REPORT #659

TAX SECTION

New York State Bar Association

COMMITTEE ON ESTATES AND TRUSTS

STATEMENT REGARDING THE MARCH 22, 1990
“DISCUSSION DRAFT” BILL PROPOSING THE REPEAL
OF SECTION 2036(C) AND THE REPLACEMENT THEREOF
BY A NEW CHAPTER 14

June 11, 1990

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June 11, 1990

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Proposed Chapter 14
Discussion Draft

Dear Mr. Leonard:

Pursuant to the telephone conversations of Beverly F. Chase with Diane Kirkland, I enclose six copies of a statement prepared by the Committee on Estates and Trusts of the New York State Bar Association Tax Section for inclusion in the printed record of the hearing held April 24, 1990 on the referenced proposal. Also enclosed is the supplemental sheet called for under the Formatting Requirements.

In addition, I enclose a double-spaced copy of the statement which you will undoubtedly find easier to read.

As indicated in the statement, the Tax Section supports the repeal of Section 2036(c) and would also support enactment of proposed Chapter 14, subject to the concerns and proposed modifications discussed in the statement.

We in particular want to offer our further help in connection with this legislation, which in any event is likely to be complex. We urge that after basic policy decisions have been made by the appropriate committees, a further draft be circulated for a brief period for comments with respect to drafting only. This might allow the final draft to be simplified and shortened and obvious drafting errors avoided. We in particular believe that an effort to simplify, to whatever extent possible, the final statutory language is essential to its successful implementation and enforcement. The Tax Section would be pleased to participate in any effort to improve the drafting of the final statute.

Very truly yours,

Arthur A. Feder
Chair

Enclosures

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Tax Report #659

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON ESTATES AND TRUSTS

STATEMENT REGARDING THE MARCH 22, 1990 “DISCUSSION DRAFT” BILL PROPOSING THE REPEAL OF SECTION 2036(C) AND THE REPLACEMENT THEREOF BY A NEW CHAPTER 14

June 11, 1990

STATEMENT OF THE COMMITTEE ON ESTATES AND TRUSTS OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION REGARDING THE MARCH 22, 1990 “DISCUSSION DRAFT” BILL PROPOSING THE REPEAL OF SECTION 2036(c) AND THE REPLACEMENT THEREOF BY A NEW CHAPTER 14

The Committee on Estates and Trusts of the New York State Bar Association Tax Section (the “Committee”) is generally favorably impressed with the discussion draft of a bill to replace Section 2036(c) released by Chairman Rostenkowski on March 2, 1990, which it views as a more rational response to the “estate freeze” transfer tax avoidance problems Section 2036(c) of the Internal Revenue Code (the “Code”) was intended to address. The Committee favors repeal of Section 2036(c). One of the Committee’s principal objections to Section 2036(c) is its open transaction approach, which imposes deferred transfer tax consequences on donors based on the conduct of their donees. Moreover, because of its overly broad scope and complexity, Section 2036(c) discourages otherwise legitimate intra-family business transactions to an extent that outweighs any potential benefit to the integrity of the transfer tax system. The proposed Chapter 14 is, as Chairman Rostenkowski stated, “more focused” and “less burdensome” them Section 2036(c) because it corrects certain valuation abuses by means of a comprehensible and logical scheme the scope of which is generally readily determinable. The Committee applauds this more focused approach as an admirable step in the direction of tax simplification and would support enactment of the proposed legislation, subject to our concerns and proposed modifications discussed below. The Committee's concerns and suggestions regarding the intended scope and application of proposed Chapter 14 fall into the following categories:

1. Open Transaction Approach.

The Committee is particularly concerned with the "open transaction" approach of Chapter 14 -- reminiscent of one "of the most troubling features of Section 2036(c) -- which imposes additional transfer tax consequences on a donor even after the original transfer has been taxed pursuant to the special rules of Section 2701(a). Under Section 2701(a), only rights to certain "qualified fixed payments" ("QFP's") are accorded value when retained by a donor of a junior interest in an entity owned in part by the donor's family. Under Section 2701(c) and (d), the failure of such entity to make the scheduled payments in respect of the donor's retained interest and the disposition by the donor of his retained interest may each result in a deemed additional gift. The Committee opposes an approach to valuation that defers the final valuation of the transfer until some possibly remote time at which hindsight is invoked to create additional transfer tax consequences with respect to the original transfer. These deemed gift provisions introduce the potential for new uncertainties and difficulties of administration, some of which are discussed in Section 5 below, which undercut the benefits of the per se approach to valuation at the time of the original gift.

To the extent Section 2701 is intended to create certainty in the valuation of gifts at the time of the irrevocable transfer by the donor, we welcome such approach. Thus, we endorse the aspect of Section 2701 that imposes per se rules pursuant to which rights retained by the donor will be accorded value. Once these special rules have been applied, however, the Committee believes that finality is in order and that no further transfer tax should be imposed upon the subsequent failure of the subject entity to make the expected payments or upon the subsequent disposition of the retained interests. Existing gift and estate tax provisions adequately address the incomplete or revocable gift as well as the transfer with a retained interest. Therefore, where the gift of an interest in a family entity is a completed gift under traditional gift tax principles, the goal of Section 2701 should be a fair and equitable approach to valuation that neither gives the taxpayer too much credit for the retained interests nor subjects the taxpayer to a revaluation of the original transfer based upon subsequent events.

To the extent the deemed and additional gift provisions are thought necessary to correct for what may be unreasonably favorable assumptions with respect to the anticipated payment of QFP’s, we recommend that the “favorable assumptions” set forth in Section 2701(a)(2)(B) be eliminated as a factor in the valuation of QFP rights. The principal concern that has driven Section

2036(c) and its proposed replacement is the risk that donors will refrain from exercising discretionary rights to which the valuation experts have accorded value. Under our approach, if retained rights were determined to be sufficiently non-discretionary as to be accorded value for gift tax purposes, they would be valued under the traditional principles of valuation, without any special favorable assumptions. Accordingly, upon the later disposition of a QFP right, there would be no need to create an artificial additional gif€ to compensate for any excess benefit previously achieved by reason of such favorable assumptions. Instead, the likelihood of the payments being made would be factored into the original valuation. Similarly, as a payment right must be cumulative to qualify as a QFP, any missed payment should simply increase the value of the right in the hands of the donor, which value will ultimately be realized and/or subject to transfer tax upon its subsequent disposition by the donor during his lifetime or upon his death, except to the extent the entity is unable or unlikely to be able to make the payments. Under our proposal, the risk that the entity might not prosper would also be taken into account in valuing the original gift. Moreover, if the value of the retained QFP is less than its face amount at the time of the donor’s disposition thereof (or death), the necessary corollary is that the junior equity interests will not have appreciated disproportionately.

We note in this connection that the draft provides no relief upon the subsequent gift or death time transfer of a retained QFP interest if such interest ultimately proves to have been worth more than its original valuation. This result is consistent with our proposal for a closed transaction approach to valuation of retained interests, but raises fairness issues if the open transaction approach, which gives only the government the benefit of hindsight, is retained.

To make our closed transaction proposal fully consistent and fair, the Committee would impose an additional restriction on the definition of a QFP by requiring, as under Section 2701(c)(2)(B), that the instrument under which the QFP is made must provide that a QFP not timely paid will bear interest compounded annually. Additionally, we would include a definition of “cumulative preferred stock” under which stock would not qualify as such unless it enjoyed a liquidation preference with respect to all unpaid cumulative dividends plus the compounded interest thereon. We would also eliminate, as inconsistent with the closed transaction approach, a transferor’s ability under Section 2701(b)(4) to elect to have certain non-QFP’s treated as QFP’s.

Having endorsed the per se approach of the proposal, we would, nevertheless, add a provision whereby non-QFP rights, while presumptively valued at zero, could be accorded value if the taxpayer established such value by clear and convincing evidence. Many commentators have criticized the bright-line test of the statute as potentially ignoring rights that are not discretionary. Because it is impossible to compile a comprehensive list of additional rights that should or should not have value, we recommend implementing the per se rule, but allowing the taxpayer to rebut the statutory presumption by proving the value of non-QFP rights. A dramatic demonstration of the impossibility of compiling such a comprehensive list is Assistant Secretary of Treasury (Tax Policy) Kenneth W. Gideon’s April 24, 1990 statement before the Committee on Ways and Means advocating the expansion of the permissible types of QFP’s to include percentage leases and share-of-production royalty interests. Undoubtedly, after enactment, other interests will be identified which should have been included in the definition of QFP’s or which, under certain circumstances, provide a high degree of certainty as to value. Allowing the taxpayer to establish such rights as worthy of being accorded value is a practical solution to this problem. To the extent dividends under such a right are noncumulative or noninterest-bearing or do not enjoy a liquidation preference, such factors will affect the value of such right, similarly, in the case of preferred stock the dividend rights under which qualify as QFP’s, a liquidation preference as to principal, while not itself a QFP, may be another attribute of value of such preferred stock. Of course, as under current law, the failure by the holder of a non-QFP that is accorded value to insist on his rights may constitute an additional taxable gift, depending on the particular facts and circumstances extant at the time of such failure. See, e.g., Snyder v. Commissioner, 93 T.C. 529 (11/2/89).

To aid in enforcement, we would require disclosure of transactions in which non-QFP’s are accorded value if valuing such rights at zero would have resulted in, or increased the amount of, a taxable transfer. It may also be necessary to provide other enforcement tools to the government to deal with failures to insist on such rights. For example, a condition to according value to a non-QFP right might be a taxpayer’s agreement to disclose any subsequent failure to receive payments under such right.

Although not directly related to our objections to the open transaction approach, we should note the potential under the draft for double taxation of a non-QFP right valued at zero under Section 2701(a) as to which the failure by the holder of such right to insist on its enforcement may result in an additional taxable gift under the Snyder case. This anomalous result could be avoided by providing specifically in the bill that failure by the holder of such a right to insist on its enforcement will not be deemed to constitute an additional taxable gift.

A similarly harsh result occurs upon the subsequent gift (or transfer at death) of a retained non-QFP right valued at zero under Section 2701(a) in the original transfer. If a retained interest is valued at zero in connection with the initial gift, the transferor is effectively treated as having transferred not only the junior equity interest which is the subject of the gift, but also that portion of the retained interest which corresponds to the junior interest. Accordingly, no further transfer tax should be imposed upon the subsequent transfer of such portion of the donor’s retained interest, inasmuch as the transferor has already been taxed on its value. This exoneration from transfer tax on the second transfer is necessary to avoid double taxation of the same property and is also consistent with the closed transaction approach which the Committee advocates.

This problem is recognized in Section 2701(e); however, the proposed relief upon such second transfer is far narrower than the Committee’s recommendation. Section 2701(e) provides for an adjustment upon the subsequent gift (or transfer at death) a£ a detained non-QFP right valued at zero under Section 2701(a) in the original trans- - fer, but does not necessarily eliminate the second gift nor does it reach back to alter the gift tax treatment of the closed original transfer. Rather, Section 2701(e) merely eliminates on a dollar for dollar basis any double counting for transfer tax purposes at the time of an actual subsequent gift or death time transfer of the non-QFP interest. If our proposal for the elimination of transfer tax on the second gift is not adopted, this minimum adjustment would remain appropriate and necessary under our closed transaction approach.

2. Scope of Chapter 14

The special valuation rules and corresponding deemed and additional gift concepts of Section 2701 come into play in the case of a transfer of an interest in an entity that is “10-percent owned” by the transferor and members of his family, regardless of whether such entity is closely-held or publicly traded.

The Committee believes that the valuation abuses with which the government has been most concerned have primarily involved situations in which (i) family members or a small group acting in concert have control over the entity so that the shift in appreciation will inure primarily to their respective family members and (ii) the value of the transferred interests are not readily ascertainable. As a preliminary matter, the Committee views the inclusion of most publicly traded entities within the scope of the proposed legislation as unnecessary. If the transferred interest is actively traded publicly, there should be no risk of the valuation abuses sought to be corrected by Section 2036(c) and the discussion draft. Even if the value of the transferred interest is not actively traded publicly, valuation abuse is unlikely if the retained interest (or another interest in the entity comparable to the transferred or the retained interest) is actively publicly traded. Accordingly, the Committee would exclude transfers from the scope of Chapter 14 if either the transferred or retained interest (or a comparable interest) is actively publicly traded.

Even in the-case of other entities, the Committee believes that the 10% test without more may cause Chapter 14 to apply to clearly non-abusive situations, especially in view of Section 2703(e)(1)(B), which treats siblings as family members for purposes of the 10% test. The inclusion of holdings by siblings for purposes of the 10% test may reduce this standard to a level of family ownership that is truly de minimus in many cases. Moreover, it has been the Committee's experience that the business and financial interests and goals of siblings are often independent of one another, particularly as siblings mature and have their own family interests. Although siblings may act together in a family enterprise in a manner to suit their common interests, their actions are frequently not more coordinated than those of unrelated business owners operating in a business context for their common good.

Accordingly, the Committee suggests that Chapter 14 not apply with respect to transfers of interests in an entity unless, in addition to the 10% test having been met, five or fewer individuals own more than 50% of such entity. For purposes of this "five or fewer test", the donor would be treated as owning all interests in the entity owned by members of his family, excluding siblings, and after taking into account the entity attribution rules in Section 2703(b). In the alternative, the Committee would recommend that the 10% test be replaced by a 51% test, using the expanded definition of family in Section 2703(e)(1)(B) and once again taking into account the entity attribution rules in Section 2703(b). Either of these alternatives would more appropriately target those situations with which the government has been traditionally and understandably concerned, i.e., those cases in which a relatively small group of individuals actually controls the entity, thereby possessing both the incentive and the opportunity for valuation manipulation.

3. Transfers of Trust Interests.

Various questions of construction arise under Section 2701 because it has only limited application to trust interests. Were the provisions dealing with trusts removed to a separate section, as the Committee recommends, some of the difficulties of construction would be solved. However, numerous serious problems will persist if transfers of trust interests are treated in all respects in a manner parallel to transfers of interests in corporations and partnerships.

The application of Section 2036(c) to trusts arose in the context of grantor retained income trusts. Section 2701 contains no such limitation. Thus, for example, the creation by a grantor of a trust in which his son has a- non-QFP income interest for life, reversion to the grantor, could be interpreted under Section 2701 to result in the gift to the son being valued at 100% of the trust property. A similarly problematic result could obtain in the following example. Assume a trust created by a father in which his son has a non-QFP income interest for life followed by a non-QFP income interest in his grandson for life followed by a remainder interest in his grandchildren. If the son who is the first income beneficiary made a gift of his income interest to a family member, the value of the gift might, under the principles of Section 2701(a), be deemed to be the value of the entire trust property.* Equally troubling is the case of a trust providing for a non-QFP income interest for the grantor's

* Interestingly, under Section 2701(a)(2)(C), if the retained interest in a corporation or a partnership is junior or equivalent to the transferred interest, Section 2701(a) does not apply. However, this exemptive provision is specifically made inapplicable to trusts.

son, remainder to the grantor's grandchildren. Under Section 2701, the gifts of each of the income interest and the remainder could be valued at 100% of the value of the trust, so that the sum of the gift tax values of the income and remainder interests could theoretically exceed (in this case by 100%) the value of the property transferred to the trust.

The Committee assumes that the foregoing results were not intended. In none of these examples was the creation of the trust interests subject to valuation abuse. Rather, each of the interests transferred would most rationally and reliably have been valued under the Treasury tables. Because the valuation abuses that were the target of Section 2036(c) occur only in the context of the grantor retained income trust, the Committee recommends limiting the application of Section 2701 to those trusts in which the grantor retains a term income interest. Such an approach would address in a more focused manner the abuse of trusts sought to be cured by Section 2036(c) and would avoid the inequitable results in the foregoing examples.

4. Options - Buy-Sell Agreements

A comprehensive body of case law has developed over the years respecting buy-sell agreements for purposes of fixing the estate tax value of a decedent's business holdings if certain requirements are met. Among the most important requirements, set forth in Treas. Reg. § 20.2031-2(h), are that the buy-sell agreement (i) be a *bona fide* business arrangement and (ii) not be a tax-avoidance testamentary device. The Committee recognizes that these guidelines have not been applied in a consistent manner, and that, as a result, the case law in this area has failed to establish a uniform interpretation of these requirements. However, the Committee believes that these guidelines are fair and reasonable and, when appropriately construed, should be adequate to prevent the use of buy-sell agreements as tax-avoidance devices.

In Section 2036(c) as originally enacted, buy-sell agreements were broadly indicted unless the purchase price formula produced a price representing fair market value at the time of the sale. In Notice 89-99, the Treasury in effect expanded the "safe harbor" under Section 2036(c) for buy-sell agreements to encompass an agreement containing 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 as of the time the sale is consummated," provided such formula is "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." (Emphasis added).

The discussion draft takes an even more restrictive approach than that taken in Notice 89-99. Under Section 2702, a buy-sell agreement will be disregarded in valuing the subject property unless (i) the property is in fact sold pursuant to the agreement and is not resold to an unrelated person within six months after the transferor's death or the date of the inter vivos transfer in question, (ii) the price formula was reviewed at least three years before the sale in question, and (iii) at the time of such review, the formula was reasonably expected to approximate the fair market value of the property at the time of such sale.

The Committee recognizes that a reasonably objective limitation on price formulae, such as that proposed in Notice 89-99, is consistent with the per se valuation rules of Section 2701 and may resolve certain of the inconsistencies among the judicial decisions in this area referred to above. Accordingly, while the Committee believes that it is not uncommon for a buy-sell agreement to set a low formula sales price for legitimate business reasons that are unrelated to donative intent, the Committee also recognizes that the certainty to be achieved by imposing such a limitation in connection with buy—sell agreements may outweigh the hardship in such cases.

Moreover, the Committee recognizes, as does existing case law, that periodic revaluation is advisable in the case of a buy-sell agreement using a fixed price. However, the Committee sees no justification for the three-year rule in the case of formula agreements. A formula that, at the time the agreement was entered into, was reasonably expected to reflect the fair market value on sale would by definition require that future appreciation or depreciation of the business be taken into account. Therefore, assuming all other regulatory and court imposed requirements were met, a buy-sell agreement containing such a formula should be respected loses of fixing the transfer tax value of a business interest without regard to when the formula was set or how recently it was reviewed. The imposition of a rule requiring periodic review thrusts the tax law unnecessarily into the negotiations among the parties (including parties who may not be family members) and may create a strategic imbalance among the contracting parties. This intrusion into the business relationships among the parties is not justified and should be dropped from Section 2702.

Finally, the Committee believes that the application of the restrictive rules of Section 2702 regarding buy-sell agreements should vary depending on the relationship between the transferor and the parties to the agreement. None of the restrictive rules should apply if non-family members have significant rights or options containing the same terms as those held by family members. If such persons participate to a meaningful extent in and are bound by the buy-sell arrangement in the first instance, no risk of estate planning abuse should exist. Similarly, if family members in the same or higher generation as the transferor, and no non-family members, have significant rights under the agreement that are equivalent to those of younger generation family members and if the older generation family members actually exercise such rights, the other restrictive rules should not be a prerequisite to permitting the formula value under the agreement to be considered for transfer tax purposes.

5. Clarifying and Technical Changes.

For ease of organization, our comments in this section are presented in the order they arise under the proposed statute, without regard to relative weight. Moreover, notwithstanding the strength of our objections to the open transaction approach and the three-year rule in the buy-sell context, our comments raise technical questions and suggest clarifications regarding certain of the provisions of the discussion draft containing those concepts.

a. Section 2701(a). The Bill should provide that in the case of the transfer of an interest in an entity which is convertible into an equity interest in such entity, the transferred interest will be deemed to be of the same class as such equity interest for purposes of determining both whether Section 2701(a) applies to the transfer and whether the transferred interest is a junior equity interest under Section 2701(b)(3).

b. Section 2701(a)(3)(B)(i). The definition of “junior equity interest” includes “in the case of a partnership, any partnership interest which is not preferential.” Because of the flexibility in a partnership structure to create special allocations, we suggest that the bill define a junior equity interest in a partnership as “any partnership interest under which the rights as to income and capital are junior to the rights retained” by the transferor.

c. Section 2701(a)(4)(B). The exception for trusts holding only a personal residence should be amended to clarify that the interest held by a remainder-man will not disqualify such a trust for the exception simply because the remainder interest is not a tens interest. In addition, it would be helpful to have assurances that a power in the trustee (or life tenant) to sell the personal residence will not render the trust ineligible for this exemptive provision and that a subsequent sale by the trust of the residence does not trigger the application of Section 2701(a) at that time.

d. Section 2701(b)(1)(B). The definition of “qualified fixed payment” in Section 2701(b) treats payments as fixed as to amount or rate if such payments are “determined at a rate that bears a fixed relationship to a specified market interest rate.” We assume that this provision is intended to include rates that bear a fixed relationship to the applicable Federal rates. If so, it would be helpful to clarify this point.

e. Section 2701(b)(3). Under Section 2701(b)(3)(B), a family member of the transferor who holds a QFP must consent to be treated as the transferor for purposes of the deemed and additional gift provisions if his interest is to be accorded value. Consistent with our objections to the open transaction approach discussed above, the Committee is concerned that this consent requirement may work inequities. For example, it may be impossible to obtain consent from an incapacitated or hostile family member, even though such family member is likely to insist on his rights under the QFP. If the open transaction approach is rejected, these problems disappear. If the open transaction approach is retained, relief should be provided in the case of such a non-consenting family member.

In addition, it should be clarified that in the case of a consent by a family member under Section 2701(b)(3)(B), all references to “transferor” contained in subsections (c) and (d) of Section 2701 will be deemed to refer to the consenting family member for purposes of applying these subsections in connection with the instrument held by such family member. The current draft language, while suggestive of this intention, is not entirely clear.

As a technical matter, Section 2701(b)(3) provides for two elections: (i) under subparagraph (A), the election by a transferor to treat payments that are QFP’s as not QFP’s and (ii) under subparagraph (B), the consent by a family member to be treated “in the same manner as the transferor” for purposes of subsections (c) and (d) of Section 2701. The draft provides no guidance as to the time and manner for making either election. While as a practical matter Section 7805(d) grants regulatory authority to the Secretary with respect to the time and manner of making tax elections, Section 2701(b)(4)(C) nevertheless provides that the election to have certain interests treated as QFP’s is to be made on or before the due date (with extensions) for filing the gift tax return for the year of the transfer in question and. (redundantly in view of Section 7805(d)) in the manner prescribed by the Secretary. The Committee questions the necessity for Section 2701(b)(4)(C) and finds its inclusion curious in light of the lack of specific guidance in connection with the elections under Section 2701(b)(3).

f. Section 2701(b)(4) and Section 2701(c). Section 2701(b)(4) permits a transferor to elect to treat certain non-QFP rights as QFP’s. If such an election is made with respect to a noncumulative dividend, it is unclear how the deemed gift provision of Section 2701(c) would work in the event of a missed payment. If there is no surviving right to the missed payment, the three-year rule is meaningless. Similar concerns exist in the case of a partnership interest limited by the income or cash flow of the partnership. This area should be clarified in the bill.

g. Section 2701(c). Section 2701(c) contains the deemed gift rule which is operative in the case of a QFP not paid within three years of the date it was due. Section 2701(c)(2)(B) provides an exception to the deemed gift rule. This exception applies if the QFP is payable under an instrument providing that a QFP paid late is to bear interest "at a rate not less than the discount rate used in valuing" the QFP on the original transfer. The Committee questions the meaning of the reference to such "discount" rate, as well as the logic of using a date that looks back to a prevailing rate at the time of the original transfer. Looking back to the original Section 2701(a) transfer is particularly problematic if the underlying instrument predates the transfer. Using a rate prevailing at the time the QFP was due would more accurately reflect the economic reality of the benefit realized by the entity that failed to make the payment on a timely basis. Moreover, the Committee urges that safe harbor rate be provided and suggests that a floating rate tied to the applicable Federal rates in effect on the date the QFP was due would be appropriate.

The Committee also believes that the taxpayer should be permitted a reduction in the value of the deemed gift to take into account ownership of a portion of the junior equity by non-family members. The hypothetical benefit to non-family members as a result of a missed payment does not constitute the kind of tax avoidance abuse Chapter 14 was intended to address. Although Section 2703(f)(1) contemplates that regulations will address this problem where the transferor is also a holder of junior equity interests no such adjustment is contemplated where third parties hole such junior equity.

Because we recognize the risk of reciprocal deemed gifts by multiple non-family members who hold preferred interests in the same entity, we would disallow this additional adjustment with respect to junior equity owned by third parties who themselves have family members holding preferred interests of the same or equivalent class as that held by the transferor.

h. Section 2701(d). Section 2701(d) contains the additional gift and additional estate asset provisions to which we object above. Were Section 2701(d) to be retained in any definitive legislation, we have the following observations:

In the case of a transfer of a right to receive QFP’s, the transferor may be treated as having made an additional gift (or his estate may be deemed to include an additional phantom asset) under Section 2701(d). The bill should clarify the identity of the donee of this-additional gift, which is not specified in the draft. The Committee assumes that this additional transfer would be deemed made to the original donee of the gift that was valued under Section 2701(a). However, we question this result where the original donee has transferred to a non-family member part or all of the property originally transferred before such subsequent transfer (or before the death of the transferor), and we suggest that in such case the additional gift (or estate asset) rules should not apply. Although it might be more logical to impose such additional tax when the donee disposes of the property, the Committee would object to this approach, which would even more closely resemble one of the most troubling aspects of Section 2036(c). In addition to the foregoing problems, transfers by the original donee may create generation-skipping transfer consequences under Section 2701(d) which are beyond the control of the original donor.

As noted above in connection with our discussion of the Section 2701(c) deemed gift, Section 2703(f)(i) provides that regulations will allow for adjustments in the application of Section 2701(c) and (d) in situations in which the transferor holds junior equity interests. However, in the case of the Section 2701(d) transfer, the Committee believes that the additional gift or estate asset should be further limited to a fraction of the amount calculated under Section 2701(d)(1) or (2) corresponding to the original gift of the junior equity interest. Thus, if a donor transferred 10% of the entity's common stock in the first transfer, the value of any additional gift upon the subsequent transfer by the donor of his retained QFP right should be only one-tenth of the total increment, if any, determined under Section 2701(d)(1).

The Committee is also concerned that use of the favorable assumptions in calculating the hypothetical value of the retained interest to determine the amount of the additional gift or estate tax under Section 2701(d), may result in a value that could in certain cases exceed the value of the underlying entity itself. This problem might be ameliorated by a provision that would cap the hypothetical favorable assumption value of the transferred preferred interest at no more than such interest's pro-rata share of 80% of the value of the entity, using an approach parallel to that used under Section 2701(a)(3) to establish the minimum value of junior equity.

In the case of the death of the transferor, the transferor’s estate may be deemed to include an additional asset under Section 2701(d). The bill should address the allocation and source of the estate tax on such phantom asset. The recipient of such a phantom asset may not be a beneficiary of the residuary estate. Moreover, the transferor’s estate may not be adequate to satisfy the estate tax liability on this phantom asset.

In addition, the bill should specify that an additional asset will not be included in the transferor’s estate ... under Section 2701(d)(2) if the entire value of the property originally transferred under Section 2701(a) is included in the transferor’s estate under another section of the Code, such as Section 2036(a) or Section 2035.

Paragraph (5) of Section 2701(d) specifies that a termination of an interest is to be treated as a transfer. It is difficult to see how this concept would apply in the case of a trust interest. Unlike interests in corporations and partnerships which may be (and under Section 2701(a)(2)(B)(ii) are deemed to be) perpetual, trust interests are finite and their limited duration is a factor in their original valuation under Section 2701(a). Thus, the use of the Federal actuarial tables in originally valuing trust QFP’s (the annuity or unitrust interests permitted under Section 2701(b)(2)) is a sufficient safeguard against any valuation abuses sought to be corrected in Section 2701(d). Therefore, Section 2701(d)(5) should be made explicitly inapplicable to terminations of trust interests.

i. <u>Section 2701(e)</u>. Section 2701(e) permits a reduction in the value of a subsequent gift of a retained right that was <u>not</u> treated as a QFP, to account for the right having been valued at zero under Section 2701(a)(2)(A) at the time of the original transfer. We have earlier suggested that this adjustment be replaced by a provision to the effect that the retained interest originally valued at zero under Section 2701(a) would also be valued at zero on its subsequent transfer.

As contained in the draft, the Section 2701(e) adjustment may not reduce the value of the subsequent gift below zero, so that no refund is available with respect to the gift tax paid on the original transfer. Moreover, no relief is provided if the retained right which was valued at zero at the time of the original transfer is later sold for value, with the proceeds thereafter constituting part of the donor's estate. If the open transaction approach of Section 2701 is abandoned as we advocate but Section 2701(e), as drafted, remains part of the statutory scheme, the failure to provide the additional types of relief described above can be rationalized. However, if the open transaction approach is retained, there is no reason that the taxpayer should benefit any less fully than the government from the hindsight approach. Thus, although permitting such subsequent adjustments would lead to even greater complexity and difficulties of enforcement and administration, such adjustments would be necessary to ensure evenhandedness in this area.

If the individual transferring the non-QFP right is a member of the transferor's family, such individual also receives the benefit of the Section 2701(e) adjustment. In that case, the reduction in value is to be determined "by reference to the actual transferor's increase in prior taxable gifts." The term “actual transferor” is confusing. While the Committee assumes the reference is intended to be to the original transferor, it could logically be interpreted to refer to the family member actually making the transfer giving rise to the Section 2701(e) adjustment. The bill should clarify that the Section 2701(e) adjustment is to be made in such a case with reference to the increase in the prior taxable gifts of the original transferor under Section 2701(a).

j. Section 2702. Under Section 2702, rights of first refusal and buy-sell obligations held by family members are generally to be ignored in valuing property for transfer tax purposes. As discussed above, however, it is not uncommon for to be held simultaneously by both family and non-family members, in which case it would appear that Section 2702 could operate to cause inconsistent valuations of different fractional interests in the same property depending upon the identity of the holder of such rights. For example, if upon the death of a shareholder all the surviving shareholders, including non-family members, exercised their rights of first refusal to purchase a portion of the decedent’s shares at a formula price, it appears that such price would be controlling for estate tax purposes only for the shares sold to non-family members. This problem would be eliminated by the Committee’s proposal that none of the restrictive rules with respect to such rights apply if non-family members also hold such rights to a significant extent.

As discussed above, the Committee also opposes the three-year review rule under Section 2702 with respect to buy-sell agreements. Nevertheless, as a technical matter, if the three-year review rule is retained, the Committee notes that the three-year period is measured with respect to the sale in question. We believe that this is unfair in the case of a decedent. It may be impossible for the estate to effect a sale promptly so as to fall within the three-year period. Therefore, if the three-year rule is retained, in the case of a sale by reason of death the formula should be required to have been reviewed no more than three years before the decedent’s death.

k. Section 2703 definitions.

(A) Section 2703(a)(2). Section 2703(a)(2) treats a donee of a gift under Chapter 12 as a member of the transferor’s family, thus automatically causing the Chapter 14 valuation rules to apply in all gift situations, regardless of whether they occur within the family. This provision not only means that Section 2701 is to be used in valuing all gifts of interests in 10% owned entities, but may also suggest that all such donees are thereafter to be treated as family members for purposes of both the 10% test and the determination of whether the retained interests held by such donees will be accorded value in the case of later gifts to family members. If so, as discussed above in connection with Section 2701(b)(3)(B), should the donor make later gifts to family members, the consent of such non-family members (who may have no interest in benefiting the donor’s other donees and who may be unwilling to subject themselves to any potential tax liabilities under the deemed and additional gift provisions) will be a prerequisite to according value to their retained interests. The Committee believes this result is unreasonable and has no relation to the estate freeze abuses sought to be curbed.

(B) Section 2703(b). Numerous clarifications are required under the entity attribution rules of Section 2703(b). For example, an individual should be treated as holding only his or her pro rata share of the right or interest in question, based on the extent of the individual’s interest in the entity that actually holds the right or interest. Rules are also necessary to deal with cases in which an individual and/or his family members hold discretionary or contingent interests in a trust holding the right or interest. Approaches to some of these problems may already be found in the Code in provisions such as Section 318. To avoid further proliferation of attribution rules in the Code, we recommend that, wherever possible and reasonable, rules contained in existing provisions of the Code be adopted.

(C) Section 2703(d)(2). Under Section 2703(d)(2), a joint purchase is generally made subject to Section 2701. The transaction is treated as the acquisition of the entire property by the holder of the term interest followed by a transfer to other persons of remainder interests therein. Such treatment might be viewed as causing Section 2036(a) of the Code to apply in situations in which, in the absence of Section 2703(d)(2), it would be inapplicable. The Committee urges that a provision be included to the effect that no provision of Chapter 14 will cause Section 2036, or any other Code section, to apply to a transfer if such section would not otherwise apply.

The reference in Section 2703(d)(2) to the "person (or persons) acquiring the term interests" implies that a joint purchase involving the creation of successive term interests was contemplated as a transaction invoking this subsection. If all holders of term interests in a joint purchase situation are to be treated as transferors, the bill should clarify exactly how the provisions of Chapter 14 would operate as a practical matter.

l. Chapters 11, 12 and 13 cross-references. Proposed Chapter 14 superimposes a novel set of valuation and transfer tax rules upon the long-standing and familiar Federal estate and gift tax scheme contained in Chapters 11 and 12 of the Code. In addition, transfers subject to Chapter 14 may be generation-skipping transfers. It would be helpful to add cross-references in Chapters 11, 12 and 13 to the applicable provisions of Chapter 14.

m. Defined terms. The use in the draft of multiple defined terms for closely related concepts (and the placement in the draft of their definitions) as well as the use of multiple different expressions to refer to the same concept render the draft confusing and difficult to read. For instance, the words "right" and "interest" are at times used interchangeably, and the expression "specially valued fixed payment right" means a "right to receive qualified fixed payments" under a "specially valued retained interest". For simplicity and comprehensibility, the Committee recommends that a single term or expression be used to express each concept. Thus, for example, the bill could refer to (1) an "interest" in an entity to describe a donor's bundle of multiple "rights", some of which "rights" may constitute QFP rights, and (2) a "retained qualified fixed payment right" to refer to a "qualified fixed payment right" which has been retained in a transaction subject to Section 2701(a). Clarification of these definitions would also eliminate any ambiguity as to whether, in the case of a retained interest consisting in part of QFP rights and in part of one or more non-QFP rights valued at zero, the donor is eligible for some relief under Section 2701(e) at the time of a gift (or death time transfer) of the retained interest.

6. Statute of Limitations.

The discussion draft makes two major modifications in the statute of limitations under Section 6501 of the Code. The first change is to extend the three-year statute of limitations to six years with respect to a gift of property valued under Section 2701. The second change generally suspends the statute in the case of any gift valued under Section 2701 which is not reported.

The Committee questions the need for either of these changes. As to the suspension of the statute in the case of unreported Section 2701 gifts, it is difficult to see why the provisions of Section 6501(c)(1), (2) and (3) and Section 6501(e) would not be sufficient to give the Internal Revenue Service (the "IRS") adequate time to assess the gift tax. Section 6501(c)(1), (2) and (3) suspend the statute in the case of a false or fraudulent return, a "willful attempt to evade tax" and a failure to file a return, respectively, while Section 6501(e)(2) extends the statute to six years in the case of an omission of items on a gift or estate tax return which items in the aggregate exceed in value 25% of the total amount of gifts stated in the gift tax return or 25% of the gross estate as stated in the estate tax return.

The Committee recognizes both the government's legitimate concern in being timely and clearly apprised of estate freeze gifts and the historical difficulties in proving fraud or willful intent in omission cases in this area. Nevertheless, once the per se valuation rules of Chapter 14 are effective, the government's burden in demonstrating culpable intent in the case of an omission or substantial understatement, other than a failure to report an annual exclusion gift, should be greatly reduced.

The Committee is equally concerned with the extension of the statute from three to six years in all cases involving reported Section 2701 gifts. The proposed Chapter 14 provides a concrete, detailed scheme for valuing estate freeze gifts and, should the open transaction approach be retained, for identifying and valuing subsequent taxable events involving the retained property. Once this scheme is in place and a gift is valued and reported pursuant to such scheme, there should be no need to treat Chapter 14 gifts differently from any other taxable gifts, and the provisions of Section 6501(c) and (e) should be adequate to deal with Section 2701 gifts.

The Committee understands that the government's enforcement problems in this area have resulted primarily from situations in which the gift is not reported at all or is otherwise "buried" within other items in a manner that does not provide adequate disclosure. Again, because of the bright-line approach of Section 2701, the risk of good faith nondisclosure or undervaluation of gifts would be substantially eliminated. To our knowledge, there has been no showing (nor, indeed, even any allegation) that the IRS cannot ordinarily carry out its assessment and audit functions within the usual three-year period once it has proper notification of a taxable gift on a properly filed return. Given the concrete nature of the provisions of Section 2701, once adequate disclosure is made, no justification seems to exist for an extended period of limitations beyond the three- year period, which has met the IRS’s requirements in virtually all areas of the tax law for many years.

To address any concern that Section 2701 gifts may be “buried” within the return or not reported because they fall within the annual exclusion and, thus, are not identifiable to the IRS as meriting attention, the Committee suggests imposing the requirement that all gifts, including annual exclusion gifts, and assets included in the gross estate, under Section 2701(a), (c) and (d), as well as any adjustment under Section 2701(e), be specifically identified as such on the return, and that a failure so to identify the gift would result in an extension of the statute to six years. The IRS would thus have adequate notice of the application of Section 2701, and all reported Section 2701 gifts disclosed as such would have the same three-year statute of limitations as all other gifts. Given the unambiguous nature of a Section 2701 gift, failure to report a Section 2701 gift as such could also be cited by the government as some evidence of the fraudulent or willful nature of an unreported or undervalued gift for purposes of the existing provisions under Section 6501(c) of the Code which have the effect of suspending the statute of limitations.

As a technical point, it may be necessary to amend Section 6501(e)(2) to include within its scope transfers made under the new Chapter 14.

7. Effective Date.

The Committee recommends that the effective date of Chapter 14 be prospective, applying only to those transfers occurring after the date of enactment, but in no event earlier than the introduction of definitive legislation. Any pre-chapter 14 “safe-harbor” transactions under Section 2036(c) should be grandfathered. In addition, we recommend a transition rule which would extend protection for a three year period with respect to existing buy-sell agreements.

Finally, in connection with the repeal of Section 2036(c), the Committee recommends that a provision be added, similar to Section 1433(c)(1) of the Tax Reform Act of 1986 with respect to the repeal of the former Chapter 13, to deal with refunds of gift and estate tax imposed pursuant to Section 2036(c).