporations*, 14 TAX'N LAW. 220 (1986).

90. See Cooper, *supra* note 12; Covey, Surrey, & Westfall, *Perspectives on Suggested Revisions in Federal Estate and Gift Taxation: Symposium*, 112 TR. & EST. 102 (1973).

91. Professor Cooper discovered a number of reasons for the failure to use all available tax avoidance techniques, including non-tax considerations such as inability to part with property or a lack of suitable recipients, difficulty of universal application of certain techniques, particularly to smaller estates, and estate planner expertise, style, and custom. See Cooper, *supra* note 12, at 164-70.

92. I.R.C. § 2001(a) (Supp. V 1987). All references herein are to I.R.C. are references to the Internal Revenue Code of 1986, as amended, unless otherwise expressly noted.

93. As Mr. Carnegie stated:

This, then, is held to be the duty of the man of wealth: To set an example of modest, unostentatious living, shunning display or extravagance; to provide moderately for the legitimate wants of those dependent upon him; and, after doing so, to consider all surplus revenues which come to him simply as trust funds, which he is called upon to administer, and strictly bound as a matter of duty to administer in the manner which, in his judgment, is best calculated to produce the most beneficial results for the community . . . .

A. Carnegie, *The Gospel of Wealth*, in *THE GOSPEL OF WEALTH AND OTHER TIMELY ESSAYS* 14, 25 (1962). A person who is charitably inclined is not required to dispose of the charitable contribution property during his or her lifetime; the estate tax savings can be realized by a testamentary charitable transfer, provided that the requirements of I.R.C. § 2055 are satisfied. Moreover, provisions can be made for both the financial needs of loved ones and the charitable donation. See *infra* note 104.

94. The lifetime gifts could be subject to the gift tax, see I.R.C. §§ 2501-2524, which was enacted as a backstop to the estate tax. See, e.g., *Estate of Sanford v. Commissioner*, 308 U.S. 39, 44 (1939). The gift tax also had the purpose of restricting income tax avoidance through the unfettered intrafamily gifting of income-producing property. See R. PAUL, *supra* note 25, at 959-64. Lifetime gifts enjoy, however, certain wealth transfer tax advantages when compared with testamentary transfers. The principal benefit of an outright gift is that if the gift is complete for estate tax purposes, without inclusionary retained powers or interests, all future appreciation inures to the donee. Except for I.R.C. § 2035(c), which includes in the taxable estate all gift taxes paid for transfers within three years of death, any gift tax paid on a gift is not included in the donor's estate. Lifetime gifts are eligible for the annual donee gift exclusion of \$10,000 (see I.R.C. § 2503(b) (1982)), which can effectively be increased to \$20,000 in the case of a married couple electing gift-splitting under I.R.C. § 2513. On the other hand, the donee loses the benefit of the date of death value income tax basis for property received by

an extravagant lifestyle, or other wealth dissipation activities. In the view of its critics, the estate valuation freeze permitted an individual to reduce his or her taxable estate without meaningfully parting with the property's lifetime benefits.<sup>95</sup>

The typical estate valuation freeze techniques shared a common assumption that property can be divided into a number of separate interests for wealth transfer taxation purposes, the result being a transfer of the appreciation elements to the younger generation, and retention of those interests that would not appreciate by the elder generation.<sup>96</sup> The corporate recapitalization was probably the most widely discussed valuation freeze technique.

In the typical case, the equity interests in a closely held corporation were recapitalized to create a common stock class, which would participate in all future appreciation, and a preferred stock class, which had senior rights to current income and liquidation proceeds, but limited ap-

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bequest, devise, or inheritance provided by I.R.C. § 1014 and receives only a modified substituted basis under I.R.C. § 1015. The donor, by paying a lifetime gift tax, loses the benefit of deferring the payment of wealth transfer taxes until death. Even in the environment prior to the Tax Reform Act of 1976, in which the gift tax rates for gifts were lower than those for the estate tax, a number of countervailing factors, often of a nontax nature, led to surprisingly little lifetime gifting. For a discussion of these factors, see C. SHOUP, *supra* note 52, at 21-25.

95. See Dunn, *Enjoy Property Now and Avoid Estate Taxes Later*, 72 A.B.A. J. 66 (Jan. 1986). I.R.C. §§ 2036-2038 were enacted to preclude cruder versions of such activities, such as the retention of a life estate, or the retention of an income interest by a trust settlor. However, these provisions were not generally effective against the common estate valuation freeze structures. The last straw for the Treasury was supplied by Judge Korner's decision in *Estate of Boykin v. Commissioner*, 53 T.C.M. (CCH) 345 (1987), in which application of I.R.C. § 2036 was rejected, at least under the facts of the case, in the context of a dual class stock structure. On the other hand, the viability of some techniques, such as the sale of a remainder interest, was called into question by judicial developments. *Gradow v. United States*, 11 Cl. Ct. 808 (1987) (applying the estate depletion concept of *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961)). See, e.g., Note, *Gradow v. United States: Death of Remainder Interest Sale as an Estate Freezing Technique?*, 8 VA. TAX REV. 183 (1988).

96. An asset value freeze is based on the concept that property can be fractionalized into different bundles of rights, each of which has a value that can be determined and made the object of a transfer within a family group. The corporate and partnership structures, through the use of differing classes of stock and partnership interests, readily lend themselves to dividing a single business enterprise or property interest into a number of separate proprietary interests. Division into separate interests can be achieved in a nonentity context through the creation of a life estate in the elder generation member, whether by a sale of the remainder or through a joint acquisition of separate interests. In addition to the articles listed *supra* note 89, the following publications address the separation of enterprise interests. Ehrlich, *Corporate Recapitalization as an Estate Planning Business Retention Tool*, 34 INST. ON FED. TAX'N 1661 (1976); Borini, *The Personal Holding Company as an Estate Planning Tool*, 26 S. CAL. TAX INST. 143 (1974); Dean, *The Family Business: Organization and Reorganization*, 5 INST. ON EST. PLAN. ¶ 300 (1971); Nash, *Family Partnerships: A Viable Planning Alternative*, 13 INST. ON EST. PLAN. ¶ 1000 (1979); Scheifly, *Partnership Recapitalization: Achieving a Capital Freeze*, 32 S. CAL. TAX INST. ¶ 500 (1980).

preciation. A relatively nominal value was usually claimed for the common stock when it was subsequently sold or gifted to the younger generation, while the older generation retained the senior preferred stock.<sup>97</sup>

Other techniques shared the estate valuation freeze rubric with the corporate recapitalization.<sup>98</sup> Installment sales of property to family members,<sup>99</sup> sales of remainder interests,<sup>100</sup> and private annuities<sup>101</sup> could also be used to shift future appreciation to others, though, at some income tax cost to the transferor. On the other hand, business buy-sell

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97. The following example demonstrates the significant tax avoidance potential presented by the recapitalization of a successful family business:

The stock of Computer Corp. is owned solely by Parent. An estimate of the value of the stock as of year 1 is \$5 million. The future prospects for Computer Corp. are very bright, and Parent wishes to shift the fruits of such success to Parent's children. Parent causes Computer Corp. to be recapitalized in a tax-deferred reorganization and receives preferred stock and common stock in exchange for the common shares previously held. It is hoped that due to the dividend, voting, and other characteristics of the preferred shares, the preferred shares will absorb most of the current value of Computer Corp., and the common shares will have only a nominal present value. On the other hand, due to the limited participation rights of the preferred shares in dividends and liquidation proceeds, it is also hoped that the preferred stock will not further appreciate in value as the company prospers. Parent immediately gifts all of the common shares to the children in year 1, retaining only the preferred shares. If a gift tax is due on the transfer of the common shares, the tax may not be significant in view of the amount claimed as the value of the common shares.

Upon Parent's death in year 20, Computer Corp. is worth \$200 million. If the freeze has its intended effect, the \$195 million in appreciation in the company is owned by the children through their stock investment, and Parent's estate includes only the \$5 million value of the preferred shares.

98. A similar effect could be achieved with a multi-class partnership. See Schriebman, *Family Partnership As an Estate Planning Device Must Pass IRS Muster: Some Guidelines*, 4 EST. PLAN. 16 (1976); Abbin, *The Partnership Capital Freeze — An Alternative to Corporation Recapitalization*, *supra* note 89; Nelson, *The Partnership Capital Freeze: Income, Estate, and Gift Tax Considerations*, 1 VA. TAX REV. 11 (1981).

99. See, e.g., Cornfeld, *Installment Sales: Are They Rushing or Slowing Down?*, 15 INST. ON EST. PLAN. ¶ 1100 (1981); Note, *The Safe-Harbor Interest Rates Under Section 483 of the Internal Revenue Code: A Gift Tax Trap*, 20 IND. L. REV. 679 (1987); Moore, *Analyzing the Complex New Proposed Regs on Imputed Interest and Original Issue Discount*, 65 J. TAX'N 14 (1986); Banoff & Hartz, *Self-Cancelling Installment Notes: New IRS Rulings Expand Opportunities*, 65 J. TAX'N 146 (1986).

100. See, e.g., Weinbaum, *Are Sales of Remainder Interests Still Available in Light of a New Decision?*, 14 EST. PLAN. 258 (1987).

101. See generally Sackett, *Using Private Annuities Today: The Benefits, the Drawbacks and Open Questions*, 49 J. TAX'N 48 (1978); Bilansky, *Making the Most of Private Annuity Arrangements to Transfer Property and Reduce Estate Tax*, 8 EST. PLAN. 102 (1981); Hartz & Banoff, *Planning Opportunities Available Using a Private Annuity for a Term of Years*, 65 J. TAX'N 302 (1986).



agreements,<sup>102</sup> split interest purchases,<sup>103</sup> and the "grantor retained income trust,"<sup>104</sup> presented wealth transfer tax avoidance avenues that did not carry as detrimental income tax consequences.<sup>105</sup> If respected for valuation purposes, the estate freeze offered tantalizing wealth transfer tax avoidance benefits.<sup>106</sup>

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102. See Dickey, *Buy-Sell Agreements Can Conclusively Limit Value Without Recapitalization Problems*, 11 EST. PLAN. 268 (1984); but see Treanor, *Is the Eighth Circuit's St. Louis Bank Case the Death Knell for Restrictive Stock Agreements?*, 57 J. TAX'N 200 (1982). See also Tobisman, *Estate and Gift Tax Considerations in Buy-Sell Agreements*, 35 S. CAL. TAX INST. ¶ 1700 (1983); Bucholtz, *Using Restrictive Sales Agreements to Fix a Low Estate Tax Value for a Business Interest*, 8 EST. PLAN. 146 (1981).

103. See Moore, *The Use of Life Estates and Remainder Interests in Estate Planning*, 19 INST. ON EST. PLAN. ¶ 1200 (1985); Adams, Bieber & Johnson, *Joint Purchases of Life Estates and Remainder Interests*, 124 TR. & EST. 32 (1985); Adams, *Value-Shifting Techniques — Bang or Bust?*, 20 INST. ON EST. PLAN. ¶ 1300 (1986); Trebby, *Current Approaches to Shifting Value Through Sales and Purchases of Remainder Interests*, 13 EST. PLAN. 362 (1986).

104. See Kelly, *IRS Expands Definition of Gift to Launch New Attack on Two Estate Freezing Techniques*, 15 EST. PLAN. 230 (1988); Zabel, *The Best (Last?) Game in Town*, 127 TR. & EST. 25 (Jan. 1988); Adams, *supra* note 103. Another technique that can be used to shift appreciation is the split interest charitable trust, in which the deduction for the charitable beneficiary's interest shelters the value of the property placed in trust for the ultimate benefit of a private beneficiary. See Abbin & Gormanous, *Creative Charitable Giving*, 51 TAXES 813 (1973); McCue & Gary, *Split-Interest Charitable Giving — Down But Not Out*, 20 INST. ON EST. PLAN. ¶ 800 (1986).

105. The income tax (as opposed to the estate or gift tax) implications of the structures could be used to separate the techniques into two groups: those resulting in income recognition in their implementation and those resulting in an effective estate freeze free of immediate income tax consequences. The distinction could be a significant factor influencing a taxpayer's choice of the appropriate freeze structure.

In most cases in my own practice the typical estate freezing client is wealthy . . . . Suddenly this wealthy client becomes aware that the transfer tax cost of passing his accumulated wealth to the next generation has become quite high, and that as his assets continue to increase, that cost will go higher. In addition, while this wealthy client is now willing to consider passing some of the future appreciation attributable to his wealth to younger generation family members, he is always inclined to keep, or insists upon keeping, control over his estate assets, if not forever, at least for the moment until the donees demonstrate that they are able to handle property satisfactorily. Finally, this typical wealthy client hates to pay taxes—in other words, he is a proponent of the 'I didn't get rich by paying taxes' syndrome. If the client is a business owner, he wants his business to be restructured without income tax liability, he wants to effect lifetime transfers without gift tax liability, and he wants to lower his estate tax liability as much as possible.

J. Wallace, remarks at the Annual Meeting of the Section of Real Property, Probate and Trust Law of the American Bar Association, in Dallas, Texas (Aug. 14, 1979), *reprinted* in 15 REAL PROP., PROB. & TR. J. 19, 22 (1980) [hereinafter *Panel Discussion*].

106. Estates in excess of \$3 million face wealth transfer taxes at a marginal rate of 55%, and estates in excess of \$10 million are subject to an overall rate (as opposed to a marginal rate) of 55%. The Revenue Act of 1987, *supra* note 13, at § 10401, postponed until 1993 the phase-in of the 50% maximum rate provided for in I.R.C. § 2001(c). It also amended I.R.C. § 2001(c) to provide for a 5% surcharge on the amount of taxable estates in excess of \$10,000,000 but not to exceed \$21,040,000 (\$18,340,000 in the case of decedents dying, and

### C. Early Treasury and Congressional Responses

The first assaults on the estate valuation freeze techniques were waged by the Internal Revenue Service ("Service") against relatively simple plans, and focused primarily on issues of valuation.<sup>107</sup> Although the Service continued to battle taxpayers with mixed success, several of its published rulings helped facilitate the income tax certainty, and to some extent the estate and gift tax certainty, of the most widely used structures.<sup>108</sup> The attitude of the Service toward the estate valuation freeze hardened noticeably with the increasing notoriety of the techniques, as evidenced by a series of progressively restrictive administrative pronouncements.<sup>109</sup> Congress also indirectly contributed to existing uncer-

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gifts made, after 1992). The surcharge has the effect of progressively eliminating the benefit of the graduated tax rates and the unified credit (*see* I.R.C. § 2010 (Supp. V 1987)) for estates in excess of \$10,000,000, with the benefits being totally eliminated for estates in excess of \$21,040,000 and \$18,340,000, respectively. The relatively steep wealth transfer taxation rates could produce high stakes in controversies with the taxing authorities. For example, in *Estate of Harrison*, 52 T.C.M. (CCH) 1306 (1987), involving a form of freeze limited partnership, the asserted estate tax deficiency was \$31,758,893.37.

On the other hand, escaping inclusion in the taxable estate carries with it loss of the I.R.C. § 1014 basis adjustment. The loss of an upward basis adjustment under this section for income tax purposes must be reconciled with the perceived estate tax savings. However, comparing the overall 55% estate tax rate on large estates with the 28% marginal income tax rate on high income taxpayers introduced by the Tax Reform Act of 1986, the loss of the I.R.C. § 1014 adjustment might not be as significant a drawback.

107. *Compare Estate of Salisbury*, *supra* note 85 (Tax Court disregarded the Service's argument that the value of the retained voting control was essentially equal to most of the corporate value); *Wallace v. United States*, 566 F. Supp. 904 (D. Mass. 1981) (Court discounted the value of the preferred stock due to the practical unlikelihood that a conversion feature would be exercised); and *Provident Nat'l Bank v. United States*, 581 F.2d 1081 (3d Cir. 1978) (Court ruled that the value of preferred stock depended on the risk of default on dividends, the arrearage provisions, and the relationship of the dividend rate to other market interest rates. Neither the common stock value nor the par value of the preferred stock would automatically be determinative of the preferred stock value).

108. *See, e.g.*, Rev. Rul. 59-60, 1959-1 C.B. 237, *as modified*, Rev. Rul. 65-193, 1965-2 C.B. 370, *amplified*, Rev. Rul. 77-287, 1977-2 C.B. 319, and Rev. Rul. 80-213, 1980-2 C.B. 102, all of which address valuation of preferred and common stock; Rev. Rul. 75-93, 1975-1 C.B. 101, and Rev. Rul. 75-179, 1975-1 C.B. 103, discussing application of I.R.C. § 305; Rev. Rul. 75-236, 1975-1 C.B. 106, Rev. Rul. 75-222, 1975-1 C.B. 105, and Rev. Rul. 75-247, 1975-1 C.B. 104, which discuss the applicability of I.R.C. § 306.

109. *See, e.g.*, Rev. Proc. 88-3, 1988-1 C.B. 579, in which the IRS continued the practice begun with Rev. Proc. 83-22, 1983-1 C.B. 680, of denying letter ruling requests for a determination of whether a transaction constitutes a tax-free corporate recapitalization unless it is an integral part of a larger transaction for which it was impossible to determine the tax consequences without a determination with regard to the recapitalization. One commentator suggested that this action was not the result of a change of position by the IRS, but was prompted "because too many requests were being received and presumably not because of any change in the IRS's view of the applicable law." Elias, *Preferred Stock Recapitalizations: Income, Estate and Gift Tax Issues*, 13 J. CORP. TAX'N 332, 334 (1987). *See also* Rev. Rul. 83-119, 1983-2 C.B. 57, addressing the effects of an excess redemption price for preferred stock issued in a

tainty by enacting additional penalties aimed at the undervaluation of property for estate and gift tax purposes, the "Achilles heel" of the common freeze arrangements.<sup>110</sup>

The estate valuation freeze had never been a planning tool for the faint-hearted. The increased risks, while reducing somewhat its attractiveness, only partially dimmed the professed zeal of its proponents.<sup>111</sup> This optimism was buoyed by favorable developments in the United

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corporate recapitalization, and Rev. Rul. 83-120, 1983-2 C.B. 170, discussing the factors determined by the Service to be significant in deriving the fair market value of preferred and common stock received in certain corporate reorganizations. In a series of private letter rulings, the IRS asserted that the retained power provisions of I.R.C. §§ 2035-2038 apply to asset freeze techniques. See, e.g., Priv. Ltr. Rul. 85-04-011 (Oct. 1, 1984), Priv. Ltr. Rul. 85-10-002 (Nov. 26, 1984), and Priv. Ltr. Rul. 86-10-011 (Nov. 15, 1985).

110. Congress added I.R.C. § 6660 as part of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984). This section provides for a valuation penalty for estate and gift tax returns where there is a valuation understatement. Proper valuation is a concern.

No matter how you dress up the preferred stock with ornaments, you just can't get virtually 100 percent of the value of the company into the preferred stock . . . [T]here is just no way that a valuation expert can substantiate a conclusion that the value of the preferred stock is equal to 100 percent of the value of the company . . . . People say to me in situations like I have described that with all the preferred stock outstanding the common stock can't possibly be worth anything at all. To which I reply, then why would anybody want it. To which they reply, because it has appreciation possibilities. To which I reply, then it has a very big value. How can the common stock be without significant value if the outlook for the company is so bright that we need a preferred stock recapitalization to freeze value in the first place?

*Panel Discussion, supra* note 105, at 54-55.

111. The revenue pronouncements cited in note 109 were generally considered as complicating the area of corporate recapitalization freezes, but by no means eliminating the potential for estate tax avoidance. See, e.g., Friedman, *New Ruling Requires Creative Planning in Structuring Recapitalizations*, 60 J. TAX'N 146 (1984); Fowler, *Planning for Recapitalizations in Light of Recent Administrative and Legislative Developments*, 63 TAXES 202 (1985). Although the IRS attacked the asset freeze on various fronts, it appeared that until the recent enactment of I.R.C. § 2036(c), discussed below, the widely used corporate freeze was a legitimate tax deferral device. In *Estate of Boykin v. Commissioner, supra* note 95, the IRS's retained power theories were rejected by the United States Tax Court. The remainder sale technique, however, was called into question by judicial developments. See *supra* note 95. Another uncertainty was presented by the IRS's position when it asserted that the holder of the preferred stock in a family corporation freeze made an indirect gift through foregoing his or her preferred stock dividends. Priv. Ltr. Rul. 87-23-007 (Feb. 18, 1987). The IRS has also held that a preferred shareholder's nonexercise of conversion rights (which are typically included to help support the value absorbing quality of the preferred stock) resulted in a gift to the common shareholders. Priv. Ltr. Rul. 87-26-005 (Mar. 13, 1987). Although the IRS won its legislative victory, it may still continue to press its gift tax theories against past and future estate freeze structures. See Kelly, *supra* note 104. For further discussion, see Abbin, *Taking the Temperature of Asset Value Freeze Approaches: What's Hot, What's Not*, 66 TAXES 3 (1988). However, new I.R.C. § 2036(c) itself should not apply to existing freeze structures and the nonexercise of such existing rights, due to special effective date provisions. See *infra* note 142.

States Tax Court. There, the Service suffered a significant defeat in *Estate of Boykin*,<sup>112</sup> setting the stage for a response from Congress.

#### D. Congressional Actions

In his 1977 article, Professor George Cooper<sup>113</sup> proposed that Internal Revenue Code section 2036 be amended to expressly address the corporate recapitalization and multi-class partnership capital freeze. Some experts in the area of estate valuation freezes predicted fallout from his suggestions.<sup>114</sup> However, Professor Cooper's comments did not publicly surface at the legislative level for a number of years.

The Treasury's proposals for estate and gift tax reform, included in its 1984 report,<sup>115</sup> suggested limiting the allowance of minority or fractional-share discounts in valuing property interests, but did not otherwise propose restrictions on the estate valuation freeze.<sup>116</sup>

The President's tax proposal to the Congress<sup>117</sup> included no provisions for estate and gift tax reform when unveiled in 1985. At the Treasury's request, the American Bar Association appointed a special task force, under the direction of the Section of Taxation, to study how the wealth transfer tax system should be reformed.<sup>118</sup> The American Bar Association study suggested that the estate valuation freeze could be limited through the promulgation of additional regulations.<sup>119</sup>

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112. See *supra* note 95.

113. See Cooper, *supra* note 12.

114. A typical response was, "So if you want a road map of where the Treasury and the Internal Revenue Service are going to seek legislative relief over the next ten years, just read this article, because, believe you me, people in the Treasury and the Internal Revenue Service have read it." *Panel Discussion, supra* note 105, at 32.

115. *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report* (Nov. 1984) [hereinafter *Treasury Report*].

116. The Treasury report proposed that no minority discount be permitted for gift or estate valuation purposes. *Treasury Report, supra* note 115, at 386-88. Instead, the value of the minority interest would be determined as the minority interest's pro rata share of the fair market value of the entire interest held by the donor. *Id.* This approach, which applied family attribution principles to aggregate property interests held by related parties, was significant because it represented a departure from the prevailing application of standard business valuation concepts. See, e.g., Rev. Rul. 59-60, *supra* note 108. However, statutory precedent did exist for valuing certain property for federal estate tax purposes at other than its highest value. See I.R.C. § 2032A, which permits a reduction in fair market value for real property used in farming and other closely held businesses.

117. The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, 21 WEEKLY COMP. PRES. DOC. (May 29, 1985) [hereinafter President's Proposals].

118. See ABA PROPOSALS, *supra* note 9.

119. The ABA noted that, "These are also areas that might be addressed in regulations that would discourage the use of such arrangements for what are, essentially substitutes for testamentary disposition. This does not mean that such arrangements should not be permitted where they conform to economic reality." *Id.* at 424.

The estate valuation freeze limitations finally arrived on the legislative scene in 1987, and not surprisingly, as a companion to minority discount valuation limitations. The staff of the Joint Committee on Taxation, together with the staff of the House Ways and Means Committee, targeted estate freezes for reform, asserting that in the corporate recapitalization, the elder generation member effectively retains a life interest in the corporation by retaining voting preferred stock.<sup>120</sup> Estate valuation freezes were not addressed by the Joint Committee on Taxation in a subsequent proposal.<sup>121</sup> However, limitations on them resurfaced in a paper prepared several weeks before House deliberations on pending tax legislation.<sup>122</sup>

The House of Representatives passed the Revenue Bill of 1987 on October 29, 1987 as part of the Budget Reconciliation Act of 1987.<sup>123</sup> The legislation addressed both minority discounts and estate valuation freezes in new Internal Revenue Code section 2211, captioned "Special Valuation Rules."<sup>124</sup> The House proposal drew immediate fire from the practicing bar.<sup>125</sup> The Senate bill omitted both provisions.<sup>126</sup> In the

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120. The staff of the Joint Committee on Taxation and the Ways and Means Committee focused on reforms with respect to preferred stock valuation freezes, intra-family grants of long-term purchase options, use of fractional share as opposed to specified dollar amount formulae for marital deduction trusts (which would reject the result in *Estate of Alexander v. Commissioner*, 82 T.C. 34 (1984), *aff'd without opinion*, 760 F.2d 264 (4th Cir. 1985)), and minority discounts. The minority discount provisions differed from those in *Treasury Report*, *supra* note 115, in that two alternatives were proposed. A proportionate share approach similar to that proposed in Treasury Report was included, but as an alternative the paper proposed a family attribution approach that would aggregate other interests in the property owned by related individuals. See STAFF OF THE JOINT COMM. ON TAX'N AND COMM. ON WAYS AND MEANS, 100th Cong., 1st Sess., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES PREPARED FOR THE COMMITTEE ON WAYS AND MEANS (Comm. Print 1987), pp. 265-67, [hereinafter DESCRIPTION OF POSSIBLE OPTIONS].

121. STAFF OF THE JOINT COMM. ON TAX'N, 100th Cong., 1st Sess., DESCRIPTION OF ADMINISTRATION REVENUE PROPOSALS, EXPIRING TAX PROVISIONS, ESTATE TAX DEDUCTION FOR ESOP'S, AND ESTIMATED TAX PROPOSAL (Sept. 30, 1987) [hereinafter DESCRIPTION OF REVENUE PROPOSALS].

122. STAFF OF THE JOINT COMM. ON TAX'N, 100th Cong., 1st Sess., DESCRIPTION OF ADDITIONAL TAX PROPOSALS SUBMITTED BY MEMBERS FOR WAYS AND MEANS COMMITTEE REVENUE RECONCILIATION CONSIDERATION (Oct. 13, 1987) [hereinafter DESCRIPTION OF ADDITIONAL PROPOSALS].

123. H.R. 3545, 100th Cong., 1st Sess., 133 CONG. REC. H9185 (1987).

124. Section 10108 of the bill proposed a new I.R.C. § 2211. *Id.* at 133 CONG. REC. H9332. I.R.C. § 2211(a) addressed minority discounts, adopting the proportionate valuation approach of the Treasury Report proposal, with an additional fallback provision utilizing family attribution rules. The new section 2211(b) addressed valuation freezes.

125. Members of the Real Property, Probate and Trust Law Section of the American Bar Association delivered a letter, dated November 9, 1987, to Senator Lloyd Bentsen. The comments considered the minority discount provisions as discriminatory, favoring "ownership in large corporations over ownership in closely held business." *Id.* at 6. Letter signed by Lloyd

Conference Committee the minority discount limitations were discarded, and the special valuation approach was eliminated. Following Professor Cooper's suggestion of a decade before, the provision was recast into the familiar retained power or interest form of Internal Revenue Code section 2036 that had been a long-standing feature of the wealth transfer tax provisions,<sup>127</sup> and one of the bases for the Treasury's unsuccessful judicial tests of freeze arrangements.<sup>128</sup> The provisions emerged from the Conference Committee to become section 10402 of the Revenue Act of 1987,<sup>129</sup> part of the Omnibus Budget Reconciliation Act of 1987,<sup>130</sup> which was signed into law by President Reagan on December 22, 1987. After some conflicting reports, the estimated revenue impact of the provisions addressing estate tax freezes was projected to be approximately \$109 million by the year 1990.<sup>131</sup>

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Leva Plaine and other members of the American Bar Association Real Property, Probate and Trust Law Section to Honorable Lloyd Bentsen (Nov. 9, 1987). The letter in part stated: "In summary, the proposed section is unnecessary, vague, lacks content and is overbroad. It should not be enacted." *Id.* at 9.

126. S. 1920, 100th Cong., 1st Sess. (1987).

127. The legislation incorporated valuation freezes as a part of I.R.C. § 2036, treating the transfer of property in connection with a freeze as a retention of enjoyment of the transferred property within the meaning of I.R.C. § 2036(a)(1).

128. *See supra* note 95.

129. Revenue Act of 1987, *supra* note 13.

130. Omnibus Budget Reconciliation Act of 1987, *supra* note 13. The Revenue Act of 1987, *supra* note 13, § 10402, enacted new I.R.C. § 2036(c), which addresses estate valuation freeze transactions (former I.R.C. § 2036(c) was redesignated as I.R.C. § 2036(d) (Supp. V 1987)).

131. The estimated revenue impact of the estate valuation freeze amendments was initially projected as \$1.4 billion additional revenues by the year 1990. *See DESCRIPTION OF POSSIBLE OPTIONS, supra* note 120, at 267. The estimated revenue impact of the new freeze legislation, as reported in the final Revenue Act of 1987, for years 1988-1990, was scaled back to \$109 million. *See H.R. CONF. REP. No. 495, 100th Cong., 1st Sess., 499, 1025, reprinted in 1987 U.S. CODE CONG. & ADMIN. NEWS 2313-1245, 2313-1771 [hereinafter 1987 CONFERENCE REPORT]*. According to the Senate Report for its version of TAMRA, the revenue effect of the TAMRA freeze amendments would result in less than a \$500,000 revenue loss in 1989 and 1990, and a \$1 million revenue loss in 1991. S. REP. NO. 445, 100th Cong., 2d Sess. 523, 543, *reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 4515 [hereinafter 1988 SENATE REPORT]*. In the House Report, the freeze provisions were included with a lump-sum "Technical Corrections" revenue amount and a separate number was not provided. However, *all* of the technical corrections yielded only \$28 million in years 1988-91. H.R. REP. NO. 795, 100th Cong., 2d Sess. 424, 628 (1988) [hereinafter 1988 HOUSE REPORT]. The Conference Report did not provide any separate revenue amounts for the freeze provisions. Because the legislation does not apply to existing freeze structures (*see infra* note 142), the revenue effect may not be significant for some time. Based on reported comments made by Treasury Tax Legislative Counsel Dana L. Trier in testimony before the Senate Finance Committee on May 17, 1989, the revenue yield of the statute could be \$555 million in 1995. Loudon, *Treasury Rejects Proposals to Retroactively Repeal Estate Freeze Limits*, 43 TAX NOTES 926 (1989). Messrs. Bradley and Gephardt coined the phrase "cats and dogs" in describing "semiannual . . . tax reform bills that chip away at the deficit by picking up small increments of revenue." Bradley &

The freeze limitations had been produced in a relatively short time in the House of Representatives. The Senate proposal omitted them altogether, resulting in no refinement of the wording or concepts at that level. In Conference Committee, however, the final statute was hammered out, using an altogether different tack than the one proposed in the original House bill. The Reagan Administration reportedly did not like the legislation, and the Treasury opposed the measure in the House of Representatives and again in the Senate.<sup>132</sup> This process ultimately produced legislation that was roundly criticized by many as vague and poorly conceived.<sup>133</sup>

Congressional haste was followed by technical corrections. Amendments to the Revenue Act of 1987 estate freeze limitations were inserted in the version of the Technical Corrections Act of 1988,<sup>134</sup> introduced in both the House and the Senate on March 31, 1988. On July 26, 1988, the House Ways and Means Committee reported its version of the bill, renamed the Miscellaneous Revenue Bill of 1988, which proposed comprehensive amendments. Between the March 31, 1988 introduction date and the July 26, 1988 report date, the legislation grew more complex and exemptions multiplied. The reported bill included the earlier technical

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Gephardt, *Fixing the Income Tax with the Fair Tax*, 3 YALE L. & POL'Y REV. 41, 43 (1984). The Revenue Act of 1987 might share that characterization.

132. The position of the Administration and Treasury was noted in comments by Frederic Grundeman, attorney with the Internal Revenue Service Passthrough and Special Industries Division, before the District of Columbia Bar Section of Taxation, at a luncheon on March 7, 1989. See Loudon, *Forthcoming Estate Freeze Guidance Explained*, 42 TAX NOTES 1297 (1989). Mr. Grundeman is the principal author of a recent administrative notice concerning application of § 2036(c). See *infra* note 141.

133. See, e.g., Mahon, *Poorly Conceived Statute is Bad for Business*, 127 TR. & EST. 45, 50 (May 1988) ("New Sec. 2036(c) has many faults. Considered by itself as a piece of legislation, it contains ill-defined terms and concepts, which leave one wondering about its exact scope . . . In short, New Sec. 2036(c) is a poorly conceived statute which furthers no social policy other than anti-competitiveness. Repeal should be immediate."); Rapkin, *New Code Section Creates Pitfalls for Planners*, 127 TR. & EST. 31, 38 (1988) ("Sec. 2036(c) may have eliminated many of the estate freezing techniques widely employed in the past, but not all . . . Sec. 2036(c) fails at its attempted purpose. However, tax advisors must be alert to the pitfalls created by Sec. 2036(c)."); Bettigole, *Use of Estate Freeze Severely Restricted by Revenue Act of '87*, 68 J. TAX'N 132, 134 (1988) ("Living with Section 2036(c) will be particularly difficult because the section is worded so broadly . . . Accordingly, it is impossible at this time to state with certainty which freeze techniques are within or outside the scope of the section. Preliminarily, however, based upon a fair reading of the legislation it appears that clients can still benefit from a number of planning techniques that should remain viable.").

134. H.R. 4333 and S. 2238, 100th Cong., 2d Sess. 134 CONG. REC. § 3545 (1988). The proposed amendments were relatively simple, and addressed deemed gifts arising upon subsequent transfers of interests in the frozen enterprise and enhanced regulation writing authority for the Secretary of the Treasury. The provisions gave rise to a new controversy as to whether the subsequent transfer provisions extended to the automatic lapse, for example, of a limited life preferred stock interest. See *infra* notes 197-98 and accompanying text.

corrections, but also added several safe harbor provisions for certain retained interests, and a right of recovery of estate taxes against transferees.<sup>135</sup> On August 4, 1988, the House passed the bill. On August 3, 1988, the Senate Finance Committee reported an amended version of the Technical Corrections Act of 1988 which incorporated many of the House additions.<sup>136</sup> On October 11, 1988, the Senate passed the House bill as further amended in the Senate. The conference version of the two bills took form in the Technical and Miscellaneous Revenue Act of 1988,<sup>137</sup> passed by both houses on October 21, 1988, and was signed into law by President Reagan on November 10, 1988.

The journey of the estate freeze limitations from relative obscurity, to enactment, and then to comprehensive amendment, took almost one year. The process had followed the familiar pattern; answer a notorious abuse with complex and sweeping legislation, and then, in response to public criticism of the measure, amend the statute to the point of relative ineffectiveness. The journey is probably not over. The American Bar Association has called for the statute's repeal, and repeal legislation has in fact, been introduced in Congress.<sup>138</sup> The effectiveness of the legislation is discussed in the pages that follow.

### III. Reviewing the Legislative Response

#### A. Introduction

It should not be surprising that a statute, which was both enacted and substantially amended in less than twelve months, would be criti-

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135. 1988 HOUSE REPORT, *supra* note 131.

136. S. REP. NO. 445, 100th Cong., 2d Sess. (1988) [hereinafter 1988 SENATE BILL]. The Senate bill differed from the House bill most significantly in its failure to amend the language of I.R.C. § 2036(c)(1)(B) requiring retention of a "disproportionately large share in the income of, or rights in, the enterprise." The House bill proposed a much broader test. See *infra* notes 185-88 and accompanying text.

137. TAMRA, *supra* note 14.

138. The American Bar Association Section of Real Property, Probate and Trust Law reportedly engaged in a letter-writing campaign urging repeal of the statute. See Loudon, *ABA Real Property Section Takes Aim at Section 2036(c)*, 41 TAX NOTES 897 (1988). The American Bar Association's Section of Taxation, the Section of Real Property, Probate and Trust Law and the American College of Probate Counsel submitted a report recommending repeal, substituting a valuation provision specifically addressing the valuation problems of estate freezes. See *Section 2036(c) Should Be Repealed, Say ABA Section Members*, 44 TAX NOTES 855 (1989). Rep. Bill Archer received the 1989 Congressional Award from the Small Business Council of America for his efforts to repeal I.R.C. § 2036(c) through introducing H.R. 60, along with 58 co-sponsors. See *Archer Honored for Fight to Repeal 'Estate Freeze'*, 43 TAX NOTES 1293 (1989). Congressman Archer's bill was not alone. As of the May 17, 1989 testimony by Treasury Tax Legislative Counsel, Dana L. Trier, before the Senate Finance Committee, there were three Senate bills providing for retroactive repeal. See Loudon, *supra* note 131.



cized as technically inconsistent. Conversely, in view of the difficult challenge in effectively addressing the many estate valuation freeze techniques, it should also not be surprising that any resulting legislation would be generally complex.<sup>139</sup> The purpose of the following discussion is not to dwell upon the technical inadequacies of the legislation or its operation.<sup>140</sup> Instead, the purpose is to give the reader a sense of the unfinished chapter that Congress has started in this area, and the confused void that remains to be filled by the Service<sup>141</sup> and ultimately the courts. The author hopes that this introduction to the new legislation and its numerous unanswered questions, exceptions, and technical embellishments will move one to question whether this type of legislation is a desirable focus of congressional attention.

## B. The Operative Provisions

### 1. The Three Statutory Requirements

If the statute applies, the retention of an interest by a person, typically an elder generation member, will be considered a retention of the enjoyment of an interest transferred to another person, typically a younger generation member, within the context of Internal Revenue Code section 2036(a). Such a retained interest will result in the inclusion

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139. For some of the current literature, see Naples, *Despite Recent Changes, Recapitalizations Can Still "Freeze" an Estate*, 17 TAX'N LAW. 160 (1988); Foster & Rabun, *Planning Strategies to Cope With the Limits Imposed on Estate Freezes by RA '87*, 15 EST. PLAN. 130 (1988); Jones, *Transfers of Remainders Can Be an Effective Technique, but Careful Planning Is Required*, 16 EST. PLAN. 38 (1989); Spewak & Keller, *Treatment of Estate Freezes Revised by TAMRA but Many Questions Remain*, 16 EST. PLAN. 82 (1989).

140. See Aucutt, *Estate Freezes After The Revenue Act of 1987*, 5 AKRON TAX J. 1 (1988), for a discussion of the Revenue Act of 1987 version of the statute. See Blattmachr & Gans, *An Analysis of the TAMRA Changes to the Valuation Freeze Rules (Parts I & II)*, 70 J. TAX'N 14 (1989) and 70 J. TAX'N 74 (1989) for a technical discussion of the statute after the TAMRA changes.

141. On August 31, 1989, a short time before this article was sent to press, the IRS issued Notice 89-99, 1989-38 I.R.B. 4, providing guidance with respect to certain issues. The Notice states that it serves as an "administrative pronouncement" as described in Treas. Reg. § 1.6661-3(b)(2) (1985) and may be relied upon in the same manner as a revenue ruling or a revenue procedure. Provisions of forthcoming regulations that are inconsistent with the Notice and generally adverse to taxpayers will be applied prospectively only. The Notice reminds taxpayers that the IRS will entertain requests for private letter rulings on the applicability of I.R.C. § 2036(c) pursuant to Rev. Proc. 88-50, 1988-2 C.B. 613. As of the time of preparation of this article, Rev. Proc. 88-50 was issued on a test basis, due to expire on December 31, 1989.

The issuance of Notice 89-99 was long awaited by the estate planning community. By some reports, it was delayed because of a personnel shuffle within the Treasury Department. Sheppard, *Estate Freezes Continue to Pose Problems*, 43 TAX NOTES 517 (1989). Ironically, even the Notice states that the significant features and operative elements of the statute "are neither adequately defined in the statute nor susceptible to generally accepted interpretation." *Id.* Overview (B).

of the transferred interest in the transferor's estate, if three requirements are satisfied: (1) any person holds a substantial interest in an enterprise; (2) such person in effect transfers, after December 17, 1987,<sup>142</sup> property having a disproportionately large share of the potential appreciation in such person's interest in the enterprise; and (3) such person retains an interest in the income of, or rights in, the enterprise.<sup>143</sup>

The three requirements incorporate a number of terms which require further elaboration.

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142. The Conference Committee Report for the Revenue Act of 1987 stated that the statute does not apply to transfers completed before December 18, 1987. The following example was given:

Thus, for example, when a person who owns all the common and preferred stock in an enterprise transfers all the common stock after December 17, 1987, while retaining the preferred stock, the provision applies, even though the two classes of stock existed prior to December 18, 1987. If, in that situation, all the common stock is transferred prior to December 18, 1987, the provision does not apply to the transferor (or his spouse), even if either the common or preferred stock is transferred in subsequent transactions after December 17, 1987, so long as that transferor or his spouse does not reacquire any common stock.

1987 CONFERENCE REPORT, *supra* note 131, at 2313-1743. TAMRA § 3031(h)(4) provides for a "correction period" in which I.R.C. § 2036(c)(1) shall not apply to a transaction entered into after December 17, 1987 and ending before January 1, 1990 if "actions are taken as are necessary to have such section 2036(c)(1) not apply" or "the original transferor and his spouse on January 1, 1990 (or, if earlier, the date of the original transferor's death), does not hold any interest in the enterprise involved." TAMRA, § 3031(h)(4), at 3639. This apparently permits taxpayers to unwind freeze transactions as far as I.R.C. § 2036(c) is concerned, but the other aspects of the unwinding, for example, gift tax consequences, are not addressed. Notice 89-99, *supra* note 141, Part VIII, states that even post-death modifications occurring not later than December 31, 1989 will be considered as occurring within the correction period. In addition, the Notice exempts corrective actions from causing inclusion under I.R.C. § 2035(d). The 1988 TAMRA Conference Report also states that "for purposes of the effective date of section 2036(c), with respect to property transferred prior to December 18, 1987, the failure to exercise a right of conversion or the failure to pay dividends, or the failure to exercise other rights specified in regulations issued by the Secretary of the Treasury, will not be treated as a transfer under section 2036(c)." H.R. CONF. REP. NO. 1104, 100th Cong., 2d Sess. 74 *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS, 5048, 5134 [hereinafter 1988 CONFERENCE REPORT]. The latter provision was inserted in response to concerns raised by the Service's position that gifts can occur through the non-exercise of rights created under existing freezes. See *supra* note 111. The 1988 CONFERENCE REPORT exemption is limited to rights in existence prior to December 18, 1987, and the IRS's argument could be made for rights created thereafter or for pre-December 18, 1987 freezes not calling the effective date into question.

143. I.R.C. § 2036(c)(1) (amended 1988). The third factor of the statute as originally enacted required "retaining a disproportionately large share in the income of, or rights in, the enterprise." TAMRA § 3031(e) deleted the retention of a "disproportionately large share" requirement, substituting the much broader test which requires only "retaining an interest." TAMRA, § 3031(e) at 3637. This change is discussed in more detail *infra*, notes 185-89 and accompanying text.

## 2. Any Person Holding a Substantial Interest in an Enterprise

### a. Attribution of Ownership

The statute applies to the holding and subsequent transfer and retention of certain interests by a "person." This term includes not only individuals, but trusts, estates, partnerships, associations, companies, or corporations as well.<sup>144</sup> Because the gift tax<sup>145</sup> and the estate tax<sup>146</sup> are imposed only on individuals, it is necessary to ultimately attribute the formal ownership of the activities to a human being. The definition of the term "substantial interest" provides that link. Internal Revenue Code section 2036(c)(3)(A) states that:

A person holds a substantial interest in an enterprise if such person owns (directly or indirectly) 10 percent or more of the voting power or income stream, or both, in such enterprise. For purposes of the preceding sentence, an individual shall be treated as owning any interest in an enterprise which is owned (directly or indirectly) by any member of such individual's family.<sup>147</sup>

The application of this section may have far-reaching impact. For example, if a natural person owns stock in the highest tier of a multiple corporation group, and a recapitalization occurs at one of the operating subsidiary levels, the Treasury would probably seek to use the "directly or indirectly" language of the first parenthetical to attribute those freezing activities to the upstream individual shareholder.<sup>148</sup>

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144. I.R.C. § 7701(a)(1) (Supp. V 1987), which states: "(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof — (1) Person — The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation."

145. I.R.C. § 2501(a)(1) (1982), which states in part: "A tax . . . is hereby imposed . . . on the transfer of property by gift . . . by any individual, resident or non-resident."

146. I.R.C. § 2001(a) (Supp. V 1987), states: "A tax is hereby imposed on the transfer of the taxable estate of every decedent whose is a citizen or resident of the United States."

147. I.R.C. § 2036(c)(3)(A) (Supp. V 1987).

148. The broad "directly or indirectly" language is not new to the Internal Revenue Code. See, e.g., I.R.C. §§ 267, 318, 707(b), and 1239(c) (Supp. V 1987). Under the terms of the statute, "family" is defined as "such individual's spouse, any lineal descendant of such individual or of such individual's spouse, any parent or grandparent of such individual, and any spouse of any of the foregoing." See I.R.C. § 2036(c)(3)(B) (Supp. V 1987). The last sentence of the preceding clause treats legal adoption as a blood relationship. Although siblings are omitted from the statutory list, they could be included if serial reattribution of ownership applies. An interest owned by a brother, for example, would be constructively owned by the parent. The transferor, would in turn own the brother's stock constructively owned by the parent. The stock of a cousin would be constructively owned by the aunt or uncle as a parent, then to the grandparents as parents, and then down to the other cousin as the grandchild of a grandparent. By comparison, I.R.C. § 318 addresses and limits multiple attribution, which might suggest that Congress did not intend that reattribution apply in this case. See I.R.C. § 318(a)(5) (Supp. V 1987). The "spousal unity" rule of I.R.C. § 2036(c)(3)(C) treats an indi-

The statute does not address entity attribution, except through the "directly or indirectly" language. Nonetheless, the Conference Committee Report for the Revenue Act of 1987 does state that interests held indirectly by a person include "interests held by an entity in which such person has an interest."<sup>149</sup> Any details of entity attribution were left for future regulations.<sup>150</sup>

b. Substantial Interest in an Enterprise

The term "enterprise" is not defined in the statute, but the legislative history states that, "an enterprise includes a business or other property which may produce income or gain."<sup>151</sup> This language is so broad as to render moot most disputes as to whether the alternate requirement of a business exists.<sup>152</sup> The Service has administratively excluded personal use assets without significant business or investment aspects from

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vidual and such individual's spouse as one person. Read literally, this could attribute ownership to a taxpayer of property owned by relatives of the taxpayer's spouse, who would otherwise not be included under the foregoing definition. For example, such an interpretation would include the parents or grandparents of the spouse. Part II(B) of Notice 89-99, *supra* note 141, states that the definition of family "is defined in section 2036(c)(3)(B), and such definition is not affected by the spousal unity rule of section 2036(c)(3)(C).

149. 1987 CONFERENCE REPORT, *supra* note 131, at 2313-1742.

150. Apparently, the regulations could not adopt the statutorily prescribed entity attribution approach of I.R.C. § 318, for example, which does not attribute ownership of subsidiary stock to the individual shareholders of a parent corporation unless the individual shareholder owns, directly or indirectly, 50% or more of the value of the stock of the parent corporation. See I.R.C. § 318(a)(2)(C) (Supp. V 1987). A strict proportional ownership scheme is suggested by the simple statutory language. In that regard, Notice 89-99, *supra* note 141, Part II(B) generally utilizes a proportional rule in determining the extent of indirect ownership.

151. 1987 CONFERENCE REPORT, *supra* note 131, at 2313-1742.

152. One commentator has noted that the only property that might not qualify is money, since in that form it does not produce income or gain. See R. Covey, *The New Section 2036(c) Anti-Estate Freeze Provision* (Audiotape, Vol. 1, No. 3, CPE Tax Planning Tapes). A loophole would exist for some activity which did not rise to the level of a business, and also which did not constitute "property" or property which may produce income or gain. The latter type of property, not producing income or gain, may not justify the freeze structure from a practical standpoint. The other type of activity raises more theoretical issues. Although commercial goodwill is property, a family name and connections probably don't qualify. See *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973); *McCarthy v. United States*, 807 F.2d 1306 (6th Cir. 1986). Moreover, certain rights may be so attenuated as to not qualify as "property" for purposes of wealth transfer taxation. See, e.g., *Estate of Barr v. Commissioner*, 40 T.C. 227 (1963), *acq. in result*, 1964-1 C.B. 4. As an interesting aside, the TAMRA loan safe harbor provisions for "qualified start-up debt" cannot be utilized by a taxpayer if accompanied by a transfer of customers, goodwill, or business opportunities. See *infra* note 157.

the "enterprise" definition.<sup>153</sup> Life insurance and personal residences will generally qualify for the personal use asset exemption.<sup>154</sup>

A "substantial interest" requires ownership of ten percent or more of the "voting power or income stream, or both," in the enterprise.<sup>155</sup> "Voting power" is not defined in the statute nor in the legislative history, and many of the corporate voting control issues already encountered in the corporate taxation area will therefore need to be resolved in the context of the freeze legislation.<sup>156</sup>

The "income stream" term is similarly undefined and could refer to gross income, net income, taxable income, cash flow, book income or some other formulation. Congress provided some guidance in the TAMRA amendments with the inclusion of certain safe harbors for

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153. See Notice 89-99, *supra* note 141, Part I. Notice 89-99, Part I(B), defines an enterprise as any arrangement, relationship or activity that has significant business or investment aspects.

A particular arrangement is classified as an enterprise based on all the facts and circumstances, including, without limitation, (1) the arrangement's inherent capacity to produce income or gain, (2) the form of organization(s) through which it is implemented or conducted, (3) the extent to which any property subject to the arrangement was previously held for a business or investment purpose, and (4) the property's investment potential.

*Id.*

154. According to the provisions of Notice 89-99:

If the arrangement exclusively involves property that will be used as either the transferor or the transferee's principal residence or a contract that qualifies as life insurance under section 7702 of the Code, the presumption [that significant business or investment aspects are lacking] is conclusive. If the arrangement involves personal use property other than such a person residence or a life insurance contract, the presumption may be rebutted by demonstrating that the arrangement's personal use aspects are subordinate to its business or investment aspects.

*Id.* Notice 89-99 limits the personal residence to only that adjacent land not in excess of that which is reasonably appropriate for residential purposes, taking into account the residence's size and location. *Id.* at n.17. With regard to life insurance, Notice 89-99, Example 7, concludes that a life insurance trust is not subject to section 2036(c) despite the presence of an amount of cash sufficient to produce income approximately equal to the annual premiums on the policy; this arrangement, however, would run afoul of the grantor trust rules of I.R.C. § 677(a)(3) (Supp. V 1987).

155. I.R.C. § 2036(c)(3)(A) (Supp. V 1987). Part II(C) of Notice 89-99, *supra* note 141, solicits comments for safe harbors in which a transferor otherwise holding a substantial interest will be exempted if the participation of a significant number of unrelated parties indicates that the opportunity for such disproportionate transfers does not exist.

156. For example, should the voting power be considered in the aggregate, or class by class? Compare Rev. Rul. 59-259, 1959-2 C.B. 115, which requires a class by class computation for purposes of meeting the control requirements of I.R.C. § 368(c). How significant or broad must be the voting rights? See Rev. Rul. 69-126, 1969-1 C.B. 218, which holds that the sole right to participate in the election of directors constitutes voting stock for purposes of I.R.C. § 1504(a). Voting power has been administratively addressed by the Service in the context of retained rights. See *infra* note 191.

loans, the sale or lease of goods and the rendering of services.<sup>157</sup> The

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157. TAMRA § 3031(c) added I.R.C. § 2036(c)(7) providing that I.R.C. § 2036(c) shall not apply to a transaction solely by reason of one or more of:

- (a) the receipt (or retention) of "qualified debt"; (b) except as provided in regulations, the existence of an agreement for the sale or lease of goods or other property to be used in the enterprise or the providing of services and the agreement is an arm's length agreement for fair market value and the agreement does not otherwise involve any change in interests in the enterprise; or (c) an option or other agreement to buy or sell property at the fair market value of such property as of the time the option is (or the rights under the agreement are) exercised.

TAMRA, at 3636. The exception described in (b) above is further circumscribed by I.R.C. § 2036(c)(7)(B), which would deny the safe harbor to services performed under an agreement for the performance of services over a period greater than three years after the date of transfer (including any period for which an extension is available at the option of the service provider). In addition, the exception is unavailable to any amount determined (in whole or in part) by reference to gross receipts, income, profits or similar items of the enterprise. The term "qualified debt" is defined in I.R.C. § 2036(c)(7)(C), which means any indebtedness if — (i) such indebtedness unconditionally requires the payment of a sum certain in money in one or more fixed payments on specified dates and has a fixed maturity date not more than 15 years from the date of issue (or in the case of indebtedness secured by real property, not more than 30 years from the date of issue), (ii) the only other amount payable under such indebtedness is interest determined at a fixed rate or a rate which bears a fixed relationship to a specified market interest rate, (iii) the interest payment dates are fixed, (iv) such indebtedness is not by its terms subordinated to the claims of general creditors except where indebtedness is in default as to interest or principal, (v) such indebtedness does not grant voting rights to the person to whom the debt is owed or place any limitation on the exercise of voting rights by others and (vi) such indebtedness is not (directly or indirectly) convertible into an interest in the enterprise which would not be qualified debt and does not otherwise grant any right to acquire such an interest. The requirements in (i) above, requiring fixed payment dates for the repayment of principal can be excused if the debt is issued in return for cash used to "meet normal business needs of the enterprise." The interest payment dates required in (iii) would still need to be observed. Congress created an additional exception for "qualified start-up debt." I.R.C. § 2036(c)(7)(D) defines such debt as indebtedness (A) unconditionally requiring the payment of a sum certain in money; (B) received in exchange for cash to be used in any enterprise involving the active conduct of a trade or business; (C) the creditor has not at any time (before, on or after the exchange for cash) transferred any property (including goodwill) which was not cash to the enterprise or transferred customers or other business opportunities to the enterprise; (D) the creditor has not at any time (before, on, or after the exchange for cash) held any interest in the enterprise (including an interest as an officer, director, or employee) which was not qualified start-up debt; (E) any person who, would have been considered an original transferee participates in the active management (as defined in § 2032A(e)(12) of the enterprise; and (F) the indebtedness meets the nonvoting and nonconvertibility restrictions described in (v) and (vi) above.

Notice 89-99, *supra* note 141, addressed a number of safe harbor issues. A full discussion of these issues is beyond the scope of this article. In general, the Notice permits subordination of qualified debt with selected creditors, although a general subordination would be precluded. The Notice states that a right to prepay the debt does not adversely affect qualified debt status. A self-canceling installment note is not qualified debt because it does not unconditionally require payment of a sum certain in money. With respect to previous transfers of property disqualifying startup debt, the Notice states that only transfers within three years of the transaction will be considered. The Notice also sets forth criteria for a new type of qualified debt which would be an equity interest in the nature of preferred stock.

inclusion of safe harbors is commendable in drawing a "bright line." However, as discussed below, the safe harbors may render the statute ineffective with respect to the wealthiest taxpayers.

The House technical corrections bill<sup>158</sup> proposed that the substantial interest test could be met if the transferor held a substantial interest in the enterprise either before or after the effective transfer. One example given in the legislative history was that of a parent transferring cash or publicly traded stock to a corporation in exchange for preferred stock, with a child already owning the common stock of the transferee corporation.<sup>159</sup> Under the House bill, the section would have applied although the parent otherwise would not have held an interest in an enterprise before the transfer.<sup>160</sup> A second example in the House explanation targeted the split purchase, in which a parent, purchases an income interest in property and a child purchases a remainder interest in the same property.<sup>161</sup> The explanation stated that the substantial interest test would be met if, after the purchase, the parent or a member of the parent's family together own ten percent or more of the voting power or income stream of the property.<sup>162</sup> The TAMRA Conference Agreement deleted the House's "before or after" substantial interest requirement. The Conference Committee Report instead states that the section is applicable if a parent transfers an "existing enterprise or assets from such enterprise to another enterprise in which a child owns a disproportionately large share of potential appreciation and in which the parent retains an income interest or other rights."<sup>163</sup> Although the split purchase might be excluded, the creation of a holding company to invest in less than ten percent interests in other enterprises would probably be subject to the statute.<sup>164</sup> In Notice 89-99<sup>165</sup> the Service has taken the contrary view that the breadth of the statutory language, coupled with the inclusion in TAMRA of limited exceptions, demonstrates the broad sweep of

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158. 1988 HOUSE REPORT, *supra* note 136.

159. *Id.*

160. The cash in the hands of the parent before the transfer was not an "enterprise," and the interest held in the publicly traded company before the transfer was probably less than ten percent so as to not be a "substantial interest in an enterprise" as defined in I.R.C. § 2036(c)(3)(A) (Supp. V 1987).

161. *See supra* note 103.

162. 1988 HOUSE REPORT, *supra* note 135, at 424.

163. 1988 CONFERENCE REPORT, *supra* note 142, at 5134.

164. The 1988 CONFERENCE REPORT requires only a transfer of an existing enterprise to another enterprise. Apparently the ten percent substantial interest rule is to be applied only to the parent's interest in the ultimate holding company, and not to the transferred interest in the publicly traded company.

165. *See supra* note 141.

the statute. The Service considers section 2036(c) as applicable to, among other arrangements, split purchases of income and remainder interests.<sup>166</sup>

### c. Spousal Unity Rule

The statute, as originally enacted, stated that an individual and the individual's spouse are to be treated as one person.<sup>167</sup> This provision was aimed at preventing circumvention of the statute through, for example, gifts of certain interests to a spouse, such that the transfers of the growth interest would be accomplished by a person different from the person retaining the limited appreciation interest, or vice versa. One complication raised by this broad language was that the nontransferor spouse could be treated as the original transferor of the growth interest, requiring inclusion of the interest in that spouse's estate. The TAMRA amendments sought to address this concern by adding the limiting prefatory language "except as provided in regulations."<sup>168</sup> The Conference Agreement states that the regulatory determination of whether spouses are to be treated as one unit will be generally a function of whether the original transfer qualified for the marital deduction or annual exclusion.<sup>169</sup> Consequently, with Notice 89-99,<sup>170</sup> the Service has limited the application of the spousal unity rule to interspousal transfers not subject to a transfer tax.<sup>171</sup>

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166. Example 16 of Part III(C)(3) of Notice 89-99, *supra* note 141, involves a parent and child purchase of a portfolio of marketable securities. Parent acquires a life estate and child acquires the remainder, each furnishing consideration for the fair market value of the interest acquired. The example concludes that section 2036(c) applies. See *infra* Part IV for a discussion of the statute's application to selected structures.

167. I.R.C. § 2036(c)(3)(C) (Supp. V 1987) stated: "Treatment of Spouse — An individual and such individual's spouse shall be treated as 1 person."

168. I.R.C. § 2036(c)(3)(C) (amended 1988).

169. If the retained interest in the enterprise is transferred to the spouse in a transaction which qualifies for the marital deduction or annual exclusion, the spouses will generally be treated as one. See 1988 CONFERENCE REPORT, *supra* note 142, at 5135-36.

170. See *supra* note 141.

171. Notice 89-99, *supra* note 141, offers 13 examples of the application of the spousal unity rule, and a discussion of the rule is beyond the scope of this article. Transfers are considered subject to a transfer tax if they (a) qualify for the annual gift tax exclusion under section 2503(b), (b) qualify for the federal gift or estate tax marital deduction, or (c) are for full and adequate consideration. A special rule is provided for interspousal grants of general powers of appointment. In Part VI(C) of Notice 89-99, the IRS solicited comments as to the advisability of a regulatory election that would permit a deceased transferor's executor to elect to terminate the application of the spousal unity rule, with inclusion in the decedent's estate of the property that would otherwise be includable in the estate of the surviving spouse.



3. Such Person in Effect Transfers Property Having a Disproportionately Large Share of the Potential Appreciation in Such Person's Interest in the Enterprise

a. In Effect Transfers

In the legislative history of the Revenue Act of 1987, the Conference Committee stated, "[a] transfer encompasses, but is not limited to, all transactions whereby property is passed to or conferred upon another, regardless of the means or device employed in its accomplishment."<sup>172</sup>

No further guidance was provided for what constitutes an "in effect" transfer. Typically, in situations where it is difficult to fashion a precise statute, Congress has included a specific directive to the Treasury for prescribing regulations to close loopholes.<sup>173</sup> This simple exercise in drafting was curiously omitted from the original statute and left for subsequent technical corrections.<sup>174</sup> Wholesale delegation of authority to the Treasury is not a complete answer because any regulations, even those considered "legislative regulations," will be subject to judicial scrutiny.<sup>175</sup> The "in effect" transfer language itself may generate arguments, however unsuccessful, that the statute suffers from unconstitutional infirmities.<sup>176</sup>

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172. 1987 CONFERENCE REPORT, *supra* note 131, at 2313-1742.

173. See, e.g., I.R.C. §§ 453(j), 483(f), and 1274A(e) (Supp. V 1987).

174. TAMRA § 3031(c) added a new I.R.C. § 2036(c)(8): "(8) Regulations — The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including such regulations as may be necessary or appropriate to prevent avoidance of the purposes of this subsection through distributions or otherwise." TAMRA, *supra* note 14, at 3637. In the absence of the foregoing directive, the Secretary would have nonetheless been able to rely upon the overall procedural authorization to "prescribe all needful rules and regulations for the enforcement of this title." I.R.C. § 7805(a) (Supp. V 1987).

175. The "legislative" regulation is best exemplified by I.R.C. § 1502 (Supp. V 1987), which states: "The Secretary shall prescribe such regulations as he may deem necessary . . ." Such a regulation has the force and effect of law, and cannot be invalidated unless clearly contrary to the will of Congress. See *Regal, Inc. v. Commissioner*, 53 T.C. 261, 263-264 (1969). From a practical standpoint, such a regulation will be upheld unless it contradicts the express language of the statute or express legislative history. The TAMRA regulation directive does not substantially increase the authority otherwise available under I.R.C. § 7805(a). See *supra* note 174. The regulations will be sustained, however, "unless unreasonable and plainly inconsistent with the revenue statutes . . ." *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). In determining inconsistency with the statute, not only the words of the statute, but rather the court's notions of the policy and objectives of Congress in enacting the statute are applied. This gives the court a great deal of flexibility, which the United States Tax Court exercised in *Professional Equities, Inc. v. Commissioner*, 89 T.C. 165 (1987), in invalidating regulations promulgated under I.R.C. § 453(j) (Supp. V 1987).

176. U.S. CONST. art. I, § 2, cl. 3 states in part: ". . . direct Taxes shall be apportioned

b. Property Having a Disproportionately Large Share of the Potential Appreciation in Such Person's Interest in the Enterprise

The phrase "disproportionately large share of the potential appreciation"<sup>177</sup> is undefined in the statute, but the Revenue Act of 1987 Conference Committee Report offers a simple explanation: "[a] disproportionately large share of potential appreciation is any share of appreciation in the enterprise greater than the share of appreciation borne by the property retained by the transferor."<sup>178</sup>

The only example of the application of this phrase in the 1987 Conference Committee Report is more helpful:

Thus, if a person who owns a substantial interest in an enterprise and whose only holdings in the enterprise consist of 100 shares of common stock and 100 shares of preferred stock transfers 80 shares of the common stock and 20 shares of the preferred stock, only 60 shares of the

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among the several States which may be included within this Union, according to their respective Numbers . . . ." and U.S. CONST. art. I, § 9, cl. 4 states in part: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census in Enumeration herein before directed to be taken." In the face of these limitations, the Sixteenth Amendment was adopted in 1913, allowing the Congress to levy the income tax. U.S. CONST. amend. XVI states: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The estate and gift taxes have been held valid as an excise tax on the act of transfer, rather than a direct tax on the property transferred. In *Knowlton v. Moore*, 178 U.S. 41 (1900), the Court upheld the constitutionality of the 1898 inheritance tax on the basis that it was a duty or excise tax on the passing of property as the result of death, and therefore "not direct within the meaning of the Constitution." *Id.* at 83. In *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921), the Court followed the holding in *Knowlton*, which involved an inheritance tax, to uphold the constitutionality of the present federal estate tax. The constitutionality of the gift tax was upheld in *Bromley v. McCaughn*, 280 U.S. 124 (1929), where the Court noted that the power to give was just one of the powers incident to ownership of property, and that a tax on the power to give was not in essence a direct tax on the property itself. The inquiry of estate and gift taxation, from a constitutional standpoint, has involved a search for a transfer of property on which an excise tax is based. In *United States v. Manufacturers Nat'l Bank*, 363 U.S. 194 (1960), the Court broadly construed the transfer requirement for constitutional law purposes. The decedent had transferred all incidents to an insurance policy years before his death, but continued to pay premium payments. Inclusion under the statute in effect at that time looked to payment of premiums, but the taxpayer claimed that no "transfer" of the insurance had occurred. The Court broadly viewed the estate tax as being levied on an overall transaction, a testamentary disposition that began with the payment of the premiums and was completed at death. The premium payments were a "generating source," although not resulting in a direct transfer at death. *Id.* at 198. In interpreting the vague "in effect" transfer requirement, a court may choose the avenue of refusing to complete the unfinished work of Congress in interpreting a woefully incomplete or vague statute, rather than entertaining constitutional objections that no "transfer" in a constitutional sense occurred.

177. I.R.C. § 2036(c)(1)(B) (Supp. V 1987).

178. 1987 CONFERENCE REPORT, *supra* note 131, at 2313-1742.

transferred common stock are included in his estate under this provision.<sup>179</sup>

The House Ways and Means Committee Report proposal, rejected by the Conference Agreement, utilized the same example, but concluded that the value of "all stock, preferred and common, transferred to his children would be included in [the transferor's] estate."<sup>180</sup> Both the House Ways and Means Committee Report and the Conference Agreement would, however, permit a transfer of fifty percent of each of the preferred and common stock classes without Internal Revenue Code section 2036(c) inclusion of any stock in the transferor's estate.<sup>181</sup>

The loose language of the 1987 Conference Committee Report noted above seemed to present a greater planning opportunity for structuring disproportionate interests.<sup>182</sup> The TAMRA House Report clarified the disproportionate appreciation test, stating:

This standard may be understood by comparing two proportions. The first is the potential appreciation attributable to the transferred property divided by the value of such 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.<sup>183</sup>

Although the test is now more narrowly defined, the practical application remains unclear, particularly in quantifying "potential appreciation."<sup>184</sup>

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179. *Id.*

180. H.R. REP. NO. 391, 100th Cong., 1st Sess. (1987) 1044, *reprinted in* 1987 U.S. CODE CONG. & ADMIN. NEWS 2313-1, 2313-660.

181. For those with modest avoidance objectives, a proportional gift of both preferred stock and common stock offers some of the benefits of the classic freeze transaction. The cost is two-fold. First, the gifted limited appreciation interests, such as preferred stock, will typically have a greater gift tax value than the growth interests. Second, the retained growth interests obviously detract from the shift of future appreciation.

182. An example of such a structure of disproportionate interests is as follows (*Example 2*):

Parent recapitalizes CORP. and receives 100 percent of the preferred shares and 100 percent of the common shares. Parent then gifts 49 percent of the common shares to Child, but retains all of the preferred shares and 51 percent of the common. Under a literal reading of the 1987 Conference Committee Report, Parent did not transfer a disproportionately large share of potential appreciation because the share of appreciation held by Child was smaller than the share retained by Parent.

183. 1988 HOUSE REPORT, *supra* note 131, at 423 n. 120.

184. The following examples illustrate this issue regarding potential appreciation (*Example 3*):

Parent recapitalizes X CORP, creating a common stock class and a preferred stock class. The common is worth \$100,000. The preferred is worth \$3,000,000. The liquidation value, today, of the common stock is \$0. Its total value of \$100,000 is the discounted estimate of future earnings giving rise to appreciation. If Parent transfers the common stock, retaining the preferred, the ratios are:

#### 4. While Retaining a Disproportionately Large Share in the Income of, or Rights in, the Enterprise

Assuming that a transfer of a disproportionate share of future appreciation in the enterprise has occurred, under the Revenue Act of 1987 version of the statute, the transferor must also have retained a "disproportionately large share in the income of, or rights in, the enterprise."<sup>185</sup> The 1987 Conference Committee Report and the statute were silent as to what constituted a "disproportionately large share." The 1987 Conference Committee Report did, however, state that "rights in the enterprise include voting rights, conversion rights, liquidation rights, warrants, options, and other rights of value."<sup>186</sup> There was concern that "rights" in the enterprise would be read expansively to include, for example, em-

Transferred Common Stock: 1 = \$100,000 (Potential Appreciation)  
\$100,000 (Value)

Retained Preferred Stock: 0 = \$0 (Potential Appreciation)  
\$3,000,000 (Value)

The test is met.

##### *Example 4*

Apply the values in Example 3 to the transfer in Example 2, *supra* note 182:

Transferred Common Stock: 1 = \$49,000 (Potential Appreciation)  
\$49,000 (Value)

Retained Common and Preferred Stock: .02 = \$51,000 (Potential Appreciation)  
\$3,051,000 (Value)

The test is again met, even for a situation apparently permitted by the Revenue Act of 1987 Conference Committee example. The Senate bill for TAMRA did not raise this issue, and the TAMRA Conference Agreement:

follows the Senate amendment, regarding the scope of section 2036(c), except that the agreement follows the House bill provision eliminating language stating that the retained income or rights must constitute a disproportionately large share of such income or rights.

1988 CONFERENCE REPORT, *supra* note 163, at 5133-34. It is unclear whether this language includes the general House Report discussion of the disproportionate appreciation test that was not directly relevant to the issue of clarifying the retention test.

Notice 89-99, *supra* note 141, Part III(C)(1), states that the share of potential appreciation attributable to the transferor's interest in the enterprise is determined with reference to the rights that the interest carries with respect to any future increase in the value of the enterprise.

With regard to shifting participation interests in the enterprise, the Notice determines potential appreciation with respect to an interest by assuming circumstances which would maximize the share of potential appreciation attributable to the transferor's interest before the transfer, and minimize the share of potential appreciation attributable to the transferor's interest after the transfer. This concept is described in Example 14 of the Notice. Example 14 is not particularly instructive of the manner in which the potential appreciation element is to be determined for comparison with the whole value of an interest because it addresses a situation which begins as a simple 50/50, strictly proportional sharing of profits, for which appreciation easily follows.

185. I.R.C. § 2036(c)(1)(B) (Supp. V 1987).

186. 1987 CONFERENCE REPORT, *supra* note 131, 2313-1742.

ployment contracts with the corporation or deferred compensation arrangements.<sup>187</sup>

In TAMRA, Congress responded to these difficulties by substituting a test, described as a confirmation of the existing law, that looks only to "retaining an interest in the income of, or rights in, the enterprise."<sup>188</sup> The broadened retention test was tempered by the TAMRA inclusion of safe harbors for certain loans, employment, sales of goods, and other relationships.<sup>189</sup> The Service has, on the one hand, administratively narrowed the retention rule such that a retained interest does not include duties in serving as a trustee or other fiduciary.<sup>190</sup> On the other hand, the Service has given notice that it will construe the retained interest language expansively, and would include employment agreements and retirement arrangements. This will place even greater significance on satisfying the safe harbors.<sup>191</sup>

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187. Similar issues are encountered in determining if a complete termination of shareholder interest has occurred for purposes of I.R.C. § 302. In redemptions purporting to completely terminate a shareholder's interest, the judicial decisions and administrative pronouncements have permitted the shareholder's retention of interests as: a landlord (Rev. Rul. 70-639, 1970-2 C.B. 74); officer and director (Rev. Rul. 76-524, 1976-2 C.B. 94); a beneficiary of an escrow of the stock, established as a security device (*Lisle v. Commissioner*, 35 T.C.M. (CCH) 627 (1976)). Compare Rev. Rul. 77-467, 1977-2 C.B. 92, which suggests that rent dependent on future earnings or subordinate to general creditors may be a proprietary interest. The rules for an I.R.C. § 302(c)(2) (Supp. V 1987) termination of interest are, however, even more strict and include as a prohibited "interest in the corporation," interests as "officer, director, or employee." *Id.*

188. TAMRA, § 3031(e), at 3637. The Conference Committee Report does not explain the amendment to the retention rule. See 1988 CONFERENCE REPORT, *supra* note 163, at 5134. However, the explanation of the House bill terms the change a "clarification," stating: "This clarification confirms that, under present law, granting a disproportionately large share of potential appreciation necessarily entails the retention of a disproportionately large share of income or other rights in the enterprise." 1988 HOUSE REPORT, *supra* note 131, at 423.

189. See *supra* note 157.

190. Notice 89-99, *supra* note 141, Part IV. Examples 22 and 23 of the Notice are interesting. Example 22 holds that if a settlor places stock in a trust, the settlor has not retained an interest in the enterprise, despite the fact that the trustee has the power (in the trustee's absolute discretion) to invade corpus for the settlor's benefit. One can assume that the settlor did not have the right to remove the trustee without cause in contravention of the Service's position in Rev. Rul. 79-353, 1979-2 C.B. 325. In Example 23, the settlor retained a "5 or 5" power to withdraw \$5,000 annually from the trust. This right was considered a retained interest in the trust.

191. "An 'interest in the income of an enterprise' may be embodied in any form of interest (present or future), agreement, or arrangement, including, without limitation, preferred equity interest in the enterprise, a promissory note, a life or term interest, an employment agreement, a retirement arrangement, a sale agreement, and a lease agreement." Notice 89-99, *supra* note 141, Part IV. "Voting rights" include: "(1) the right to vote corporate stock; (2) the right as a limited partner to select, and consent to the acts of, a general partner; and (3) the right as a general partner to participate in the management of the partnership." *Id.*

### C. Special Rules and Other Complicating Factors

#### 1. Dispositions of Interests by the Decedent/Transferor

The estate tax provision for transfers with retained powers or interests, of which the freeze limitations are now a part, excludes transfers by the decedent for "adequate and full consideration in money or money's worth."<sup>192</sup> An obvious estate tax avoidance device would be the sale of the growth interest, for example, the common stock, to the younger generation upon implementation of the freeze structure, such that a transfer under the retained powers or interests provisions would not occur. On the other hand, even if the original transfer were not for adequate and full consideration, the decedent could free his or her estate of the pernicious retained power or interest by a sale of the interest before death. The first avoidance technique relies upon the adequate and full consideration exception on the transfer of the growth interest to completely render the statute inapplicable at the outset. The second avoidance technique relies upon disposing of the retained interest.

The Revenue Act of 1987 legislation anticipated the first avoidance technique. The statute provided that the sales for adequate and full consideration exception does not apply to transfers to a member of the transferor's family.<sup>193</sup> However, the statute arguably would not have restricted the subsequent sale to family members of the retained limited appreciation interest if the disquieting effect of decisions such as *Gradow*<sup>194</sup> could be overcome.

TAMRA addressed the foregoing issues, adding a further measure of complexity. With respect to subsequent transferor or transferee dispositions, the legislation creates a deemed gift to the transferee in the amount that otherwise would have been includable in the transferor's

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192. This exception is found in the parenthetical language of I.R.C. § 2036(a) (Supp. V 1987).

193. See I.R.C. § 2036(c)(2) (Supp. V 1987). The definition of family is that used in determining whether the transferor held a substantial interest in an enterprise. However, the "directly or indirectly" language and entity attribution language that was part of the substantial interest requirement does not literally apply to the definition of "family." I.R.C. § 2036(c)(3)(B) (Supp. V 1987) states in part: "Family - The term 'family' means, with respect to any individual, such individual's spouse, any lineal descendant of such individual or of such individual's spouse, any parent or grandparent of such individual, and any spouse of any of the foregoing. . . ." Consequently, the statute seemingly could be circumvented by a sale of the retained interest to an entity owned by a family member.

194. See *supra* note 95. In the sole footnote to its Report, the Revenue Act of 1987 Conference Committee noted: "[The property subject to the retained interest that was sold] may be includable even if the retained interest is sold for its fair market value during the three-year period." See *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961). 1987 CONFERENCE REPORT, *supra* note 131, at 2313-1741.

estate under section 2036(c), if either: (1) the original transferor transfers all or any portion of his or her retained interest to anyone, or (2) the original transferee transfers all or any portion of the transferred property to a person who is not a member of the original transferor's family.<sup>195</sup>

The first provision eliminates the advantages of disposing of one's retained interest, by sale or gift, to avoid inclusion of the growth interest, because the post-freeze appreciation in the growth interest will be captured by the gift tax at the time of disposition. The second provision has a mixed effect. It does clarify the issue of whether the estate of the transferor will pay an estate tax on the growth interest that has been already transferred out of the family unit, and for which future appreciation consequently will not continue to accrue. On the other hand, a deemed gift by the original transferor is again created. In a simple Senate Report example, the operation of the technical corrections is reasonably clear:

For example, assume that a person who holds all the preferred and common stock in a corporation gives away the common stock while retaining the preferred stock. If the transferor or transferee subsequently transfers all of his stock to a person outside the transferor's family, the original transferor is treated as having made a gift with respect to the common stock at that point in time. The amount of the gift equals the fair market value of the common stock at the time of the subsequent transfer reduced by the fair market value of the common stock at the time of the initial transfer. The common stock will not thereafter be included in the transferor's estate under section 2036(c) or subsequently give rise to a deemed gift under the provisions.<sup>196</sup>

If a limited life retained interest were used,<sup>197</sup> the expiration of the retained interest, by its own terms, might not have been considered as a transfer within the foregoing provisions. This loophole was immediately spotted by persons analyzing the Revenue Act of 1987.<sup>198</sup> The TAMRA amendments responded by including "terminations, lapses, and other

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195. See I.R.C. § 2036(c)(4) (amended 1988).

196. 1988 SENATE REPORT, *supra* note 131.

197. An example of a limited life interest is as follows (*Example 5*):

Parent recapitalizes CORP, receiving preferred stock and common stock. Parent gifts the common stock to Children, retaining the preferred stock. The "preferred" stock, however, retains its preferred characteristics only for a given number of years (hopefully the period of greatest appreciation for CORP), after which the stock automatically converts into common stock.

Arguably, no transfer of the retained interest has occurred; instead, the preferred stock has been converted by its own terms, and not by any action of the transferor.

198. As just one example, the author has a flyer of a planning firm which labeled this structure as an estate freeze "without tax consequences under IRC Section 2036(c)." Management Planning, Inc., Flyer, *Estate Freezing Without Tax Consequences Under IRC Section 2036(c)* (1988).

changes in any interest in property of the original transferor or original transferee,"<sup>199</sup> as subsequent transfers.<sup>200</sup>

The statute's provision, that sales to family members will not be deemed as for adequate and full consideration, departs from well-established wealth transfer tax principles of what constitutes a gift. While there is some precedent for treating related party dealings differently than arm's length transactions,<sup>201</sup> it has been asserted that this provision may unconstitutionally discriminate against sales to family members.<sup>202</sup> Singling out family transactions in this limited context probably does not rise to the level of a constitutional infirmity, particularly in view of the expansive reading given by the courts to the exercise of the power to tax.<sup>203</sup>

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199. See I.R.C. § 2036(c)(4)(D)(iv) (amended 1988).

200. Transfers of portions of interests are addressed by the technical corrections, with the proportionate amount transferred being treated as a gift and with the otherwise prevailing treatment for the remainder. Referring to the common stock, preferred stock recapitalization example, the explanation notes:

[I]f the transferor or the transferee subsequently transfers half of his stock to a person not a member of the transferor's family, the transferor is treated as having made a gift with respect to half of the common stock at that point in time, and that half is not includible in his estate. If no later deemed gift occurs, the other half of the common stock is includible in the transferor's estate.

1988 SENATE REPORT, *supra* note 131, at 5026.

201. See, e.g., I.R.C. § 267 (Supp. V 1987), which prohibits the recognition of a loss in a sale or exchange between related parties.

202. See Covey, *supra* note 152. Professor Bittker, commenting on the family attribution rules that apply absolutely to corporate transactions states: "Lacking, as they do, any mechanism to relieve the taxpayer of attribution from relatives who are clearly independent or hostile, it is surprising that the attribution rules have not been subjected to more political and even constitutional attack." Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1462 (1975). See *Bloch v. United States*, 261 F.Supp. 597 (S.D. Tex. 1966), *aff'd per curiam*, 386 F.2d 839 (5th Cir. 1967) (Court rejected, without discussion, the taxpayer's argument that the attribution rules are unconstitutional). See also *Estate of Johnson v. Commissioner*, 42 T.C. 441 (1964) (the court rejected an argument that I.R.C. § 267 was unconstitutional. However, the argument was not based on equal protection arguments, but rather on a constitutional concept of gross income.).

203. Only one recent case has invalidated a tax statute on the basis of equal protection, and it involved distinctions based on sex, a suspect class. See *Moritz v. Commissioner*, 469 F.2d 466 (10th Cir. 1972).

In determining the existence of a gift, for example, a distinction is made between arm's length business transactions and all other transactions. Treas. Reg. § 25.2512-8 (1958) states that a gift will occur to the extent "that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor." The regulation, however, provides for an ordinary course of business exception in which the relative values of the transferred property and the consideration will not be scrutinized. *Id.* "... [A] sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered as made for an adequate and full consideration in money or money's worth." *Id.* This exception would not apply to a typical family gift situation. However, there have been several intra-



The constitutional objections are further diluted by TAMRA amendments that enable a family member to acquire an interest and limit application of section 2036(c) if the purchase price was never received or acquired, directly or indirectly, from the transferor for less than full and adequate consideration in money or money's worth.<sup>204</sup> The adjustment for consideration paid by the transferee utilizes an exclusion based on the relative value of consideration as compared with the value of the interest that would otherwise be included in the estate of the transferor.<sup>205</sup> The

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family transfers in which the courts have applied the ordinary course of business rule. *See, e.g., Estate of Friedman v. Commissioner*, 40 T.C. 714 (1963); *Messing v. Commissioner*, 48 T.C. 502 (1967), *acq.*, 1968-1 C.B. 2; *Shelton v. Lockhart*, 154 F. Supp. 244 (W.D. Mo. 1957).

Congress has the constitutional power to draw distinctions between classes of taxpayers and transactions, only so long as the distinction is rationally related to an overall purpose. *See Keeler v. Commissioner*, 70 T.C. 279 (1978); *Grauvogel v. Commissioner*, 47 T.C.M. (CCH) 1269 (1984); *Sjoroos v. Commissioner*, 81 T.C. 971 (1983). Professor Cooper originally proposed a bona fide sale in the "ordinary course of business and without any significant donative purpose" exception for sales in connection with freeze transactions. He would, however, create a rebuttable presumption that sales to specified family members were donative in nature. Cooper, *supra* note 12, at 239.

Because one cannot meaningfully separate a possible sale of the unfrozen interest from the overall tax avoidance technique, the statutory presumption is necessary to preserve the efficacy of the statute. This is particularly true because the freeze transaction could be structured such that the growth interest would have a very nominal claimed value. The sale for adequate consideration, which is a reasonable exception in other contexts, cannot be extended to this statute because it would open an easy avenue for avoidance. The exception is narrowly drawn and applies only to the estate freeze statute, a situation in which the sale would be an integral part of the overall tax avoidance package. For example, in one case an irrebuttable presumption was upheld because the expense and difficulties of individual determinations justified a prophylactic rule. *See Sakol v. Commissioner*, 574 F.2d 694 (2d Cir. 1978), *cert. denied*, 439 U.S. 859 (1978). The court required a rational relationship between criteria set forth in the statute and a legitimate congressional purpose. In that regard, an attempt to limit tax avoidance was considered a rational purpose. *But see Heiner v. Donnan*, 285 U.S. 312 (1932) (irrebuttable presumption was held violative of due process). Consequently, it is wise that the statute is conclusively drafted without presumptions of any kind. To propose that there is discrimination between similarly situated taxpayers is based upon the premise that taxpayers selling property outright to family members are engaged in a transaction that is essentially similar to selling an unfrozen part of a freeze structure. Recognize that the term "outright" is a little circular. To state the issue as "outright" sales as compared with freeze sales, is to first assume that freeze interests are not separate property interests that can be bought or sold. Drawing the line between sales of individual, simple interests and proscribed freeze transactions is the fundamental issue which plagues the statute. On one pole is the corporate recapitalization; at the other is a sale or gift of the proverbial gift horse. Although one intuitively seems more prone to tax avoidance than the other, perhaps we shy away from the complexity of the one transaction. One cannot easily distinguish the underlying difference between the transactions.

204. I.R.C. § 2036(c)(2)(B) (amended 1988).

205. The 1988 CONFERENCE REPORT provides the following example:

A parent owns all the common and preferred stock in a corporation worth \$2 million. After December 17, 1987, the parent sells to his child the common stock for \$1 million not directly or indirectly received or acquired from the parent. If the parent

Service has been directed to issue regulations that will tackle the difficult question of whether the consideration was received from the transferor.<sup>206</sup>

## 2. Miscellaneous Amendments

### a. Collection of Tax from Transferees

The Revenue Act of 1987 freeze provisions could operate to include property in a transferor's estate, while ownership of the property and the source of payment for the transfer taxes fell to another party. This problem was not confined to the freeze provisions and plagued all transfers subject to section 2036. In TAMRA, Congress added a new section 2207B, which permits a recovery of the estate tax, and in some cases the gift tax, from the recipient of the property.

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continues to hold the preferred stock until his death, one half of the value of the corporation is includable in the parent's estate.

1988 CONFERENCE REPORT, *supra* note 163, at 5136.

206. The 1988 CONFERENCE REPORT notes that, "The Secretary might, for example, elevate the standard of proof for making such demonstration. Or, the Secretary might create a presumption that consideration was received from gifts made by the transferor to the transferee within a certain period of time." *Id.* Note that a clear waiting period will advantage those taxpayers with the time for advance planning, and the wherewithal to make transfers in their discretion. Notice 89-99, *supra* note 141, Part VII supplied restrictive guidelines for determining if consideration is received from the transferor. Consideration furnished by the transferee is presumed to come from property received or acquired from the transferor. Property received from the transferor includes that received from the transferor's spouse. Proceeds, gain, and income from property are deemed to be from the same source as the property from which they are derived. Amounts borrowed from the transferor are deemed acquired or received if pursuant to a "gift loan" described in I.R.C. § 7872(f)(3). A gift loan only arises if a below-market loan is utilized so this could be satisfied by a loan utilizing the appropriate I.R.C. § 7872 interest rate. Amounts borrowed from third parties are deemed received from the transferor to the extent the transferee's repayment obligation is guaranteed or collateralized by the transferor for less than full and adequate consideration in money or money's worth. Further, to rebut the presumption the transferee must prove that (1) the transferee acquired property from sources other than the transferor in amounts sufficient, considering only a reasonable rate of growth, to enable the transferee to accumulate the consideration, and (2) the transferee's financial ability to furnish such portion of the consideration was not to any extent dependent on the acquisition or receipt of property from the transferor during the three years immediately preceding the disproportionate transfer. What an administrative nightmare! Moreover, could not wealthy non-transferor family members, other than spouses, extend loans or gifts to the transferee? President Bush reportedly got his start in the oil business with a sizable loan from an uncle. It would appear that the ability to loan money to the transferee, at the I.R.C. § 7872 rate creates a large loophole. If the new enterprise is truly profitable as expected, loan repayments can be made out of the profits. If not, then a non-recourse loan may mitigate this risk, disguising a gift loan intent.

## b. Adjustment for Changes in Corporate Structure

The statute requires "appropriate adjustments" to reflect extraordinary distributions and other changes in the capital structure of the enterprise after the transfer.<sup>207</sup> The legislative history states that some adjustments may be required, for example, to reflect subsequent capital contributions by the transferee.<sup>208</sup> The Conference Committee Report suggests that the approach is a refinement of the overall adjustment for consideration received from the transferee.<sup>209</sup>

## IV. Assessing the Statute's Impact on Existing Valuation Limiting Techniques

The statutory language is by most accounts vague; the Service has admitted as much.<sup>210</sup> In its first interpretative announcement concerning section 2036(c), Notice 89-99,<sup>211</sup> the Service has turned to meaning that "can only be ascertained by reference to Congressional intent as reflected in the statute's essential themes and underlying committee reports."<sup>212</sup> Although the Treasury has authority to issue regulations, that power is not absolute.<sup>213</sup> The interpretations discussed in Notice 89-99 will need to withstand scrutiny in the face of uncertain or undisclosed legislative intent.

### A. Preferred Stock Recapitalizations and Partnership Asset Freezes

The sole example provided in the Conference Committee Report for the Revenue Act of 1987 was of a simple preferred stock-common stock

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207. I.R.C. § 2036(c)(5) (amended 1988).

208. 1988 CONFERENCE REPORT, *supra* note 163, at 5136. This provision is subject to a number of technical difficulties in interpretation beyond the scope of this article. For a discussion, see Blattmachr & Gans, *supra* note 140, at 75-77.

209. The adjustment language is found in I.R.C. § 2036(c)(5), which states, "Appropriate adjustments shall be made in the amount included in the gross estate by reason of this subsection for the value of the retained interest, extraordinary distributions, and changes in the capital structure of the enterprise after the transfer described in paragraph (1)." This provision reflects a TAMRA amendment which expanded the prior I.R.C. § 2036(c)(5), which stated, "In lieu of applying section 2043, appropriate adjustments shall be made for the value of the retained interest." *Id.* The provision addressing consideration furnished by family members, discussed *supra* notes 205-06 and accompanying text, is found at I.R.C. § 2036(c)(2). The language of I.R.C. § 2036(c)(5) could be read as a general adjustment provision, rather than as a refinement of the furnished consideration rule, although the few sentences in the Conference Committee Report seem to be using the provision in the latter context. 1988 CONFERENCE REPORT, *supra* note 163, at 5136.

210. See *supra* note 141.

211. See *supra* note 141.

212. Notice 89-99, *supra* note 141, Overview (B).

213. See *supra* notes 173-75 and accompanying text.

corporate recapitalization. That type of transaction was clearly contemplated by Congress when drafting the statute. Additionally, in the 1987 Conference Committee Report, partnership asset freezes were also expressly included.<sup>214</sup>

Under the pre-TAMRA statute, the focus of planners shifted to limited life freezes and inter vivos extrication from the freeze structure.<sup>215</sup> The TAMRA amendments answered the limited freeze with the deemed gift provisions that apply to terminations of interests and probably include shifting equity interests.<sup>216</sup> Planners have been left with proportional freezes that still present some limited benefits.<sup>217</sup> In addition, if a business owner desires to transfer the ownership of a business while retaining control, the use of a combination of voting and non-voting common stock will be permitted.<sup>218</sup>

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214. The conference Committee Report provides:

For example, if, after December 17, 1987, a person who holds all the preferred and common stock in a corporation transfers the common stock and retains the preferred stock until his death, the common stock is includible in his estate. Likewise, a similar transaction undertaken by transferring a partnership interest with greater rights to appreciation than the retained interest will result in the transferred interest being included in the estate.

1987 CONFERENCE REPORT, *supra* note 131, at 2313-1742.

215. The partnership capital freeze would have become even more popular, as it may permit a dissolution of the freeze structure without immediate income tax consequences. For example, assume that a parent created a partnership capital freeze with the children holding the growth interests. If gifting the parent's frozen interest to the children would trigger a gift, not only of the value of the retained interest but of the amount includable under I.R.C. § 2036(c), the parent could instead cause a dissolution of the partnership. All of the partners would receive in kind distributions of the partnership property, which they would hold in various undivided proportions. Assuming that the "enterprise" continues, parent arguably retains only a proportionate share of the income from or rights in the enterprise. The directive to the Treasury to prescribe regulations to prevent avoidance expressly refers to "through distributions or otherwise." I.R.C. § 2036(c)(8) (enacted 1988). The TAMRA Senate Report expresses the concern that liquidating distributions could be used to avoid the freeze restrictions. In a corporate structure, dividends could be used to drain the corporation of value at appropriate times e.g., before the death of the elder generation member. In particular, a distribution "substantially equivalent to a liquidation" might be treated as a deemed gift of the amount that otherwise would have been included in the transferor's estate. 1988 SENATE REPORT, *supra* note 131, at 5028.

216. The House Report states:

Terminations, lapses and other changes in any interest in property of the transferor or transferee are treated as transfers under the provision. For example, if a person gives away common stock in an enterprise while retaining preferred stock which by its terms retires in ten years, there is a deemed gift with respect to the common stock at the end of the ten years.

1988 HOUSE REPORT, *supra* note 131 at 420.

217. See *supra* note 181 and accompanying text.

218. Notice 89-99, *supra* note 141, Part III, Example 17, addresses a dual stock structure. The capital structure of the corporation in question consisted of 100 shares of non-voting

## B. Buy-Sell Agreements and Purchase Options

While some of the case law may suggest that the judicial scrutiny of intra-family buy-sell agreements has been too liberal,<sup>219</sup> a more appropriate response would be in the form of legislation specifically addressing buy-sell agreements. The Staff of the Joint Committee on Taxation singled out a relative of the buy-sell arrangement, the long-term intra-family purchase option, as an abusive valuation freezing technique in its Description of Possible Options to Increase Revenues Proposal for the Committee on Ways and Means.<sup>220</sup> At the time the staff produced its report, the pro-taxpayer District Court decision in *Dorn v. U.S.*<sup>221</sup> was reportedly generating "near euphoria in the estate planning community."<sup>222</sup> At the time of the Conference Committee deliberations on the Revenue Act of 1987, however, the Third Circuit Court of Appeals had dampened tax planner enthusiasm with its reversal of the lower court decision.<sup>223</sup>

Some commentators<sup>224</sup> have suggested that the following Revenue Act of 1987 Conference Committee Report language would exempt buy-sell agreements, and arguably purchase options as well. The Committee report stated, "[t]he provision only makes certain property includible in the estate; it does not affect the valuation of such property for estate tax purposes."<sup>225</sup>

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common stock and 100 shares of voting common stock. The two classes of stock differ only with respect to voting power. (Compare I.R.C. § 1361(c)(4) (Supp. V 1987), which permits dual stock structures in an S corporation where there are only differences in voting rights among shares of common stock). On these facts, the Notice concludes that the transfer of the non-voting stock to the sole shareholder's son does not give rise to a transfer of property having a disproportionately large share of potential appreciation.

219. See *supra* note 102.

220. DESCRIPTION OF POSSIBLE OPTIONS, *supra* note 120, at 266.

221. 86-2 U.S. Tax Cas. (CCH), ¶ 13,701 (W.D. Pa. 1986). Mrs. Dorn gifted options to acquire stock held in her personal portfolio to thirty-six of her children and grandchildren. The options were nonassignable except by operation of law, and none were exercised prior to her death. The District court held that Mrs. Dorn's taxable estate included only the exercise price of the optioned stock, and not its fair market value. The effect was that all appreciation arising after the grant of the options had shifted to the option holders. *Id.*

222. Abbin, *supra* note 111, at 10.

223. *Dorn v. United States*, 828 F.2d 177 (3d Cir. 1987). The appeals court found that no bona fide business arrangement existed, and applied Treas. Reg. § 20.2131-2(h) (1958), disregarding the value depressing effect of the options for estate taxation purposes as "a device to pass the decedent's shares to the natural objects of [her] bounty for less than adequate and full consideration in money or money's worth." *Id.*

224. In discussions with legislative staff, Mr. Covey learned that the apparent intent of the Committee Report language was to exclude buy-sell arrangements. See Covey, *supra* note 152.

225. 1987 CONFERENCE REPORT, *supra* note 131, at 2313-1742.

The language might be construed as validating the existing valuation approach applicable to buy-sell agreements and options. That interpretation is subject to question. The context of the passage is one of inclusion under Internal Revenue Code section 2036(c). As a result, the statement could mean that inclusion under section 2036(c) and valuation are not mutually exclusive. The Treasury could assert that the freeze was ineffective, and the retained interest was not frozen. Alternatively, the Treasury could assert that section 2036(c) does apply and the growth interest is includable. Another possible reason for the inclusion of the foregoing language might be to clear up any existing confusion remaining from the House Ways and Means Committee's version of the 1987 statute, which addressed minority discount freeze issues by adopting a new valuation section.<sup>226</sup>

An existing TAMRA safe harbor does exclude options or other agreements to buy or sell property at the fair market value of the property as of the time the option is exercised.<sup>227</sup> Qualifying for the exemption would eliminate most of the estate tax valuation advantage otherwise available with a buy-sell agreement. The Service has administratively interpreted this exemption as not requiring a price determined by appraisal. The Service will consider a buy-sell agreement as qualifying for the exception if the sales price is determined under a formula, based on currently acceptable valuation techniques, that reasonably can be expected to produce a result that approximates the fair market value of the property at the time the sale is consummated.<sup>228</sup>

The fundamental question remains as to whether buy-sell agreements are even properly the subject of section 2036(c). An ominous negative inference was created by the 1988 House Ways and Means Committee Report's use of a buy-sell agreement in its example of qualification under the safe harbor.<sup>229</sup> However, the House Ways and Means Committee description of its version of TAMRA stated that the safe

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226. See *supra* notes 123-27 and accompanying text. TAMRA also affected the valuation of property interests such as annuities, life estates, remainders, and reversions through the addition of I.R.C. § 7520, which prescribes actuarial tables more closely tied to prescribing interest rates.

227. See *supra* note 157.

228. Notice 89-99, *supra* note 141, Part V(E). A good faith buy-sell agreement that adopts a formula generally recognized as suitable to the valuation of the type of property involved and acceptable in arm's-length negotiations taking place at the time the agreement is executed meets the safe harbor. A bona fide agreement exclusively among persons who are not members of the same family meets such requirements. Example 26 of the Notice concludes that a formula based on book value is not an acceptable valuation method for valuing a real estate investment venture. Both parties to the agreement were family members.

229. See 1988 HOUSE REPORT, *supra* note 131, at 427.

harbors do not create an inference as to the treatment of transactions falling outside of them.<sup>230</sup> The Service has asserted that, "by reasonable inference," the safe harbors illustrate the types of arrangements that, if ineligible for the safe harbors, are within the scope of the statute.<sup>231</sup>

One could argue that if an elder generation member agrees to sell his or her interest in the enterprise to younger family members for a fixed price, the statute might apply. In this scenario, the elder generation member clearly held an interest in the enterprise. By obligating himself or herself to the agreement, the elder generation member transferred a property right to the younger generation. If the purchase price was fixed, that is, not based on an appraisal or on a formula reflecting future appreciation, a disproportionately large share of potential appreciation in the enterprise would be transferred to the younger generation.

Under the Revenue Act of 1987 language, as applicable to the preceding example, the retention of a disproportionately large share of income or rights in the enterprise might not have been satisfied. If viewed as of the time of execution of the agreement, and in the absence of any consulting agreement or other special rights, it would be doubtful that the elder generation had retained such an interest. Moreover, in a traditional mutual buy-sell agreement, where the younger family members are also obligated to sell to the elder generation if certain events occur, the argument is even stronger that all parties have given something up and received something in return, and that no disproportionate retention of rights in the enterprise has occurred with respect to any party. If the probability of the occurrence of the elder generation's death or other buy-sell triggering event is so much greater than that attributable to the younger generation, it would seem that the younger generation, if anyone, has greater or disproportionate rights in the enterprise. TAMRA's deletion of the retention of a disproportionately large share of income or rights in favor of a simple retention of an interest in the income or rights in the enterprise,<sup>232</sup> however, makes an easier case for application of the statute.

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230. *Id.* at 424.

231. Notice 89-99, *supra* note 141, Overview (B). In footnote 2, the Service noted that it "rejects the suggestion of some commentators that the quoted statement requires it to disregard the exceptions in delineating the statute's scope because the suggestion implies that Congress either did not know what it intended or added the exceptions as a meaningless appendage." *Id.*

232. See *supra* notes 185-89 and accompanying text.

### C. Installment Sales

The installment sale of property can achieve an estate freezing effect,<sup>233</sup> and the valuation freeze limitations can therefore apply. In such a situation, there has been a transfer of property to the younger generation. Because the sale is to a family member, the statute still prospectively applies even if the price is fair, subject to the supplied consideration adjustment.<sup>234</sup> If a fixed price is used, which would usually be the case in a family situation, where limiting estate values is a desire of the parties, the future appreciation in the enterprise has been transferred to the younger generation.

Under the Revenue Act of 1987, the pivotal question was whether the elder generation had *retained* a disproportionately large share of the income or rights in the enterprise. If the elder generation were permitted, in a corporation, for example, to hold the shares as collateral for the purchase money obligation, to vote on major corporate decisions (even if only upon a monetary default), and were paid a guaranteed fixed interest rate, one could come very close in substance to the position of a preferred shareholder. The TAMRA amendments did not directly resolve the confusion,<sup>235</sup> but in a practical sense, had likely eliminated many installment sales from the statute's application. First, if the consideration for the purchase comes only from the purchasing party, the new consideration rules should exclude a portion of the property from the seller's estate.<sup>236</sup> Second, the installment obligation itself could be structured to fall within the prescribed debt safe harbors.<sup>237</sup>

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233. See *supra* note 99 and accompanying text.

234. See *supra* notes 192-215 and accompanying text.

235. The Service has taken the position that installment sales are subject to the statute. Notice 89-99, *supra* note 141, Overview (B).

236. See *supra* notes 204-06 and accompanying text. A self-cancelling installment obligation would, however, detract from this result because the consideration would probably be deemed to come from the transferor. The Service has asserted that such an obligation also fails the qualified debt safe harbor. See Notice 89-99, *supra* note 141, Part V(C).

237. See *supra* note 157. The TAMRA Senate Report offers the example of a shareholder whose common stock is redeemed in exchange for qualified debt and retained no other interest in the enterprise. 1988 SENATE REPORT, *supra* note 131, at 5031. The Report concludes that I.R.C. § 2036(c) does not apply so long as the former shareholder holds only qualified debt. Example 24 of Notice 89-99, *supra* note 141, presents an installment purchase of corporate stock. The retention of interest issue is addressed by direction to the debt safe harbors.



## D. Sales of Remainders and Private Annuities

### 1. Sales of Remainders

The sale of a remainder<sup>238</sup> was likely subject to the Revenue Act of 1987 statute, a conclusion in which the Service has concurred.<sup>239</sup> The remainder interest that captured future appreciation enjoyed a disproportionate share, if not all, of future appreciation in the enterprise. The life income interest retained by the seller was retention of a disproportionate share, if not all, of the income from the enterprise. The sale of remainder apparently continues to be subject to the statute, but the consideration rule added by TAMRA would tend to mitigate the effect of the statute, particularly if the value of the remainder is significant.<sup>240</sup>

### 2. Private Annuities

The private annuity is akin to the sale of a remainder,<sup>241</sup> but formally at least, the structure is different. In this type of arrangement, the elder generation/transferor parts with all interest in the enterprise outright for an annuity obligation, which is, in effect, a separate contractual promise. The statute should not apply to these arrangements if the annuity is not considered an interest retained in the enterprise. In that regard, the annuity probably cannot be secured by the property sold, and usually would not be for income tax reasons.<sup>242</sup> Despite these formal distinctions, the Service has asserted that private annuities are subject to section 2036(c).<sup>243</sup>

The TAMRA amendments are of mixed effect as applied to the private annuity. Even if the private annuity could be considered a debt obligation, the debt safe harbor provisions probably cannot be satisfied definitionally. On the other hand, if the statute would otherwise apply to private annuities, the provided consideration rule could limit the appreciation attributed to the transferor.<sup>244</sup>

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238. See *supra* note 100.

239. Notice 89-99, *supra* note 141, Overview (B).

240. See *supra* notes 204-06 and accompanying text. See also Jones, *supra* note 139.

241. See *supra* note 101.

242. See 212 Corp. v. Commissioner, 70 T.C. 788 (1978); Estate of Bell v. Commissioner, 60 T.C. 469 (1973).

243. Notice 89-99, *supra* note 141, Overview (B).

244. See *supra* notes 204-206 and accompanying text.

## E. Grantor Retained Income Trusts

The grantor retained income trust <sup>245</sup> perhaps avoided the outstretched net of the Revenue Act of 1987. However, under TAMRA the lapse of the retained income interest by its own terms will be treated as a transfer by the settlor for purposes of the deemed gift provisions.<sup>246</sup> The termination of the grantor's income interest will be considered such a deemed gift unless the exception for "qualified trust income interests" applies. Under this exception, the freeze provisions will not apply to a trust if the retained right to income does not exceed ten years, the person holding the right is also the transferor of the property to the trust, and the transferor is not the trustee.<sup>247</sup> The Service has stated that the grantor-retained income trust is otherwise subject to the statute.<sup>248</sup> However, the Service has indicated that a contingent reversion or general power of appointment held by the transferor will not invalidate use of the safe harbor exception, if the value of the interest is insubstantial relative to the value of the retained interest in income.<sup>249</sup>

## F. Joint Purchase of Split Interests and New Enterprise Formation

### 1. Joint Purchases

If the elder generation and the younger generation each use their separate funds to purchase a jointly held interest, the statute should not apply. Each party is contributing money, which by itself should not be considered an enterprise,<sup>250</sup> to acquire an enterprise, and the elder generation member has therefore neither held nor transferred an interest in an enterprise. If the elder generation member gifted the funds for the purchase to the younger generation member as part of the overall transaction, the estate tax consequences are placed in greater jeopardy.<sup>251</sup> The

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245. See *supra* note 104.

246. See *supra* notes 197-98 and accompanying text.

247. I.R.C. § 2036(c)(6) (enacted 1988)

248. Notice 89-99, *supra* note 141, Overview (B).

249. Notice 89-99, *supra* note 141, Part V(B). For this purpose, the Notice considers a contingent reversion or general power of appointment to be insubstantial if its value does not exceed twenty-five percent of the value of the retained income interest, determined without regard to the value of the reversion or power.

250. See *supra* note 152.

251. See, e.g., *Gordon v. Commissioner*, 85 T.C. 309 (1985). One might argue that even in this situation, the elder generation member is gifting money and not an interest in the enterprise. That argument, however, gambles with the propensity of courts to apply the step transaction doctrine. If the gift of the funds is part of an overall plan to acquire the split interests, there seems to be no reason, other than respect for formalities, to validate this transaction.

Service has asserted that the joint purchase of split interests is subject to section 2036(c).<sup>252</sup>

## 2. New Enterprise Formation

Formation of a new enterprise presents similar issues. If all of the founders are contributing cash to a new enterprise, the statute should not apply because no generation member held an interest in an enterprise, or transferred such an interest. This scenario is to be contrasted with the creation of a family holding company, where the statute should apply if the elder generation is simply rebottling existing enterprises into a new ownership vessel, thereby transferring the growth interests to the younger generation in the process.<sup>253</sup>

The formation of the new enterprise, however, might be subject to the statute, even with cash exclusively, if one expansively applies the "in effect transfer" language. One could argue that the elder generation's acquiescence in receiving preferred stock upon incorporation would result in an "in effect transfer" of a disproportionately large share of potential appreciation in the enterprise where, for example, common stock goes to the younger generation. In the absence of bona fide business reasons for acquiring solely preferred stock, most founders would presumably want some common stock, preferred stock or debt enjoying liberal conversion rights, or warrants if estate tax avoidance factors were ignored.

Even if the foregoing argument is valid, it ignores the statutory language, which requires that a person first hold "a substantial interest in an enterprise." Because this requirement is not prefaced with "in effect" or direct or indirect language, it would be difficult to argue that the elder generation in effect held a substantial interest in an enterprise, and then in effect transferred a portion of it.<sup>254</sup> The Service has rejected this inter-

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252. See Notice 89-99, *supra* note 141, Overview (B). It is questionable whether much comfort can be derived from the Conference Committee's rejection of the 1988 House bill provision, which would have clearly restricted split purchases. See *supra* notes 158-63 and accompanying text.

253. This would be the result under the TAMRA Conference Committee Report. See *supra* note 163 and accompanying text.

254. One could argue that the holding of a substantial interest is met by receiving the preferred stock and that the interest in effect transferred need never have been held by the transferor, so long as the transferor through any means held a substantial interest in the enterprise. Even under such a confusing construction, the formation of a family capital corporation would still be covered because the elder generation held an interest in the prior enterprise. Arguably, the purpose of the statute is more frustrated by the recapitalization, holding company formation, and other estate tax avoidance motivated restructuring of an established en-

pretation, arguing that the statute applies.<sup>255</sup> The Service's treatment rests upon the assumption that a transferor hypothetically acquires a share of every interest and right in the enterprise in proportion to the value of the loan or capital contribution in comparison with the value of the enterprise after the transaction. If rights are disproportionately allocated, a transfer has occurred.<sup>256</sup>

### G. Summarizing the Effect of the Legislation in Application

The estate valuation freeze limitations, as amended, are subject to avoidance by those who are most capable of estate tax avoidance; not the pioneer entrepreneurs, but those with extensive business expertise, connections, and cash from prior established enterprises. If the younger generation is inexperienced in business, it would typically not be a taxable event if one generation transfers to another, a business or investment tip

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terprise that already has, or is preparing to, take off. This is to be contrasted with the formation of an untested and unproven new enterprise which is untested and unproven.

On the other hand, if the younger generation is comprised of infants or other parties unable or unwilling to participate in the business, it is unclear why appreciation in an untried business is more desirable for an estate tax exemption than appreciation from an established business. Granted, the estate tax avoidance in an established business is much more tangible and predictable, and one might argue that fewer restrictions should be placed on new entrepreneurial endeavors as compared with mature enterprises. However, if the dividing line is existing enterprises and new enterprises, there must be some basis on which one separates related businesses. That is, if the elder generation takes his or her expertise in oil, computers, perfumes, or dry cleaning, for example, and cash, and establishes a new separate and distinct business in another state or another country, is the new business a "new" enterprise or an extension of the old.

The distinction between "old" and "new" businesses, compared with simple enlargements of existing businesses, fostered litigation in the area of divisive corporate reorganizations. See, e.g., *Estate of Lockwood v. Commissioner*, 350 F.2d 712 (8th Cir. 1965), where the issue was whether a new Maine corporation was a new business, or an outgrowth of the existing business that was active in Colorado, Idaho, Nebraska, North Dakota and Wisconsin. See also *Boettger v. Commissioner*, 51 T.C. 324 (1968). The Service recently issued regulations that eliminate the geographical distinctions, and broadly construe all operations as one business so long as the new activities are in the same line of business. See *Treas. Reg. 1.355-3(b)(3)* (1989).

255. Notice 89-99, *supra* note 141, Part III(C)(3). The Service notes that the argument "assumes a temporal element that is not apparent in the wording. As written, the statute requires only that the transferor's substantial interest exist *at the time of the transfer*." *Id.*, n. 24. (emphasis in original). Recognizing that one cannot gain a great degree of comfort from closely parsing a statute that is so vaguely worded, the Service's position does eliminate contrivances exalting form in defeat of the statutory themes. The problem is that this particular issue goes to the heart of the statute and the confusion as to what its theme is.

256. Example 15 of Notice 89-99, *supra* note 141, demonstrates this concept, but in the situation of an existing enterprise owned by a child, to which the parent is contributing funds in exchange for preferred stock. The existing enterprise versus new enterprise distinction perhaps exalts the temporal nature of matters. In this case, the son could have created the enterprise as the sole owner, one minute before the subsequent capital contribution by father.

or lead that is more an expectancy than an identifiable property right.<sup>257</sup> Although the qualified start-up debt safe harbor of the TAMRA amendments purports to address transferred goodwill,<sup>258</sup> it can be easily circumvented if the younger generation member can otherwise obtain funds through family gifts, other means, or family loans structured around the other debt safe harbor which does not contain such restrictions.<sup>259</sup>

With the extremely wealthy families and successful businesses described in Professor Cooper's article, the TAMRA safe harbors render the statute largely ineffective. These families have the funds for loans to their younger generation members, and with established businesses, the repayment can certainly be made within the safe harbor time periods. Although the regulations interpreting the supplied consideration test have not been issued, any attempt at imposing a definite time period for determining direct or indirect transfers of consideration can be most readily avoided by those individuals with alternate non-transferor family sources of funds or the waiting time that wealth can allow.<sup>260</sup> With the debt safe harbors and supplied consideration rule acting in concert, together with the special safe harbor for short-term trusts, the amended legislation clearly limits only the standard corporate recapitalization or multi-class partnership, just one of the many freeze devices. Ironically, the most restrictive treatment was reserved for the business buy-sell arrangement; the structure for which application of the original version of the statute was most vague and which structure is probably most applicable to small and intermediate-sized family businesses, rather than entrenched fortunes.

It is the author's conclusion that the new legislation is a response to a concern that was admittedly notorious, at least in academic and practitioner circles, but was not a source of great untapped revenue.<sup>261</sup> Faced with the difficulty in drafting an effective statute, and in view of the numerous exceptions introduced by TAMRA, it is questionable whether

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257. The most widely discussed example is that of the family which produces Estée Lauder perfumes. Reportedly, the new lines of products are commercially exploited by corporations primarily owned by the younger generation, such that over time the entire business, with the natural attrition created by changes in consumer taste, will shift to the younger generation. Cooper, *supra* note 12, at 176. Another popular example was provided by former President Nixon's dealings with his daughter, Patricia, in which Patricia was made part of a very successful Florida land venture promoted by a friend of Mr. Nixon. See S. SURREY, P. McDANIEL & H. GUTMAN, *supra* note 2, at 926-27.

258. See *supra* note 157.

259. *Id.*

260. See *supra* note 206 and accompanying text.

261. See *supra* note 131.

the statute will touch Professor Cooper's elite few.<sup>262</sup> With TAMRA, Congress has repeated its established pattern of amending a comprehensive statute to the point that it becomes applicable to none but the foolish or those without the financial resources needed for effective avoidance measures.

## Conclusion

The estate valuation freeze techniques stretched the law that existed prior to the Revenue Act of 1987. Even assuming that the technical aspects of the new legislation are clarified, it is difficult to optimistically predict a successful curbing of many of the available techniques. Moreover, the TAMRA amendments may have reduced the statute to a complex, yet ineffective piece of legislation. In light of the modest estimated revenue gains from the statute, Congress might be well-advised to shift its focus to raising revenues and overall simplification. A number of alternatives are available. The missing ingredient, however, is a change in public and congressional attitudes about reforming wealth transfer taxation.

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262. Professor Cooper received an estimate that only 2,400 persons had wealth in excess of \$10 million. Cooper, *supra* note 12, at 205. 1982 estimates indicated that 32,000 persons had a net worth in excess of \$5 million, while the number in the \$1 million to \$5 million range was almost 376,000. U.S. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME BULLETIN, Winter 1984-85, *reprinted in* U.S. DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, TABLE No. 723 (108th ed. 1988). During 1986, only 900 estate tax returns were filed that reported gross estates in excess of \$5 million. See U.S. INTERNAL REVENUE SERVICE, ANNUAL REPORT OF THE COMMISSIONER AND CHIEF COUNSEL OF THE INTERNAL REVENUE SERVICE, *reprinted in* U.S. DEPT. OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, TABLE No. 486 (108th ed. 1988). Only 345 of the returns filed in 1985 reported a gross estate in excess of \$10 million. STATISTICS OF INCOME, *supra* note 77.