S. HRG. 101-1233

ESTATE FREEZES

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

AND THE

SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

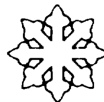
OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

JUNE 27, 1990



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
36-968 WASHINGTON : 1991

For sale by the Superintendent of Documents, Congressional Sales Office
U.S Government Printing Office, Washington, DC 20402

S361-30.

COMMITTEE ON FINANCE

LLOYD BENTSEN, Texas, *Chairman*

DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BILL BRADLEY, New Jersey
GEORGE J. MITCHELL, Maine
DAVID PRYOR, Arkansas
DONALD W. RIEGLE, JR., Michigan
JOHN D. ROCKEFELLER IV, West Virginia
TOM DASCHLE, South Dakota
JOHN BREAUX, Louisiana

BOB PACKWOOD, Oregon
BOB DOLE, Kansas
WILLIAM V. ROTH, JR., Delaware
JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
JOHN HEINZ, Pennsylvania
DAVE DURENBERGER, Minnesota
WILLIAM L. ARMSTRONG, Colorado
STEVE SYMMS, Idaho

VANDA B. MCMURTRY, *Staff Director and Chief Counsel*
EDMUND J. MIHALSKI, *Minority Chief of Staff*

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

DAVID L. BOREN, Oklahoma, *Chairman*

JOHN BREAUX, Louisiana

WILLIAM L. ARMSTRONG, Colorado
STEVE SYMMS, Idaho

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

TOM DASCHLE, South Dakota, *Chairman*

LLOYD BENTSEN, Texas
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
DAVID PRYOR, Arkansas

WILLIAM V. ROTH, JR., Delaware
JOHN C. DANFORTH, Missouri
STEVE SYMMS, Idaho

CONTENTS

OPENING STATEMENTS

Page

Daschle, Hon. Tom A., a U.S. Senator from South Dakota 1
Roth, Hon. William V. Jr., a U.S. Senator from Delaware 3
Boren, Hon. David L., a U.S. Senator from Oklahoma 4
Symms, Hon. Steve, a U.S. Senator from Idaho 5

COMMITTEE PRESS RELEASE

Finance Subcommittee to Hold Joint Hearing on Estate Freezes; Proposals for Changing Rules to be Discussed 1

ADMINISTRATION WITNESSES

Graetz, Michael J., Deputy Assistant Secretary, (Tax Policy), U.S. Department of the Treasury 6
Hayward, Mark S., Acting Chief Counsel for Advocacy, U.S. Small Business Administration, Washington, DC, accompanied by Dan R. Mastromarco, Assistant Chief Counsel for Tax Policy, Office of Advocacy, U.S. Small Business Administration 55

PUBLIC WITNESSES

McGaffey, Jere D., chair-elect, section of taxation, American Bar Association and partner, Foley & Lardner, Milwaukee, WI 21
Lubick, Donald C. Esq., attorney, Hodgson, Russ, Andrews, Woods & Goodyear, testifying on behalf of the taxation section, District of Columbia Bar, Washington, DC 23
Burton, David R., manager, Tax Policy Center, U.S. Chamber of Commerce, Washington, DC 24
Walker, Deborah, member, executive committee, American Institute of Certified Public Accountants, Washington, DC, accompanied by William T. Diss, chair, estate and gift tax committee 26
Lajoie, David E., partner, Coopers & Lybrand, Dallas, TX 31
Gutman, Harry L., partner, Drinker Biddle & Reath, Philadelphia, PA 33
Dees, Richard, capital partner, McDermott, Will & Emery, Chicago, IL 36
Gamble, James E., chair, estate and gift tax committee, American College of Trust and Estate Counsel, Detroit, MI 37
Apolinsky, Harold I., vice president, government affairs, Small Business Council of America and adjunct professor, estate tax law, University of Alabama School of Law and Cumberland School of Law, Birmingham, AL 40
Howitt, Idelle A., national director, ESOP services, American Appraisal Associates, Inc., New York, NY, accompanied by William Pittock, group manager, American Appraisal Associates, Inc., New York, NY; and Kenneth Miller, group manager, American Appraisal Associates, Inc., New York, NY 44
Lee, Mark M., associate director, Bear, Stearns & Co., Inc., New York, NY 47
Roberts, James O., president, Management Planning, Inc., Cleveland, OH 48
Lord, Fletcher E. Jr., president and chief executive officer, Crow-Burlingame Company, testifying on behalf of the National Federation of Independent Business, Little Rock, AR 52
Massie, Steve L., vice president, Jack L. Massie Contractors, Inc., testifying on behalf of the Associated General Contractors of America, Williamsburg, VA 58
Zaucha, Thomas K., chairman of the board, Small Business Legislative Council and president and chief executive officer, National Grocers' Association, Washington, DC 59

Page

ALPHABETICAL LISTING AND APPENDIX MATERIAL SUBMITTED

Apolinsky, Harold I.:
- Testimony 40
- Prepared statement 63

Boren, Hon. David L.:
- Opening statement 4
- Prepared statement 66

Burton, David R.:
- Testimony 24
- Prepared statement 67

Daschle, Hon. Tom A.:
- Opening statement 1
- Prepared statement 79

Dees, Richard:
- Testimony 36
- Prepared statement 125

Gamble, James E.:
- Testimony 37
- Prepared statement 131

Graetz, Michael J.:
- Testimony 6
- Prepared statement 141

Gutman, Harry L.:
- Testimony 33
- Prepared statement 150

Hayward, Mark S.:
- Testimony 55
- Prepared statement 155

Howitt, Idelle A.:
- Testimony 44
- Prepared statement 162
- Response to question submitted by Senator Daschle 166

Lajoie, David E.:
- Testimony 31
- Prepared statement 166

Lee, Mark M.:
- Testimony 47
- Prepared statement 169

Lord, Fletcher E. Jr.:
- Testimony 52
- Prepared statement 173

Lubick, Donald C.:
- Testimony 23
- Prepared statement 179

Massie, Steve L.:
- Testimony 58
- Prepared statement 183

McGaffey, Jere D.:
- Testimony 21
- Prepared statement 187

Roberts, James O.:
- Testimony 48
- Prepared statement 191

Roth, Hon. William V. Jr.:
- Opening statement 3

Symms, Hon. Steve:
- Opening statement 5
- Prepared statement 195

Walker, Deborah:
- Testimony 26
- Prepared statement 201

Zaucha, Thomas K.:
- Testimony 59
- Prepared statement 203

Page

COMMUNICATIONS

American International Automobile Dealers Association 214
American National Bank 215
Bergman, Horowitz & Reynolds, P.C 218
Blattmachr, Jonathan G. 219
Coopers & Lybrand 221
Dingwerth, Jim 223
Family Holding Company Group 224
Harter, Secrets & Emery 226
Harwell Martin & Stegall, P.C. 229
Hopkins & Sutter 231
National Association of Industrial and Office Parks 232
National Association of Wholesaler-Distributors 232
National Automobile Dealers Association 239
National Retail Hardware Association 240
National Telephone Cooperative Association 242
New York State Bar Association 243
Overbey Law Firm 244
Plaine, Lloyd L., et al. 245
Regional and Distribution Carriers Conference, Inc. 248
Seeligson & Steinberg 249
Simpson Investment Company 253
Simpson Timber Company 253
Solberg, Thomas A. 255
True, H.A., Jr. 266
U.S. Chamber of Commerce 268

ESTATE FREEZES

WEDNESDAY, JUNE 27, 1990

U.S. SENATE, SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION AND THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:07 p.m., in room SD-215, Dirksen Senate Office Building, Hon. David Lyle Boren and Thomas A. Daschle (chairmen of the subcommittees) presiding.

Also present: Senators Breaux, Roth, and Symms.

[The press release announcing the hearing follows:]

[Press Release No. H-37, June 12, 1990]

FINANCE SUBCOMMITTEES TO HOLD JOINT HEARING ON ESTATE FREEZES; PROPOSALS FOR CHANGING RULES TO BE DISCUSSED

WASHINGTON, DC.—Senator David L. Boren, Chairman of the Senate Finance Subcommittee on Energy and Agricultural Taxation, and Senator Thomas A. Daschle, Chairman of the Finance Subcommittee on Taxation and Debt Management, announced Monday that the Subcommittees will hold a joint hearing on proposals to prevent abuses in determining estate and gift tax values.

The hearing will be at *2 p.m. on Wednesday, June 27, 1990* in Room SD-215 of the Dirksen Senate Office Building.

Prior to 1987, an estate freeze allowed business owners to transfer companies to heirs while paying minimal transfer taxes. Under current law, the business owner's estate pays taxes on the appreciation on the property that occurred between the transfer and the owner's death.

Boren (D., Oklahoma) said, "I understand the concerns about the potential for estate tax avoidance, however the current estate freeze rules—or section 2036 (c) of the Internal Revenue Code—go too far. These rules are too complex, broad and vague. As a result, they pose an unreasonable impediment to the transfer of family-owned businesses. These rules must be changed."

Daschle (D., South Dakota) said, "Section 2036(c) is a trap for unsuspecting owners of small family businesses. Its provisions are capable of ensnaring a host of transactions that were not intended to fall within the scope of the original legislation."

The subcommittee will analyze a discussion draft introduced by Congressman Dan Rostenkowski, Chairman of the House Ways and Means Committee, and other proposals developed by the task force of the American Bar Association and the American College of Probate Counsel, the District of Columbia Bar, the U.S. Chamber of Commerce and others.

OPENING STATEMENT OF HON. THOMAS A. DASCHLE, A U.S. SENATOR FROM SOUTH DAKOTA

Senator DASCHLE. The hearing will come to order. This afternoon we will be discussing Internal Revenue Code, Section 2036(c). I am pleased to note this is the first hearing that I will be holding as

Chairman of the Taxation and Debt Management Subcommittee. I am very pleased to be holding this hearing jointly with my colleague from Oklahoma, Senator David Boren, the Chairman of the Energy and Agricultural Taxation Subcommittee. He will be here momentarily.

Last year when I introduced legislation to repeal Section 2036(c) retroactively I was very concerned about forcing small family businesses to live under its overly broad and ambiguous provisions until a substitute could be devised. At that time I indicated I would entertain proposals for a more limited measure that would target the specifically alleged abuses in this area.

A number of alternatives to Section 2036(c) have been advanced by individuals and groups who have expertise in the estate and gift tax area. One of the primary purposes of this hearing is to place some of these alternatives on the table and discuss their merits.

A substitute proposal that has been the subject of debate already is the discussion, draft written through the combined efforts of the Department of Treasury and the Joint Committee on Taxation staffs. It will be the subject of a good deal of discussion this afternoon. This proposal was released in April, and individuals and businesses have had a chance already to evaluate its provisions. Some of the witnesses are prepared to discuss it today.

Based upon the comments that I have heard, primarily from small family businesses, I have some very serious concerns about the approach taken in the Treasury proposal. As far as I know, none of the small business groups have come out in support of this proposal thus far. I hope today that we will not only discuss some of the reasons why, but some of the other alternatives for resolving the problems raised by estate freeze techniques.

On its face, the Treasury proposal appears to offer more certainty to family businesses by purporting to deal with the issue in the gift tax, rather than the estate tax. However, closer scrutiny of this proposal reveals that it would allow the IRS to come back and pray upon the taxpayer years after the transaction has taken place. This is precisely the problem that we face currently with Section 2036(c).

Another concern is that the Treasury proposal seems to be every bit as broad as current law. It takes the approach of saying that all transactions in this area are suspect, except those specifically enumerated. Those that are enumerated are drafted so that any errors are overwhelmingly in favor of the IRS.

I seriously question the soundness of this approach. To begin with, there is no evidence that the abuses Section 2036(c) was intended to target were widespread at the time of its enactment. Moreover, small family businesses require and deserve some flexibility in structuring their companies. I wonder whether the Discussion Draft wouldn't unfairly restrict businesses far beyond what is necessary. We should be careful of going too far and saying that family members cannot engage in the same transactions as people who are dealing at arms' length.

Finally, the Discussion Draft worries me because it would repeal a single section of the Estate and Gift Tax Law and replace it with an entirely new chapter. I am sure everyone here today would agree that the last thing we need is more complexity in the Tax

Code, particularly if it is a million dollar solution to a thousand dollar problem.

I mentioned that there are a number of other substitutes for Section 2036(c) that have been advanced by other individuals and groups. We will be hearing about those today. I would also like to encourage all the witnesses to feel free to offer additional suggestions that do not fall within any of the major proposals. We have a great deal of estate and gift tax brain power in this room today, and we ought to have every opportunity to use it.

I appreciate, as well, the presence of one of the ranking members on this Committee. Let me call upon Senator Bill Roth with whatever opening comments he might have.

[The prepared statement of Senator Daschle appears in the appendix:]

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE

Senator ROTH. Well thank you, Mr. Chairman. I will be very brief. But I do want to express my appreciation to you for holding these hearings on a very important issue. I know that you, as well as Senator Boren, as well as Senator Symms and myself, have spent considerable time and effort trying to correct the mistake that was made in 1987.

I realize that there is a proposal that Treasury is anxious to receive feedback on and I appreciate their efforts in trying to address the problems created under Section 2036(c).

In addition, I believe we have some competing proposals with a great deal of merit which deserve our careful attention. I have said over and over again that I think Congress went too far when it became easier to pass on property to a stranger than to your children; and that is exactly what I think is the case with the current law.

I have co-sponsored two repeal bills offered by my colleagues on this Committee and I am prepared to support repeal again this year, as I did in this Committee last year. I am not satisfied that the concerns of family-owned businesses are adequately addressed by some so-called replacement provision.

On the other hand, I am not supportive of change that will open the door to future abuses by a handful of sharp practitioners either.

So, Mr. Chairman, I look forward to the testimony we will hear today and hope we proceed quickly to find some solutions so that Government and small business can work better together.

Thank you, Mr. Chairman.

Senator DASCHLE. Thank you, Senator Roth.

Senator Boren has not yet arrived. So at this time let me call upon our first witness. Mr. Michael Graetz is the Deputy Assistant Secretary for Tax Policy of the Department of Treasury. Mr. Graetz, we are delighted you are here. Before I invite you to proceed with your testimony, let me call on Senator Breaux for any comments that he might have.

Senator BREAUX. No comments, Mr. Chairman.

Senator DASCHLE. He has no comments. So we will proceed, if you will, to your testimony at this time.

Excuse me, Mr. Graetz, let me call on Senator Boren to make his opening remarks.

OPENING STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA

Senator BOREN. Thank you very much, Senator Daschle. I will try to be as brief as possible because I know Mr. Graetz has another meeting to attend. We have had some discussion about this matter recently and I am anxious to hear the suggestions that you might outline.

As has already been indicated by Senator Daschle we are conducting this hearing to deal with one of the most severe problems facing small businesses in the country today. At a time when we should be doing all that we can to help keep small family-owned businesses afloat, the Estate Freeze Provision, (Tax Code Section 2036(c)) poses a real threat to their survival.

This provision of the law makes it virtually impossible for families to keep their small businesses together from one generation to the next. It almost forces a trend under which bigger businesses gobble up the smaller ones. In some cases, because of huge estate tax burdens, it literally forces small businesses to close their doors for good, throwing more and more people out of work.

We have had testimony to that effect in the Small Business Committee. Small family businesses provide the bulk of new jobs in our country. The more people who have the experience of running their own businesses and having responsibility for them, the stronger our country is. Therefore, I think it is time to repeal this unfair portion of the Tax Code helping small family-owned businesses for a change.

I am particularly pleased that we have an opportunity to focus on this issue. Senator Daschle and I together have introduced S.849, a bill to repeal this Section. The Finance Committee previously held general hearings which included the repeal provision. But today we have an opportunity to really specifically consider the impact of this unworkable law.

I think a lot of things are clear. I will just mention one or two. I think there is a general agreement that the current law is overly broad. I also think that the law is unintelligible to even the most sophisticated counsel, let alone counsel representing many small family-owned businesses or farms throughout the United States.

It is worth noting that even the supporters of 2036(c), the few though they may be, concede that the 1987 law was clumsily fashioned. What they really mean, virtually every knowledgeable observer has concluded that the new rules are simply not administrable and that they are not really subject to a patch-up job.

Treasury and some other academics have suggested modifications. I have to say, I haven't seen very many modifications yet that I think are workable. Given the tremendous burdens of this rule and the burdens it places on small family-owned businesses, I hope that we can start over with repeal & wipe the slate clean. We then can come back and see if we can fashion some very tightly

controlled and very narrowly targeted provisions that might help us deal with any abuses, evaluations that might occur.

Just to quote one of my own constituents, Bob Tutty, president of the Shoto Telephone Company, whose testimony we are receiving for the record today, he said often the only reason an individual remains in a community is because they have inherited or will inherit a small family-owned business. We are talking about small communities, such as telephone companies, small family farms, other small businesses. Passing a business to the next generation is a common occurrence in a small town or rural community. It is really what keeps that community going and what holds it together.

The same kind of job opportunities that are available in urban areas simply do not exist in rural areas. If we stop this ability to pass on property and businesses from one generation to the next, we are going to have the effect of drying up the small communities in our country. We have already had an outflow of some 5 million people from the small communities, from States like mine and Senator Daschle's. Senator Symms I noticed has just come in and I am sure Senator Roth has the same kind of experiences in small communities in his State as well.

So we are dealing with a problem that is extremely serious. It is time for us to have action. We are willing to consider all constructive suggestions that might come forward. If there is a way to fix this provision without making the fix worse than the current problem that we are dealing with, we are willing to look at that. But I think most of us start with a strong feeling that we ought to wipe the slate clean, and then try to deal with any problems that might be there without trying to do some modification that would not work in the current law.

I appreciate your being with us today and look forward to hearing what your suggestions are. We know you are under a tight time schedule, so I won't go further. I will just put the rest of my statement into the record.

[The prepared statement of Senator Boren appears in the appendix:]

Senator DASCHLE. Thank you, Senator Boren.

Mr. Graetz, I see that Senator Symms has arrived. Since I have interrupted you once, before we interrupt you a second time, let me call on him for any comments.

OPENING STATEMENT OF HON. STEVE SYMMS, A U.S. SENATOR FROM IDAHO

Senator SYMMS. Mr. Chairman, thank you very much. I appreciate it. I will be as brief as I can, Mr. Graetz, but I do want to make a brief statement.

The present, as well as the historical, importance of family owned businesses to America's economy needs to be addressed. Due to the present tax laws, a family's business is heavily taxed upon the death of the majority owner and this is causing a great deal of chaos and problems to businesses in America.

The citizens of this country have asked their elected officials for simplicity and relief from all kinds of taxes. Yet the Federal Gov-

ernment imposes no less than 17 different tax rates, ranging from 18 to 55 percent, on inherited estates. At current rates, an estate worth more than $500,000 and less than $750,000 owes in tax $155,800, plus 37 percent of the excess of such an amount over $500,000.

Now, Mr. Chairman, I introduced legislation yesterday and I hope that the members of the Finance Committee will carefully consider it. I would invite all of you to co-sponsor it. The American Family Enterprise Preservation Act makes much progress towards correcting the inequity created by Congress and gives the family businesses the relief from tax oppression that they deserve.

Bill number S.2783 will do the following: It will repeal Section 2036(c) of the IRS Code by eliminating the estate tax freeze and an heir will only pay taxes on the portion of the estate that is actually inherited. It will reduce the number of tax brackets from seventeen to two, bringing the top bracket down to 28 percent, which is the same as the top income tax bracket and this will then be indexed for inflation. Mr. Chairman, one of the most important factors of my proposal is indexing the estate tax for inflation.

We will increase the unified credit to a higher amount equivalent to a million dollar estate and index that for inflation. We will extend the 4 percent interest rate to the entire amount of the tax due instead of being increased after the first $153,000 paid.

Now, Mr. Chairman, this is a very straightforward and simple bill. I will look forward to getting the numbers back from the Joint Tax Committee. I would like to have Treasury's appraisal of this situation and this bill. But I think estate taxes discourage normal interfamily transaction and stand as a barrier to the hopes and dreams of the American people.

Realizing the importance of preserving the family business in the United States. I believe now is a good opportunity to seriously consider either my American Family Enterprise Presentation Act or a similar package.

I thank you very much.

[The prepared statement of Senator Symms appears in the appendix:]

Senator DASCHLE. Thank you, Senator Symms.

Now, Mr. Graetz, I promise, no more interruptions. I would ask that your full statement be printed not showing interruption in the record. My apologies once again, and I now invite you to proceed as you see fit.

Mr. GRAETZ. Mr. Chairman, as you may know, in my other life I teach law school and interruptions are quite common in law school. [Laughter.]

Mr. GRAETZ. I have no objection to them even as I go further. I appreciate your comments.

STATEMENT OF MICHAEL J. GRAETZ, DEPUTY ASSISTANT SECRETARY (TAX POLICY), U.S. DEPARTMENT OF THE TREASURY

Mr. GRAETZ. Thank you, Mr. Chairman.

Mr. Chairman and members of the Subcommittee, I am pleased to have the opportunity to present the views of the administration on proposals to repeal and replace Section 2036(c) relating to estate

freeze transactions. Estate freezes can take many forms but have as their common objective limiting or reducing the value of a business interest or other property for estate tax purposes. I have listed some of the more common freeze transactions in the Appendix to my written statement.

The Treasury Department does not object to techniques that freeze value in a transferor's estate so long as the value of the business or other property for gift tax purposes is adequately measured. The problem, however, is that before the enactment of Section 2036(c) taxpayers were using techniques which resulted in improper valuation for gift tax purposes. This in turn effectively eliminated gift tax on a significant portion of the fair market value as of the transfer date.

Let me outline some of the techniques we view as abusive. They typically involve retention by the older generation of discretionary rights, including dividend and other income rights. Many of these rights were likely not to be exercised at all in a family context because to do so would have significantly undermined the tax benefits of the freeze.

Nevertheless, appraisers would assign value to these rights on the assumption that the rights would be exercised and as a result tax planners would counsel their clients to retain such rights. The cumulative effect of these valuation techniques was significant undervaluation of the transferred interests for gift tax purposes. As a result, little or no gift tax would be paid on the transfer, even though all of future appreciation in the value of the business would inure to these interests.

These discretionary rights would soak up virtually the entire value of the business and for this reason are commonly referred to as "soak up" features. It is the transfer tax avoidance due to the discontinuity between the assumptions used in valuing the transferred interests and the likely behavior of family members that the Internal Revenue Service and the Treasury Department consider abusive.

Section 2036(c) was enacted in 1987 to deal with these abuses. However, Section 2036(c) is not specifically directed at the valuation abuses that I have described, but instead returns the entire value of property, including future appreciation, back into the transferor's estate. Many have raised serious questions about this result as well as about the uncertain operation of the provision.

While sharing many of these concerns, the Treasury Department is strongly of the view that these abuses should not be allowed to return and that repeal of Section 2036(c) without a replacement would cause that result. We, therefore, support repeal of Section 2036(c) only if coupled with enactment of a replacement provision adequate to prevent the valuation abuses that I have mentioned previously.

The testimony on April 24 before the House Ways and Means Committee revealed a consensus that estate freezes present a serious potential for tax abuse. Many small business organizations—as well as professional groups such as the American Bar Association, the American College of Trust and Estate Counsel, and the American Institute of Certified Public Accountants—agreed that a provi-

sion to replace Section 2036(c) was necessary and that outright repeal would not be appropriate.

We believe that a replacement for Section 2036(c) is essential and that the Discussion Draft circulated by the Ways and Means Committee offers the most constructive and workable approach for such a replacement. It would eliminate the abuses described above by appropriately valuing the various interests on the date of the freeze transaction and by assuring that the subsequent behavior of the various parties will not undermine that valuation.

At the same time the draft provides flexibility in interfamily transfers and allows future appreciation to be transferred to younger generation family members without subsequent estate tax.

The basic mechanism of the draft is straightforward. It does not affect how a business as a whole is valued, but rather affects how that value, once determined, is allocated among the various interests in the business. In valuing a transfer of rights in a business among family members, generally only qualified fixed payment rights (QFPs) which the transferor retains will be valued. Discretionary rights generally will be disregarded because such soak up features have so frequently been used in cases of valuation abuse.

In valuing QFPs the draft assumes that they will be paid; however, if they are not paid after a three-year grace period, generally a deemed gift will result.

Finally, a minimum value rule ensures that taxpayers cannot significantly undervalue the transferred interest by providing that the appreciating equity interest, such as common stock, cannot be valued at less than 20 percent of the total equity in the business. The Discussion Draft incorporates several rules which are intended to provide relief in specific circumstances such as insolvency and bankruptcy, as well as rules to prevent double taxation and to enhance planning flexibility.

As a result of the hearing before the Ways and Means Committee, as well as through meetings with interested groups, we at the Treasury have received many constructive comments for improvement of the draft. We agree that many improvements can and should be made.

Several of such improvements are described in my written statement, including changes in the way the draft would apply to debt and leases—one of the most frequent criticisms of the Discussion Draft—substantial broadening of the types of income rights that can be treated as QFPs, additional flexibility to avoid treatment of missed payments as deemed gifts, an increase in the ownership threshold before the provision would apply at all, as well as changes that generally would mean that the draft does not apply to publicly traded stock or extend the gift tax statute of limitations when transactions have been reported.

We are prepared to support other modifications that improve the draft in terms of taxpayer flexibility and ease of administration. We will oppose, however, changes that in effect would undermine the fundamental premise of the Discussion Draft—proper gift tax evaluation at the time of transfer.

Let me touch briefly on the other proposals specifically mentioned in the announcement to this hearing. We believe that the District of Columbia Bar Association proposal, by focusing on inad-

equate reporting, rather than misvaluations, fails to address what we regard as the fundamental problem of estate freezes. Therefore, we do not believe this approach is adequate.

The proposal of the Chamber of Commerce is essentially a variation of the Discussion Draft. We believe, however, that the Chamber's proposal is too narrow in scope, in particular because it retains current law valuation rules in many situations and fails to address adequately the serious problem of nonpayment of promised amounts. We also believe that the proposal contains worthwhile ideas which merit serious consideration in crafting a replacement proposal.

We believe that the ABA-ACTEC Task Force proposal also is too limited. It does not deal adequately with retained discretionary rights. It may create new valuation uncertainty and it also fails to address the fundamental problem of nonpayment of valued rights.

Although we are not endorsing any of the other proposals here today, we have not ignored the concepts and suggestions they contain. We have instead focused our energies on improvements to the Discussion Draft that take the various concerns of these and other groups into account without undermining its basic features.

The Treasury's Office of Tax Analysis estimates that repeal of Section 2036(c) would reduce revenues during the period 1991 through 1995 by $1.02 billion. Treasury also estimates that if the Discussion Draft in its current form were enacted to replace Section 2036(c) revenues during the same period would be reduced by $50 million from current law.

The Treasury Department looks forward to working with the Congress and interested members of the public in an effort to develop a fair and workable replacement for Section 2036(c). To retain our support any proposal must prevent abusive valuations in estate freeze transactions.

We are encouraged so far by the willingness of groups interested in this issue to work together with us and with the Congress to develop a reasonable and responsible solution to a problem universally acknowledged to exist. We hope that this spirit of cooperation will continue.

Thank you, Mr. Chairman.

Senator DASCHLE. Thank you for your testimony, Mr. Graetz. You have just outlined nearly—in your formal testimony you do it even more clearly—almost 20 objections or concerns that have been raised about the discussion draft. It would lead me to believe that even you, in your heart of hearts, have probably come to the conclusion that the draft as it is written is maybe even fundamentally flawed. Certainly whether it is fundamental or whether it is something less than that, we are going to have to address the shortcomings that you have outlined in your testimony.

It leads me to question whether or not even now Treasury may be looking a little more carefully at some of the alternatives. As you considered the alternatives you said that those alternatives that you have spent some time looking at are inadequate. You mean they are inadequate because they do not address the fundamental abuse or are they inadequate because they just don't go as far as you would like them to go?

Mr. GRAETZ. Mr. Chairman, let me make two comments. First, while we are concerned with improving the Discussion Draft, we do not regard it as fundamentally flawed. We regard its flaws as fixable. I wanted to make that clear.

I think that the basic problem with the alternatives is really twofold. First, we are concerned that they are unduly narrow in scope and our concern simply is that estate planners who are faced with a very narrow solution will create alternative abusive opportunities similar to those which the narrow focus is intended to address.

And secondly, we are concerned that the alternatives do not adequately address the problem of valuation where a flow of payments originally given value subsequently prove not to be made. The Discussion Draft addresses that problem far more comprehensively than any of the other alternatives with which we have been presented.

Senator DASCHLE. Well I can appreciate that. I am amused, frankly, that we started out with about a half a page when the law was originally drafted. We went from a half a page to four pages. We went from 4 pages to 25 pages. We are now talking about an entire new chapter to the tax code, and you have just outlined in your testimony almost 20 different things that are going to have to be addressed. I would imagine that is going to take more paper.

And so, it seems to me that we may go from a chapter to God-only-knows what before we are done. We may need a wheelbarrow to carry this all in here and examine it before it is over. I do not mean to sound facetious, but, frankly, I am becoming more and more concerned that, in the effort to get everything, to make sure we have all of our bases covered, we are going to have a document that thick (motioning) before it is over.

It seems to me that we really have one of two approaches. One approach is to say everything is illegal, with these minor exceptions, and these exceptions are legal. That is what the Discussion Draft appears to me to be doing. All this is illegal and, if you can just get around these few obstacles, we will accept these exceptions.

Another approach is to say that everything is legal and judge the bad actions for what they are. You have one of two things. Rather than declaring everything illegal with a few exceptions, wouldn't it be much more simple to say all is legal, period, and identify certain bad exceptions?

Mr. GRAETZ. Well, Mr. Chairman, I do not think that one should judge the complexity of this provision by its length. Section 2036(c) itself, as you know well, was quite short in length, but led to enormous complexity. I think that the basic structure of the proposal and the provision is in fact rather straightforward and can, once enacted, be dealt with by estate planners without great difficulty.

My concern about enumerating those aspects which are bad, rather than those which are good, is that our experience is that the estate planners of America are really a remarkably creative lot. I do not mean to demean the Committee staffs or the Treasury Department or the IRS by saying that I am skeptical of our ability to fashion a proposal that lists enumerated rights which would not, at the first tax conference held for practitioners after its enactment, be described in a way that suggested all of the alternative means to get around it.

I think what we ought to strive for here, Mr. Chairman, is a solution which is stable, a solution which is permanent. I hope that we can do that. I am concerned that if we limit this replacement to a narrow classification, the result will be that we will be back here again adding those pages to the statute that we have omitted on this occasion in an effort to capture newly created transactions. I do think that the draft itself is comprehensive and offers a comprehensive framework and that that is what we ought to strive for if we possibly can manage it.

Senator DASCHLE. I guess I share your optimism or at least your hope. I am not sure either of us is very optimistic. But I must say that any time you lay down a 25-page document and then come up with almost 20 different problems with that document before we have even put it into law, I guarantee you that that imagination will continue regardless of how tightly drawn you try to make it with more and more pages. It is just not going to happen.

I am extraordinarily skeptical about our ability to do it with the Discussion Draft as I see it today.

Senator Boren?

Senator BOREN. Let me ask, have we had any studies made in terms of the number of estate freezes that have occurred on an annual basis prior to 1986 through the change in the law?

Mr. GRAETZ. Mr. Chairman, I have not seen a study of the number of estate freezes that were made before that. I do know that those transactions—that is, the hole that was in prior law—was commonly the subject of estate planning advice in the tax community, but I have not seen a report of the number of those transactions.

I do not think, frankly, that we could ever determine how many of those transactions took place because many of those transactions were made under circumstances where the taxpayer took the position that there was no taxable gift and, therefore, no need to report the transaction to the Internal Revenue Service. So I do not think it would even be possible to answer that question.

Senator BOREN. I know back in 1963, almost 30 years ago, the SBA did a study on valuation of family-owned firms. Their study found that—I quote from it—"The IRS has tended to use whatever approach to fair market value that would result in the highest value for tax liability purposes." That was the last Government study I have seen.

Has Treasury undertaken a study to indicate whether or not correct valuation procedures are being used in family-owned business transactions? Are there any recent studies of a scientific nature on this matter?

Mr. GRAETZ. I do not have any studies to advance of a scientific nature on this matter today, Senator.

I do want to say that the valuation problem is a significant problem when one is trying to value, for transfer tax purposes, hard-to-value assets, such as small business ownership interests or other nonpublicly traded assets. We believe that the pre-1987 law is wrong in fundamental concept—that is, that it looks to the price that a willing buyer would pay a willing seller in a non-family context. We believe that we have to address the basic structure of the valuation rules in order to deal with the problems before us today.

Senator BOREN. Let me say, I think some of us share the suspicion that the early study of 1963 might be right, and that the IRS has generally followed the procedure of whatever brings in the most money to the Government without regarding whether it is fair or not. It would appear we made these changes in 1986 without the value of scientific study, simply acting on that bias of the Internal Revenue Service rather than acting upon any kind of scientific study which shows abuse.

I would like to read a few lines from one of our witness's testimony today and get your reaction. He states that, "The Discussion Draft would use artificial rules of valuation, specifically designed to overvalue an asset. Therefore, our transfer tax system would no longer be related to the taxpayer's ability to pay and would unfairly burden the taxpayers." He goes on to state that, "Family members would be deemed to have made gifts to each other if the corporation fails to make a payment on the preferred stock or debt, even where the family members do not control the business, and where the business might have a compelling economic reason for not being able to make those payments."

Therefore, we could be in the position of taxing people on the basis of their not being able to make payments when the business is simply not generating sufficient income in order to make those payments. We would make it therefore impossible for this kind of transaction to go forward for the transfer to occur because we would not allow for economic circumstances that in fact are necessary to defer the payments to keep the business going and it will have to close its doors.

Do you agree or disagree with those criticisms?

Mr. GRAETZ. There are two parts to it, Senator. I would like to respond to both of them. It is not the intention of the Discussion Draft, nor do I think the effect, to overvalue the gift for gift tax purposes. The basic idea is to restructure the system in this area so that you collect an adequate amount of gift tax up front and then the children can be given the right to future appreciation without the property being thrown back into the estate.

I think the structure of the Discussion Draft would reach that result in most of the cases. It does not allow value for discretionary rights because often those rights will not be exercised. That may be the heart of the dispute about whether the draft is overvaluing or not.

With respect to the second part of the question, Senator, the imposition of gift tax under circumstances where a business is in a difficult financial situation and unable to pay the tax or to pay the dividend that it has agreed to pay—the draft does have a number of provisions that would allow postponement of that tax under those circumstances. And we have suggested here today additional leaway in that regard.

Others have made suggestions—the Chamber of Commerce among them—for further addressing that problem. We are concerned with that problem and we are looking at solutions to that problem. As I say, we have offered some here today and the Discussion Draft itself has a number of escape routes from that burden. I think that this is an area of genuine concern.

Senator BOREN. Right. I appreciate that. I think that is the one we really need to delve into. In many cases if the tax liability were to flow under economic conditions where it simply could not be met we would frustrate the entire ability of the business to even continue operation.

I notice—and let me ask just one more question and we will turn to our colleagues—there are a lot of reasons why you might have a buy-sell agreement. There are arms length buy-sell arrangements between unrelated parties as well as between related parties. But I noticed in the Discussion Draft the rule would require a review of the agreement and new appraisal every 3 years. I am sure that would be music to the estate planners ears, to bodies of appraisal and others. Since we are anxious not to cause an economic downturn and to keep lawyers, accountants, estate planners and others occupied as we are turning out record numbers in our country. We are certainly ahead in the litigation business internationally if we are not keeping up in the productivity business internationally.

I wonder if this is the aim of this proposal. Why should a family, just because family members are dealing with each other in good faith, be prevented into entering into buy-sell agreements which unrelated parties are allowed to enter into. Are we taking a valued position in the law that it is somehow evil for family businesses to stay in the families instead of passing into giant and personal corporate ownership?

Mr. GRAETZ. Mr. Chairman, the Treasury Department certainly does not regard it as "evil" for family businesses to stay in the family, nor do we endorse the Appraisers Unemployment Act of 1991 or 1990, as the case may be.

The provision that you refer to that does require a triennial updating is one that has received a lot of criticism. We do not regard that as a perfect or even near perfect approach to the question of buy-sell agreements; and we regard this as an area that merits further consideration and additional efforts to identify the problem and tailor a solution limited to any genuine problems that exist.

I share your concern about shifting wealth from small businesses to tax appraisers in this area. They have plenty of work to do as far as I can tell.

Senator BOREN. They are doing better than most small businesses are, as well as estate planners.

Mr. GRAETZ. They are doing just fine.

Senator BOREN. Thank you very much.

Senator DASCHLE. Thank you, Senator Boren.

Senator Roth?

Senator ROTH. Mr. Graetz, the Treasury has indicated not only in this area dissatisfaction with the provisions, but has indicated that the Discussion Draft needs some revision. Now I am wondering, will the Treasury be in a position to offer what it views as changes and modifications that should be made since we may have a markup sometime in July?

Mr. GRAETZ. Well, Senator Roth, we have offered a number of changes that we regard as important improvements in the draft. We remain open to any further suggestions that emerge from this hearing.

I want to congratulate the Congress on the open process in which it is addressing this extremely complicated problem. I think a Discussion Draft and public hearings on both sides of the Capitol is an improvement in the process, particularly as compared to that which brought us Section 2036(c). We will be prepared to respond should the Committee mark-up at any time.

Senator ROTH. Well, the Discussion Draft establishes an arbitrary requirement that the junior equity interest be valued at no less than 20 percent of the sum of the equity of the business, plus any debt owed by the business to the transferor. Again, those commenting on the Discussion Draft have stated that 20 percent is far too high a figure and will result in a prohibitively high gift tax for businesses that might do freezes under the Discussion Draft.

Is Treasury willing to consider a reduction of that; and if not, why not?

Mr. GRAETZ. Senator, we are willing to consider a reduction. There are a number of proposals that have no minimum value rule at all. We do not regard that as appropriate because when you transfer the rights to future appreciation in a business, that is a valuable right that needs to be taken into account for gift tax and transfer tax purposes.

On the other hand, the 20 percent level has been criticized and we are certainly willing to take a look at whether a different level might be appropriate.

Senator ROTH. Again, the Discussion Draft in this case does not contain a specific discount rate to be used for the purpose of valuing the retained interest. Should the draft include a discount rate; if not, how will IRS administer this aspect of the Discussion Draft?

Mr. GRAETZ. Senator Roth, a number of people have asked that question. I think the reason that the draft does not contain a specific discount rate is the view that different industries and different businesses produce different rates of return and there ought to be some flexibility in reaching the appropriate discount rate.

On the other hand, there have been suggestions—I think along the lines of those of Senator Boren earlier—that the IRS will simply exaggerate the discount rate in an effort to produce too great a value. We are concerned about that and we are certainly prepared—if we could get an agreement as to how to solve the discount rate problem and come up with a range of discount rates that was reasonable—for the Congress to specify that rate or a range of rates rather than to leave it to the Internal Revenue Service to decide.

Senator ROTH. That is all the questions I have, Mr. Chairman.

Senator DASCHLE. Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman. I am certainly pleased that my first Committee hearing is so simple and not very complicated. [Laughter.]

Let me ask, so I may understand a little bit more about what we are doing—I am also a co-sponsor of the legislation. I take it that under the previous situation the person assigning the value of the transferred equity under the estate freezes was pretty much the transferor, i.e. his estate planners. And the problem was that there weren't any real guidelines on how to value of the transferred property under the existing estate freeze rules.

Mr. GRAETZ. I think that captures it pretty well. The only thing I would add is that the guideline that exists under normal estate tax valuation purposes is that one assess value based on what a willing purchaser would pay a willing seller at arm's length. What that meant was that by retaining certain discretionary rights that in a family context the transferor would never exercise, rights that simply would not be exercised, you could assign value to the right that was retained by the transferor and avoid gift tax.

The problem, therefore, was not just one of factual dispute, but in fact was a problem of the wrong legal standard, that is, applying a rule that simply did not measure value properly when a family transaction was under consideration. That rule enabled significant amounts of assets—not limited to small businesses, I might add, for large businesses as well as small—to escape the transfer tax system entirely.

It is the concern with the reintroduction of that prospect that makes it necessary, I think, for the Congress to fashion a replacement for Section 2036(c), rather than simply repealing it. This was recognized, by the way, in the report of this Committee last year.

Senator BREAUX. As I understand it, the recommendation that you are making would be to take the value of the whole estate minus for instance the QFPs and then assign that total value to the transferee which results in an increase in amount of gift taxes that would be paid to the Government?

Mr. GRAETZ. What the basic proposal of the Discussion Draft does is treat as retained value those rights which represent fixed rights to payment. That allows all future appreciation in the property to be transferred to the younger generation free of tax. That is a major difference between the draft and current law which will return the value of that property to the transferror's estate upon death, including appreciation that occurs subsequent to the transfer.

The second thing the draft does is enable the older generation to provide themselves sufficient income for retirement security, so that they can retain income during their lifetime and also retain voting control of the business without triggering tax.

It gives the children an incentive through their enjoyment of the appreciation to continue the business and to improve the business. And it allows a small business to determine its estate taxes in advance of death.

Those are major improvements in current law. That is why we regard the Discussion Draft as a flexible solution, a flexible approach to this problem. What it is attempting to do, which is difficult—and I share your feelings about some of these tax provisions even though I do deal with them more regularly than you have in the past, although I feel you will be seeing them with a great regularity in the future—what it does is it creates a good bit of certainty in an area in which both prior and current law have been very uncertain. That is a hard thing to do.

That is why the Discussion Draft has created the comment that it has created. That is why this process is so useful in trying to solve those problems.

Senator BREAUX. One final question if I may, Mr. Chairman.

I take it that under the proposal we assume that the QFPs are in fact made?

Mr. GRAETZ. Yes.

Senator BREAUX. Suppose only half of them are made.

Mr. GRAETZ. The Discussion Draft says that if the amounts are not paid, the unpaid amounts will be treated as a deemed gift if they are not paid within 3 years of the time that they were supposed to be paid, unless the taxpayer makes an election to have those unpaid amounts compound. In the latter case, there is no gift tax at the time the payment was not made. There also is an exception for insolvent businesses to that rule.

Senator BREAUX. Thank you, Mr. Chairman.

Senator BOREN. Thank you, Senator Breaux. Let me say again we do welcome you to the Finance Committee and to your first hearing.

I would say to the witness, we have learned by a long tradition in this Committee that any time a member of this Committee from the State of Louisiana—and there is a lot of history to bear this out—says I do not understand too much about the complexity of this Tax Code, you better hang onto your wallet for sure. [Laughter.]

I can tell that Senator Breaux is carrying on in that worthy tradition of Louisiana representation.

Senator BREAUX. They also did not tell me it was going to be like this.

Mr. GRAETZ. I appreciate the advice, Senator. [Laughter.]

Senator BOREN. Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman. I join in welcoming Senator Breaux here also.

Senator BREAUX. Well I think I am welcome here.

Senator BOREN. Let me say we would rather have him on the Finance Committee though than any other possibility you mentioned. [Laughter.]

Don't quote me on that.

Senator SYMMS. Mr. Graetz, one of the questions that I have concerns your testimony that the outright repeal of Section 2036(c) would be in the neighborhood of a billion dollar cost to the Treasury over a five-year period. Is that correct?

Mr. GRAETZ. Yes, sir.

Senator SYMMS. Have you done a dynamic model to analyze the long-term gains to or losses from Treasury of taxable income resulting from a policy of allowing and encouraging businesses to continue to produce taxable income. The current policy causes a decrease in taxable income by forcing families to remove capital from their businesses to pay the tax collector. We should, instead, promote a simplified policy that increases taxable income.

The death tax, is one of the most obnoxious taxes in America, because people have already paid taxes throughout their life time to accumulate the estate and then as a reward for death, the Government comes in and claims another share of it. So have you done a dynamic model of what would happen if we just repealed it?

Mr. GRAETZ. Well, Senator Symms, the estate tax currently applies to about 1 percent of decedents dying in the United States. It is a tax which applies to a very narrow group of income earners

and, therefore, I would be surprised if even over a long-term analysis one would show a great impact on taxable income due even to full repeal of the estate tax. I do not think that is very likely, given the fact that this is a relatively small tax, burdening a relatively small number of people.

Senator SYMMS. Well it is not a small tax when you tax someone 55 percent or 37 percent in excess of an estate. I think it also impacts those employees that work for the person who dies. They are also affected by this. And the spill off of millions of Americans are affected by it.

Mr. GRAETZ. Senator, I did not mean to suggest it was a small tax to those people who face the burden of paying it.

Senator SYMMS. Also consider the employees of those people.

Mr. GRAETZ. The evidence of the estate tax's effect on wages is really not significant.

Senator SYMMS. Let me ask another question then. Out of those 1 percent of the taxpayers who are in this situation, do you have any numbers on how many businesses are forced to liquidate out of business in order to meet their estate tax obligations?

Mr. GRAETZ. I do not know of a specific answer to the liquidation question. I think that number would be very small. That is because the proportion of small business assets within the overall compass of those assets subject to the estate tax is relatively small. That is, it is on the order of 10 or 15 percent of total assets. So I think that that number would be quite a small number.

On the other hand, Senator, if your concern is with liquidation of small businesses, there are currently provisions for postponement of estate tax and for special valuation in some cases. Those provisions seem better addressed to the problem of liquidations forced by estate taxation than the problem that we are discussing today, which is the voluntary transfer of the business to the younger generation through a freeze transaction.

So I think that to the extent that that is the concern—and I think it is worth examining that concern; it is a genuine concern—there are really other provisions of the estate tax that are better suited to addressing that kind of concern.

Senator SYMMS. Just how would the Treasury's proposal address that situation of business liquidation?

Mr. GRAETZ. Well the Treasury's proposal, as compared to current law, will produce far fewer—It is not, by the way, the Treasury's proposal. You have referred to it a number of times and now I have lapsed into the same language. It is the Discussion Draft of the Ways and Means Committee which the Treasury Department has supported. So I am prepared to—But the Treasury's——

Senator BOREN. Is the legitimacy of its parentage somewhat in doubt now? [Laughter.]

Mr. GRAETZ. I have expected to create much havoc, but putting the legitimacy of parentage of statutory provisions into question is unanticipated in my experience.

Senator BOREN. We could refer to it as the bastardized proposal. [Laughter.]

Senator SYMMS. Mr. Chairman, I thought our goal here—I was to simplify the Tax Code. It appears to me like this provision complicates the situation. We should be looking for ways to simplify it.

Without simplification business owner's heirs will be exessively burdoned with an increased cost to them and be forced to hire more professional assistance people simply to maintain compliance with the tax laws. A flat, straight out repeal would be a much simpler way to handle the estate tax freeze.

And then, as I have suggested, simplify the rates. I can see no justification in the current estate tax laws to tax people on an estate at a rate greater than the highest income tax level. There just seems to be no rational, fair justification for this current policy. It seems logical and natural for the Treasury Department to be supportive of a rational change in the current estate tax.

Mr. GRAETZ. Mr. Chairman, since I have distracted us with my comment about the parentage of the proposal I would just like to respond briefly to say that the Discussion Draft will burden estates far less than current law. It imposes a gift tax at the time of the transfer. It finalizes the tax liability at that time. And it says to owners of businesses, you are done, you do not have to worry about estate taxes on the subsequent appreciation on the property that you have transferred to your children.

So I think that rather than causing businesses to liquidate, as compared with current law, this provision would greatly ameliorate the affects of Section 2036(c). I just wanted to make that point clear.

Senator BOREN. Secretary Graetz, let me say that I understand what Senator Symms is getting at. He and I have worked together on a number of estate tax provisions in the past. One of the first things I did when I came here as a Senator was to write the provision of the law that did away with inheritance taxes in essence between spouses. I feel that that should not be an incidence of taxation, and that husband and wife work together as a team.

The estate taxes today are in a much different framework than they were back when estate taxes were imposed. Because we did not have income taxes back in the early period in time or we had income taxes exceedingly at low rates, we were therefore using estate taxes to prevent huge concentrations of wealth from building up in the country. We are not in that situation now. It is almost impossible for that to occur today given the nature of the tax system.

For example farms generate very little cash flow. Therefore, even if an estate tax is postponed the ability to ever come up with sufficient cash to get over a big hump in terms of a chunk of money that is due and owing a large amount, even though it is apportioned out over a number of years through a postponement mechanism, it becomes very hard. Because there are some small units—farms, small businesses in small towns, rural communities are examples—where the generation of cash flow is very, very difficult.

It does not really make a difference whether the lump of cash has to be obtained after the death of the owner to be paid by the next generation whether the lump of cash has to be obtained now up front through say a 20 percent valuation rule or something else in order to have an incidence of taxation. The problem is, the business especially small businesses, just cannot generate the kind of cash flow needed to come up with that lump of cash.

So I think we have to be very, very careful when we get into 20 percent rules. The other thing is, the smaller the business, obviously, the higher percentage burden the hiring of expertise becomes. When we get into reappraisals and we get into having to hire additional estate planners in complexity, as Senator Symms has said, the harder burden that is on a very small business. The smaller the business is, the bigger proportional burden it becomes in order to take care of the business.

I wonder if we might consider doing something additional for small businesses as a category, if there are certain valuations that would relieve them further from certain rules and regulations and that the costs of these become even more onerous. But, if we were going to err on losing a few dollars to the Treasury or losing a lot of small business units that were forced into liquidation or sale to larger units, I would far rather run the risk of losing a few dollars to the Treasury as opposed to losing a whole lot of units, small family-owned economic units, in the country. People that make up the small businesses pay income taxes anyway.

I think in the long run the Treasury will be worse off because that income will not be generated and those jobs will not be there.

So philosophically, I think we need to go back and look very, very carefully at everything in your draft that gives small businesses a hill to climb at any one point in time. We need to start with the assumption that they are not going to generate very much ability to come up with lumps of cash.

Mr. GRAETZ. Mr. Chairman, just to comment on that. To the extent that you are concerned with liquidation of small businesses, we share your concern. The estate tax does have liberal rules for deferred payment. And if we could craft a provision that would deal with liquidation situations and hardship situations we would be delighted to respond to that.

I do want to express caution about the approach of trying to give small business relief by allowing people to engage in what might well be abusive estate freeze transactions which would only occur after the kind of professional advice that you are trying to avoid. This is a problem that is not limited to small or illiquid businesses. To the extent that that is the concern, I think we ought to focus our efforts on addressing that concern without opening up opportunities for large liquid businesses and owners to simply drop out of the transfer tax system, in response to a situation where the concern of the Committee is really far more limited.

This is an arbitrary way to help small businesses. I think we should be careful to focus on the small business problem to the extent that is the problem the Committee is concerned about.

Senator BOREN. I understand what you are saying. I think we do have to be very careful. Quite frankly though, there are a lot of us who feel that the damage done by 2036(c), that the cure for any potential abuse which we do not have too much scientific basis to prove is really there, that the cure is far, far worse than any possibility, even any wildest hypothetical possibility of abuse that existed before this outrageous provision was put into the law.

So given the choice between repeal or keeping the law as it is, in my mind, I do not have to think about that three seconds. I think that there is a clear case to be made for getting rid of this out of

the law. If we cannot come up with something that really works, that does not put a burden on, small business then I think any possible problem we had is very small compared to the problem we have created by putting this in the books and we ought to get rid of it.

So I think I have to say honestly the burden is on the Treasury. From my point of view, to tell us that they have come up with a plan that is so workable, unburdensome to small business, and unlikely to cause a liquidation of small business, that we should adopt it as opposed to outright repeal.

Otherwise, I think we should move on as speedily as possible and it should not be a very complicated mark-up. You would just need one line to get this out of the bill. So we keep coming up with problems. In terms of the alternatives I noticed, for example—I believe this is true—that the Discussion Draft would apply to stock that is traded on an exchange or sold over the counter under this rule, the 10 percent rule, that if a child if they happened to buy stock in an exchange and the family happened to own 10 percent or more of the preferred stock, even though they bought it on the stock exchange, for obviously a publicly traded value, that they would fall under this rule potentially.

I do not know that that was intended, but that is——

Mr. GRAETZ. Our statement agrees that that provision is unnecessary and overbroad and we would support cutting back on it.

Senator BOREN. So I worry that there may be a lot of other ticking time bombs. We have isolated some others. We have noticed some here today and some which you have agreed that we should look at. For example we should look at this 20 percent rule three-year reevaluation; we should look at this one and some others. There may be more.

I just think we have to take seriously what Senator Symms, Senator Breaux, and Senator Daschle said. If we are not going to stick with outright repeal we have to be sure we are coming up with something that is simple, workable and not too burdensome on the small business that really will be an improvement. This would be a very significant improvement over the current law.

We appreciate very much your coming. I know you have to go on to another meeting and we know that you are standing in today for the Assistant Secretary. We appreciate it very much that both of you have been available to our staff and to the members of the Committee. Let me say we appreciate the fact also that the essence of your testimony as you understand there is a problem with current law. You are not here defending current law, you are looking for ways to change it and improve it. That certainly is a good starting point. You certainly have been willing to intellectually confront the suggestions that we have made and to be open to these.

We appreciate that spirit and we are very hopeful we will find a way through this to really do something positive.

Mr. GRAETZ. Thank you, Mr. Chairman. We look forward to working with the Committee as this process continues.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. Graetz appears in the appendix.]

Senator BOREN. We will now move to our panel consisting of Mr. Jere McGaffey, Donald Lubick, David Burton, Deborah Walker,

Mr. Jere McGaffey is chair-elect of the section on taxation of the American Bar Association which of course has had interest in this matter and some proposals to make. He is (a partner of Foley & Lardner) from Milwaukee, WI. Mr. Donald Lubick is with Hodgson, Russ, Andrews, Woods & Goodyear, testifying on behalf of the Taxation Section of the District of Columbia, which has made proposals in reference to 2036(c). Mr. David Burton is manager of the Tax Policy Center, U.S. Chamber of Commerce. And Ms. Deborah Walker is a member of the executive committee, the American Institute of Certified Public Accountants here in Washington.

I should have looked at this list and not said that we were opposed to keeping accountants and lawyers employer awhile ago. I will have to apologize for that.

But we are happy to have the members of the panel here. I would suggest that we will enter the full statements of each of you into the record. And what might be most helpful to us is to have you—since the members will all read your written testimony—summarize or hit the high points of your testimony; and perhaps it would be best to hear from the entire panel. We will then open to questions from members of the Committee.

I do not know if you have talked among yourselves who would like to lead off. Mr. McGaffey, would you like to lead off and then we will just perhaps follow in the order of which I have read them off here just a moment ago.

We are happy to have all of you here. We appreciate your taking time to be with us and share your expertise.

STATEMENT OF JERE D. McGAFFEY, CHAIR-ELECT, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION AND PARTNER, FOLEY & LARDNER, MILWAUKEE, WI

Mr. McGAFFEY. Thank you, Mr. Chairman, and members of the Committee. My name is Jere McGaffey. I am Chair-Elect of the Section of Taxation of the American Bar Association. I am here today speaking on behalf of the American Bar Association at the request of Stanley Chauvin, President.

I wish to explain the alternative to Section 2036(c) which was developed by a Task Force of not only the Section of Taxation, but also the Section of Real Property, Probate and Trust Law of the American Bar Association and the American College of Trust and Estate Counsel.

I am pleased to be able to testify today on alternatives to the present Section 2036(c). Repeal of 2036(c) is the position of the American Bar Association. I believe there is general agreement that 2036(c) is too broad and ambiguous. Its scope has been extended to too many transactions that are not only not abusive but have no estate planning intent. Detailing these did not seem to be necessary at this time. But important is, the experience with 2036(c) demonstrates the large number of taxpayers and transactions that can be affected by legislation in this area.

We recognize that there were abusive freeze transactions prior to the enactment of 2036(c) and we, therefore, believe that an alternative is necessary. The substitute, however, should not interfere with other non-abusive transactions.

We want to compliment all those involved on the Government side in considering alternatives. The tax writing committee staffs and the Treasury have been interested in our views on alternatives. We have been provided with statutory language and a Discussion Draft making it possible to analyze an alternative in light of a variety of transactions that it might affect. Holding these hearings provides a formal means of providing comment. We are most appreciative of the suggested changes made by Treasury today. We thank all those involved for this procedure.

Too often in the past it has seemed to me personally at least that major revisions in the estate tax area have been viewed by both sides as part of some "cold war." The approach to revision of 2036(c) has caused confrontation to be reduced and more recognition of common goals.

I believe the action of the American Bar and of ACTEC has been balanced and thoughtful. We recognized that there were problems with 2036(c), pointed them out, asked for their repeal, began work on a substitute and the core idea of our substitute was adopted, we believe, by the Discussion Draft; and we all testified before the Ways and Means Hearing and pointed out suggestions. I gave 34 specific suggestions for improvement.

And even though we had some basic problems with the Discussion Draft we continued to make technical comments to improve it. Our willingness to cooperate and our appreciation for the process followed to date, however, does not lessen our belief that there are some significant problems.

In the Discussion Draft we stated that we were mindful of the concern for adequate enforcement of the estate and gift tax laws; and in our proposal then, therefore, we recommended substantive change rather than merely urging more stringent enforcement efforts by the Service.

We viewed that the classic problem was in a preferred stock recapitalization was that noncumulative preferred was issued on which dividends were not to be paid and some other feature was added in order to give justification for value. The typical features were ones of being able to put the stock or convert it or liquidate.

Therefore, in our proposal we started by addressing those problems and we stated that for gift tax purposes in the case of nonpublic stock and partnership interest, they should be valued in order to maximize the value of the gift by assuming the discretionary liquidation conversion dividend or put rights retained by the donor or the donor's spouse will not be exercised in a manner adverse to the donee's interests if the donee is a member of the donor's family.

We also went on and provided for a safe harbour in the provisions which dealt with the issue of compounding and a minimum value. We believe that there is substantial value in this approach. We and the Treasury, I think, agree on where we differ. We believe that it is better to define what is bad and prohibit them rather than to indicate what is good because of the large number of transactions that are involved in this area. We believe that there is a lot of value to a safe harbour. That it is better to have a safe harbour at 20 percent so that people can then realize they have to face that issue, the problem is not whether 10 or 30 percent is correct, the abusive transactions were less than one percent.

We have given careful consideration to the approach taken by the Discussion Drafts. We testified before Ways and Means. We find merit in it. However, we seriously believe our report is a better approach. We believe it is significantly less intrusive and complex and equally able to take care of the historic abuses.

Thank you, Mr. Chairman.

[The prepared statement of Mr. McGaffey appears in the appendix.]

STATEMENT OF DONALD C. LUBICK, ESQ., ATTORNEY, HODGSON, RUSS, ANDREWS, WOODS & GOODYEAR, TESTIFYING ON BEHALF OF THE TAXATION SECTION, DISTRICT OF COLUMBIA BAR, WASHINGTON, DC

Mr. LUBICK. Mr. Chairman, everybody seems to be agreed that the basic abuse in the estate freeze situation is one of improper valuation. The transfer to the transferee, to the child in that generation, is undervalued. The retained interests are overvalued.

It seemed to us at the D.C. Bar Tax Section as we studied the problem that the best approach is not that of 2036(c) which is to change the structure and put new substantive rules and bring new things into the estate nor is it the approach of the discussion draft which prohibits by taxing or by valuing at zero certain transactions that are arbitrarily defined. Then it requires subsequently at the time of the estate a complicated tracing procedure in order to readjust things.

But instead, let's go at the problem. Let's deal with the valuation of the transfer at the time the transfer is made. In order to do that it seemed to us that one had to put appropriate tools in the hands of the Internal Revenue Service, which is faced with the problem of valuing things all of the time. That is part of the tax law. And if adequate reporting of those transactions that are within the 2036(c) framework is required, that would deal with a great part of the problem.

Too often, as Mr. Graetz testified, these transactions were structured so that the transferror could claim that no gift was made or a gift under $10,000 which did not need to be reported or that the transaction was a sale. We would require reporting to the Internal Revenue Service of the sale transactions, of transactions regardless of the amount, if the transfer is claimed to be as small as zero and then let the Service have the opportunity in the light of day to deal with the situation.

Second, we would give the Service an additional tool by giving it time. If the transaction was not reported or if it was improperly reported, if it was not audited, the subject could be revisited at the date of death because we would require again reporting of these transactions that were made during lifetime. The Service would have the benefit of seeing whether or not by the virtue of conduct that had occurred after the transfer whether or not those conditions and limitations that had been put in to justify the valuation were indeed part of the original intention.

We would not foreclose a business showing of business reasons for deviation, but we would have a chance to get a crack at it in the light of history. In that case we believe that the most abusive

transactions would never surface. It has been my experience that taxpayers who felt that the abusive situation would be scrutinized by the Internal Revenue Service would not do it.

Now in addition to extension of the time for the Service to go after these and for them to have an opportunity to deal with the transaction, we have also suggested that where there are technical rules of valuation as decided by the courts that appear to be inappropriate, that make it difficult to achieve a correct valuation, those rules can be addressed specifically. But we do not need a whole new comprehensive, but not comprehensible, scheme that will make it even more impossible for the Service to administer. We have too many provisions that are of such great complication that not only can taxpayers not deal with them, but the Service itself cannot do it.

So we think that what you should be looking at is taxing the value of a transfer at the time it is made and taxing it at its fair market value. If subsequent transfers are made through the lapse or failure to exercise certain privileges retained, then those are taxable transfers as well. They should be required to be reported, and taxable. And finally, at the time of death, the Service will have a look back and be able to deal with the entire situation.

It seems to me we can therefore solve the problem of abuses without introducing new substantive concepts that are basically of a Humpty Dumpty nature. You are defining things as so that are not so.

I will yield the rest of my time.

Senator BREAUX. Thank you, Mr. Lubick.

[The prepared statement of Mr. Lubick appears in the appendix.]

Senator BREAUX. Mr. Burton?

STATEMENT OF DAVID R. BURTON, MANAGER, TAX POLICY CENTER, U.S. CHAMBER OF COMMERCE, WASHINGTON, DC

Mr. BURTON. Thank you very much, Mr. Chairman. My name is David Burton. I am manager of the Tax Policy Center of the U.S. Chamber of Commerce. We appreciate the opportunity to present our views today on various proposals to repeal Section 2036(c). The Chamber has actively supported repeal of Section 2036(c) and we would like to express our appreciation of your support of repeal legislation, Mr. Chairman, and the work of Senators Daschle, Boren, Senator Roth and also Senator Symms in this area.

The Chamber supports the core concept underlying the House Ways and Means Discussion Draft of establishing reasonable rules to value for gift tax purposes retained interests and estate freeze recapitalizations while abandoning the estate inclusion approach of 2036(c).

There are, however, significant problems with the Discussion Draft and unless a number of improvements are made in the Draft the Chamber cannot support it. The Draft covers far more than abusive recapitalizations. It is extremely complex and provides inadequate protection against business downturn.

We have drafted a statute based on the core concept set forth in the Discussion Draft which we believe corrects the shortcomings in

the Discussion Draft and will provide a workable solution for these problems.

The Discussion Draft affects all buy-sell agreements whether or not they are estate and gift tax motivated and whether or not they are abusive in any way. This represents one of the most serious problems with the draft. It would disregard rights of first refusal and require buy-sell agreements to be renegotiated every 3 years. It is hard to overemphasize the importance of this provision to small businesses.

The Draft establishes an arbitrary and unfounded requirement that the junior equity interest be valued at no less than 20 percent of the sum of the equity and any debt owed to family members. Including debt in the calculation is improper and also in practice will lead to situations in which many very typical small businesses will not be able to engage in a transaction. Twenty percent (20%) is simply too high for estate recapitalizations to remain viable for family businesses.

The only exception to the deemed gift provision and compounding election under the Draft is for bankruptcy and insolvency. There should be an additional exception where a dividend would not be paid in an arm's length transaction, particularly when the business has suffered a serious downturn. The Chamber has developed a specific rule in our draft statute which states that if the business had adequate coverage to begin with and then suffered a downturn then deemed gift rule would not apply.

The Draft permits only two rights to hold value in determining the value of retained interests. They are voting rights and qualified fixed payments. This approach unfairly excludes many rights that are not abusive and are routinely used in the business world. Our Draft would value discretionary rights as zero and value nondiscretionary payments at their discounted value.

In addition, a number of enumerated rights, including rights under buy-sell agreements and rights of first refusal would be valued under normal market principals. Because of the importance of the discount rate to the valuation process there is considerable concern in the business community over how the rate will be determined in practice. There is concern that the rate may be set by the IRS or later in the political process at an artificially high rate. There must be some assurance that this will not, in fact, occur.

Additional issues that are of concern are the inclusion of leases and debts as interests in the entity, the definition of insolvency, the definition of family, the statute of limitations extension under the Discussion Draft, inclusion of trusts and joint purchases in the Draft and the potential unfavorable result of the compounded accumulative preferred election, which could result in the retained interest having a value in actual excess of the business. There are a number of other technical clarifications that we have suggested.

The ABA Task Force proposal has a number of desirable features in our view. It is narrowly targeted at recapitalizations, has no deemed gift provision and identifies specific discretionary rights that are zerc valued and permits others. This is preferable to the Discussion Draft which allows only QFPs and voting rights to have value.

The Chamber objects to a number of provisions in the ABA proposal, however, in particular the 20 percent minimum value requirement and the requirement that dividend or preferred income right be no less than the applicable Federal rate.

The D.C. Bar proposal also has a number of desirable features, but it has major problems as well. It is far less complicated than the Discussion Draft and it abandons the look back approach of 2036(c). However, it makes a number of changes that are traps for the unwary—in particular, if you do not jump through a number of hoops that they establish, you have what is, in effect, an unlimited statute of limitations and it also has some very adverse affects on rights of first refusal.

Thank you very much, Mr. Chairman.

Senator BREAUX. Thank you, Mr. Burton.

[The prepared statement of Mr. Burton appears in the appendix.]

STATEMENT OF DEBORAH WALKER, MEMBER, EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC, ACCOMPANIED BY WILLIAM T. DISS, CHAIR, ESTATE AND GIFT TAX COMMITTEE

Ms. WALKER. Mr. Chairman, I am Debbie Walker, a member of the Federal Taxation Executive Committee of the AICPA, and with me is William Diss, who chairs our Estate and Gift Tax Committee. We thank you for giving us and others the opportunity to present our views on a matter of intense interest to our membership—the difficulty of making lifetime transfers of family business interests.

We have testified a number of times concerning the repeal of Section 2036(c). We continue to believe that it should be repealed. Congress adopted a system far too intricate and complicated for efficient enforcement by the Internal Revenue Service or compliance by taxpayers and practitioners. Discussion of the estate and gift tax values must include an understanding of two inter-related goals—preservation of the transfer tax system and continuation of family-owned businesses.

Transfer by gift before death provides incentives to younger generations to further develop a family business. The transfer tax system should encourage transfers by gift. The preferred stock recapitalization was a reasonable means of alleviating the transfer tax problem. Other measures could encourage lifetime transfers. These include such as Senator Symms mentioned, lower transfer tax rates, a significant exemption for family-held businesses, special valuation techniques, and a delayed pay out of estate and gift taxes perhaps at a lower interest rate.

The transfer of businesses should be encouraged and the valuations used for the transfer of a business interest should be the same rules that apply to other property, fair market value, as embodied in the willing buyer/willing seller concept. The value, however, should be supportable during an Internal Revenue Service audit. We recommend an expanded reporting requirement which informs the Internal Revenue Service when sales or transfers were made, irrespective of whether taxes were paid at the transfer. The reporting should include a detailed analysis of the valuation and

the computation method used. For transfers in excess of certain amounts an appraisal could be required.

Congress should not legislate a valuation system with a conclusive presumption. However, some taxpayers would be well served with a safe harbour methodology for valuing property. Once you have determined the total fair market value of the business entity the transfer tax system next should determine the value when an individual transfers only a partial interest in the entity.

Turning for a moment to the discussion draft, we support the application of a special valuation approach for transfers of interests in family businesses because we believe that an approach such as that can be a means of encouraging the transfer of property by gift. We want to emphasize, however, our concerns regarding the market interest rate used to value the stream of payments reserved by the transferor.

While we believe it is appropriate to use a market discount rate to value retained rates such as preferred stock in the entity, the rate of return generated by a closely-held business is not equivalent and cannot even use as a model the market rate for traditional or portfolio investments. Many closely-held businesses and farms realize a much lower rate of return for the risk that they assume than that commensurate with the return demanded by the capital markets for equivalent risk.

Many entrepreneurs and small business owners traditionally evaluate the decision to remain in business, to continue to provide a service, much differently than the capital markets do. In fact, these businesses cannot go to the market place and raise capital since the market place itself demands too high a risk premium. The valuation system incorporated in the transfer tax system must consider this inability to go to the capital markets and the reason that that inability exists.

We recommend a series of elective safe harbour rates which can be used by the taxpayer to discount a stream of payments. One safe harbour which we especially urge you consider is a discount rate based on the internal rate of return calculation, a cash flow calculation. The calculation can be made with the information reported on annual income tax returns.

A second safe harbour could contemplate a discount rate based on industry norms in which the business operates. Whatever rate is used, it is absolutely mandatory that the rate take into account the difference between dividends that are nondeductible and deductible interest. In many cases a business cannot structure a stream of payments as interest even though our income tax laws make it preferable to do so.

In determining the valuation of transfers other possible implications within the Internal Revenue Code need to be considered. Specifically, the valuation systems should be usable by S Corporations. We recommend that the benefits of Section 303 redemptions be extended. Whatever proposal is adopted should adequately focus on other transfer techniques that could become as abusive as certain estate freezes have become.

The replacement for 2036(c) and any new valuation rules should consider existing arrangements which cannot be altered or modified.

36-968 0 - 91 - 2

We are pleased that a discussion of a review of Section 2036(c) is focused on the larger question of valuations. It is important that 2036(c) be repealed. A replacement to eliminate the valuation abuses which sometimes occur should be focused narrowly on those abuses and not involve sweeping changes. Detailed information reporting will significantly curtail those abuses, conclusive valuations cannot be legislated but safe harbours would be appreciated.

Computation of the valuation for the retained interest should truly reflect the market in which individuals operate. Small business tends to short on working capital and cannot go to the capital markets. Thus self-generated funds are the only means available for maintenance and growth of the business and these self-generated funds should not be consumed by transfer taxes.

Thank you.

[The prepared statement of Ms. Walker appears in the appendix.]

Senator BREAUX. Thank you very much, and thank all the members of the panel.

Before I turn it over to our Chairman, let me just ask one more or less general question. That is, were the Congress to adopt some of those suggestions in a Discussion Draft are we still going to provide a system of rules and regulations that will allow for the transfer of businesses? Are we going to make it so complicated that it is no longer going to be feasible to in effect transfer a business from one generation to the next?

Mr. BURTON. I will take it first, Senator. If you enact the entire Discussion Draft in its present form, it would clearly make it impossible for most small businesses to do reasonable estate freezes or recapitalizations. On the other hand, if you just take some of the core ideas in the Discussion Draft and take away a lot of the unnecessary and adverse rules in the Discussion Draft, we believe that it represents a workable solution to the problem that would enable a lot of small businesses that need to do recapitalizations to do so.

Senator BREAUX. Mr. Lubick?

Mr. LUBICK. Mr. Chairman, we believe that the Discussion Draft is ill advised in setting up these artificial constraints in making it very difficult to enter into transactions that are shaped by normal business considerations. However, I do not think I could honestly say that it is going to preclude the transfer of businesses. People will adapt to those things. There are other techniques that can be used.

In particular, if estate planning starts at an early stage on a timely basis that can be used even under 2036(c), I do not think you are facing Armageddon.

Mr. MCGAFFEY. We are dealing with two different issues here. One, Section 2036(c) and the Discussion Draft are dealing with valuations in a preferred common context. A great many corporations operate with solely common stock and they are transferred by gifts of the common stock from one generation to another or people die with common stock and one way or another the estate plan is dealt with.

I think that the greatest danger in the Discussion Draft is not the estate planning transaction that is designed with preferred and common stock; I think those will be drafted in order to meet the

safe harbours of the Discussion Draft. I am worried about the transaction that nobody thought of as an estate planning device. It was motivated by totally different considerations. A preferred issued because a widow needed income or a member of the family that wasn't in the family needed income and they did not go to an estate planning lawyer; the corporate lawyer drafted it and made those kinds of arrangements.

I think then all of a sudden the dividend is not going to be paid and we are going to get a big deemed dividend tax. We really need to be able to make other kinds of transactions that are not estate planning motivated that the Section does not impinge upon. We are dealing now with an area where every kind of transaction that affects the capital structure will have to be analyzed in terms of whatever the substitute legislation is.

So we think a more narrow focus is the one that should be used.

Senator BREAUX. Okay. Let me turn it over back to our Chairman. Ms. Walker, do you have a comment on it?

Ms. WALKER. Go ahead.

Mr. DISS. Could I add a general comment? We believe that the buy-sell agreement governance should be excluded from Chapter 14. Also that only equity interests in enterprises or entities should be considered. If leases and loans and other forms of interest can be reached by Chapter 14 you have the same complication and uncertainty that is present with Section 2036(c).

Senator BREAUX. Thank you.

Mr. Chairman?

Senator BOREN. Thank you very much.

Do you feel that the IRS would have proposals administering any of the individual proposals that you have made? Do you see difficulties for the IRS mechanically?

Mr. LUBICK. I think the IRS would have an awful time administering the Discussion Draft. As has been indicated, if certain items are valued at zero at the time of transfer, then at the time of death they have to trace it through and do a revaluation.

I think that the purpose of our testimony, was to indicate that you are playing Humpty Dumpty. You are saying things mean something that they are not by paying them well. That is why our approach essentially was to go under the pre-existing, old-fashioned way of doing things. Let's value things as they are transferred under valuation techniques, but give the IRS the tools. Put the sunshine on it to make sure that they are apprised of all of the facts of the transaction, that it cannot be cloaked as a sale, it cannot be cloaked as a zero or a $500 gift. But give them the chance to get out there and fight.

There are plenty of IRS agents sitting around waiting for something to do since, Senator Boren, you put in the unlimited marital deduction. They have a lot less to do in the estate tax field. Let them go after this.

Senator BOREN. Do the rest of you agree that one of the real things to avoid is not having the valuation made at the time of the transaction, but having the possibility of it never being fully completed until later?

Mr. BURTON. Yes. In addition, in our draft we propose that there be parity for both the original gift tax valuation and the estate tax valuation.

Mr. MCGAFFEY. I think one difference between the Discussion Draft, and the Chamber, and the ABA proposals, and the D.C. Bar proposals is the Discussion Draft and our proposal attempt to devise a substantive rule that will be self-enforcing in an self-assessment system, where you will not be able to use bells and whistles to give an excuse.

I think in the discussion draft, the most complicated thing that I think the Service would have to deal with, is the deemed gift which requires gift tax and then refunds of gift tax. I think that there is going to be problems in administering that, even though in theory it ought to work fine.

I think that is the most difficult issue to come up with a solution for; and it is one key issue which as Treasury points out, the two of us disagree on.

Senator BOREN. Each of you have put a slightly different proposal forward. If you were ranking the proposals other than your own, that come close to meeting the objectives of the specific proposals you have met, what would you say would be preferable from your point of view?

Mr. BURTON. Well from our perspective, I think the two we have studied in detail are the ABA proposal and the D.C. Bar proposal. If faced with that choice, we would prefer the ABA proposal to the D.C. Bar.

Mr. LUBICK. I just moved the Chamber of Commerce down to four, Senator Boren. [Laughter.]

Senator BOREN. We do not want to start any fisticuffs here at the table.

Mr. MCGAFFEY. Well I guess we are in a situation where we look at the kind of approach that the Chamber is closer to our kind of approach. The D.C. Bar approach, there is a lot in it about statute of limitations, and information reporting, and there is some real merit. And we gave a lot of consideration to that approach. We kept being told that it was going to be very difficult to enforce a system on that basis, on the one side.

On the other side, I have to say that a good many of my colleagues were very leery of an open statute of limitations and wanted certainty.

Senator BOREN. Wanted finally to come to closure on this at some point.

Mr. MCGAFFEY. Then they can figure out how much insurance they need to buy. You know, let's face up to it in the estate planning liquidity situation.

Senator BOREN. I understand.

Ms. WALKER. We would have to go with the U.S. Chamber proposal. The way we approached it was to start with the discussion draft and look at that and see if we could refine that.

I would just like to point out that I think that within all these systems, if you are going after the abusive transactions which, of course, we are, the place to do that is in enforcement. And enforcement should not involve writing a statute that tries to catch everything. We should spend our resources giving tools to the Internal

Revenue Service to stop the abuses. Practitioners, taxpayers, everybody will be better off.

Mr. LUBICK. Senator, I would just like to say that any proposal that is attacked by the Treasury, the ABA, the accountants and the Chamber cannot be all bad. [Laughter.]

Senator BOREN. As John McLaughlin will say, that will be the last word from this panel. We appreciate all of you taking time to be with us today. We appreciate the suggestions you have made and the thoughtful advice that has come from you.

Our next panel will be a Mr. Harry Gutman a partner of Drinker, Biddle & Reath of Philadelphia; Mr. Richard Dees, capital partner of McDermott, Will & Emery of Chicago; Mr. David Lajoie, partner of Coopers & Lybrand, chairman of the Subcommittee on Income Taxation of Estates and Trusts, American Institute of Certified Public Accountants; Mr. James Gamble, chair of Estate and Gift Tax Committee of the American College of Trust and Estate Counsel; and Mr. Harold Apolinsky, vice president of government affairs, Small Business Council of American, adjunct professor of estate tax law, University of Alabama.

We are happy to welcome all of you here. We will do as we did before. We will put your full statements into the record and ask if you might simply proceed with the high points and then we will open to questions after we have heard from each one of you. You have also had the benefit of hearing the previous panel and it would be most helpful to us if you could just take two or three key points that each one of you would say. Give us the issues you most want to focus your attention upon and draw our attention to those. We will receive your full statements for the record.

Why don't we just work down the table. Maybe that will be easier. We will begin with Mr. Lajoie and we will just work our way down the table.

STATEMENT OF DAVID E. LAJOIE, PARTNER, COOPERS & LYBRAND, DALLAS, TX

Mr. LAJOIE. Thank you, Senator. My name is David Lajoie. I am a CPA and a partner with Coopers & Lybrand in Dallas, TX. I also Chair currently the Income Taxation of Estates and Trust Committee for the American Institute of CPAs.

I want to address just a couple of points that relate specifically to the concern that I have about the appropriate market rate. I had a client who attended the House Ways and Means Committee Hearing and the commentators were talking in terms of an appropriate market rate along the lines of the junk bond interest rates. It is absolutely frightening.

The client asked us to put together a projection under the Chapter 14 valuation provision as it would relate to his business so that he could see how this would affect some planning that he might do within his family for his family business. I would like to suggest that those of you that have the copy of the written testimony take a look at the example that we have on page 7. I would like to draw your attention to certain facts that are indicated in terms of the financial situation that would relate to that family business.

We have a family business that would have a total value of about $32 million. We would have to attribute 20 percent of that to the common stock, which would be about $6.4 million, and the balance—the 80 percent—would be attributed to the preferred stock. The concern that we had is if we compute a qualified fixed payment at any one of a number of different rates, we would want to see what kind of cash profit it takes merely in order to fund this qualified fixed payment.

So we ran 9, 12, 15 and 18 percent rates for the qualified fixed payments attributed to the 80 percent interest for the preferred stock. Now on page 7 let me just draw your attention to the fact that this particular result would occur whether you move the decimal point one point to the left or one point to the right. That is, whether it's a $3 million or $300 million business, the results expressed in percentages do not change.

In order to fund a 9 percent qualified fixed payment dividend on the preferred stock, you would have to have cash profits of 11.5 percent before taxes. You would have to have an 11.5 percent return on the entire value of the company in order to fund a 9 percent QFP based upon 80 percent value attributed to the preferred stock. If you move to 12 percent, you would have to have a return, a cash return before taxes, of 15.3 percent. With a 15 percent QFP, you would need a 19.1 cash profit before taxes merely to fund the QFP.

And if you got into the junk bond interest rates at 18 percent you would need a 23, percent return, before taxes. Obviously, not all businesses are going to be able to generate these kinds of cash profits before taxes, whether you are dealing with the 18 percent or you go all the way back to the 9 percent.

When the client saw this, he was very much concerned about whether he would be able to do anything. Even with the 9 percent, he said it would be a close call. Because in some years he might be able to fund that, but over a long haul he couldn't guarantee that his business, which is a successful business, would be able to generate those kinds of cash profits merely to fund the QFP.

Now the problem is that you cannot run the business merely to fund the QFP. You must have a sharing of benefits in the corporation that would be attributed to the common shareholders. And so what we need to do is to have value and benefit that would go to them in addition to the preferred shareholders. But we also must remember one thing else. We are dealing with the family business. And the way that a family business is going to be able to survive is to generate enough cash profits that they can retain in the business to make the business grow and to keep the business secure and to provide capital improvement and capital expansion opportunities.

Obviously, all of these things are very, very good when we think in terms of the family business context. So we would say that even the 9 percent QFP is too much. Part of the problem with funding a QFP is that some family businesses are less successful than others; even successful businesses are going to have lean years, and a lot of businesses are cyclical. For instance, cattle raising businesses are cyclical—good years and bad years cash-wise. These cash-flow concerns have to be taken into consideration.

One of the things that I would suggest for consideration, if we had to go this direction on a preferred stock, is to allow some kind of a relief provision that would be based on cash flow, perhaps a moving average over a three-year period. In the event cash flow does not allow the dividends to be paid during the period of time covering the current year and the 3 years following, we would have a provision which would allow you to waive the dividend payment and not have it constitute a deemed gift.

So what we are really saying is, we have to face some of the financial realities of life for the family business. And if you do not do this, we are going to end up back in the same boat where we were with 2036(c). This particular statute does not do the good job that it needs to do.

Senator BOREN. Thank you very much, Mr. Lajoie.

[The prepared statement of Mr. Lajoie appears in the appendix.]

Senator BOREN. Mr. Gutman?

STATEMENT OF HARRY L. GUTMAN, PARTNER, DRINKER BIDDLE & REATH, PHILADELPHIA, PA

Mr. GUTMAN. Thank you, Senator Boren, Senator Daschle. I am happy to be here today. I am going to focus my remarks on one particular issue. If there is time left I will discuss another discreet issue within the scope of the legislative solution to the estate freeze problem.

The particular area I want to address is the need for the statute to deal with buy-sell agreements. If there is an additional moment I will talk about joint purchases of property, which is a little more technical, and is in any event discussed in my statement.

I would like to emphasize the following points. First, buy-sell arrangements can be used to effect estate freezes and no one should be under any illusion that that cannot happen.

Second, current law is not adequate to deal with the abuse potential that can arise in the buy-sell area. As a result, I think that buy-sell arrangements between related parties with a striking price that is at other than fair market value ought presumptively to be disregarded for purposes of determining value.

Third, the purchase price that is set forth in a buy-sell arrangement ought to fix value if the parties can demonstrate that the terms of the arrangement are equivalent to those that would be entered into between unrelated third parties. In other words, there shouldn't be a penalty for all related party transactions. But we should recognize that there is an abuse potential and not just ignore it.

Fourth—and this is an issue that came up a little earlier—I believe that installment payment of the estate tax attributable to illiquid assets ought to be more widely available. If it were, I think that some of the pressure on the use of buy-sell agreements to anticipate liquidity needs could be alleviated. But in my view the interest rate on that deferred tax ought to be sufficient so that the present value of the deferred tax is the same as if the tax were paid presently. If the interest rate is lower than the market rate, in effect, the tax on the assets that are eligible for the deferred estate tax payment has been reduced. That is a decision that ought

to be made consciously directing that kind of relief to a specifically identified assets. That gets back, Senator Boren, to the discussion you were having with Mr. Graetz about targeting relief to small business.

The final point, which is a technical point, is that the income tax rules governing joint purchases ought to be modified in a way that treats the transaction essentially as if it were a coupon stripping bond. But that is, as I say, rather technical.

Let me just spend a couple of minutes discussing with you the buy-sell issue and then we can get back to it if you want. I take it that we are all familiar with what a buy-sell agreement is, essentially an agreement pursuant to which at some specified event, property that is subject to the agreement is going to be purchased or offered for purchase to another party at a price and on the terms that are specified in the agreement.

They are very important devices that are used in the business area, and in closely-held businesses, in particular. They serve very important and legitimate business functions. They are commonly used to control the devolution of ownership in a closely-held business, which is important. They are used to avoid expensive appraisals for determining purchase price and to determine and provide for liquidity needs in advance. All of these are legitimate concerns.

But, I think, on the other hand we have to understand that buy-sell agreements may be used to attempt to pass wealth on without the payment of transfer tax.

I have in my statement a simple example that I would like to share with you. Suppose we have an individual age sixty and the individual's daughter age thirty, both of whom own all the common stock in their business. The father owns 80 percent; the daughter owns 20 percent. They enter into an agreement which provides that no shares in that corporation are going to be sold without first offering the shares to the other at a price that is equal to book value at the date the agreement is executed, and at death the person who is the survivor has to buy out the other. So it is a book value purchase price.

Let us even assume for the moment that book value is representative of fair market value at the time the agreement is entered into. But in time, of course, the corporation increases in value and let us assume that book value is no longer representative of fair market value. That is the kind of agreement, if it is upheld for Federal transfer tax purposes, that ends up fixing the value of the stock at book value. In substance that agreement has exactly the same effect as a preferred stock recapitalization.

That is the point that is important. The value of the retained interest is frozen in the hands of the transferror and all of the post-execution value passes to the transferee and there is no transfer tax that is paid. That is exactly what happens with a preferred stock recapitalization.

Now given the age disparities in my example, it is more likely that the father is going to predecease the daughter; and the post-execution growth in the value of the common stock that is owned by the father is going to pass over to the daughter at a below-market value purchase price. It is unlikely that unrelated third parties of these ages would enter into this kind of an agreement.

Unrelated individuals who are dealing in this context would be likely to want to capture the full fair market value of their interest for the benefit of their families.

That is the problem that is posed by the buy-sell agreement. It serves legitimate business purposes but it can be used to manipulate value in exactly the same way as the recapitalization. Facing that issue is not an unfair attack on closely-held businesses. It is simply recognizing the fact that the potential for abuse is greater in closely-held family businesses than in businesses with unrelated third parties.

Now Mr. McGaffey and Mr. Gamble and others have said that there is no need for Chapter 14 or section 2036(c) to deal with buy-sell agreements. In their view, current law adequately protects the fisc in this area. I have enormous respect for them, but I just have to disagree. My reading of the law in the area leads me to believe that there are opportunities here for buy-sell agreements to be used to effectuate preferred stock recapitalizations in an abusive way and I think we ought to face up to that.

My short recitation of the cases, if you will, is in my statement. We do not need to go through that now.

Now I think, then, that what we have to do is address the issue. I would like to give you a couple ideas that I have on how to do it and then we can move on. I think the following parameters ought to be guidelines in this area.

First, there is nothing wrong with a buy-sell agreement pursuant to which the striking price is the fair market value of the property that is subject to the agreement. Everybody agrees with that. There is no abuse there.

When the striking price is less than fair market value then what is happening, obviously, is a transfer for less than full consideration. The real question is whether that increment of value ought to be subject to the transfer tax. In general, if that striking price has been negotiated in an arm's length transaction between unrelated parties it represents a bona fide business arrangement between the two of them, essentially a gamble between the two, as to who is going to die first. And it neither will, nor should, be subject to transfer tax.

When that increment arises in the context of a transaction among family members, it is suspect and it ought to have to be justified as the equivalent of an arm's length transaction. And essentially, that is the proposition: Arrangements between family members that have a striking price that is less than fair market value would be presumptively ignored but that family members have an opportunity to show that what they have done is the equivalent of what has been done or can be done among unrelated parties.

It seems to me that a resolution of that type strikes an appropriate balance between the recognition of the fact that buy-sell agreements have an abuse potential and also serve a legitimate business function.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Gutman appears in the appendix.]

Senator BOREN. Thank you very much.

Mr. Dees?

STATEMENT OF RICHARD DEES, CAPITAL PARTNER, McDERMOTT, WILL & EMERY, CHICAGO, IL

Mr. DEES. Thank you. My name is Richard Dees and I am a partner in the Chicago office of the national law firm of McDermott, Will & Emery. My testimony today really continues my testimony as an independent expert to the Finance Committee a year ago when as an invited witness I argued that the Section 2036(c) solution was more of a problem than the problem of estate freeze abuses. Due in large measure to the Finance Committee's leadership on that question, it is now the nearly universal view.

Since the estate tax was enacted family business interests have been valued by comparing those interests to non-family interests. Despite Treasury's startling testimony today to the contrary, everyone thought this was a fair rule because it taxed non-family and family owners alike. It is easy to lose sight of the basic policy issue in terms of a replacement statute and dwell on its technicalities.

The question here is how much higher estate tax will all family business owners have to pay to offset the possibility that some owners might abuse the fair market value test. Stated this way, any replacement to Section 2036(c) should be as fair as possible to family business owners by using the fair market value analogue and as narrow as possible to correct the abuse.

It is my view that the gift tax valuation approach endorsed by Treasury and reflected in the Discussion Draft is an acceptable framework. I think the Chamber's draft proves that it can be made to work. The reasons I think it is acceptable is that it gives a gift tax solution to a gift tax problem. It discards the notion of imposing both a gift and estate tax on the same transaction. It eliminates the strings concept. Taxing strings impact smaller businesses adversely. It means that the parents who own the business have to be forced out to escape the gift tax or adverse rules and that is not fair. It finally treats the family business as a mere estate planning device which I think is an inaccurate characterization although widely held by those who write the laws.

Third, it values the bells and whistles at zero. Although this is contrary to valuing these rights at their fair market value. If narrowly limited to the abuse situations and discretionary rights, it is an acceptable deviation from the market analogue.

Fourth, it values payment rights by discounting. This is an appropriate as the market would value similar payment rights. If we know the discount rate and it is acceptable and fair to family businesses, then this is a more certain approach than leaving it open.

Finally, it prevents abuse by imposing an upfront gift tax. If the retained rights are specially valued at less than the market value and a deemed gift if expected payments are not made. This substitutes a subjective business reasons test with more objective standards such as bankruptcy or insolvency and we would argue more objective standards might include diminution of income, limiting it to the value of the business, those kinds of things.

The Discussion Draft, however, in its details is not fair to family businesses. Its treatment of buy-sell agreements results in family business owners paying a higher estate tax than non-family busi-

ness owners having the same interest and I would refer in greater detail to the buy-sell discussion in my statement.

I believe that as a personal matter I could not advise on Mr. Gutman's example that they have really fixed the value under current law. So I do not think there is as much a possible of abuse as he does.

The 80/20 rule is another separate arbitrary valuation rule as Senator Roth described it. The inclusion of family debt in the computation is particularly discouraging. The qualified debt safe harbor was added to Section 2036(c) in 1988 to avoid the need for bank financing for family businesses where family financing was available. Adding it here is a step backwards in our understanding and there is really no explanation for including family debt.

However, no change in the percentage or computation can change the inherent discrimination in allowing an investor with cash to lend 100 percent of the capital to a child to buy a business while allowing the family business owner only to provide only 80 percent of capital to a child, even though the child may be active in the business. This is a rule designed to tax not 100 percent of the value of the business, but 120 percent, in the parent's estate.

The Discussion Draft also subjects certain retained rights to both gift and estate tax. This violates three principles of the gift tax valuation approach. It applies both estate and gift tax on the same transaction. It resurrects the strings approach and is inconsistent with the notion that the strings are just too hard to value.

Finally, there is no attempt to limit the IRS from applying a very high value to the business and, in fact, the Discussion Draft encourages it. I share Senator Boren's concern that there is no reason to value the business at its liquidation value when we have an ongoing family business.

In addition to making the Discussion Draft fairer, it has to be made narrower. And much of the criticism of Chapter 14 is directed at its complexities. This complexity is acceptable if only those who intentionally engage in preferred stock freezes or their partnership equivalents are impacted. It should be impossible to stumble into Chapter 14. A family compensation lease or debt arrangement should not be impacted by Chapter 14. The way the discussion draft is currently set up it is too easy to stumble into the Chapter.

By redefining preferred stock to include only frozen stock and by disregarding this cookie cutter notion that we have to have a laundry list of rights that are okay, the statute can be acceptably narrowed.

Thank you.

Senator BOREN. Thank you, Mr. Dees.

[The prepared statement of Mr. Dees appears in the appendix.]

Senator BOREN. Mr. Gamble?

STATEMENT OF E. JAMES GAMBLE, CHAIR, ESTATE AND GIFT TAX COMMITTEE, AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, DETROIT, MI

Mr. GAMBLE. Good afternoon, Mr. Chairman. My name is James Gable. I am attorney practicing in Detroit, MI with the firm of

Dykema Gossett. I appear here today on behalf of the American College of Trust and Estate Counsel in my capacity as chairman of its Estate and Gift Tax Committee.

I want to say to you that the College supports the retroactive repeal of Section 2036(c) as proposed by the Discussion Draft. We also support the objective of preventing abusive valuation freezes which is the objective of the Treasury Department and the House Ways and Means Committee. But we prefer our Joint Task Force Proposal which Mr. McGaffey described to you earlier this afternoon to the other proposals that have been placed before the Senate and the House.

I would like to address my remarks this afternoon to buy-sell agreements. We may have a bit of controversy here because I do not see eye-to-eye with Mr. Gutman, but I guess that is one of the purposes of the hearing.

As Mr. Gutman pointed out there are many valid business purposes for using buy-sell agreements and restrictions on transfer. They provide for the continuity of the business in the case of the death of a principal owner. They provide a market for the stock at a negotiated price when a person bows out of the business either during his life or at death. And they prevent transfers to persons not compatible or competent to be participants in the particular business.

These are very common uses for restrive agreements, not just rights of first refusal but also consent restraints of the sort that are sanctioned by many State statutes, which are provisions that prevent stock from being transferred without the consent of the other stockholders or without the consent of the Board of Directors.

What then is the abuse that we are concerned about? Well the abuse is said to be the fact that transfers to family members may occur for less than a fair value. Mr. Gutman has described to you how that might happen. Our position is that the present case law and the regulations themselves prohibit that from happening. There is law on the books that is sufficient to deal with this problem. The regulations say that such agreements and the price provided by the agreements will be disregarded unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's share to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

It is a matter of enforcing that rule, and that is where the Internal Revenue Service comes in. Why is there concern that the Service is not doing its job? Fundamentally it stems from the notion that families cannot be trusted. Now that is a policy question. I do not know if that is a policy that Congress has formally adopted, but if Congress after it has finished its hearings and finished its examination of this question concludes that families indeed cannot be trusted, then perhaps there is a need for legislation.

But the legislation that has been proposed in the Discussion Draft is not adequate from our point of view. There are a number of problems with it. If more legislation is needed there are a number of things it should not do that the Discussion Draft does do.

First of all, it should not apply to agreements that are binding on all of the parties who entered into them prior to the effective date of the legislation. The Discussion Draft would affect agreements that have been entered into many years before without any knowledge that Congress might adopt legislation of the sort that has been proposed.

We also believe that it should not apply if non-family members who are parties to the agreement own more than 10 percent of the stock. Why not? Bear in mind that the objective of the proposal is to eliminate abuses. Family members, the ones who cannot be trusted, do not enter into these arrangements to benefit people who are not members of their family. Ten (10%) percent in my experience is a good threshold because at that point if you talk about any kind of a transaction or redemption of stock or anything else that begins to benefit non-family members, there is a great deal of concern on the part of the people who do control the corporation. I doubt that you will find any abusive buy-sell agreement if you have non-family members who own more than 10 percent of the stock of the corporation.

Next, the legislation, if such is adopted, should not cause two values to be used for estate tax purposes when there are family members and non-family members. That is what the Discussion Draft does. It produces one value for the portion of the stock that is transfered to family members; and a different value, presumably governed by the agreement, for the portion of the stock that would pass to the non-family members.

It should also permit negotiated price agreements. It should not be confined just to formula agreements. There are some businesses that simply cannot be valued by reference to a formula either because the circumstance of the business are so unusual that they do not lend themselves to it or because the parties involved just do not operate that way. They should be permitted to sit down and negotiate the price from year to year and not have that price disregarded because it was not a formula arrangement.

It should not increase the number of valuation disputes with the Service, and the Discussion Draft would do that. Instead of arguing just over what the fair market value might be, it is possible to come in and have to argue with the Service about three different valuations under the Discussion Draft in some circumstances. That is a bad result and we should not have legislation that causes that.

And finally, it should not cause a high degree of likelihood that the estate tax value may be significantly higher than the price for which the person is compelled, or the estate is compelled, to sell the stock. That is the thing that terrifies small business people more than anything else.

I call your attention to the last two pages of our prepared statement which is a short, non-technical article that we have prepared that describes the things that concern small business owners the most about the proposed legislation.

Now, one last statement to close my remarks: I have a great deal of regard for Mr. Gutman and his approach to things, but I have to say that his example is unrealistic. I have been practicing law for over 30 years and I have never seen a buy-sell agreement prepared by anybody in our office or one that has been prepared by another

office that has been brought to us that even begins to approach the kind of an agreement he has described. When agreements are tied to book value, in virtually all of the cases that I have seen they are tied to a book value that is as of a date normally a month before the date the person died or the year-end before the person died, but never one that is 20 or 30 years before the event that causes the sale to occur.

Thank you very much.

Senator Daschle. Thank you, Mr. Gamble.

[The prepared statement of Mr. Gamble appears in the appendix.]

Senator DASCHLE. Mr. Apolinsky?

STATEMENT OF HAROLD I. APOLINSKY, VICE PRESIDENT, GOVERNMENT AFFAIRS, SMALL BUSINESS COUNCIL OF AMERICA AND ADJUNCT PROFESSOR, ESTATE TAX LAW, UNIVERSITY OF ALABAMA SCHOOL OF LAW AND CUMBERLAND SCHOOL OF LAW, BIRMINGHAM, AL

Mr. APOLINSKY. Mr. Chairman, I am Harold Apolinsky. I am Vice-President for Governmental Affairs with the Small Business Council of America and a practicing tax lawyer for over 25 years. I am the Managing Lawyer of Sirote & Permutt law firm in Birmingham, Alabama. In addition, I presently teach estate planning at both the University of Alabama School of Law and the Cumberland School of Law and have taught those courses for the last 15 years.

Looking back, getting ready for this, I think I noted over 20 freezes for which I had been the tax lawyer. I must have taught the techniques to some 750 law students. I guess they would be described by Mr. Graetz as creative estate planners—at least I hope so.

I appreciate the opportunity to share my thoughts with you and agree with everyone that 2036(c) should simply be repealed. I disagree with some of the esteemed members that have come before you on the idea that we should have new Chapter 14. I do not think we should have new Chapter 14. I do not think it can be fixed to become something worthwhile. I agreed with your statement that you made at the beginning. We should not try to exchange 4 pages of the statute 2036(c) that does not work for 25 pages or whatever number it comes out with (proposed chapter 14), that will not work.

We have had so many changes since 1981. There were eight major tax laws in 9 years. Since 1981 over 8,287 Code subsections have been changed. I have a feeling there is another one coming along for 1990. What we need is simplification.

Proposed Chapter 14, or something similar is going to be similar to 2032(a). That was a great concept in 1976—save the family farm, keep it in the family. That concept turned into 11 pages of statute. We have had 30 pages of regulations and have not finished explaining all of the provisions though it has been some 14 years. There have already been 80 court cases decided. If 80 cases have been decided, there are probably 80 or 100 cases pending. That is great business for tax lawyers. We appreciate it.

From the standpoint of the Tax Bar, I have 25 tax lawyers. They love to litigate. You get paid the most for that. I just do not think it is good for the taxpayers. We need your help. We really need your help for family businesses and family farms. Frankly, they will not survive a 50 or 55 percent estate tax. There may be something left for the family, it just will not be an active business with employees. Because businesses cannot keep 50 percent in liquid funds. They need it for inventory, receivables, expansion, downturns in businesses.

Up until 1987 when I would meet with clients I would explain to them and quantify for them for the first time the amount of the estate taxes. It was a shock to them. If I had a client with an $11 million business and said: "When you and your wife die, there is going to be about $5.5 million of tax." That was just an absolute surprise.

It may be possible at that time, to have or require $5.5 million of life insurance. But projecting out the growth of the business over the life of the individual or his wife after his death, you just could not keep up with the insurance. After all the money was needed for the business not just to pay to the insurance company. So I would suggest the freeze.

Before December 17, 1987 a freeze was possible. You could have $10 million of preferred stock for the older generation and $1 million of common for the children. Give away the common and file a gift tax return. There might not be a gift tax to pay because of the credit. The older generation had the $10 million of preferred. When they died the $10 million of preferred was in their estate and there was going to be $5.5 million of tax, but that tax had been anticipated and funded. There were no abuses in the ones that I did. The valuations of the stock and business were correct.

We would retain the services of the best appraiser. Sometimes it would really hurt me that the appraisal fees were greater than the legal fees. But I could see that that was necessary. Also, these were the best clients we had. The biggest clients. And if the IRS were to jump them on a valuation question they would fire me. I have seen that happen to other lawyers we were very careful to have the correct valuation.

I think we have talked around the problem. The problem Treasury, IRS, and staff have, is that they believe if you do not pay a dividend on the preferred stock you do not have anything of value. I think that is incorrect. The $10 million of preferred in my example will be in the estate tax return irrespective of the dividend. If you require a business to pay a 10 percent dividend in my example where you have $10 million of preferred stock, that is $1 million a year after tax. There is no way for them to do that and stay in business.

Anything you come out with which mandates the payment of a dividend will not work. The IRS takes the position, if you do not pay the dividend you have made a gift. There have been convertible preferred. They have jumped that and said that is a gift. If you are going to keep a mandated dividend or a gift in lieu thereof, you might as well keep 2036(c).

What we need is your help in removing family businesses and farms from the estate and gift tax laws altogether. Let them go

down to the next generation, let them not have a stepped-up basis, but a carry-over basis. When the business is sold income tax would be paid.

If we had to rate all the proposals we would rate the D.C. Bar proposal first. We would rate the rest of them last, as much as I respect my colleagues that have drafted them. Because we believe that if there are abuses, and we have not seen them, what could be done is to simply mandate the filing of a gift tax return, and require the filing of the appraisal. This was done in the mid-1980s for gifts to charity under Section 170.

The emphasis should be on simplicity. We would urge the repeal of 2036(c) entirely and no substitute.

Thank you.

Senator DASCHLE. Thank you, Mr. Apolinsky.

[The prepared statement of Mr. Apolinsky appears in the appendix.]

Senator DASCHLE. We have a vote. Let me see if we can get a couple of questions in prior to that time. And, if Senator Boren has no questions, maybe we can excuse this panel.

Mr. Gutman, I thought your example was very intriguing. You had me sold on it. Mr. Gamble doesn't think it's valid.

Mr. GUTMAN. That happened last time too, Mr. Daschle.

Senator DASCHLE. I wasn't here last time but I would be interested in exploring that just a little bit.

Mr. GUTMAN. Sure.

Senator DASCHLE. Because I thought it was an appropriate example. But I thought Mr. Gamble raised some interesting observations with regard to how realistic it is. Do you care to respond?

Mr. GUTMAN. Yes, I would.

There are a couple of different levels at which I would like to respond. On the example itself, it may be the case in Mr. Gamble's office he has never seen a book value purchase price agreement, but I have. I saw them in Boston where I practiced before and I see them in Philadelphia now. But, I do not want to get into an argument about whether they exist or not. If you are interested in that, I suspect the easiest way to find out whether they exist is to ask the Service to take a survey of estate tax returns that have buy-sell agreements and see the extent to which they do.

I do not think the example is necessarily the principal point. By picking on the example and calling it a bad example perhaps Mr. Gamble intends to obscure the point.

I agree with Mr. Gamble that the regulation he cites says precisely what it says. The problem is how that regulation has been interpreted, not by the IRS, but by the courts. One could read that regulation to say if testamentary intent exists in a buy-sell agreement, then the purchase price is going to be disregarded. One could also read that regulation to say that we have to balance between the extent that there is a business purpose for the agreement and the extent to which testamentary intent exists. My reading of at least some of the case law, is that the courts have said that the existence of a business purpose trumps the existence of testamentary intent. And the courts have gone further to say that keeping control in the family is a valid business purpose. If that is the case, then it is a slam dunk for the family business. They will always be

able to argue that the existence of family control is a business purpose and, as interpreted by some courts, that is sufficient to carry the day.

The point that I was making is that the law here is ambiguous. Mr. Dees just said the law is not ambiguous. But if you look at footnote 6 in his testimony, it is a long footnote about how the Tax Court is changing its mind about what the law is. My point simply is that if we have an ambiguous situation that is susceptible of abuse, fix it. That's all.

Senator DASCHLE. You would have to agree the law is ambiguous, wouldn't you, Mr. Gamble?

Mr. GAMBLE. I do not feel it is ambiguous. I feel the problem here is that each of these cases has to be dealt on a case-by-case situation. And you have to have a general principle which is what the regulation sets down to apply to it. And then an intelligent revenue agent and an intelligent representative of the family have to sit down and resolve their differences on this.

I have seen many book value buy-sell agreements. I have never seen one that was tied to the book value as of the date the agreement was signed and would last forever after, as I said at the end of my comments. The book value agreements I normally see are the ones that are tied to the book value at a point in time no more than 12 months prior to the date of death. And that is a more realistic kind of a situation. I think it would be very useful—and the question was asked by you and Senator Boren earlier today of Mr. Graetz—just to what extent the Service actually has made a study that indicates the frequency with which abusive buy-sell agreements of this kind surface.

I do not think it is nearly as frequent as suggestions would indicate. But we cannot debate that. That is only speculation. I think a study and some hard facts would shed a lot of light on that.

I can speak only to my experience. And I do know that the statement in the regulations, and it has been supported by some courts, that you cannot use these agreements as devices to pass property to the objects of your bounty at less than a fair value has a guiding and chilling effect, if you will, on people who want to go to the extreme that Mr. Gutman suggests. And that many people in this country have never entered into buy-sell agreements that are abusive in nature, although they may have thought about it, because they have been told by their advisors that this rule exists; and, therefore, they ought to find something more realistic.

Senator DASCHLE. We have about six or seven minutes left before my time runs out on the vote. Senator Boren has indicated he has no oral questions. We may submit some questions for the record to be responded to in writing. Rather than keep you here waiting for my return, I think I will excuse this panel with our sincere gratitude. Excellent testimony, and you have certainly shed some light on some important issues this afternoon.

Thank you.

The Committee will stand in recess for about 15 minutes.

[Whereupon, the Committee recessed at 4:32 p.m. and resumed at 4:50 p.m.]

Senator BOREN. If I could, Senator Daschle is on his way back. I apologize. We have had so many interruptions here. If I could, I

would like to ask both of the last panels to come up if they will. I think we had better just do it this way. This panel is going to focus mainly on the valuation question, as I understand. So why don't we go just with this panel at this time.

Mr. Roberts is President of Management Planning, Incorporated of Cleveland; Ms. Howitt, National Director of ESOP Services for American Appraisal Associates; Mr. Lee, Associate Director of Bear, Stearns & Co. I am sorry, we will have to have the other two of you introduce yourselves. I do not have you on my list here.

Mr. PITTOCK. Very good. I am Bill Pittock from American Appraisal Associates, a Group Manager with the Wall Street office.

Senator BOREN. Thank you very much.

Mr. MILLER. Kenneth Miller, Group Manager with the American Appraisal Associates.

Senator BOREN. Thank you very much. We appreciate having you all with us. I think what we will do again is take your full statements for the record. If you could hit the major points that you would like to emphasize to us and leave with us in terms of the valuation problem. This would be most helpful to us.

So why don't we begin with Ms. Howitt. We will begin with you.

STATEMENT OF IDELLE A. HOWITT, NATIONAL DIRECTOR, ESOP SERVICES, AMERICAN APPRAISAL ASSOCIATES, INC., NEW YORK, NY, ACCOMPANIED BY WILLIAM PITTOCK, GROUP MANAGER, AMERICAN APPRAISAL ASSOCIATES, INC., NEW YORK, NY; AND KENNETH MILLER, GROUP MANAGER, AMERICAN APPRAISAL ASSOCIATES, INC., NEW YORK, NY

Ms. HOWITT. Thank you, Mr. Chairman.

Mr. Chairman and members of the Committee, on behalf of American Appraisal Associates we thank you for the opportunity to testify before you today. For the benefit of those of you who may be unfamiliar with American Appraisal Associates I would like to introduce our firm and its representatives who are with me here today.

My name is Idelle Howitt, and I am the National Director of ESOP Services for American Appraisal. Seated behind me is Michael S. Megna, Senior Vice President and Chief Operating Officer of American Appraisal. Also present are the two gentlemen who have just introduced themselves—Kenneth Miller and William Pittock, from our Wall Street office. These two gentlemen have over 25 years of personal experience in the valuation of closely-held securities. They are based at the Wall Street office which is dedicated primarily to the valuation of closely-held securities and has been so dedicated for almost 60 years.

American Appraisal itself was founded back in 1896 and is based in Milwaukee, Wisconsin. Today it is the world's largest and oldest valuation firm with offices in 32 cities throughout the United States and in 19 other cities throughout the world. Each year we value more than $100 billion worth of assets for well over 1,000 clients. And a significant number of those valuations are for estate and gift tax purposes.

We are very pleased that the staff of the Committee invited us to testify before you today, and we hope that sharing our views based

on our day-to-day business experience will be helpful to you in your analysis of estate freeze valuation issues.

We agree that Section 2036(c) should be abolished, and we believe that the Discussion Draft under consideration represents a positive step toward developing an alternative.

We wish to share with you specific concerns that we have with selected portions of the draft that address valuation. For purposes of today's hearing we shall limit our remarks to the following three issues—the treatment of omitted dividends as deemed gifts; the 20 percent minimum rule for the retained common interest; and the formula approach for valuing securities subject to a buy-sell agreement.

Turning first to the deemed gift issue. The characterization of omitted dividends as deemed gifts does not recognize legitimate business purposes for which dividend payments to shareholders are omitted or postponed. In light of increasingly adverse economic conditions and the limited availability of credit for business, some companies may need to conserve cash to keep their businesses afloat.

Such conditions are not necessarily limited to 3 years as provided in the deemed gift provision section, especially for cyclical companies. Indeed, the Bible recognized its extended business cycles when it spoke of seven lean years following seven fat ones.

Attached to my testimony as Appendix A are recent examples of publicly-owned corporations whose dividend payments on their cumulative preferred stocks have been suspended for more than 3 years. This list includes Chrysler Corporation, which you may recall suspended dividends on its cumulative preferred stock for a period of 4 years—from December 1979 to September 1983.

I dare say, no one would claim that the preferred shareholders of the Chrysler Corporation made gifts to the common shareholders. In fact, to have suggested the application of such a rule as this one would have caused more than a little disruption, both on Wall Street and on Main Street.

The second issue within the deemed gift issue is the compounding issue. We also have serious reservations about the proposal to compound accrued but unpaid QFPs (Qualified Fixed Payments). The Discussion Draft offers a choice of characterizing omitted dividends as gifts or of accruing unpaid dividends at a compound interest rate. The latter alternative imposes a particular hardship on all the common shareholders who would in effect be subsidizing these fixed payments to the extent of any compounding. American Appraisal feels that family-owned corporations should not be singled out and subject to such an onerous rule.

Finally, in this subsection we turn to the 10 percent rule. We are also concerned that a threshold of 10 percent is too low for the purpose of defining a family corporation that is subject to these valuation rules. For example, there are many public corporations of which more than 10 percent of the stock is owned by a single family. Considering only those corporations listed on the New York Exchange whose names begin with "A", there are 19 such examples. I have listed them for you in Appendix B.

A 10 percent owner of a publicly-held company may indeed have control because of the dispersion, diversity, and actual number of

other shareholders. However, a 10 percent owner of a closely-held business is rarely in a position to wield control over general corporate matters, much less to implement an abusive recapitalization.

The proposed 10 percent rule is particularly unfair because it includes debt in the calculation of an interest. American Appraisal believes that the threshold percentage should be based on equity alone and should correspond to the percentage required for corporate control as defined by applicable State law, which is always in excess of 50 percent.

Turning briefly to the 20 percent rule which limits post-recapitalization common equity to a minimum of this amount, we believe that it poses a problem since it applies to the total of both equity and debt. It is inherently fraught with, shall we say, the potential for mischief, since an entity could circumvent this rule merely by paying down debt, affecting the transaction and then borrowing more money. If a lower limit of value needs to be imposed on junior equity, it should be based on a percentage of equity alone.

Finally, with regard to buy-sell agreements which has been a topic of much discussion today: at the risk of sounding self-serving, a valuation formula will not yield as accurate a determination of value as an independent appraisal. Moreover, a valuation performed contemporaneously with the valuation, or transaction date is more accurate than a valuation calculated on the basis of a formula devised 3 years previously.

We believe that reference to the process for valuing closely-held securities in connection with ESOPs, for example, is instructive. As a result of consideration by Congress, the Internal Revenue Service and the U.S. Department of Labor, under Section 401(28)(C) of the Internal Revenue Code, and under the Department of Labor's proposed Adequate Consideration Regulations, annual valuation updates are required by an independent appraiser.

Secondly, Congress also requires appraisals for the valuation of closely-held stock with respect to charitable contributions. Under Section 170 an independent appraisal is required in order to claim a deduction for a charitable contribution of closely held securities. Moreover, the value essentially must be determined within 60 days of the transaction.

We strenuously urge that the valuation requirements for closely held securities be consistent throughout the income, estate and gift tax provisions of the Internal Revenue Code. The establishment of different methodologies undercuts the concept of fair market value which will then necessitate multiple valuations and make tax planning unnecessarily difficult and costly.

In conclusion, let me thank you again for being permitted to express the views of American Appraisal here today. We remain available to you and members of your staff in the coming weeks and months as the Discussion Draft undergoes revision.

Thank you, Mr. Chairman.

Senator BOREN. Thank you very much. Those were very helpful suggestions and very constructive ones.

Ms. HOWITT. Thank you.

[The prepared statement of Ms. Howitt appears in the appendix.]

Senator BOREN. Mr. Lee?

STATEMENT OF M. MARK LEE, ASSOCIATE DIRECTOR, BEAR, STEARNS & CO., INC., NEW YORK, NY

Mr. LEE. Yes. My name is Mark Lee. I am an associate director of Bear, Stearns. As part of my capacity of Bear, Stearns I sit on the firm's Valuation Committee of seven members and I am responsible for reviewing virtually all of the opinions and valuations that are issued by the firm. Bear, Stearns does not do estate freezes. But I have in the past. And I speak on my own behalf and not on the behalf of Bear, Stearns.

Prior to Bear, Stearns I was a principal of KPMG Main Herdman and prior to that a Senior Vice President of Standard Research Consultants, then an operating division of the American Appraisal Associates.

Ms. HOWITT. We know him.

Mr. LEE. I have conducted over the past 20 years over 500 valuations. I have appeared both for taxpayers and for the Internal Revenue Service. One case in which I appeared was *Snyder* v. *The Commissioner,* which I am sure that you are familiar with. I have been asked to talk about two things, essentially the repealing of Internal Revenue Code Section 2036(c) and the House Ways and Means Committee proposal, Chapter 14, for regulating estate freezes, which I call the House proposal.

Quite simply put, repealing 2036(c) is a very good idea. Get rid of it. But based upon my experience in working with the Service and absent what you recommend, which is essentially a substantial rate cut in the estate and gift tax area, and indexing it and having a higher threshold in indexing estate taxes, something has got to be put in its place, some bright letter law or else abuses will continue.

Now the House proposal in establishing QFPs has a central core of some good ideas. This is what I think they are: (1) The idea of establishing a reasonably accurate, but not completely accurate, method of determining the value of a junior equity interest in a business, such as common stock, by first establishing the fair market value of the equity as a whole and then subtracting out the present value of the dividend payments. That concept is reasonable in finance. (2) The concept of setting up some sort of a minimum value for the appreciation interest is also reasonable. (3) The idea of providing an ability to defer cash payments so you do not bankrupt the business is also reasonable. And even more reasonable is the idea of providing the ability for these cash payments to be deferred and compounded.

Nevertheless, the House proposal is deficient in many respects. It is very complex and leaves a lot of questions unanswered. I have about seven simplifying assumptions which you could institute which might go a ways to getting what you want, which is a simplified proposal. And I would like to go to those.

First, establish the minimum percentage not at 20 percent but around 10 to 15 percent. This is more realistic in terms of finance. In my work in looking at recapitalizations and estate freezes, this is not an unreasonable amount.

Second, establish a statutory reference rate of return, either fixed or variable or both, for the QFP or the senior equity interest. Rates of return that I would recommend would be the applicable

AFR rates, either short-term or long-term or some Standard Poor's BBB preferreds or bonds of equivalent risk.

What will happen in this scenario is you will establish a growth threshold above which the country will benefit. This threshold that I am talking about will essentially be a threshold that takes care of inflation, national economic risk and some business equity risk. If the business can grow faster than this particular risk rate, then the company will benefit and the taxpayers will benefit as well. This does not help your small businesses. Nothing short of rate relief or tax cuts will help them.

Having this kind of statutory rate will also reduce the risk of a reverse freeze. A reverse freeze is essentially gifting out the preferred stock and retaining a common stock and setting a high rate of return on the preferred. What will happen is, all the appreciation will be drained out of the business because of the compounding cumulative rate of return on the preferred stock.

Another important point is to require that, if a required distribution of a senior equity interest is not paid out, add it to the value of the preferred stock but not its basis. This will not create a cash drain on the company. Another important proposal is provide a safe harbour. If we permit this kind of a freeze technique, what happens is that most people will freeze when the expectation for the growth in the value of a business is high. When the value of the business declines the value of the junior interest, that is the children's interest, is wiped out.

Provide a safe harbour so a freeze can be unwound under certain situations with no tax impact and perhaps with any taxes paid being credited against future estate and gift taxes. There are some other proposals, but my time is up.

Senator BOREN. Thank you very much. We will examine all of them. Again, these are the kinds of concrete ideas that we have heard from both of you that really help us in terms of fine tuning and refining that House proposal.

[The prepared statement of Mr. Lee appears in the appendix.]

Senator BOREN. Mr. Roberts?

STATEMENT OF JAMES O. ROBERTS, PRESIDENT, MANAGEMENT PLANNING, INC., CLEVELAND, OH

Mr. ROBERTS. Mr. Chairman, Senator Daschle, thank you very much for the opportunity to make this statement this evening. My name is James Roberts and I am president of Management Planning, Inc., of Princeton, New Jersey and Cleveland, OH. We are a firm of financial analysts that specialize in the valuation of closely-held companies, both in the East and throughout the country.

Since our founding in 1939 we have valued thousands of companies, all of them closely-held, family-owned type businesses and we have counseled on preferred stock recapitalizations or estate freezes.

When Section 2036(c) was enacted by the Revenue Act of 1987 I frankly could not believe that the Section meant what it said. In our experience of over 50 years in the business we have seen virtually no IRS challenges on the preferred stock freezes that we were ever involved in. It, therefore, was inconceivable to me that Con-

gress would subject all family businesses and all closely-held companies and farms to the very punitive rules that Section 2036(c) included.

The owners of thousands of closely-held and family companies that I and my associates talk to each year in the process of our business are desperately concerned about their inability to ever pass on the business to their children. In most cases they have spent their life time and committed virtually all of their assets to developing the business itself. The preferred stock recapitalization had proven to be one of the fairest and most appropriate methods for allowing the senior generation to retire with some security of their investment while providing the next generation with the incentive to build the business on a sound and equitable basis.

In most every case that I have personally observed the children were deeply involved in the business and building the appreciation that they were sharing in, and therefore the motivation came to them.

First of all, it might be helpful to give you a little background on the closely-held or the family-held business and the place that they hold in our national economy. There are something like 20 million business enterprises in the United States, with the exception of about 15,000 to 20,000 that are publicly owned, the rest are all privately-owned. These range from the single employee business to the extremely large and vital privately-owned companies that may rival in size, some of the 100 largest publicly-traded companies in the country.

The importance of the family and the closely-held business to the economy cannot be overemphasized. This is the segment that produces the most new products, the greatest productivity increases, the most new jobs and the greatest capital accumulation. Indeed, it has been a lynch pin of the free enterprise system since our country's founding. The driving force of the founding famiiy is often what guarantees this continued success. The truly damaging effects that Section 2036(c) has is that it creates financial disincentives to continue the family business into the next generation.

The constraints of this legislation have forced all too many owners to reach the frustration level that triggers the decision to sell out. It has also been my experience that the primary beneficiaries of this decision are quite often foreign financial interests who have been able to buy up a major segment of America's family-owned business enterprises due to this inability to continue the ownership within the family.

I will give you one example. In the newspaper industry, since the enactment of 2036(c) and the Act of 1987—that is only 30 months ago, there have been 40 or more privately held newspapers who have been sold to foreign interests. And practically all of these were because the family could not plan for the future ownership transfer.

All businesses have a need to plan for this orderly succession, both in ownership and in management. Now it is a far more complicated transaction in the private companies than it is for the public company—due to the family, due to the need for liquidity, and because of the estate tax considerations. The transaction or rather the transition in a public company is normally an orderly

process that the successor is succeeded by a person two to maybe ten years younger than he is.

In the family business it is entirely different. Here the successor, son or daughter, is not 5 to ten years younger than the senior but rather 25 to 40 years younger. The time horizon for ownership and management planning represents an extraordinary problem for the family company. To be repeatedly battered with the deluge of tax legislation and regulation that the owners and their advisors have encountered in recent years has been devastating to this orderly succession planning process.

Since 1976 there have been 15 major laws enacted by Congress dealing with income and estate taxation. With rare exception, they have negatively influenced the ability of a small business to provide continuity of ownership. Section 2036(c) was perhaps the most devastating of all this legislation. Without a means by which the family business can provide for the orderly succession within the family, the business will be taxed out of its independent existence. I urge you to repeal the confiscatory statute 2036(c).

Now the question following repeal is probably: To what? To regulations and legislation current on the books or to something else? The solution lies, I believe, on reliance on in-place legislation and regulation. For an example, Internal Revenue Service Ruling 83-120 provides guidelines for valuing preferred stock recapitalizations. Unfortunately, this regulation did not go far enough. But I believe the guidelines can be developed to fairly value these securities and without a negative revenue flow to the Government.

Since many of the problems arising from 2036(c) legislation are valuation problems, I believe the solution lies within the valuation industry and the Internal Revenue Service. Together we can target the abuses and develop guidelines on how to correct them without a loss of revenue. I then encourage the IRS to enforce these guidelines actively.

Thank you.

Senator DASCHLE. Thank you, Mr. Roberts.

[The prepared statement of Mr. Roberts appears in the appendix.]

Senator DASCHLE. Anyone familiar with bells and lights around here knows that once again there is another vote. I hate to do this to our witnesses but I am going to have to put the Committee in recess. I will be back just as quickly as I can and we will resume the hearing at that time.

[Whereupon, the hearing recessed at 5:13 p.m. and resumed at 5:26 p.m.]

Senator DASCHLE. The hearing will reconvene. My apologies once more to our witnesses. As I understand it Mr. Pittock and Mr. Miller have not yet testified. Is that correct?

Ms. HOWITT. They will not be testifying. They are actually here to be available to you as an information resource because of their many years of experience.

Senator DASCHLE. I see. Okay.

You are all experts on valuation. Clearly the impression you have given me is that if we are going to find a substitute to 2036(c) it really has to be focused. Is that a fair assessment, a summary of it? And if you were to focus, if there were one or two things upon

which you would really try to focus with regard to valuation, how would you frame it? How would you put that focus into form, as concisely as you can conceptually?

Mr. Roberts?

Mr. ROBERTS. Well, I would say the two areas that probably get the most expressed concern are the deemed gift and maybe the percentage rule of how much equity you can soak up with the value of the preferred stock. The deemed gift, when a dividend is defined in the terms and conditions of the preferred stock, but never declared in terms of a dividend actually issued.

There is always the concern that the family never did intend to pay the dividend and the gift, of course, accrues to those shareholders who are common shareholders.

The 20 percent rule, which has been proposed, is an area that we are very comfortable with. A small business particularly in a downturn has to have some sort of an equity cushion to soak up or else the preferred stock goes well below its par value and the common stock is literally under water, has no value.

Those are the two areas that we have the greatest concern.

Senator DASCHLE. Good answer.

Mr. Lee, were you the one who testified that you thought maybe 10 or 15 percent would be more appropriate?

Mr. LEE. Yes.

Senator DASCHLE. So you take mild issue, I suppose, with Mr. Roberts with regard to the 20 percent.

Mr. ROBERTS. That is allowed.

Mr. LEE. Yes, that is correct.

Senator DASCHLE. I'm sorry?

Mr. LEE. Yes.

Senator DASCHLE. Would you agree with what Mr. Roberts said with regard to deemed value and the percentage figure? I mean, is that adequately focused to do the job?

Mr. LEE. I think I look at it a slightly different way. In the sense that what I look at as the estate tax freeze is essentially a device where the Government would say to the family who owns a business, assuming we are leaving out the family farm and the marginal business, that if you grow faster than a particular hurdle rate and increase the wealth of the country, increase employment, we will allow you to have a deferral of appreciation. Okay?

That to me is the central issue. So that a gift is made. It is made on the basis of a present value of an income stream. That income stream, whether it is paid out or not, is retained by the senior family member. That income stream is discounted at a specific rate and that is the bargain. That bargain can only be unwound or is possible to unwind if the business, for the sake of a better word, declines significantly in value, in which case the Government can say you can unwind this freeze with limited damage.

Senator DASCHLE. Ms. Howitt, how would you respond to Mr. Lee? Do you think that that concept would work?

Ms. HOWITT. Well, there is an old joke about having three appraisers in a room and having them come to four different conclusions of value. This is no exception. Because we would take a different spin to answering your original question. It is more of a philosophical answer, I believe. That is, I believe that 2036(c) imputes

rather nefarious motives to people who are involved, if you will, in a family. And the result of 2036(c) is that members of families are treated differently than "outsiders" or non-blood relatives in terms of transferring, be it through income tax, estate tax or gift tax oriented type transfers.

Valuation of closely-held securities goes beyond just estate freeze perspectives and to general estate planning, gift tax planning, and ESOPs. And if you begin to establish different definitions of what fair market value is because you categorize people because of their relationship to the potential seller or transferror, you really undermine the ability of an appraiser to come in and economically determine what fair market value is.

So our underlying problem with all of this is the disparate treatment of family members versus outsiders and how you determine what value is and then how you tax it.

Senator DASCHLE. Do you differ at all with Mr. Roberts in his assessment that if we deal with the 20 percent requirement and deemed value that we would really in essence deal with the issue effectively and in a focused way?

Ms. HOWITT. Well, I think my initial response is that these are two of the items that we addressed in our remarks as well. I think we are moving in the right direction. I would also like the opportunity to reflect upon it and to submit a formal written response to you.

Senator DASCHLE. Fair enough.

[The response appears in the appendix.]

Senator DASCHLE. Thank you. We appreciate your testimony and your insight. You have given us a good deal to think about.

Our final panel consists of Mr. Mark Hayward, Mr. E. Fletcher Lord, Mr. Thomas Zaucha, and Mr. Steve Massie. Welcome panel members. My apologies for having you wait as long as you have to present your views. We appreciate your being here. The entire text of your statement, of course, will be made a part of the record. We invite you to proceed any way that you see fit.

Mr. Lord, let's begin with you.

STATEMENT OF E. FLETCHER LORD, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, CROW-BURLINGAME COMPANY, TESTIFYING ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS, LITTLE ROCK, AR

Mr. LORD. Thank you. Mr. Chairman, my name is Fletcher Lord, Jr., and I am President and CEO of Crow-Burlingame Company of Little Rock, AR. I am here on behalf of the National Federation of Independent Business, and I ask that their statement be attached to and made a part of the permanent record.

Senator DASCHLE. Without objection that will be done.

[The prepared statement of the National Federation of Independent Business appears in the appendix.]

Mr. LORD. I am a real live recipient of the decisions that you are making here today. My grandfather and a partner started our family company in 1919. The two men were not related and together controlled 75 percent of the stock. The rest of the stock is owned by families of the original investors, plus many employees who

bought stock at one time or another through the 71 years of the company's existence. My family now owns about 52 percent of the company stock.

My grandfather's partner sold much of his stock late in life and the family which bought his stock still controls about 22 percent. My grandfather died at eighty-four, forty-five years after founding the company. The entire time he was active in the company most of its earnings were plowed back to finance future growth.

The auto parts business which we are involved with requires a lot of capital to support the large inventories required to provide parts coverage in the automotive aftermarket. The size of the inventories greatly inflate the value of businesses for estate tax purposes.

My grandfather's best friend was a tax accountant. They played golf and traveled together for years. Because of this relationship my grandfather was very aware of tax laws and how to structure the company and his estate. He used the best advice available to time. Despite the best advice, between the time the will was written and the results were measured, the laws changed so much that the best of plans worked out in ways you could never have dreamed of.

Although my grandfather split his stock into three parts and used generation skipping to give part to me and my brother, I still ended up paying a huge amount of estate taxes. When my grandfather died it was thought that my grandmother might live several years past him and his estate left enough to her to provide for her needs. She died 11 months later and all that was left to her was taxed twice.

Although my grandfather planned well and was frugal, after paying the taxes on both of my grandparents' estate, the family had virtually nothing left but company stock. Everything else had to be sold to pay estate taxes. And at that point the family had moved control of the business to a second generation.

My dad had been working for the company over 20 years when my grandfather died. Today he is 82 and my mom died last Christmas. Unfortunately, dad did very little estate planning. And although he will pass less than a third of his stock than my grandfather did, it will take all of his assets, which include his pension, a lump-sum distribution, his investments and his home to raise enough money to pay estate taxes. The best guess is that my brother and I will still need to chip in some of our own money to pay the taxes in order to keep the stock in the family.

Today it is my generation's turn to try to pass our business on to the next generation. My brother and I pay ourselves modest salaries and our total compensation is in line with norms for our kind of business in other distribution companies of our size. There is not much room in the company's budget for additional salaries to plan for estate taxes. Our company is an above-average performer in our type of private business. We have been at it for a long time and kept putting the investment in year after year and I have outlined in this report what our assets look like.

Roughly 2.5 percent of our company is cash; our inventory represents 44 percent of our business; accounts receivable, 16 percent; property, plant and equipment, about 37 percent. A very unliquid

company. The profit on sales are about 5 percent. Pre-tax, we pay about 38 percent of our income in taxes and after-tax income is about 3.5 percent of sales.

It can be easily seen that the company is very capital intensive with inventory requirements growing at almost 10 percent a year because of all the new types of parts entering the marketplace. Because of this inventory growth, the company must maintain a sales growth large enough to support the inventory. Our ability to maintain the large inventory and carry the slow moving items makes us valuable to the market place and is an important part of our success.

Unfortunately, estate tax law does not differentiate between cash on hand and inventory. Our large inventory gives us a competitive advantage but it also greatly increases the amount of estate taxes owed when a family member dies. The failure of current estate tax law to differentiate between liquid assets and assets of an operating family business will destroy many family businesses.

I have three children—ages 18, 14 and 10—the first one starts college this fall, and the house is less than half paid for, and my wife needs a new car. She drives a Volkswagen that is 8 years old and has over 100,000 miles on it. It is not possible for us to put enough aside to help pay the estate tax bill when my children take over the company.

The company carries $1.5 million life insurance policy on me so that if I die before I retire there is money to buy back have of my stock. This will take the ownership of the business away, but it will allow my family to have some security and income past any early death. However, this protection ends on my 65th birthday.

I personally carry around $600,000 of life insurance. With the current tax laws there is no way for my family to move the ownership of our business to the next generation. I cannot afford to carry anymore insurance to protect my stock and I cannot afford to save enough over the years to pay the tax. And just as a side note, I asked my accountant to tell me what my estate taxes would be if I died today and it is roughly ten times my pre-tax income.

My family will lose our majority control of my company if my children have to redeem stock to pay estate taxes. If either my brother or I die prematurely it is entirely possible that the company will be in jeopardy of survival at that time, let alone pass to a new generation. I feel that our family has been a responsible member of the community, managed our business affairs well, and been one of the more successful companies of our type in the country. But unfortunately that is not enough to survive estate taxes.

Congress needs to make up its mind whether capital formation and the preservation of small family farms and businesses is more or less important than current income gained through estate taxes. My feelings are that by confiscating the assets of small farms and businesses the country is eating its own seed corn. In the longer term, the country is better served by helping small businesses pass from generation to generation and encouraging their growth through its tax laws than the short term effect of raising more revenue up front.

When the seed corn is eaten, what are we going to use for the next year's crop? Capital is business's seed corn. The one thing

small business is short on is capital. It is not hard work or the willingness to take risk or doing a good job, it is capital. Congress knows this, but it sure is hard to read the tax laws and realize that most of Congress is in support of small business.

One of the other problems that small businesses face is that tax laws change almost every year. The IRS hasn't even printed guidelines that the court has ruled in any cases before the law changes again, in almost a 180 degree direction. Most of the time when Congress changes its direction it takes away all that was set in place in previous laws.

Congress should not change the way the law works after someone has made a decision which they cannot change or get out of for years. Tax laws change and disrupt plans which were put in action sometimes years before. It is not anybody's best interest—small business, individuals, farmers, large business or government.

Thank you.

Senator DASCHLE. Thank you, Mr. Lord. That is excellent testimony. I sympathize with you in particular. My father owned the same kind of business and sold it a couple years ago. So I certainly can appreciate the situation you are in.

[The prepared statement of Mr. Lord appears in the appendix.]

Senator DASCHLE. I would call attention to the light system we have here. You have been very tolerant, of course, in the hearing. You have waited so long to testify. I want to be equally as tolerant with you. But when you see the red light, that does mean your five minutes are up, and if you have to go over a little bit, I understand.

Mr. Hayward?

STATEMENT OF MARK S. HAYWARD, ACTING CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC, ACCOMPANIED BY DAN R. MASTROMARCO, ASSISTANT CHIEF COUNSEL FOR TAX POLICY, OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. HAYWARD. Thank you, Mr. Chairman. It certainly is a pleasure to be here today. Mr. Lord has basically laid out the case to you, probably better than anyone else could lay it out to you or the members of this Committee.

I am pleased to appear before you as the Acting Chief Counsel for the Office of Advocacy at the Small Business Administration. I am accompanied today by the Assistant Chief Counsel of the Office of Advocacy, Dan Mastromarco.

As you know, the Treasury Department is the spokesman for the administration. My views are those of the Chief Counsel for Advocacy and do not reflect those of the administration. Mr. Chairman, I commend the Committee for working to fashion a replacement proposal. More than any tax issue this year, 2036(c) has commanded the attention of small business. In addition to eliminating abuses, 2036(c) prohibits common transactions for transferring business assets, favors families whose wealth is in marketable securities rather than small businesses, and dramatically increases the costs of transferring ownership.

We are no longer confronted with the question of whether or not the law needs changing. We are confronted with the question as to how best to balance enforcement and business concerns.

Mr. Chairman, I would like to briefly reflect on the nature of the problems that have led us to this point. The grassroots efforts to repeal 2036(c) by small business have not been grounded in a desire to merely reconstruct a tax avoidance advice. The issues before this Committee are more fundamental and go to the heart of the tax policy debate—the imposition of estate taxes on business assets.

The question over the proposed structure of the replacement provision to 2036(c) should be divorced from the philosophical question concerning the concentration of family wealth. The principle justification of estate and gift taxes is not to raise revenue. Unlike taxing the transfer of wealth in the form of cash, the taxation of a business can dismantle a successful, economic unit that has not only succeeded in innovation, in generating and creating jobs, but more importantly paying taxes.

Mr. Chairman, I would recommend that four broad considerations should guide this Committee. First, the replacement must be limited to areas of known abuse. Revenue considerations do not justify the expansion of an anti-abuse mechanism to non-abusive transactions.

Second, the replacement should be flexible and should strike a balance between enforcement and business concerns with regard to the preeminence of neither. Third, the proposal must be equitable and apply to businesses in different industries, in different growth phases, and of different sizes. Finally, the Committee must recognize that the ability of a firm to transfer future appreciation must remain intact. It is often the only way a family business, as Mr. Lord has proven here, can be transferred from one generation to the other.

The impact of 2036(c) on small business is difficult to quantify. What we do know, however, suggests that the impact would be substantial, and this question was raised by the Chair earlier. First, we know that there were at least 718,000 businesses with assets substantial enough to be subjected to estate taxes in 1986. This number is likely to even be larger today. The question was raised as the impact on the number of businesses.

Second, our data, which was derived from the national survey of small business finances—an effort between the Federal Reserve Board of Gcvernors as well as SBA—indicate about 57 percent of all partnerships and 80 percent of all corporations are family-owned. We estate that 164,000 partnerships and 242,000 corporations are potentially affected by 2036(c).

Let me briefly outline the perspective of small business. The Ways and Means Discussion Draft has several advantages. The proposal validates transfers of future appreciation. The proposal also recognizes the problem which gave rise to 2036(c), which was one of valuation. In an effort to solve a valuation problem, a gift tax solution is appropriately offered to a gift tax problem.

However, several problems remain with the Ways and Means Committee proposal. First, the proposal is overly broad. The IRS has not made clear from TCMP data exactly what types of transactions have afforded the greatest abuses or whether these transac-

tions involve personal assets or business assets. The proposal should address only devices which data affirmatively indicate are the crux of the problem. Buy-sell agreements, for example, are common estate planning devices, not because they are motivated by tax avoidance, but because they allow families to fix the value of transferred interest at an early stage. Businesses are also not given sufficient leeway to avoid a QFP. Exemptions provided under the deemed gift rule attempt to address the problem, but they are not an adequate solution. The application of the deemed gift rule would still assume the failure to pay a QFP automatically results in the transfer of equivalent value of the residual interest—when this assumption may not hold true at all.

Downturns in industry and even the loss of a customer can cause firms to have difficulty adhering to the QFP. The problem is not just a question of equity. It is a question of efficiency. A firm may need working capital, as Mr. Lord has indicated, to meet competition or even to grow into new markets.

Third, the proposal assumes an arbitrary value of junior equity interest at 20 percent—the sum of the equity of the business plus debt to the transferror. The 20 percent floor reflects the assumption of the option received in future appreciation of the company is always worth 20 percent of the value of the company.

There are at least three problems with this assumption. It ensures that the firm will gain no benefit from approximating the market test rate, whatever that is. We do not know what that is. And I will very briefly, Mr. Chairman, sum up. Secondly, it sets an arbitrary high price for the option value; and third, it improperly includes debt as a part of the calculation. Theoretically, the closer a firm gets to the appropriate market testing rate, the closer the transaction reflects an arm's length transaction, something that ought to be encouraged.

We suggest four modifications to the Ways and Means proposal. First, that the proposal should be narrowed to address areas of known abuse. It should not propose a separate valuation system for buy-sell agreements and it should not extend to joint purchases. Second, the proposal must provide for greater leeway for a firm to avoid a FP for valid business reasons, as in an arm's length transaction. Third, the proposal should not establish an arbitrary option value of 20 percent, and it should not include debt in the calculation. Fourth, the proposal must define the parameters as acceptable market testing rate in a flexible manner and should establish those rates at the lowest acceptable levels given revenue considerations.

Mr. Chairman, 2036(c) should be seen for what it is intended to be—a device to assist the IRS in correcting valuation abuses. It should not seek to accomplish this objective by prohibiting common sense transactions in estate planning or by invoking a legislative panacea to the enforcement concerns.

Mr. Chairman, I appreciate the opportunity to appear before you today. I realize that the Committee's time is valuable and we would be happy to submit any answers to any questions that the Committee would have.

Senator DASCHLE. Thank you, Mr. Hayward.

[The prepared statement of Mr. Hayward appears in the appendix.]

Senator DASCHLE. Mr. Massie?

STATEMENT OF STEVE L. MASSIE, VICE PRESIDENT, JACK L. MASSIE CONTRACTORS, INC., TESTIFYING ON BEHALF OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA, WILLIAMSBURG, VA

Mr. MASSIE. Good afternoon, Mr. Chairman. My name is Steve Massie. I, and my brother, Gary, are part owners and Vice Presidents of a family-owned highway construction company known as Jack L. Massie Contractor, Inc. in Williamsburg, Virginia. Our company was founded in 1947 by our father who is still very active in our business. My two sons are now showing an interest in working in our business. Our gross annual receipts average $5 million.

I am here today on behalf of the Associated General Contractors of America, a construction trade association. Eighty-five (85%) percent of AGC's membership averages less than $10 million in receipts annually. AGC appreciates this opportunity to offer its views on Section 2036(c) and the problems of valuing transfers of family business.

The construction industry is dominated by small family-owned businesses like ours, competing in local geographic markets. The broad language contained in Section 2036(c) makes estate planning and an orderly business succession very difficult. The IRS's ability to expand the scope of the statute through regulations creates great uncertainty. AGC therefore supports the proposal to repeal Section 2036(c).

AGC also supports the abandonment of taxing future increases in value by including it in the transferror's estate. In considering any replacement for Section 2036(c) the main goal should be preserving the family business, for we are the foundation of the entrepreneurial system in our country. My generation should not be penalized for spending our lifetime working to build up the family business. We are contributing to the business's growth and increased equity and to the common stock's increased value. We should not be taxed more harshly than strangers.

The ABA and the AICPA proposals would subject transfers to gift taxes and additional levels of taxation. The rules would limit the ability of our company to grow. The Draft proposal substitutes a gift tax approach for the estate tax approach. If the company is unable to pay the preferred stock dividends the company pays a gift tax on the unpaid dividend. If the preferred dividends are not set at a prescribed rate, that decreases the value of the preferred stock and increases the value of the common stock. That would ultimately lead to higher gift taxes.

The Draft proposal contains several excellent provisions for flexibility. However, we are concerned that the proposal would worsen the effect of business cycles. If the company is cash poor or is encountering problems with operating capital paying obligatory gift taxes would worsen the financial problems. The Committee should consider making the dividend on the preferred stock cumulative.

The proposal would also reduce the ability of the business to accumulate capital for expansion. It would force certain payments, regardless of whether the timing would help or hurt the business. It poses a particular problem for the construction industry in that insurance and bonding capabilities are directly impacted by the business's capital structure. The construction contractors must leave equity in the business to ensure adequate bonding capacity so that they may bid on future jobs. The equity my brother and I helped create, that must be left in the business, will cause the gift taxes to be higher than they would otherwise be.

The Draft proposal sets certain valuation rules. The total value of the common stock should not be less than 20 percent of the sum of the total equity in the corporation. And any debt owed to the transferror's family, options unlikely to be exercised would not affect the business's valuation. This is a sensible solution to the problems Congress has identified if the percentage is adjusted downward. It should eliminate the valuation problem.

However, it is not clear that the transferor should then be subject to the higher gift tax rates.

AGC appreciates this opportunity to testify and we look forward to being able to help the Committee on this issue.

Thank you, sir.

Senator DASCHLE. Thank you, Mr. Massie.

[The prepared statement of Mr. Massie appears in the appendix.]

Senator DASCHLE. Mr. Zaucha?

Mr. ZAUCHA. Yes, sir.

Senator DASCHLE. You have waited a long time.

Mr. ZAUCHA. Well, not that long.

Senator DASCHLE. Go to it.

STATEMENT OF THOMAS K. ZAUCHA, CHAIRMAN OF THE BOARD, SMALL BUSINESS LEGISLATIVE COUNCIL AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL GROCERS' ASSOCIATION, WASHINGTON, DC

Mr. ZAUCHA. My name is Tom Zaucha and I am President of the National Grocers' Association, and here today appearing as Chairman of the Board of the Small Business Legislative Council. And, yes, with the name Zaucha, I have spent a lot of time being called on last, especially in my academic career. You know, in some situations it is beneficial because it gives you the final word, although I would guess that in this debate we have yet to hear the final word. But it also perhaps provides an opportunity to provide perspective on what has transpired not only in today's hearing, but over the last year.

In fact, the testimony that we are presenting offers gives three perspectives—what happened with 2036(c) in the past, the present and the future. I am somewhat concerned with the progress that we are not making, for as George Allen's phrase, that "the future is now," reminds us, we had better be moving to the future quite quickly.

Mr. Chairman, at the outset I would like to compliment you and Senator Boren for the leadership that you have given to this issue of 2036(c). All of small business, those represented here today, part

of the Small Business Legislative Council or NFIB or National Small Business United. Our respect and appreciation for that effort is universal.

In addition, after reviewing the record and what has transpired we would like to make a request to you—that is, please don't let the 101st Congress adjourn without resolving 2036(c).

There is a division over the interpretation of valuation. I would suggest, sir, that a protracted debate over the breathe and scope of a valuation should not allow to hold the normal and necessary transfer of family-owned businesses hostage. That dragnet approach to taxing family-owned businesses must end.

You were quite correct in your opening comments when you said that no evidence of widespread abuse has been presented. I would go one step further, there has been no evidence of even moderate abuse. We have now had three hearings over the last year and a half—Senate Small Business, Senate Finance today and House Ways and Means Committee. And with the exception of one witness at the Senate Small Business, who laid out six possible scenarios, five of which had nothing to do with 2036(c), we have yet to have any concrete examples of abuse.

This afternoon we heard Mr. Gutman give us another "what if" possibility. I thought Mr. Gamble was quite correct in explaining that in his 30 years of experience that situation has not occurred.

Mr. Chairman, we have asked Mr. Dees who testified earlier, to provide further substantiation on this one issue, the buy-sell agreements, suggesting that there is regulations already in effect to deal with any abuses in that area; and secondly, that the court interpretations are moving towards a more clarified enforcement of that regulation. So why do we have language in the House Draft?

So with all of the Committee hearings that have taken place, where is the broad-based evidence of abuse? I was concerned today to hear the Assistant Secretary, in his testimony, observe first and most importantly that the testimony before the Ways and Means Committee revealed a consensus estate freezes present a serious potential for tax abuse. He and I must have been attending a totally different hearing. Because that was not what was presented at that hearing. As I said, there were no examples of abuse.

Those of us, Small Business Legislative Council and other witnesses, who have been willing to work within the process and will continue to work within the process are willing to work towards a more clear interpretation of valuation. But again, sir, I would suggest that you were right on target when you said that the Discussion Draft is all too broad. It does not have to be that difficult a problem.

We have not seen any abuses regarding to voting stock, buy-sell agreements, employment contract arrangements, or debt and lease agreements. But yet, all are still part of the Draft proposal. I would suggest to you that the remedy is a very reasonable one. It is a simple one. That is, the valuation should be limited to those special abuses that are related to the recapitalization agreements. That is what 2036(c) initially was all about.

But I would say to the Committee and to you, sir, as I did at the outset, if we are going to get involved in another type of Section 89 protracted debate over the interpretation of valuation, if we are

going to err, let's remove the error with which we have been living and simply repeal 2036(c). To do that in the 101st Congress would be a real benefit to the small business community.

Thank you.

[The prepared statement of Mr. Zaucha appears in the appendix.]

Senator DASCHLE. Mr. Zaucha, you were worth waiting for.

Mr. ZAUCHA. Thank you. [Laughter.]

Senator DASCHLE. That was excellent. You presented a summary as well as anyone could. Your points are absolutely right on target. Number one, that repeal is what we ought to do; and number two, we ought to do it this year. I only wish Treasury would have been here to hear this panel because it was excellent.

That is the trouble sometimes in this place. We get all tied up in nuances and potential abuses and regulatory responses, and all of this ultimately leads to what we have today—a half a page of law, leading to four pages of regulatory clarification, to a 25-page chapter, with 20 specific objections raised to that chapter as it is written today. And God only knows where it is going to end up.

But it really means an inordinant amount of unfairness on family businesses, which we have to address. That is the message out of this hearing that I have heard loud and clear. I have to say, you would have to be deaf not to hear it. So you have certainly provided us with an excellent insight, all the way from Mr. Lord's business—very similar to my father's—to your summary.

I thank you, each and every one. We may have some questions, and I would like to submit them for the record. We will keep the record open for a few days to ensure that everyone who wants an opportunity to ask questions of some of the witnesses in writing will be able to do so.

[The questions appear in the appendix.]

Senator DASCHLE. With that, the hearing stands adjourned.

[Whereupon, the hearing was adjourned at 6:03 p.m.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF HAROLD I. APOLINSKY

Mr. Chairmen and Members of the Committee and Subcommittees, my name is Harold Apolinsky. I am entering this statement into the record on behalf of the Small Business Council of America (SBCA), a nonprofit, nonpartisan national organization which represents the interests of small business organizations on Federal tax and employee benefit matters.

SBCA is an organization of approximately 1,000 small businesses, which provides a tax voice for the 17 million often overlooked small businesses in our country. With its leadership of tax experts, SBCA's primary goals are to prevent Federal tax laws from becoming more complex and burdensome for small businesses and their owners and to support legislation which creates needed economic incentives.

I am the managing member of Sirote & Permutt, P.C., an Alabama law firm, and have been practicing tax law for almost 30 years. Over 65 percent of my practice is estate planning. For over 15 years, I have taught estate planning at both the University of Alabama School of Law and the Cumberland School of Law. I presently also serve as President of the Estate Planning Council of Birmingham, and have held leadership positions in the American Bar Association Section of Taxation, the Alabama Bar Association Tax Section and the American College of Tax Counsel.

The subject of these hearings, estate freezes (Section 2036(c) and proposed modifying legislation), is of major concern to small business and farm owners. The outcome of your findings and whatever corrective measures you undertake, be they outright repeal of 2036(c) which we advocate or major simplification of this extremely complex, unwieldy and burdensome statute, will significantly impact many small business and farm owners who wish to pass ownership ultimately to their children.

The Small Business Council of America applauds the efforts of those members of the Senate, most notably Senators Boren, Daschle, Symms, Baucus, Heflin and Shelby who introduced S. 659, S. 838, and S. 849, the bills to repeal section 2036(c), and the over 36 Senators co-sponsoring. In the House, SBCA also applauds Congressman Archer and over 200 co-sponsors of H.R. 60, to repeal Section 2036(c).

Section 2036(c) was adopted, without any hearings in the House of Representatives or the Senate, to stop family business owners from exchanging common stock which grows in value if the business becomes more valuable, for preferred stock which is frozen in value. This approach may have been first used by the DuPont family around 1935. It has been used by many family business owners for over 50 years.

Unfortunately, Chapter 14, new Sections 2701, 2702 and 2703, proposed by Treasury and the Ways and Means staff, effect the same result as 2036(c). Parents will not be able to transfer businesses and farms to children without significant and devastating estate and gift taxes, at a level of over 50%.

The vast majority of family businesses and farms will not be able to achieve a practical estate freeze if new Chapter 14 to the estate and gift tax laws or something similar is enacted. Owners will not be willing to commit to the cash flow mandated by the "qualified fixed payments." The alternatives provided will not help the owners. Thus, there will continue to be significant estate taxes levied on family businesses and farms preventing orderly transfers to family members.

It is wrong to force corporations to either declare preferred dividends or face gifts or inclusions for the holders of preferred stock under proposed Section 2701. The advisability of paying dividends is a business decision by boards of directors and depends upon profits, working capital needs, plans for expansion, etc. The holders of

the preferred stock frequently will not have voting control and should not make or influence business decisions for their personal gain which might adversely affect other stockholders. They could be sued. The concept in 2701 of excusing dividends only in the event of bankruptcy or formal insolvency is thus flawed and should not be adopted.

Section 2702, as a practical matter, rules out all meaningful buy-sell agreements for family businesses. Buy-sell agreements containing formulas which may or may not equate fair market value at death are just as appropriate and necessary in family business situations as when the co-owners are not related. In fact, they may be more important in family situations. Such agreements are made when neither party is sure who will be the first to die, and thus contain safeguards from the marketplace, without the need for more statutory prohibition and rules.

For 25 years, the regulations under Section 2031 of the Estate Tax Law have set forth comprehensive rules governing buy-sell agreements. Regulations Section 20.2031-2(h) provides in part as follows (more complex rules are not needed):

> "Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money and money's worth."

Section 2703 creates another set of family attribution rules. In fact, there are two new sets in this Chapter 14. Add this to the sets in Section 318 and 267, plus other provisions, and we may now be to an approximate total of ten different sets of family attribution rules.

Those of us working with the SBCA and other groups representing family businesses and farms were encouraged and excited some weeks ago when key members of the tax committees spoke of the need for simplification of the Tax Code. Individuals and especially owners of family businesses and farms can no longer cope with the complexity of the Code and the number of complex provisions and changes. Since 1981 the following changes have occurred:

Law	No. of code subsections changed
1981-Economic Recovery Tax Act (ERTA)	483
1982-Tax Equity and Fiscal Responsibility Act (TEFRA)	530
1984-Deficit Reduction Act (DEFRA)	2,245
1984-Retirement Equity Act (REACT)	44
1986-Internal Revenue Code (FGSA)	2,704
1987-Omnibus Budget Reconciliation Act (OBRA)	231
1988-Technical and Miscellaneous Revenue Act (TAMRA)	1,588
1989-Omnibus Budget Reconciliation Act	462
Total changes in nine years	**8,287**

Proposed Chapter 14 with new code Sections 2701, 2702 and 2703 is not a good start toward simplification. What is being suggested is 25 pages of new, complex statutory provisions to replace the four burdensome pages of 2036(c).

We urge that family businesses and farms be totally excluded from a person's gross and taxable estate. Families should be encouraged to keep and expand their businesses and farms.

Sections 2701, 2702 and 2703 must have been drafted by the same team that did 2032(A) in 1976. You may recall that Congress had a wonderful idea to let family farms be taxed as farms. This simple concept was unfortunately converted to 11 pages of statutory complexity. Many pages of regulations have only explained some of the questions. By latest count, there have been 80 court decisions deciding 2032(a) issues. Sections 2701, 2702 and 2703 will provide a wonderful bonanza for tax lawyers to litigate.

Proposed Chapter 14 (Draft) provides that "qualified fixed payments" ("QFP") from a corporation or partnership includes, among other things, a cumulative preferred dividend payable on a periodic basis and at a fixed rate. The explanation accompanying the announcement of the Draft states that taxpayers are free to set the rate of QFP at whatever rate they wish, but to avoid adverse tax consequences, they must set any such rate at "appropriate market discount rates." The Draft contains no definition of what constitutes such appropriate market rates.

There is a grave concern among the owners of closely-held businesses and their representatives that, in setting or defining "appropriate market discount rates," Treasury will select rates comparable to yields provided on publicly held preferred stock instruments. If this happens, it will be extremely unlikely that a closely-held business or farm will ever engage in a capitalization. It will simply not be affordable.

The capital markets generally recognize that the yields held on publicly held preferred stock should be higher than the yields on corporate bonds. This is due, in part, to the fact that bond obligations are more secure and thus the bond holders are assured of being repaid before the holders of preferred stock receive any return of their investment.

As recent as last week, the yield on the Merrill-Lynch corporate bond index was around 9.75%. Accordingly, the market rate for publicly held preferred stock would be in the 10% range and higher. In light of these high market rates, no prudent businessman will create a corporate capital structure comprised primarily of cumulative preferred stock with a required dividend rate of 10% and beyond. Any such capital restructuring would potentially be a financial disaster for most closely-held businesses. These businesses need to maintain working capital to finance inventories, accounts receivable, expansion and new products or services. Forcing a 10% payout of funds would also render the business vulnerable to down-turns in the economy.

It is inappropriate to have a market rate dividend yield for preferred stock of a closely-held business. First, the market rates established in the public capital markets are designed to provide additional capital or financing for a public corporation in exchange for offering attractive yields to investors above and beyond what the investors could obtain by investing in corporate bonds and Treasury securities. By contrast, the yields on preferred stock in a closely-held corporation are primarily designed to provide a level and safe rate of return to the older generation owner of the closely-held business who is nearing retirement. Such owners desire to transfer the business to the next generation in an orderly fashion. The goal is to avoid the confiscatory estate taxes (maximum rate of 60%) which may force the sale of the business.

The yields on preferred stock of publicly held companies can afford to be higher because the capital structure of almost all publicly held companies is comprised of almost exclusively common stock and very little, if any, preferred stock. By contrast, the typical non-abusive recapitalization or "estate freeze" transaction usually results in the capital structure of the closely-held corporation being comprised significantly of preferred stock with a small amount of common stock. Under the Draft, the value of the preferred stock cannot exceed 80% or the value of the corporation's capital structure.

No prudent businessman will arrange the capital structure of his or her corporation so that a substantial required non-deductible dividend payment would threaten the continued financial viability of the business. Any such dividend payments would only put more corporate funds in the hands of the older generation shareholders to the detriment of the corporation which could have used those funds for expansion and other purposes which would create additional employment opportunities and jobs so desperately needed in this country.

A simple example will illustrate the above points:

EXAMPLE: Father owns 100% of the common stock of A Corporation worth $11,000,000. A Corporation's net after tax profits approximate $1,000,000 annually. Son is active in the business of A Corporation and father plans for son to someday run A Corporation. As a part of his estate plan, father recapitalizes A Corporation and in exchange for 100% of his common stock, he receives preferred stock worth $10,000,000 which provides for a cumulative preferred dividend of 10%. Father also receives $1,000,000 of common stock. The common stock is then gifted by father to son and father pays gift taxes on the gift.

After the recapitalization, father commences receiving the cumulative preferred dividend of $1,000,000 ($10,000,000 x 10%) annually. It takes corporate profits of more than $1,500,000 to generation the $1,000,000 dividend because corporate taxes at a 34% rate had to be paid. The corporation gets no income tax deduction for the

$1,000,000 dividend payment. Father has $1,000,000 of taxable income and nets $720,000 after paying income taxes at a 28% rate. Thus, corporate profits of $1,500,000 leave father with $720,000 after both the corporate and personal income taxes are paid on the dividends. The income tax bite is substantial in that it approximates 52%.

The corporation is using its entire $1,000,000 of after-tax profits to meet the required cumulative dividend payment to father. No corporate profits remain with which to expand, buy equipment, etc., which would create additional jobs in the community. No corporate profits remain as a hedge against a down-turn in business Father subsequently dies owning the $10,000,000 of preferred stock. Father's estate has to pay estate taxes approximating $5,500,000 (55%) attributable to the partnership being included in father's estate for estate tax purposes.

In conclusion, prescribing an expected high rate of return for preferred stock issued in connection with a recapitalization of a closely-held business, will not help. The Small Business Council of America respectfully submits that the cure (the Discussion Draft) is worse than the disease.

§2036(c).

By its very terms, the Draft or similar legislation, for all practical purposes, will result in the continued nonutilization of the legitimate and non-abusive recapitalization or "estate freeze" transactions. Accordingly, IRS §2036(c) should be repealed retroactively to date of enactment and the Discussion Draft should never become law.

The SBCA is aware that some abuses of the tax laws have been alleged but no specifics eve been shared. The tax laws existing prior to IRC §2036(c) prevented abuses from becoming prevalent. We recognize that improvements can always be made and accordingly concur with the suggestions of the D.C. Bar to mandate disclosure of estate freezes or gift tax returns and would suggest also the furnishing of appraisals to the IRS. Any abusive situations could be corrected through audit. This would be a simple but effective solution to a problem—if indeed one exists.

Prepared Statement of Senator David Boren

We are conducting this hearing to deal with one of the most severe problems facing small businesses in the U.S. today. At a time at when we should be doing all that we can to help keep small family-owned businesses afloat, a provision of the tax code, Section 2036(c) known as the estate freeze provision, poses a real threat to their survival.

This provision of the tax law makes it virtually impossible for families to keep their small businesses together from one generation to the next. It almost forces a trend under which bigger and bigger businesses gobble up smaller ones. In some cases because of huge estate tax burdens it forces small businesses to close their doors for good, throwing more and more people out of work.

Small family businesses provide the bulk of new Jobs in our ec nomy. The more people who have the experience of running their own businesses and having responsibility for them, the stronger our country will be. It's time to repeal this unfair portion of the tax code and help small family owned businesses for a change.

I am particularly pleased to have the opportunity to hold further discussions on the problem of estate freezes. I have cosponsored with Senator Daschle S. 849, a bill to repeal section 2036(c). The Finance Committee has previously held general hearings on the need for repeal of this provision. Today we have the opportunity to specifically consider the impact of this unworkable law on small business. Let me touch briefly on a few points which will undoubtedly be focused on more fully by the witnesses and those submitting testimony today. It is clear to me a compelling case can be made for enactment of this legislation calling for the repeal of section 2036(c).

The current law is overly broad and unintelligible to even the most sophisticated counsel, let alone counsel representing many small family owned business or farms throughout the United-States. It is worth noting that even supporters of 2036(c), few though they may be, concede that the 1987 law was clumsily fashioned. What they really mean is that virtually every knowledgeable observer, many of whom we will hear from today, has concluded that the new rules are simply unadministrable and not at all subject to a "patch-up" job of revision. While Treasury and other academics have suggested "modifications," very few have come forward with hard and fast revisions. Given the tremendous burdens this rule places upon family-owned small business, the only fair and meaningful course is to cleanly and clearly "start over" with repeal.

The current law affects many ordinary, day-to-day business transactions that almost everyone would agree should not be covered. This law clearly discourages the continuation of family businesses by almost requiring sales to "outsiders." Bob Tutty, President of the Chouteau Telephone Company, Chouteau, Oklahoma, in comments he has filed on behalf of himself and the National Telephone Cooperative Association, said:

> "Often, the only reason an individual remains in a community is because they have inherited, or will inherit, a small family-owned business, such as a telephone company or a family farm. Passing on a business to the next generation is a common occurance in a small town or rural community. The same kind of job opportunities that are available in an urban area don't exist in rural areas."

It is interesting to note that the legal permission of "estate freezes" is seen by opponents as a "giant loophole" simply because it permits the transmission of a family-owned business from one generation to another without the imposition of confiscatory tax rates. The facts are that our entire tax code is designed to raise revenue and to fairly promote economic activity. With the exception of 2036(c), I think Congress has generally chosen to promote not discourage the growth and prosperity of some 20 million small, family-owned businesses in this nation.

I believe the most efficient way to solve this problem is to consider very seriously the option of repeal. Perhaps some type legislation may ultimately be necessary to prevent valuation abuses in family transfers. Nevertheless we should begin with a clean: late, only then can we begin to consider a much more narrow, focused and equitable alternative to the current section 2036(c).

Prepared Statement of David R. Burton

I am David R. Burton, Manager of the Tax Policy Center for the U.S. Chamber of Commerce. I appreciate this opportunity to present the Chamber's views on a number of proposed replacements for section 2036(c) of the Internal Revenue Code. I will comment on the "Discussion Draft" proposal released by the House Ways and Means Committee, the proposal of the American Bar Association and the American College of Probate Counsel (ABA-ACPC joint task force), the District of Columbia Bar proposal, and the Chamber's draft statutory replacement for section 2036(c).

The Chamber has actively supported the repeal of section 2036(c). This provision eliminates estate freeze recapitalizati ns, calls into question the viability of many other legitimate methods of transferring family business assets from one generation to the next, and creates uncertainty with respect to many business arrangements that are unrelated to estate and gift tax planning. It jeopardizes the continuity of family ownership of many farms and businesses. Section 2036(c) was enacted without Congressional hearings or debate, and even now many families who are affected by the law are just discovering its existence. For three years, a cloud of complexity and confusion has hung over the entire family business community. As a result, there now seems to be a consensus that section 2036(c) should be repealed. The issue has therefore become what will replace section 2036(c).

I want to thank the Subcommittee on Energy and Agricultural Taxation and the Subcommittee on Taxation and Debt Management for holding this important hearing. A bipartisan effort in the Senate has moved the process to the present point. Senator Daschle has introduced S. 849, Senator Symms has introduced S. 659 and Senator Heflin has introduced S. 838. There are presently 39 Senators sponsoring or cosponsoring at least one of these bills, including seven members of the Finance Committee. Indeed, the Finance Committee approved the repeal of section 2036(c) as part of its budget reconciliation legislation last year. In the House of Representatives, 229 members are cosponsoring H.R. 60, Representative Archer's 2036(c) repeal legislation.

Much of my testimony is a review of the Ways and Means Committee Discussion Draft. Before addressing the discussion draft, I will comment on the proposals of the ABA-ACPC joint task force and the District of Columbia Bar. Finally, utilizing the discussion draft as a starting point, the Chamber has drafted a statute incorporating the changes suggested in its testimony. That statute is discussed in and appended to this testimony.

PROPOSAL OF THE AMERICAN BAR ASSOCIATION AMERICAN COLLEGE OF PROBATE COUNSEL JOINT TASK FORCE

In June of 1989, a joint task force of the ABA (Sections of Taxation and Real Property Probate and Trust) and the ACPC released a proposed alternative to section 2036(c). This proposal, like the discussion draft, is targeted at proper valuation of the gift at the time of a recapitalization. In order to keep the gift tax low, special discretionary rights (puts, conversion features, etc.) were often used to give value to preferred stock even though the dividends were noncumulative. The joint task force concluded that because a related party could fail to execute such rights and thus give value to the instrument which really was not retained, the solution was to recommend that such discretionary rights be disregarded in the valuation process. This is part 1 of the joint task force proposal.[1]

The second part of the joint task force proposal is a safe harbor which includes the requirement of a compounding cumulative dividend, a 20 percent minimum value for transferred junior interests, and a safe harbor interest rate equal to the applicable Federal rate.[2]

The ABA-ACPC proposal appears preferable to the discussion draft in most respects. The ABA-ACPC proposal is more narrowly targeted to recapitalizations; it does not propose legislation concerning joint purchases, trusts or buy-sell agreements. Furthermore, for purposes of valuing gifts, the ABA-ACPC proposal defines certain discretionary rights that are "bad" and requires that they be ignored for valuation purposes. The discussion draft defines what is good (only a qualified fixed payment and voting rights) and values everything else at zero. As will be noted in our comments on the discussion draft, this excludes many perfectly legitimate rights. An additional difference in the ABA-ACPC proposal and the draft is the taxation of unpaid dividends as gifts. The ABA proposal has no deemed gift provision. While dividends may not be paid for estate tax avoidance reasons, they may also not be paid because of a business downturn or change in the economic fortune of the company. Imposing a gift tax in the latter case is not justified since there is obviously no gift. Furthermore, in cases where a corporation can pay a dividend but chooses not to, the IRS could assess a gift tax under pre-2036(c) law.

The Chamber has several objections to the ABA-ACPC proposal safe harbor. Here, as with the discussion draft, the transferred junior interest will have to be at least 20 percent of the value of the equity in the company. A lower requirement is desirable and the Chamber continues to question the need for any such minimum requirement. Finally, the requirement of a dividend or preferred income right not less than the applicable Federal rate fails to account for the corporate level tax on dividends (as opposed to interest payments). If it is determined that the applicable Federal rate is a reasonable guide (and the Chamber questions whether one particular rate is appropriate in all contexts), then the appropriate dividend payout requirement is 66 percent of AFR, thus accounting for the corporate-level tax.

PROPOSAL OF THE TAXATION SECTION OF THE DISTRICT OF COLUMBIA BAR

The District of Columbia Bar proposal is also an attempt to reach a solution based on proper gift valuation. In its comments on the discussion draft, the DC Bar, though stating that the draft was a step in the right direction, was particularly con-

---

[1] PART 1—VALUATION ASSUMPTION: For gift ax purposes only, nonpublic stock and partnership interests shall be valued in order to maximize the value of the gift by assuming any discretionary liquidation, conversion, dividend or put rights retained by the donor or donor's spouse will not be exercised by them in a manner adverse to the donee's interest if the donee is a member of the donor's family.

[2] PART 2—A SAFE HARBOR: For purposes of valuing any gift of a junior or residual equity interest in a nonpublic corporation or partnership ("common interest") which interest is subject to one or more senior or preferred equity interests in such corporation or partnership ("preferred interest"), any such preferred interest shall be deemed to have a value not less than the amount which such preferred interest would receive if the corporation or partnership were liquidated on the date of such gift ("the liquidation amount"), provided that

(a) such preferred interest is entitled to a cumulative dividend or preferred income right not less than the liquidation amount multiplied by the applicable Federal rate on the date of such gift determined under IRC Section 1274 compounded semiannually; and

(b) in the event of any failure of the corporation or partnership to pay dividends or make cash distributions in the amount stipulated in (a) above for 36 months, the preferred interest shall be entitled to voting control of the corporation or partnership; and

(c) the sum of all such preferred interests does not exceed 80% of all of the equity interest in such corporation or partnership.

cerned that the draft adopts complex new property concepts and expands transfer-tax law beyond abuse cases.

The DC Bar proposal addresses what it regards as the two primary problems in this area of tax law, the inadequacy of rules for determining the valuation of inter-vivos transfers, and the inadequacy for the Service of reporting and auditing tools.

The Proposal would apply where the transfer involves an "enterprise," currently defined in section 2036(c), as a transfer in a 10 percent or more owned entity, and where there is a retained interest.

In a section 2036(c) situation, all transfers would have to be reported on a gift tax return even if the transfer were within the annual exclusion amount or were a bona-fide transfer for value. All prior applicable transfers would have to be reported again on the estate tax return of the transferor.

For purposes of valuing transfers in section 2036(c) situations, generally no minority discount would be available and either the Service or the taxpayer would be able to value transferred property without regard to the Treasury Department's actuarial tables in cases where it could be established that the nontabular valuation more closely reflects mortality factors and the actual income produced by the enterprise.

In a section 2036(c) situation, if a transfer were reported on a gift tax return and is audited by the Service within the applicable statute-of-limitations period, the Service would be permanently foreclosed from revaluing the property transferred either for gift-tax purposes or for subsequent estate-tax computation purposes upon the death of the transferor.

In a section 2036(c) situation, if a transfer were properly reported on a gift tax return, and the return was not audited, the Service would be foreclosed after expiration of the statute of limitations from revaluing the property transferred for the purpose of redetermining gift tax, but the Service would be able to revalue (with the burden of proof) the property for estate tax purposes in connection with the tentative tax computation under section 2001(b)(1) and limit the section 2001(b)(2) offset to the actual gift tax paid with respect to the transfer.

If, in a 2036(c) situation, a transfer is not properly reported on a gift tax return, the statute of limitations would remain open with respect to the transfer, and the Service would subsequently be able to revalue the transferred property both for gift tax purposes and for the purpose of making the tentative estate tax computation at death under section 2001(b)(1).

With respect to a transfer in a section 2036(c) situation, the Service would be able to assess, within the statute of limitations, a substantial undervaluation penalty in either a gift tax proceeding or an estate tax proceeding, but not in both. If there had been full return disclosure of a transfer, however, the Service would have the burden of proof with respect to assertion of the penalty in the estate tax proceeding, assuming no gift tax audit was conducted. If, on the other hand, a timely gift tax audit were conducted by the Service and the Service did not assert a penalty, it would be foreclosed from asserting the penalty in the subsequent estate tax proceeding.

An expanded six-year gift tax statute of limitations would apply to transfers in section 2036(c) situations. At any time after a disclosure of a section 2036(c) type transfer, whether or not within the six-year statutory period, a taxpayer could file with the Service a request to review the transfer. The Service would then have until the later of either (i) the expiration of the six-year limitations period or (ii) the period ending two years after the request, to audit the taxpayer's gift tax return with respect to the transfer. If it fails to conduct an audit within the statutory period, the Service would be foreclosed from revaluing the property transferred whether for gift tax purposes or for the purpose of the tentative estate tax computation under section 2001(b)(1). The proposal explicitly recognizes that periodic gift taxation may result where certain post-transfer discretionary action or inaction by the taxpayer inures to the benefit of the transferee.

There are a number of desirable features in the DC Bar proposal. It is far less complicated than the discussion draft. It abandons the "look back" approach of section 2036(c) and gives considerable flexibility to taxpayers in structuring transactions. Unlike the discussion draft, the proposal does not attempt to impose what would often be fictional and arbitrary values on interests, nor does it establish an arbitrary minimum value of 20 percent on the transferred interest. In exchange for extensive reporting, the taxpayer is provided with a high level of certainty. Following the expiration of a six-year statute of limitations, a properly reported transfer would not be subject to further review for gift or estate tax purposes if the gift tax return has been audited. The Chamber believes that if the DC Bar approach is adopted, then this procedure should apply as well where the transfer is reported and the Service chooses not to audit the return. The taxpayer has done his part and

should not later be punished merely because the Service chose not to audit the return.

The Chamber continues to believe that any legislation in this area should apply only to entities owned 50 percent or more by the transferor or his immediate family; the DC Bar proposal retains a 10 percent ownership threshold. The Chamber is also concerned with the severe limitations on the minority interest discount in the DC Bar proposal. Lack of control in the transferred property may well warrant a discount for its status as a subordinate minority interest. The Chamber believes the current three-year statute of limitations is adequate and, as with the discussion draft, the Chamber is opposed to an unlimited statute of limitations, i.e., where the transfer is not properly reported. Finally, the reporting requirements in the proposal are more extensive than necessary.

WAYS AND MEANS COMMITTEE DISCUSSION DRAFT

The Chamber carefully reviewed the discussion draft released by the Committee on Ways and Means as a replacement for section 2036(c). We support the discussion draft's core concept of establishing reasonable rules to value, for gift tax purposes, retained interests in recapitalizations while abandoning the 2036(c) approach of considering retained interests as retention of the transferred property. However, we have identified significant problems with the discussion draft, and unless a number of substantial improvements are made, the Chamber cannot support it. My testimony will identify these issues and the manner in which the Chamber believes they should be addressed. In addition, attached as an appendix to this testimony is draft statutory language indicating changes such as would need to be made to the discussion draft before the Chamber could offer its support. We view our draft as a starting point. There are no doubt ways in which it could be improved and we welcome suggestions in this regard. We are convinced, however, that our draft is a framework for a permanent solution to the problems caused by section 2036(c).

BUY-SELL AGREEMENTS

Nearly every closely held business has a buy-sell agreement. These agreements can take many forms, including cross-purchase, redemption or right of first refusal agreements. Rarely are these agreements motivated by the desire to avoid transfer taxes. Unfortunately, for reasons unclear to the Chamber, section 2702 of the draft would fundamentally alter the transfer tax treatment of buy-sell agreements. Section 2702 arbitrarily values taxpayers' property (generally an interest in the entity) without regard to a right of first refusal or a lease burdening the property. Furthermore, for purposes of the estate and gift tax subtitle, the value of property would be determined without regard to any option or agreement to purchase the property at a price less than fair market value (determined without regard to the option or agreement) as of the time the option or rights under the agreement are exercised unless the formula determining the price at which such property is sold is "reviewed" (an ambiguous term which may or may not mean renegotiated) every three years.

This aspect of the discussion draft is universally viewed within the business community as unacceptable. The provision affects all buy-sell agreements of any type, whether or not part of a recapitalization, whether or not estate and gift tax motivated and whether or not they are abusive in any way. The provision would affect literally hundreds of thousands of routine buy-sell agreements that are of greater duration than three years and based on a formula—no matter how reasonable or commonplace the agreement may be.

The requirement that the agreement be reviewed every three years will be an additional expense and burden that every prudent small business will need to incur, and the provision poses practical difficulties, particularly if nonfamily members are parties to the agreement. The provision is virtually guaranteed to lead to inadvertent noncompliance because many small businesses in America do not have a comprehensive review of every agreement to which they are a party every three years. Small businesses are in the business of running their business, not reviewing legal minutia. And for businesses that have not done a recapitalization with sophisticated estate planning counsel, this provision no doubt ranks as legal minutia. To address a putative "problem," this provision would introduce a new dimension of complexity into every buy-sell agreement in the U.S. Neither the Treasury Department nor Congressional staff has argued that buy-sell agreements are generally abusive or generally entered into for tax avoidance purposes. If there are abuses in this area, and the Chamber is not convinced that there are, then legislation should be narrowly drafted to stop those abuses.

The Chamber believes that the entire proposed section 2702 should be dropped from any replacement statute. The requirement of a three-year review of buy-sell formulas should be dropped. Any replacement statute must also acknowledge that property can be valued with reference to rights of first refusal, leases burdening the property and buy-sell agreements.

THE MINIMUM VALUATION RULE FOR THE JUNIOR EQUITY INTEREST

The draft establishes an arbitrary and unfounded requirement that the junior equity interest (generally common stock in a corporate context) be valued at no less than 20 percent of the sum of the equity of the business plus any debt owed by the business to the transferor (and his family). There are three problems here.

First, including debt in the calculation of the 20 percent is improper. The calculation should include only the equity of the business; otherwise the "unfrozen" portion of the business could in fact be considerably higher than 20 percent of the equity of the business. In fact, this provision alone could virtually prohibit recapitalizations in fairly typical situations. Assume the following facts: A business has assets worth 100x; debt of 80x (held by family members) and shareholders' equity of 20x; 100 shares of common held by parent p; therefore, the shareholders' equity is 0.2x per share of common. Parent p wants to initiate a recapitalization and transfer his common interest and future appreciation (or depreciation) to children c in exchange for a preferred stock interest with a market value approaching the value of his common stock interest. The draft would require that the children c's common stock be worth 20 percent of the sum of 80x (the debt owed to the family) and 20x (the equity). Twenty percent of 100x (the sum) equals 20x. Thus, under the draft, and under these fairly typical facts, there would be no amount parent p could freeze because the junior interest would have to be equal in value to the entire equity value of the firm. If parent p retained any preferred interest, the value of junior interest would fall below 20x, yet the statute would ignore any decline in value. Follow the example further. Assume parent p does a recapitalization retaining a preferred stock interest equal to 80 percent of the equity of the firm (16x) in exchange for 80 shares of common worth 16x and gives 20 shares of common to children c worth 4x. Under normal economic principles, a fair result would be that parent p owed a gift tax on his gift of 4x. But under the discussion draft, he would owe an immediate gift tax on 20x—an amount equal to parent p's entire equity interest and an amount 400 percent higher than the actual gift. Moreover, it is not clear whether the rules under proposed section 2701(e) that parent p would not be liable for an estate tax on the retained preferred stock interest worth 16x.[3] Under the draft, a firm with a four to one debt-to-equity ratio would be able to freeze no portion of the value of the enterprise, and a firm with any debt to any family member would conceivably be liable for double taxation on any frozen portion.

Second, 20 percent is simply too high a figure if recapitalizations are to remain a viable option for most family businesses. The immediate gift tax consequences (or income tax if the 20 percent interest is sold to the heirs) of a recapitalization under this proposal will be prohibitive for many business owners. The stated goal of the draft is to prevent abusive recapitalizations, not all recapitalizations. And it should not be forgotten that the gift tax can often be more burdensome than the estate tax since the Code has no gift tax analog to the installment payment provisions of section 6166.

Third, there is no need for a minimum valuation rule. By disallowing the use of discretionary rights for purposes of valuing the retained interest, the proposal would provide at least a fair market value for the equity interests in the business and will often overvalue them. There is no reason for an arbitrary floor on the value of the junior interest.

THE DEEMED GIFT PROVISIONS

The only exception to the deemed gift and compounding election regime under the draft is bankruptcy or insolvency. Analytically, there should be an additional exception where a dividend would not have been paid to an unrelated party in an "arms-length" transaction. The nonpayment of a dividend in the arms-length situation would not be considered a gift and should not be a deemed gift under the draft. Yet

---

[3] Proposed section 2701(e) attempts to eliminate the double taxation of "specially valued retained interests". That term is defined in section 2703(e)(2) to include only those interests determined under subparagraph (A) and (B) of section 2701(a)(2). Therefore presumably section 2701(e) would not operate to alleviate double taxation that resulted from overvaluations occurring due to the application of section 2701(a)(3).

drafting a rule that would capture all situations in which a business might not pay dividends in an unrelated party context is quite difficult. Therefore, the Chamber recommends a highly administrable, bright-line rule designed to capture the situation when a business is not paying dividends because of a business down-turn. If such a rule is not adopted, then business owners that have done recapitalizations may well find themselves liable for a gift tax at the very time they can least afford it. We recommend an exception to the deemed gift rule where the sum of the entity's annual earnings and profits plus compensation to family members is less than the required earnings payout. This exception would apply only where there had been adequate coverage in the three years prior to the transaction giving rise to the required payout.

RETAINED INTEREST VALUATION

The primary goal of the draft should be to prohibit the use of certain abusive discretionary rights in valuing the retained interest of the business. Basing value on these rights can be abusive in a family business context because they can be granted to the retained interest with the understanding and intention never to exercise those rights and therefore to increase the retained interest's value and to decrease the junior interest's value. Unfortunately, the approach to the valuation of retained interests in the draft turns this approach on its head. The statute identifies those rights (QFPs and voting rights) that are to be assigned value and requires all other senior retained rights to be valued at zero. In essence, the draft assumes that everything other than voting rights and QFPs are abusive. This is an unreasonable and incorrect assumption. The correct approach for the draft would be to list those retained rights that are abusive and therefore can be assigned no value and permit all others to hold their appropriate fair market value. In addition, it would aid the practical understanding and administrability of the statute if the statute made it clear that certain commonly created rights could be valued according to ordinary valuation rules.

QFPS

If the right to QFPs were to remain as the only right that holds value other than voting rights, then the definition of a QFP would at minimum have to be expanded to include a number of nondiscretionary rights often retained by the transferor for business reasons rather than for tax avoidance. The draft defines a QFP as a payment that is fixed as to time and amount. Therefore, any interest not absolutely fixed as to time and amount is valued at zero. This produces an unreasonable result. For example, a lease providing that a portion of the lease payment is based on a percentage of the lessee's revenue is both quite common and quite valuable, but will be valued at zero under the draft. For example, a grocery or retail store that paid a percentage of sales lease when transferred would be valued as though it paid no lease at all. Other retained interests that appear to be non-QFPs include royalties and any equity interest that has any participatory component, including a covenant that the holder of the retained interest be fully repaid for his investment before the junior interest receives a return. This is particularly common in a partnership context when an agreement provides that one partner receives all profits until his initial investment in the partnership is recovered and then receives a relatively determinable return. The draft would therefore have two adverse effects. First, many nondiscretionary retained interests would be valued at zero. Second, the value of junior interests could be inaccurately inflated because it will be assumed that none of these payments are made.

THE DISCOUNT RATE

The proposal implies that businesses will be permitted to select their own cumulative dividend or payout rate and that this will be matched against an appropriate but undefined discount rate. The rate at which the stated dividend or payout is discounted will in large measure determine the value of the retained interest. There is, of course, a high degree of intellectual merit to the idea that this rate should be set at a market rate based on the circumstances of each individual firm. Yet because of the importance of the discount rate to the valuation process, there is significant anxiety in the business community over how the rate will ultimately be determined. There is fear that, later in the political process or in the regulations the rate will be set at an artificially high figure. There is also fear that on audit the Service will regularly attempt to characterize small business securities as low-grade, high-risk securities that should be discounted at a high rate. There should be some assurance, perhaps in report language, that this will not occur. A specified rate, of course, is

attractive in some respects. Most importantly, it would provide for certainty, but a specified rate would also simplify the process of recapitalization.

LEASES AND DEBTS

Debts and leases are specifically identified as interests in the entity in section 2703(e)(3). This is unwarranted because there does not appear to be evidence that valuation abuses have occurred with leases, and any problems that might arise with debt can be adequately dealt with by code provisions such as section 7872 and section 6662(g). Furthermore, many people do not consult with attorneys when simple debt or lease agreements are entered into, and their inclusion in the proposal will unnecessarily complicate the negotiation of such agreements and impose costs on taxpayers.

THE COMPOUNDING CUMULATIVE PREFERRED ELECTION

A business that does not experience the long-term growth anticipated at the outset of a recapitalization may find that the compounding effect defeats the very purpose of a recapitalization by creating a huge estate in relation to the value of the business. In fact, as the draft is presently written, the value of the preferred interest for estate tax purposes may well exceed the fair market value of the entire business. The draft should provide for a cap on the value of the preferred stock for estate tax purposes and should not exceed the value of the equity of the company.

THE 10 PERCENT THRESHOLD FOR APPLICATION OF CHAPTER 14

A transferor who owns only a 10 percent interest in the "entity" would not be able to initiate an abusive recapitalization. Moreover, the draft uses family attribution rules that would include virtually all family members in determining whether there is 10 percent ownership. The Chamber believes the appropriate threshold is a 50 percent interest in the entity, including those interests attributed under appropriate attribution rules.

THE DEFINITION OF INSOLVENCY

Section 2701(f)(2)(A) excludes from the determination of insolvency any liabilities to the transferor or members of the transferor's family. This appears to exclude not only loans but also any unpaid dividends due to family members. Ignoring legitimate debts due to family members in determining insolvency would be highly burdensome. In a small business context, loans to businesses are routinely made by family members because banks and other sources of credit are unwilling to take the risk of financing a small, entrepreneurial venture. Yet these debts remain debts all the same and should certainly be included in calculating the total debt burden of the business.

THE DEFINITION OF FAMILY

The definition of family under section 2703(a)(1) is quite broad but reasonable. However, the addition of 2703(a)(2) treats any person as a member of the transferor's family if the transfer would otherwise be considered a gift. Therefore, it is clear that relatives outside the immediate family or even nonrelatives will be considered family members.

THE STATUTE OF LIMITATIONS

The draft makes several unwarranted changes concerning the statute of limitations. First, the gift tax statute of limitations is extended from three years to six years for transfers subject to these provisions. The Chamber sees no reason for such an exception. It is highly important that the determination of tax liability become certain within a reasonable period. Three years is as long a period as tax years should remain open. Second, the statute of limitations is tolled where any gift of property valued according to section 2701 and required to be reported on a gift tax return is not reported on that return. The tolling of the gift tax statute of limitations indefinitely is unfair to taxpayers and could create particular burdens where the transferor considered the transaction in question to be a sale and therefore did not report it on a gift tax return. This becomes a particular problem in any area where the statute may be interpreted broadly to include transactions about which various parties are unaware or which they would not assume are included under the statute. In any such situation, the transaction will go unreported and the statute of limitations is endless. It should be noted that the law already includes section 6501(e), which extends the statute of limitations from three to six years where an

estate or gift tax return improperly omits an amount exceeding 25 percent (substantial omission of items) of the amount reported on the return.

The Chamber is also concerned that the information reporting requirements will increase substantially with this proposal. Section 2703(f)(3) authorizes regulations to impose information reporting requirements. These would apparently apply to not only the initial transfer but also to all deemed gift transactions under section 2701(c) and section 2701(d). There is, at the very least, the need for greater specificity about what kind of requirements can be imposed on taxpayers.

TRUSTS AND JOINT PURCHASES

Much of the complexity of the draft comes from the fact that it addresses far more than recapitalizations. Those aspects of the proposal addressing trusts and joint purchases should be addressed in separate legislation. The rules governing the valuation of trusts are unique, and the attempt to address trusts in this legislation makes the proposal overly complex. It is not clear to the Chamber why joint purchases are included in the draft. If there is a need for legislation in this area, it too should be addressed separately, not as part of legislation intended to deal with corporations and partnerships.

Another reason for the overbreadth and practical complexity of the draft is that it adopts an expansive definition of "abuse." No statute can anticipate and eliminate all conceivable abuse. Statutes that attempt to do so will more often than not simply impose extreme burdens on law-abiding and well-intentioned citizens. The Chamber and others involved in the effort to repeal section 2036(c) are willing to consider legislation that will curb valuation abuses in business recapitalizations. Yet, in the interest of fairness to the vast majority of taxpayers who do not abuse the system, the antiabuse provision should be narrowly drafted and easily understandable and must not result in high compliance costs for most taxpayers.

THE CONSENT REQUIREMENT

Section 2701(b)(3)(B) of the proposal provides that payments under any instrument held by a member of the transferor's family shall not be treated as QFPs unless such member consents to be treated in the same manner as the transferor for purposes of applying the deemed gift rule and other requirements. Therefore, if consent is not obtained, rights held by family members not immediately involved in the transaction covered by chapter 14 will have no value in the calculation of the value of an interest transferred between parent and child. There is concern that in certain situations this provision may even give relatives veto power over the recapitalization arrangement. The provision assumes a harmonious relationship among family members that often does not exist, and once again further complicates the valuation procedure outlined in the draft.

TECHNICAL CHANGES

In addition to the broad issues outlined above, there appears to be a need for clarification of the statutory language used at various points in the draft. Many will be technical clarifications arising from complexity in this area of the law generally and in the discussion draft in particular. For example, it seems fairly clear that only section 2207B(b) should be repealed, not the entire section.

Another example concerns the wording in section 2703(c) of the draft, stating that any redemption, recapitalization, contribution to capital or other change in capital structure that has substantially the same effect as a transfer of an interest in such entity shall, except as provided in regulations, be treated as a transfer of an interest in the entity. The preferable reading would be to state that such transactions will constitute a transfer of an interest in the entity *to the extent* provided in regulations.

Finally, a third example concerns the refund provision for the gift tax paid on an omitted dividend that is later paid. Provision is apparently made under section 2701(c)(3) for the gift tax (although it is unclear if the statute works as intended). No provision provides for a refund of the generation-skipping transfer tax.

CONCLUSION

The Chamber hopes these comments will help in the difficult task of devising a workable and uncomplicated replacement for section 2036(c). The process that the Finance Committee, Ways and Means Committee and the Treasury Department have inaugurated is commendable. The Chamber looks forward to continuing a constructive dialogue and to a satisfactory replacement to 2036(c) being enacted into law. Thank you.

APPENDIX: U.S. CHAMBER OF COMMERCE DRAFT STATUTE

The proposal set forth in this appendix is based on the discussion draft but incorporates the changes outlined in my testimony. This statutory language no doubt can be improved, and we welcome suggestions in this regard. Yet I believe it offers a workable alternative to the discussion draft that would prevent abusive recapitalizations and solve most if not all of the major problems business has experienced with 2036(c). It is offered in the hope that it will provide some guidance as to the sort of statute that business community could support. Description of proposal: The amended draft repeals section 2036(c) retroactively. Section 2036(c) is replaced with special valuation rules for business recapitalizations. The valuation rules would not apply to buy-sell agreements, trusts or joint purchases. In valuing a retained interest any discretionary liquidation, conversion, put, discretionary dividend right or other right to a payment or distribution the payment of which is at the discretion of the transferor or the corporation or partnership would be valued at zero. Any promise to make a Qualified Non-Discretionary Payment (QNDP) will be valued according to rules substantially the same as the discussion draft's QFP rules. All other rights, a number of which are specifically enumerated, would be valued under normal valuation principles. As with the Ways and Means Committee draft, the nonpayment of a QNDP within three years will trigger a deemed gift (unless the compounding option was provided for in the instrument paying the QNDP). In addition to the bankruptcy and insolvency exceptions, there is an exception where the sum of the entity's annual earnings and profits plus compensation paid to family members is less than the QNDP provided the entity had adequate coverage in the three years prior to creation of the instrument giving rise to the QNDP.

The draft statute applies only where the transferor or his immediate family owns 50 percent or more of the entity, and there is no minimum value requirement for the transferred junior equity interest. Certain other changes to the discussion draft are also made.

PRELIMINARY DISCUSSION DRAFT

(June 27, 1990)

PART ———— PROVISIONS RELATING TO ESTATE FREEZES

SEC. ————. REPEAL OF SECTION 2036(c).

(a) IN GENERAL.—Section 2036 (relating to transfers with retained life estate) is amended by striking subsection (c) and by redesignating subsection (d) as subsection (c).

(b) CONFORMING AMENDMENTS.—Section 2207B is amended by striking subsection (b) and by redesignating subsections (c) through (e) as subsections (b) through (d).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply in the case of property transferred after December 17, 1987.

SEC. ————. SPECIAL VALUATION RULES.

(a) IN GENERAL.—Subtitle B is amended by adding at the end thereof the following new chapter:

"CHAPTER 14—SPECIAL VALUATION RULES

"SEC. 2701. SPECIAL VALUATION RULES IN CASE OF TRANSFERS OF INTERESTS IN 50-PERCENT OR MORE OWNED ENTITIES.

"(a) TRANSFERS OF INTERESTS IN CERTAIN ENTITIES.—

"(1) IN GENERAL.—

"(A) TRANSFERRED EQUITY JUNIOR INTERESTS.—Solely for purposes of determining whether a transfer of a junior equity interest in a 50 percent or more owned entity to a member of the transferor's family is a gift (and the amount of such gift), the value of any preferred equity interest in such entity retained by the transferor (or his or her spouse) shall be determined under paragraph (2).

"(B) PREFERRED EQUITY INTERESTS.—For purposes of subparagraph (A), the issuance to an individual of any preferred equity interest in a 50 percent or more owned entity in exchange for property constitutes a transfer of an equity interest by that individual to the owners of the junior equity interests in such entity proportionately of an amount equal to the excess, at the time of issuance, of the value of the property exchanged by that individual for such preferred equity interest over the value determined under paragraph (2) of such preferred equity interest received by that individual.

"(C) DISPOSITION OF SPECIALLY VALUED PREFERRED EQUITY INTERESTS.—For purposes of this subtitle, the value of a transfer by the transferor (or his or her spouse) of a preferred equity interest which has been valued under paragraph (A) (a "specially valued preferred equity interest") or the value of any other right under the instrument evidencing such interest, shall be the value determined under paragraph (2), except that this subparagraph (C) shall not apply to transfers to the spouse or surviving spouse of the transferor which qualify for a deduction under any one of sections 2056, 2106(a)(3) or 2523 or would qualify for such deduction except for the consideration paid by the spouse.

"(2) VALUATION OF CERTAIN PREFERRED EQUITY INTERESTS.—

"(A) IN GENERAL.—The value of the preferred equity interest shall be determined by valuing any discretionary rights under the instrument evidencing such preferred equity interest (meaning any liquidation, conversion, put, call, or other right to a payment or distribution the payment of which is at the discretion of the transferor or the corporation or partnership) at zero.

"(B) VALUATION OF QUALIFIED NON-DISCRETIONARY PAYMENTS.—For purposes of determining the value of the right to receive qualified non-discretionary payments under any instrument, the value shall be determined by discounting such payments employing the assumption that—

"(i) such qualified non-discretionary payments will be made as provided in such instrument, and

"(ii) if such instrument has no non-discretionary termination date, payments under such instrument will be made in perpetuity.

"(C) VALUATION OF CERTAIN OTHER RIGHTS. — This section shall not apply to the valuation of the following which shall be determined without regard to this section:

"(i) Any interest of the same class as the transferred interest. (ii) Any discount for minority interest or lack of marketability with respect to the transferred junior interest

(iii) Any rights with respect to the retained preferred interest which have no preference over any rights under the transferred interest

(iv) Any option, buy-sell, cross-purchase, redemption or other agreement to buy or sell property interests.[1]

(v) Employment agreements, debt, leases and other non-equity interests

(vi) Rights of first refusal agreements and other transfer restrictions

(vii) A payment or right which is (i) a function of any published index, (ii) directly related to sales or production, or (iii) otherwise not subject to the discretion of the transferor, his or her spouse or the 50 percent owned entity

"(D) DISCOUNT RATE.—The value of the qualified non-discretionary payments under any instrument shall be determined by appropriately discounting future payments.

"(E) BUSINESS VALUE.—The value of any preferred equity interests determined under this paragraph (2) shall be reduced by an amount equal to the value reduction ratio times the excess value amount. For purposes of

---

[1] Additional language in the statute or report language based on Treasury Regulations Section 20.2031-2(h) may be appropriate on further examination. It would read: The effect of any such agreement shall depend on the circumstances of each particular case. Little weight will be accorded a price if the agreement permits the disposition of the underlying securities at any price during lifetime, such as an agreement to purchase the shares a decedent may own at his death. Even if the agreement precludes transfers during life at other than the agreed price, such price will be disregarded unless it is determined under the circumstances of the particular case that the agreement is *both (1)* a bona fide business arrangement and *(2)* not a device to pass property to the natural objects of the transferor's bounty for less than an adequate and full consideration in money or money's worth. If the agreed price is disregarded under this subparagraph, the restrictions may still be considered transfer restrictions that affect value. A number of commentators have argued that the courts have misapplied these regulations by viewing taxpayer compliance with the first prong of the test as sufficient. The underlined changes should clari that the test is a two-prong test and that the fact that a taxpayer has met the first prong of the test is not dispositive of th case. The Chamber strongly believes that any further changes in the area of buy-sell agreements would be inappropriate. The mere fact that an agreement will affect value to the same degree that it would affect value in an unrelated party context should not give rise to gift tax consequences.

the preceding sentence, the term "value reduction ratio" means the value determined under paragraph (2) divided by the value of all preferred interests (including all accrued dividend or other payments with respect to such interests),[2] and the term "excess value amount" means the amount by which the value of all preferred interests exceeds the value of the 50 per cent owned entity.

"(b) DEFINITION OF QUALIFIED NON-DISCRETIONARY PAYMENTS.—For purposes of this section-

"(1) QUALIFIED NON-DISCRETIONARY PAYMENT.—

"(A) IN GENERAL.- The term 'qualified non-discretionary payment' means—

"(i) any payment or distribution (other than a dividend) with respect to any interest in the entity to the extent such payment or distribution is non-discretionary as to both amount and time for payment, and

"(ii) any dividend payable on a periodic basis under any cumulative or non-cumulative preferred stock to the extent such dividend is determined at a non-discretionary rate.

"(B) TREATMENT OF VARIABLE RATE PAYMENTS.—For purposes of subparagraph (A), a payment shall be treated as non-discretionary as to amount or rate if such payment is determined at a rate which bears a fixed relationship to a specified market or other interest rate. "(C) CERTAIN PAYMENTS NOT QUALIFIED.—An amount which is payable under any instrument issued by a corporation or partnership and which is subject to a life contingency shall not be treated as a qualified non-discretionary payment.

"(2) ELECTIONS.--

"(A) Waiver.—A transferor may elect to treat any payments under any instrument as payments which are not qualified non-discretionary payments.

"(B) SPOUSAL CONSENT.—Payments under any specially valued preferred interest retained by transferor's spouse (who has not otherwise consented under section 2513 to the transfer of the junior equity interest) shall not be qualified non-discretionary payments unless such spouse consents to the application of paragraph (C) below.

"(C) OTHERWISE DISCRETIONARY PAYMENTS.—A transferor or his or her spouse may elect to treat any right to a payment or distribution with respect to a retained preferred equity interest as a qualified non-discretionary payment by specifying the amounts and times at which such payments or distributions shall be made, provided such times and amounts are not inconsistent with the instrument giving rise to such rights.

"(D) TIME AND MANNER OF ELECTION.—The elections provided in this subparagraph (2) shall be made on the first gift tax return due for the period in which the transfer of the junior equity interest occurred and once made shall be revocable only with the consent of the Secretary or his designate.

"(c) DEEMED GIFTS WHERE QUALIFIED NON-DISCRETIONARY PAYMENTS ARE NOT MADE.—

"(1) IN GENERAL.—A qualified non-discretionary payment under any retained specially valued preferred interest, to the extent not made before the close of the 3rd calendar year following the calendar year in which such payment was due, shall be treated as a gift made by the transferor (or the transferor's spouse in the case of consent under section 2513 or section (b)(2)) on the last day of such 3rd calendar year

"(2) EXCEPTIONS.—Paragraph (1) shall not apply to any payment under any retained instrument if—

"(A) the transferor or his or her spouse does not hold such instrument as of the close of the 3rd calendar year referred to in paragraph (1), or

"(B) a family member of the transferor did not hold the transferred junior equity instrument at the time the non-discretionary payment was due, or

"(C) the instrument evidencing such interest provides that any qualified non-discretionary payment not timely paid shall bear interest compounded annually from the date such payment was due at a rate not less than the

[2] This language represents a clarifying change from the Chamber's Ways and Means Committee submission.

discount rate used in valuing such qualified non-discretionary payment under subsection (a)(2)(D), or

"(D) INADEQUATE EARNINGS AND PROFITS.—

(i) the retained interest's proportionate share of the sum of the entity's annual earnings and profits plus compensation (as defined in section 162(a)) paid to family members (as defined in section 2702(a)) in any calendar year is less than the qualified non-discretionary payment payable in such calendar year with respect to that instrument, provided that this exception shall not apply unless, in each of the three taxable years prior to the year of creation of the instrument giving rise to the qualified non-discretionary payment, the proportionate share of the sum of the entity's annual earnings and profits plus compensation (as defined in section 162(a)) paid to family members (as defined in section 2702(a)) exceeded 150 percent of the average qualified fixed payment payable in the first three full taxable years after creation of the instrument giving rise to the qualified non-discretionary payment.

(ii) DEFINITION OF EARNINGS AND PROFITS.— For purposes of this subsection, if the entity is a corporation, then the definition of 'earnings and profits' in section 312 shall apply and if the entity is a partnership, then 'earnings and profits' shall be the sum of net income or loss, and net capital gain or loss (but excluding charitable contributions) as defined in section 702.

(iii) PROPORTIONATE SHARE.—For purposes of this subsection, the term proportionate share means the ratio of the value of the retained interest to the value of all the preferred interests of the entity.

"(E) it becomes due during any period of insolvency or bankruptcy (as defined in subsection (e))

"(3) REFUND OR CREDIT IF PAYMENT SUBSEQUENTLY MADE.—If any portion of a qualified non-discretionary payment is treated as a gift made by the transferor under this subsection and such portion is subsequently paid to the transferor—

"(A) any tax paid by the transferor under chapter 12 by reason of such gift shall be treated as a payment of tax under chapter 12 made by the transferor for the calendar year in which such portion is paid, and shall be refundable to the transferor upon application to the Secretary in such manner as he shall prescribe, and

"(B) such portion shall be excluded from taxable gifts (and any credit allowable under section 2505 by reason of such gift shall be disregarded) for purposes of determining the amount of the tax imposed by this subtitle on transfers (including by reason of death) made by the transferor during the calendar year in which such portion is paid or any subsequent year.

"(4) ADJUSTMENT TO SUBSEQUENT VALUATIONS OF INSTRUMENT.—The portion of any qualified non-discretionary payment under any instrument which is treated as a gift by the transferor under this subsection shall be disregarded in subsequently determining the value of such instrument for purposes of this subtitle in the case of any transfer of such instrument by such transferor or the death of such transferor

"(d) ADJUSTMENT IN VALUE OF SPECIALLY VALUED RETAINED RIGHTS.—In the case of any right under a specially valued retained interest other than a right to receive qualified non-discretionary payments, for purposes of—

"(1) determining whether any transfer of such right by the transferor is a gift (and the amount of such gift), or

"(2) determining the amount includible in the gross estate of the transferor by reason of such right,

under regulations prescribed by the Secretary (and subject to such conditions as may be prescribed in such regulations), the amount otherwise treated as the value of such right shall be reduced (but not below zero) by the amount of the increase in any prior taxable gift made by the transferor resulting from such right being valued under subsection (a)(2)(A).

"(e) INSOLVENCY AND BANKRUPTCY.—For purposes of this chapter—

"(1) INSOLVENT.—The term 'insolvent' has the meaning given to such term by section 108(d).

"(2) TITLE 11 CASE.—The term title 11 case means any case under title 11, United States Code.

"(3) EXTINGUISHMENT.—Subsection (c) shall not apply to any qualified non-discretionary payment to the extent the right to receive such payment is extinguished in the title 11 case.

"SEC. 2702. DEFINITIONS AND SPECIAL RULES.

"(a) FAMILY.—For purposes of this chapter, 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. For purposes of the preceding sentence, a relationship by legal adoption shall be treated as a relationship by blood.

"(b) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this chapter—

"(1) 50-PERCENT OR MORE OWNED ENTITY.—

"(A) IN GENERAL.—The term '50-percent or more owned entity' means—

"(i) any entity taxed under subchapter C of subtitle A if 50 percent or more of the value of the stock in such corporation is held (directly or indirectly) by the transferor,

"(ii) any entity taxed under subchapter K of subtitle A if 50 percent or more of the value of the capital or profits interest in such partnership is held (directly or indirectly) by the transferor.

For purposes of the preceding sentence, the transferor shall be treated as holding any interest in an entity held (directly or indirectly) by such individual's spouse, parent or grandparent. [Indirect ownership shall be determined applying the attribution rules under section 318(a)(2)].

"(B) EXCEPTION.—The term '50 percent or more owned entity' shall not include an entity for which market quotations for the equity interests or securities in such entity are readily available on an established securities market.[3]

"(2) PREFERRED EQUITY INTEREST.—The term 'preferred equity interest' means any retained interest having a prescribed value on liquidation, conversion or redemption that is preferred over (or shares proportionately in appreciation only to such prescribed value with) another equity interest (a 'junior equity interest').[4]

"(3) EXERCISE OF DISCRETIONARY RIGHTS.—Except as provided in subparagraph (c) of section 2701, no exercise or failure to exercise a discretionary right with respect to a preferred equity interest shall be considered a transfer for purposes of this subtitle.

"(c) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this chapter.".

(b) TECHNICAL AMENDMENT.—Section 1015 (relating to basis of property acquired by gift) is amended by adding at the end thereof the following new subsection:

"(f) SPECIAL VALUATION RULES TO APPLY.—The rules of chapter 14 shall apply in determining the fair market value of any property at the time of the gift for purposes of this section."

(c) CLERICAL AMENDMENT.—The table of chapters for subtitle B is amended by adding at the end thereof the following new item:

"Chapter 14. Special valuation rules."

PREPARED STATEMENT OF SENATOR TOM DASCHLE

I am pleased to be discussing Internal Revenue Code Section 2036(c) today for my first hearing as Chairman of the Taxation and Debt Management Subcommittee. I am also pleased to be holding this hearing jointly with my colleague from Oklahoma, Senator David Boren, the Chairman of the Energy and Agricultural Taxation Subcommittee.

Last year, when I introduced legislation to repeal Section 2036(c) retroactively, I was very concerned about forcing small family businesses to live under its overly broad and ambiguous provisions until a substitute could be devised. At that time, I indicated that I would entertain proposals for a more limited measure that would target the specifically alleged abuses in this area. A number of alternatives to Section 2036(c) have since been advanced by individuals and groups who have expertise in the estate and gift tax area. One of the primary purposes of this hearing is to place some of these alternatives on the table and discuss their merits.

---

[3] This definition is borrowed from section 170(e)(5).

[4] This language represents a clarifying change from the Chamber's Ways and Means Committee submission.

A substitute proposal that has been the subject of debate lady is the discussion draft written through the combined efforts of the Department of Treasury and the Joint Committee on Taxation staffs. This proposal was released in April, and individuals and businesses have had a chance to evaluate its provisions.

Based on the comments I have heard, primarily from small family businesses, I have some very serious concerns about the approach taken in the Treasury proposal. As far as I know, none of the small business groups have come out in support of this proposal, and I hope that today we not only will discuss some of the reasons why, but also some other alternatives for resolving the problems raised by estate free techniques.

On its face, the Treasury proposal appears to offer more certainty to family businesses by purporting to deal with the issue in the gift tax, rather than the estate tax. However, closer scrutiny of its provisions reveals that it would allow the IRS to come back and prey upon the taxpayer years after a transaction has taken place. This is precisely the problem we face currently with Section 2036(c).

Another concern is that the Treasury proposal seems to be every bit as broad as current law. It takes the approach of saying that all transactions in this area are suspect *except* those specifically enumerated. Those that are enumerated are drafted so that any error is overwhelmingly in favor of the IRS.

I seriously question the soundness of this approach. To begin with, there is no evidence that the abuses Section 2036(c) was intended to target were widespread at the time of its enactment. Moreover, small family businesses require and deserve some flexibility in structuring their companies. I wonder whether the discussion draft wouldn't unfairly restrict these businesses far beyond what is necessary. We should be careful of going too far in saying that family members cannot engage in the same transactions as people who are dealing at arms' length.

Finally, the discussion draft worries me because it would repeal a single section of the estate and gift tax law and replace it with an entirely new *chapter*. I am sure everyone here today would agree that the last thing we need is more complexity in the tax code, particularly if it is a million dollar solution to a thousand dollar problem.

I mentioned that there are a number of other substitutes for Section 2036(c) that have been advanced by other individuals and groups, and we will be hearing about those today. I would also like to encourage all the witnesses to feel free to offer additional suggestions they may have that do not fall within any of the major proposals. We have a great deal of estate and gift tax brain power in this room today, and we ought to make use of it.

[JOINT COMMITTEE PRINT]

PRESENT LAW AND PROPOSALS RELATING TO FEDERAL TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES

SCHEDULED FOR A JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

AND THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

ON JUNE 27, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JUNE 22, 1990

U.S. GOVERNMENT PRINTING OFFICE
31-371 WASHINGTON : 1990 JCS-21-90

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

JOINT COMMITTEE ON TAXATION

101st Congress, 2d Session

Senate	*House*
LLOYD BENTSEN, Texas, *Chairman*	DAN ROSTENKOWSKI, Illinois, *Vice Chairman*
DANIEL PATRICK MOYNIHAN, New York	SAM GIBBONS, Florida
MAX BAUCUS, Montana	J.J. PICKLE, Texas
BOB PACKWOOD, Oregon	BILL ARCHER, Texas
ROBERT DOLE, Kansas	GUY VANDER JAGT, Michigan

Ronald A. Pearlman, *Chief of Staff*
Stuart L. Brown, *Deputy Chief of Staff*
Mary M. Schmitt, *Associate Chief of Staff (Law)*
Bernard A. Schmitt, *Associate Chief of Staff (Revenue Analysis)*

(II)

CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. AN OVERVIEW OF THE TRANSFER TAX SYSTEM	4
A. Rates and Credit	4
B. Transfers Subject to Tax	4
1. Gift tax	4
2. Estate tax	5
C. Allowable Deductions	6
D. Valuation of Property	6
E. Treatment of Small Business	7
F. Statute of Limitations	7
III. TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES PRIOR TO 1987	9
A. General Description of Estate Freezes	9
B. Examples of Estate Freeze Transactions and Their Tax Consequences	10
1. Preferred interests in corporations and partnerships	10
2. Grantor retained income trusts	12
3. Options and buy-sell agreements	13
4. Sales of remainder interests and joint purchases of interests in properts	15
5. Installment sales and private annuities	16
IV. TRANSFER TAX CONCERNS RAISED BY ESTATE FREEZES	17
A. Undervaluation of Initial Transfer	17
B. Subsequent Transfers	18
C. Disguised Testamentary Transfers	19
V. PRESENT LAW: CODE SECTION 2036(c)	20
A. General Description of Section 2036(c)	20
B. The Effect of Section 2036(c) on Specific Estate Freeze Transactions	21
1. Preferred interests in corporations and partnerships	21
2. Grantor retained income trusts	22

	Page
3. Options and buy-sell agreements	22
4. Sales of remainder interest and joint purchases of interests in property	23
5. Installment sales and private annuities	23
VI. GENERAL CRITICISMS OF SECTION 2036(c)	24
A. The Merits of an Incomplete Gift Approach	24
B. The Breadth of Section 2036(c)	24
C. Effect on Small Business	25
VII. ALTERNATIVES TO SECTION 2036(c)	26
A. Repeal of Section 2036(c) Without Replacement	26
B. Proposal of the Task Force of the American Bar Association and American College of Probate Counsel	26
1. General description of Task Force Proposal	26
2. Application of the Task Force Proposal to specific transactions	27
a. Preferred interests in corporations and partnerships	27
b. Other transactions	27
C. Discussion Draft Released March 22, 1990	27
1. General description of Discussion Draft	27
2. The effect of the Discussion Draft on specific estate freeze transactions	29
a. Preferred interests in corporations and partnerships	29
b. Grantor retained income trusts	31
c. Options and buy-sell agreements	31
d. Sales of remainder interest and joint purchases of interests in property	31
e. Private annuities and installment sales	32
D. Proposal of the Tax Section of the District of Columbia Bar Association	32
1. General description of D.C. Bar Proposal	32
2. The effect of D.C. Bar Proposal on specific estate freeze transactions	33
a. Preferred interests in corporations and partnerships	33
b. Grantor retained income trusts	33
c. Options and buy-sell agreements	33
d. Sales of remainder interest and joint purchases of interests in property	33
e. Private annuities and installment sales	33
E. Proposal of the U.S. Chamber of Commerce	34
1. General description of Chamber of Commerce Proposal	34
2. The effect of the Chamber of Commerce Proposal on specific estate freeze transactions	35
a. Preferred interests in corporations and partnerships	35
b. Other transactions	36
APPENDIX: DATA ON FEDERAL ESTATE AND GIFT TAXES	37

INTRODUCTION

The Subcommittees on Energy and Agricultural Taxation and Taxation and Debt Management of the Senate Finance Committee have scheduled a joint hearing on June 27, 1990, on proposals for changing rules relating to estate valuation freezes.

In the Omnibus Budget Reconciliation Act of 1987, the Congress enacted Internal Revenue Code section 2036(c), relating to the estate valuation freezes. On October 3, 1989, the Senate Finance Committee approved a provision that would have repealed section 2036(c), as part of the Senate Budget Reconciliation Bill (S. 1750 as reported by the Senate Budget Committee). In so doing, the Finance Committee indicated its concern for abusive freezes, and its intent to study alternatives to section 2036(c). The provision was removed from the bill by a Senate floor amendment deleting all revenue-losing provisions.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation in connection with the hearing, provides a discussion of the Federal transfer tax consequences of estate freezes, a description of prior and present-law tax rules, a discussion of issues relating to section 2036(c), and a description of proposed alternatives to section 2036(c). The Appendix presents data on Federal estate and gift tax collections.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Present Law and Proposals Relating to Federal Transfer Tax Consequences of Estate Freezes* (JCS-21-90), June 22, 1990.

I. SUMMARY

Estate freeze transactions

An estate freeze is an estate planning technique that has the effect of limiting the transfer tax value of property held by an older generation at its then current value. Although sometimes reflecting the actual business relationships among the parties, the freeze transaction often is intended to pass appreciation in the property to a younger generation without incurring Federal estate and gift taxes while retaining all or a significant portion of the income or control over the property. The value of the retained rights may be increased through the retention of one or more discretionary rights which, under the "willing buyer, willing seller" valuation standard of present law, are assumed will be exercised so as to maximize the value of the owner's retained interests.

In one common form, the "preferred stock freeze," an owner of a corporation restructures the corporation to have two classes of stock: (1) preferred stock purportedly worth substantially all of the value of the corporation; and (2) common stock with purportedly little value. The owner then transfers the common stock to a younger generation while retaining the preferred stock. In addition, the owner might retain a discretionary right to require the redemption of the preferred stock at its par value, thereby increasing the value of the retained preferred stock (and decreasing the value of the transferred common stock) without regard to the amount of dividends the preferred stock may reasonably be expected to pay.

Code section 2036(c)

Section 2036(c) treats an estate freeze transaction as inherently testamentary and, therefore, includes the value of the transferred interest in the donor's gross estate for Federal estate tax purposes. This treatment also reduces the pressure to properly value the retained interests, especially discretionary rights, in freeze transactions.

Section 2036(c) applies when a person transfers interests in property that are likely to appreciate while retaining an income or voting interest in that property. In doing so, it adopts in essence an incomplete gift approach that leaves open the final transfer tax consequences of the transaction. Section 2036(c) has been criticized as inexact and overbroad. In addition, opponents of section 2036(c) argue that lower Federal transfer taxes should be imposed on closely held businesses than on other forms of property.

Proposed alternatives

The proposed alternatives reject the characterization of estate freeze transactions as inherently testamentary. Instead, the alter-

natives treat the transfer as complete at the time of the transfer. They generally provide various rules intended to determine the value of the transferred interest at the time of the transfer.

II. AN OVERVIEW OF THE TRANSFER TAX SYSTEM

A. Rates and Credit

Estate and gift tax

Generally, a gift tax is imposed on transfers by gift during life, and an estate tax is imposed on the taxable estate at death. The Federal estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative transfers. The estate and gift marginal tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent on taxable transfers over $3 million. After 1993, the top rate is scheduled to decrease to 50 percent.

The amount of estate and gift tax generally is determined by applying the unified rate schedule to cumulative taxable transfers and then subtracting the taxes payable for prior periods. The tax is first computed without any exemption, and then a unified credit is subtracted to determine the amount of estate or gift tax payable before the allowance of other credits. U.S. citizens and resident noncitizens are allowed a unified credit of $192,800, which effectively exempts the first $600,000 of transfers from tax. For a married couple, the unified credit potentially exempts the first $1,200,000 of transfers from tax. The benefit of the graduated brackets and unified credit is phased out after transfers exceeding $10 million, creating a top marginal tax rate of 60 percent for decedents dying prior to 1993.

Generation-skipping transfer tax

A generation-skipping transfer tax is imposed on certain transfers to a person two or more generations below the transferor. The generation-skipping transfer tax uses a flat rate equal to the highest estate and gift tax rate. Each transferor is allowed a $1 million exemption.

B. Transfers Subject to Tax

1. Gift tax

The gift tax is imposed on any transfer of property by gift whether made directly or indirectly and whether made in trust or otherwise. A transfer includes all transactions whereby property is passed to or conferred upon another regardless of the means or device employed in its accomplishment.

In *Dickman v. Commissioner*,[2] the United States Supreme Court held that an interest-free or below-market interest-rate demand loan resulted in a transfer for Federal gift tax purposes. In reach-

[2] 465 U.S. 330 (1984).

ing its conclusion, the Court emphasized that the right to use money is a valuable right, and that the failure to demand repayment over time passes wealth.[3] After the Supreme Court decision in *Dickman*, Congress enacted section 7872, which provides that certain loans bearing a below-market rate of interest result in (1) the borrower being treated as if he paid interest to the lender, and (2) the lender being treated as if he made an annual gift of the foregone interest to the borrower.

The first $10,000 of gifts of present interests to each donee during any one calendar year is excluded from Federal gift tax. A husband and wife may elect to treat a gift in fact made by one spouse as having been made one-half by each spouse. The net effect of this gift-splitting provision is to make the gift tax exclusions and credit of the spouse available to the donor. Thus, the first $20,000 of gifts of present interests is excluded when the non-donor spouse consents to split the gift. Although treated as a gift to its shareholders, a gift to a corporation generally is a gift of a future interest, not qualifying for the annual exclusion.[4]

The Federal gift tax generally is imposed only on the value of property actually passing to the donee net of tax. This is known as a "tax-exclusive" base.[5]

2. Estate tax

The estate tax is imposed on all property included in the "gross estate" of the decedent less allowable deductions. The gross estate generally includes the value of all property in which a decedent has an interest at his or her death (Code sec. 2031). In addition, the gross estate includes the value of certain properties not owned by the decedent at the time of death under certain circumstances. These include, generally, transfers for less than adequate and full consideration if (1) the decedent retained the beneficial enjoyment of the property during his or her life (sec. 2036) or the power to alter, amend, revoke, or terminate a previous lifetime transfer (sec. 2038); (2) certain property if an interest in such property is held within three years of death (sec. 2035); (3) the property was previously transferred during the decedent's lifetime but the transfer takes effect at the death of the decedent (sec. 2037); and (4) interests in certain annuities (sec. 2039). In addition, the gross estate includes the value of property subject to the decedent's general power of appointment (sec. 2041). Lastly, the gross estate includes the proceeds of life insurance on the decedent if the insurance proceeds are receivable by the executor of the decedent's estate or the decedent possessed at death incidents of ownership in the policy (sec. 2042).

No reduction in the gross estate is made for the portion of the estate used to pay the Federal estate tax. This is known as a "tax-

[3] 465 U.S. at 336 and n. 7.

[4] *See Chanin v. United States*, 393 F.2d 972, 976 (Ct. Cl. 1968); *Heringer v. Commissioner*, 235 F.2d 149, 152 (9th Cir. 1956); *Hollingsworth v. Commissioner*, 86 T.C. 91, 105-108 (1986); Rev. Rul. 71-443, 1971-2 C.B. 337.

[5] See footnote 6, *infra*, for an example.

inclusive" base. Thus, the estate and gift taxes are computed on different bases.[6]

C. Allowable Deductions

Marital deduction

Both the gift and estate tax generally allow an unlimited deduction for property passing between spouses which will be includible in the gross estate of the recipient spouse.

Charitable deduction

In determining the amount of estate and gift tax, a deduction is allowed for certain amounts transferred to certain organizations organized and operated exclusively for charitable, etc., purposes, to the United States or any State or local government, and to certain organizations of war veterans. Where the charitable transfer is of an interest in property that is less than the entire interest of the donor or decedent (e.g., a term or remainder interest), the gift must take certain specified forms in order to be deductible. In general, a charitable deduction is permitted for a term interest only if such interest is in the form of a guaranteed annuity or is a yearly distribution of a fixed percentage of the annually determined fair market value of the property. A charitable deduction generally is permitted for a transfer in trust of a remainder interest in property only if the trust is a pooled income fund, charitable remainder annuity trust, or charitable remainder unitrust.

Expenses, indebtedness, taxes, and losses

In addition to the charitable and marital deductions, estate tax deductions are allowed for certain administrative expenses of the estate, certain indebtedness of the decedent, and certain taxes (sec. 2053). A deduction also is allowed for casualty losses incurred by the decedent's estate (sec. 2054).

D. Valuation of Property

The value of property transferred by gift or includible in the decedent's gross estate generally is its fair market value at the time of the gift or death. Fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer.[7]

Accordingly, courts have refused to consider familial relationships among co-owners in valuing property. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.[8] Likewise, courts reduce the value of property to re-

[6] For example, assuming a 50-percent rate and no deductions or exclusions, a death-time transfer of $100 results in $50 passing to heirs and a $50 estate tax. In contrast, a person with $100 can make a $66.67 lifetime gift while paying only $33.33 in gift tax.

[7] *See* Rev. Rul. 59-60, 1959-1 C.B. 237, 237.

[8] *See, e.g., Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981).

flect the effect of restrictions even when the restrictions exist for the benefit of family members.[9]

E. Treatment of Small Businesses

Current use valuation

If certain requirements are met, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at its current use value, rather than its full fair market value, provided that the gross estate may not be reduced by more than $750,000 (sec. 2032A).

Installment payments of estate tax

In general, estate tax must be paid within 9 months after a decedent's death. However, if certain requirements are satsfied and the executor makes an election, payment for estate tax attributable to certain interests in closely held businesses can be extended and paid in installments over 14 years (interest only for 4 years followed by from 2 to 10 annual payments of principal and interest) (sec. 6166). A special 4-percent interest rate applies to the deferred tax attributable to the first $1 million in value of the closely held business interest (sec. 6601(j)). Tax in excess of this amount accrues interest at the regular rate charged on deficiencies (sec. 6601(a)). To qualify for the installment payment provision, at least 35 percent of the value of the decedent's adjusted gross estate must consist of the value (net of business indebtedness) of an interest in a closely held business. Accrued interest is deductible in determining estate or income tax but not both (sec. 642).

Other extensions of time to pay estate tax

If an estate is not eligible to defer estate tax under the installment payment provision, payment of the tax may be extended under the general estate tax extension of time to pay. An extension of time to pay tax for up to 10 years is permitted upon a showing of reasonable cause (sec. 6161). This extension is granted for a maximum period of one year at a time and can be renewed annually (as long as the reasonable cause continues to exist). Reasonable cause may exist where an estate does not have sufficient funds to pay the tax when otherwise due without borrowing at a rate of interest higher than that generally available (Treas. Reg. sec. 20.6161-1(a)(1), Example (4)).[10]

F. Statute of Limitations

Generally, any estate or gift tax must be assessed within 3 years after the filing of the return. No proceeding in a court for the collection of an estate or gift tax can be begun without an assessment within the 3-year period. If no return is filed, the tax may be as-

[9] *See* notes 34-47 *infra* and accompanying text

[10] In addition, there are special income tax rules for certain distributions in redemption of stock included in the gross estate of a deceased shareholder Such distributions are treated as sales (and not taxable dividends) to the extent of estate, inheritance, legacy, and succession taxes paid by the estate and the funeral and administration expenses allowable as deductions in computing the taxable estate (sec 303) Because the basis of such stock is its fair market value at the date of death, generally little gain is recognized on the redemption.

sessed, or a suit commenced to collect the tax without assessment, at any time. If an estate or gift tax return is filed, and the amount of unreported items exceeds 25 percent of the amount of the reported items, the tax may be assessed or a suit commenced to collect the tax without assessment, within 6 years after the return was filed.

Courts differ over whether the Commissioner may redetermine the value of prior gifts in order to determine the appropriate bracket and unified credit for the estate tax, notwithstanding the expiration of the gift tax statute of limitations [11]

[11] *Compare Smith Estate v. Commissioner*, 94 T.C. No. 55 (June 13, 1990) (Commissioner permitted to revalue gifts) *with Boatman's First National Bank v. United States*, 705 F. Supp. 1407 (W.D. Mo. 1988) (Commissioner not permitted to revalue gifts).

III. TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES PRIOR TO 1987

A. General Description of Estate Freezes

An "estate freeze" is a technique that has the effect of limiting the value of property held by an older generation at its current value and passing any appreciation in the property to a younger generation. Generally, the older generation retains income from, or control over, the property.

To effect a freeze, the older generation transfers an interest in the property that is likely to appreciate while retaining an interest in the property that is less likely to appreciate. Because the value of the transferred interest increases while the value of the retained interest remains relatively constant, the older generation has "frozen" the value of the property in its estate.

In one common form, the preferred stock freeze, a person owning preferred stock and common stock in a corporation transfers the common stock to another person. Since common stock generally appreciates in value more than preferred stock, the transferor has "frozen" the value of his holdings in the corporation. Future appreciation in the common stock is not included in the transferor's estate.

An estate freeze can be achieved with almost any kind of property, including interests in active businesses, listed stocks, real estate and art.[12] The older generation may retain a variety of rights in a freeze transaction. Retained rights may include, for example, the right to vote stock, to receive income from property, or to control or use property. The retained right also may be the right to a fixed or variable amount, sometimes known as a "capital call" right. A capital call right may include (1) a right to "put" the frozen interest for an amount equal to the liquidation preference of the frozen interest; (2) a right to liquidate an entity and receive assets; or (3) a right to convert the nonappreciating retained interest into an appreciating interest.[13]

The retained rights in an estate freeze may be structured to lapse or terminate, particularly at death. Retained rights often involve discretion regarding the amount, timing, or fact of payment.

---

[12] For one practitioner's list of commonly frozen assets, *see* B. Abbin, "The Value-Capping Cafeteria—Selecting the Appropriate Freeze Technique," 1981 *U. Miami Inst. Estate Planning* at 20-69 to 20-80.

[13] *See, e.g.*, W. Nelson and P. Genz, "New Uncertainties in the Equity Freeze: The Impact of Dickman on Capital Call Rights and Other Issues," 63 *Taxes* 999, 1001 (December 1985). *See also* R. Shattuck, "Taxpayers Try Estate Freeze Into Preferred Stock Convertible Into Constant Dollar Amount of Common Stock," 59 *Taxes* 323 (1981); D. Freeman, *Estate Tax Freeze: Tools and Techniques* at 2-30 to 2-32 (1985).

BEST AVAILABLE COPY

B. Examples of Estate Freeze Transactions and Their Tax Consequences

1. Preferred interests in corporations and partnerships

Description

A common form of freeze relies upon a preferred interest in a corporation or partnership. This may involve recapitalization of an existing entity [14] or creation of a new entity.[15] The preferred interest may be created before or after the transfer of an interest to the younger generation.

The preferred interest may enjoy preferred rights as to income or management. It also may carry a right to liquidate, convert or redeem. The preferred interest may consist of either debt or equity,[16] and may involve S corporations as well as C corporations.[17]

In a corporate freeze, the preferred interest commonly provides for noncumulative dividends. In a partnership freeze, the preferred interest often is defined as a right to a fixed dollar amount (guaranteed payment) or a decreasing percentage of profits; distributions are often contingent upon cash flow.[18]

Gift tax consequences

The transfer of a residual interest in a corporation or partnership for less than full and adequate consideration is a gift. The fair market value of the residual interest is the price that a willing buyer would pay for it. Appraisers often determine such value through methods that consider the risks and potential returns for each interest over time. For example, corporate finance literature suggests that the common stock may be valued as a call option on the value of the firm, under which the common shareholders may purchase the firm by paying off more senior claims, such as bonds and preferred stock (the "option method").[19]

More commonly, appraisers determine the value of the common stock by subtracting the present discounted value of the anticipated dividends on the preferred stock from the total value of the corporation or partnership (the "discounted cash flow method"). The value of preferred stock is often determined by looking to comparable, often publicly traded, stocks. The position of the Internal Revenue Service is that the most important factors in determining the

---

[14] *See* D. Freeman at sec. 2.

[15] *See* J. Wallace, "Overview of Estate Freezing Techniques and Attendant Estate and Gift Tax Problems," 15 *Real Property, Probate and Trust Journal* 71, 74-76 (1980); D. Freeman, at 2-41.

[16] *See* D. Freeman at 2-34 (noting that debentures may be substituted for equity).

[17] *See* B. Lemons and D. Child, "Using a Partnership Freeze to Shift Future Appreciation in Corporate Assets," 69 *Journal of Taxation* 84 (1988).

[18] *See e.g.*, D. Freeman at 3-60. *See generally*, J. Elias, "The Partnership Capital Freeze: A Path Through the Maze," 40 *Tax Lawyer* 45 (1986).

[19] *See generally*, R. Brealey and S. Myers, *Principles of Corporate Finance*, Chapter 20 (1988); J. Van Horne, *Financial Management and Policy*, Chapter 4 (1986); F. Black and M. Scholes, "The Pricing of Options and Corporate Liabilities," 81 *Journal of Political Economy*, 637-654 (May-June 1973).

The trading on major exchanges of equity instruments with option type rights suggests that such rights affect market values. For example, it is possible to purchase on the American Stock Exchange, separately: a warrant, or call option, on the future value of a share of American Telephone and Telegraph; and the share of American Telephone and Telegraph subject to the warrant.

value of preferred stock generally are its yield, dividend coverage, and protection of its liquidation preference.[20] Voting, redemption, liquidation, and conversion rights also may add to the value of the preferred interest. All these rights are valued under the willing buyer, willing seller standard, without regard to how the parties actually holding the rights, in fact, will exercise them.

The recently decided case of *Snyder v. Commissioner*[21] illustrates the application of the willing buyer, willing seller standard. There, the taxpayer transferred publicly traded shares of a growing corporation worth $2,592,000 to a newly created holding company in exchange for 2,591 shares of preferred stock and 1,000 shares of common stock of the holding company. The preferred stock had a par value of $1,000 per share, was callable at the election of the preferred shareholders, and, in effect, could be put to the company at par.

The taxpayer transferred the 1,000 shares of common stock to a trust for the benefit of her grandchildren and valued the common stock at $1,000 (i.e., $1 per share). Although finding that the taxpayer did not expect to exercise the put option in the absence of unanticipated and extraordinary financial need, the U.S. Tax Court nonetheless held that the value of the common stock was $1,000, because a willing buyer would pay more only with some assurance that the option would not be exercised. Within five years of the transfer, the value of the publicly traded stock had increased to $5,340,000. If the preferred shareholders had elected to have the preferred shares called at that time, the value of the holding company after the redemption would have been $2,748,000 (i.e., $5,340,000 minus $2,592,000).

The failure to exercise rights in an arm's-length manner after the initial transfer of common stock may give rise to a gift under the reasoning of the *Dickman* case.[22] Prior to the *Dickman* case, there was authority that waiver of an undeclared dividend for a business purpose did not constitute a gift.[23] Since the *Dickman* case, the Internal Revenue Service has held in several private letter rulings that the failure to exercise rights can give rise to a gift.[24] Commentators have questioned whether the *Dickman* case creates a gift in such situations.[25]

Estate tax consequences

Where an individual retains enjoyment of, or the right to income from, transferred property, the gross estate includes the full value of such property (sec. 2036(a)). In addition, the decedent's retention of the right to vote corporate stock that was given away results in the inclusion of that stock in the estate (sec. 2036(b)). In the pre-

---

[20] *See* Rev. Rul. 83-120, 1983-2 C.B. 170.

[21] 93 T.C. No 43 (Nov. 2, 1989).

[22] *See* note 2, *supra*. *See Snyder* at 28-29 (stating that *Dickman* generally does not apply to an equity instrument but nonetheless finding a gift by reason of the failure to exercise a conversion right that would have permitted accumulation of unpaid dividends).

[23] *See Collins v. Commissioner*, 1 T.C. 605, 609 (1943), *nonacq.*, 1943 C.B. 29; Rev. Proc. 67-14, 1967-1 C.B. 591.

[24] *See* LTR 8723007 (Feb. 18, 1987) (finding a gift on the failure to declare a noncumulative dividend); LTR 8726005 (March 13, 1987) (finding a gift on the failure to exercise conversion right); LTR 8610011 (Nov. 1, 1985) (finding a gift on the failure to redeem stock).

[25] *See, e.g.*, W. Nelson at 1009 (arguing that *Dickman* does not apply to unexercised freeze rights).

ferred interest estate freeze, however, it has been held that the preferred and residual interests may be considered separate property and therefore that a decedent's gross estate did not include the full value of a corporation in which the decedent gave his children common stock but in which he retained voting preferred stock.[26]

The IRS has privately ruled that the value of a voting right that lapses on the decedent's death is includible in the gross estate under section 2031.[27] In *Estate of Harrison v. Commissioner*,[28] however, a court held to the contrary. In that case, a father retained both a limited and general partnership interest after forming a partnership in which his sons received limited partnership interests. Held in conjunction with the general partnership interest, the father's limited partnership interest was worth $59 million (because the general partnership interest carried with it the right to liquidate the partnership); held alone, the limited partnership interest was worth $33 million. The father died owning both interests, but the general partnership interest was immediately sold to the sons for $700,000 pursuant to a buy-sell agreement taking effect at death. The United States Tax Court held that the limited partnership interest was includible in the father's gross estate at a value of $33 million. Thus, $26 million in wealth was passed without incurring either gift or estate tax. Several commentators agree with the Tax Court and argue that the retention of lapsing rights reduce the value of the transferred interest but are not includible in the gross estate.[29]

2. Grantor retained income trusts

Description

The grantor retained income trust ("GRIT") is an irrevocable trust to which the grantor transfers property or money while retaining an income interest for a term of years.[30] This transaction has the effect of transferring a contingent or vested remainder interest to another person. The grantor also may retain a contingent reversion or power of appointment that takes effect only if the grantor dies within the term.

Gift tax consequences

The transfer into the trust is treated as a taxable gift for transfer tax purposes. The amount of the gift is the value of the entire property less the value of rights in the property retained by the grantor. Rights retained by the grantor are valued pursuant to Treasury tables that assume a rate of return on the underlying property equal to 120 percent of the applicable Federal midterm rates (sec. 7520, Treas. Reg. sec. 20.2512-5(f)). Use of the Treasury tables is allowed even when they do not accurately predict the actual rate of return from the trust. For example, in 1977, the Internal Revenue Service ruled that the application of tables based

[26] *See Estate of John G. Boykin*, 53 T.C.M. (CCH) 345 (1987)
[27] *See* LTR 8510002.
[28] 52 T.C.M. (CCH) 1306 (1987).
[29] *See* W. Nelson at 1010; D. Freeman at 2-50.
[30] *See, e.g.*, S. Leimberg and R. Doyle, "GRITS and SuperGRITS," 45 *Tax Notes* 1503 (1989); J. Mahon, "Grantor Lead Trusts: New Tax Savings Under the 10 Percent Tables," 128 *Trusts and Estates* 26 (August 1984).

on an interest rate of 6 percent per year was appropriate in valuing a trust whose corpus consisted of stock that had paid an average dividend of 3 percent for the preceding ten years.[31] According to the ruling, "departure from strict application of the tables is permissible in exceptional cases where use of the tables would violate reason and fact; for example, where transferred property may yield no income at all or the income is definitely determinable by other means." [32]

The IRS has ruled privately that the failure of an income beneficiary to exercise a State law right to force the trustee to invest in income-producing property results in a gift to the remainderman.[33]

Estate tax consequences

If the grantor dies during the term of the trust, the value of the trust property is includible in his gross estate (sec. 2036(a)), with an adjustment for gift tax previously paid. The property is included regardless of whether the decedent retained a contingent reversion or power of appointment. If the grantor dies after the term of the trust, none of the trust property is included in his gross estate.

3. Options and buy-sell agreements

Description

Under another common freeze device, a member of an older generation grants a member of a younger generation an option to purchase property at a fixed or formula price. Such an option may be part of a buy-sell agreement among family members under which the survivor (or the corporation) has the right to purchase stock from the estate of the first to die. An option may freeze the value of property at the strike price if the strike price is below the fair market value of the property at the date of death.[34]

Gift tax consequences

The transfer of a binding and enforceable unilateral option results in a gift equal to the excess of the fair market value of the option over the consideration received in exchange for the option.[35] Receipt of services in exchange for the option can provide adequate consideration.[36] Little judicial authority discusses the gift tax consequences of an agreement creating bilateral options. Such an agreement might give rise to a gift if the values of the options are not equal, for example, when the life expectancies of the two par-

---

[31] *See* Rev. Rul. 77-195, 1977-1 C.B. 295.

[32] *Id.* at 297.

[33] *See* LTR 8805029 (Nov. 9, 1987), LTR 8806082 (Nov. 18, 1987).

[34] *See, e.g.*, T. Solberg, "Buy-Sell Agreements Can Freeze Asset Values and in Some Cases Make Them Disappear," 59 *Taxes* 437 (July 1981); S. Tobisman, "Estate and Gift Tax Considerations in Buy-Sell Agreements," 35 *U.S. California Tax Institute*, para. 2700 (1983).

[35] *See Hoffman v. Commissioner*, 2 T.C. 1160, 1187-88 (1943), *acq.* 1944 C.B. 13, *aff'd on other issue*, 148 F.2d 285 (9th Cir. 1945), *cert. denied*, 326 U.S. 730 (1945); Rev. Rul. 80-186, 1980-2 C.B. 280.

[36] *See Bensel v. Commissioner*, 36 B.T.A. 246 (1937) *aff'd*, 100 F.2d 639 (3d Cir. 1938) (continued services by son constituted adequate consideration for option given by father); *Cobb v. Commissioner*, 49 T.C.M. (CCH) 1364 (1985) (exchange of option for agreement to act as farm manager did not result in gift).

ties holding the options differ although the exercise price is the same.[37]

Estate tax consequences

A restriction upon the sale or transfer of property reduces its fair market value. For example, a right of first refusal depresses value, since it reduces the attractiveness of the stock to other potential buyers.[38] Treasury regulations issued in 1958 acknowledge that the existence of an option or contract to purchase may affect the estate tax value of stock. Those regulations provide that the restriction is to be disregarded unless the agreement represents a bona fide business arrangement and not a device to pass the decedent's stock to natural objects of his bounty for less than full and adequate consideration.[39] IRS rulings of that period give substantial weight to a price contained in a buy-sell agreement for purposes of determining value.[40]

Courts have gone beyond the published position of the Internal Revenue Service and generally have held that the price contained in a buy-sell agreement will limit fair market value for estate tax purposes if the price is fixed or determinable, the estate is obligated to sell, the agreement contains restrictions on lifetime transfers, and there is a valid business purpose for the agreement.[41] One court has held that, in addition to having a business purpose, the agreement cannot also be a testamentary device.[42]

The precise effect of an agreement meeting these requirements depends upon the extent of the buyer's obligation. If the buyer is obligated to purchase the property under the agreement, the agreement determines fair market value because, knowing of the approaching sale, a willing buyer would pay no more, and a willing seller would accept no less, than the strike price.[43] If the buyer merely possesses an option to purchase property, the option price creates a ceiling on fair market value because no willing buyer would pay more than the option price knowing that he would be obligated to sell the stock at the option strike price.[44]

Authorities generally consider continuation of family ownership and control to be a business purpose. It has been found sufficient even when the "control" being preserved is merely a right to par-

---

[37] Some judicial authority suggests that the creation of the agreement does not result in a "transfer." *See Littick v. Commissioner*, 31 T.C. 181, 186 (1958). The Internal Revenue Service disagrees with this conclusion. *See* AOD CC-1985-008 (Dec. 24, 1984).

[38] *See Reynolds v. Commissioner*, 55 T.C. 172 (1970), *acq.*, 1971-2 C.B. 3.

[39] *See* Treas. Reg. sec. 20.2031-2(h). Nonetheless, in a subsequent memorandum, the Internal Revenue Service has stated: "The difficulty [with the regulation] is that there may be a legitimate business purpose in restricting shares to the decedent's descendants and yet the option price may be so low as not to fairly reflect value. The primary inquiry should be the correct estate tax value, and the motives or purposes behind the restriction should be of concern to the Internal Revenue Service only as they bear on the valuation question. . . What is important should be, . . not so much the legitimate purpose of the decedent in imposing the restriction, but whether the purchase price was an arm's length price that fairly represented value both at the time the restriction was imposed and at the time of death." G.C.M. 37958 (1978).

[40] *See* Rev. Rul. 59-60, 1959-1 C.B. 237, 243 (option price "usually accepted as fair market value for estate tax purposes").

[41] *See Seltzer v. Commissioner*, T.C. Memo 1987-568, 54 T.C.M. (P-H) para. 85.515 at 2345. *See also Weil v. Commissioner*, 22 T.C. 1267, 1273-74 (1954), *acq.*, 1955-2 C.B. 10.

[42] *See Saint Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982).

[43] *See, e.g., Broderick v. Gore*, 224 F.2d 892, 896 (10th Cir. 1955).

[44] *See Wilson v. Bowers*, 57 F.2d 682 (2d Cir. 1932) (buy-sell agreement that binds the estate caps the value of corporate stock even if the holder of the option does not exercise the option and instead obtains the interest under the will).

ticipate as a limited partner,[45] or when a party to the agreement has already contracted a terminal illness.[46]

Although some courts suggest that the business purpose requirement necessitates that the option price be reasonable when the agreement was made,[47] others do not.[48] In either case, the strike price need not approximate fair market value at the date of death, even when such value is stipulated.[49] Thus, courts have found a fixed price contained in a buy-sell agreement to be determinative of estate tax value even though the stock was not in fact sold until many years later.[50] Similarly, formulas based on book value or capital accounts have fixed value.[51] A formula has been upheld even when it has the effect of creating an estate tax value of zero.[52]

4. Sales of remainder interests and joint purchases of interests in property

Description

Other common freeze transactions involve terms of years, life estates and remainder interests in property. For example, an owner of property may sell a remainder interest in the property to a child. Alternatively, older and younger generations may jointly purchase term and remainder interests in property from a third party. Both these transactions effect freezes because all the future

---

[45] *See Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977).

[46] In *Littick v. Commissioner*, 31 T.C. 181, (1958), *acq.*, 1959-2 C.B. 5, acq., 1984-2 C.B. 1 (in result),

the decedent, who had contracted a terminal illness entered into a fixed-price buy-sell agreement with his brothers one year prior to death. Finding "nothing in the record to indicate that the [fixed price] was not fairly arrived at by arm's-length negotiation or that any tax avoidance scheme was involved," the U.S. Tax Court valued the stock at its fixed price, rather than its stipulated fair market value. 31 T.C. at 187.

[47] *See Bischoff*, 69 T.C. at 41 n.9.

[48] *See Davis v. United States*, 5 AFTR 2d 1902 (D. Utah 1960) (finding that a formula price of 25 percent of the "appraised value" of a partnership determined the value of a one-half interest in the partnership, low price necessary to ensure continued family control), *Seltzer*, T.C.M. (P-H) at 2346 (formula based on book value found determinative notwithstanding exclusion of goodwill from purchase price). *See also Reynolds v. Commissioner*, 55 T.C. 172, 194 (1970), *acq.*, 1971-2 C.B. 3 (holding that a voting trust agreement containing formula price equivalent to $100 per share was not a device to pass wealth for less than full and adequate consideration even though, when the agreement was made, the over-the-counter market price for the stock was $250 per share).

[49] *See, e.g., Commissioner v. Childs' Estate*, 147 F.2d 368 (3d Cir. 1945) (estate tax value of $10 per share upheld when market price was $100 per share); *Novak v. United States*, 1987-2 T.C.M. (CCH) para. 13728 (D. Neb.) (estate tax value at $1,000,750 upheld rather than fair market value of $1,657,465), *Littick*, 31 T.C. at 187 (1958) (estate tax value almost $60,000 below stipulated fair market value); *Weil v. Commissioner*, 22 T.C. 1267, 1272 (1954), *acq.*, 1955-2 C.B. 10 (estate tax value of $172,000 upheld by court that conceded that fair market value was $538,000 higher).

[50] In *Slocum v. United States*, 256 F. Supp. 753 (S.D.N.Y. 1956), a fixed price ($100) contained in an agreement entered into in 1915 fixed the estate tax value of stock of a decedent dying some 40 years later. In *Wilson v. Bowers*, 57 F.2d 682 (2d Cir. 1932), a fixed price contract entered into in 1909 determined the estate tax value of stock passed by the decedent some ten years later. *See also Novak*, 1987-2 T.C.M. (CCH) para. 13728 (fixed price option determined estate tax value).

[51] *See Bischoff*, 69 T.C. at 41 n.9 (formula based on capital account found determinative); *Fiorito v. Commissioner*, 33 T.C. 440 (formula based on capital account found determinative). *See also Hall v. Commissioner*, 92 T.C. 312 (1989) (transfer restrictions considered in determining fair market value; fair market value held to be adjusted book value).

[52] In *May v. McGowan*, 194 F.2d 396 (2d Cir. 1952), father and son entered into a buy-sell agreement for a fixed price less a percentage of debt guaranteed by the son. Application of this formula resulted in an estate tax valuation of zero. The Second Circuit concluded: "It seems clear that with the option outstanding, no one would purchase the stock of the decedent when it was subject to call by [the son] at zero. . . [citing cases] . . . Such a loophole, if important, should be closed by legislative action rather than by disregarding the cases we have cited." 194 F.2d at 397.

appreciation potential in the property inures to the younger generation.

Gift tax consequences

The gift tax consequence of a sale of a remainder interest or a joint purchase are similar to those of a GRIT. If the younger generation pays less than fair market value for the remainder interest, there is a gift from the older generation. The value of the remainder interest is determined pursuant to IRS tables.

Estate tax consequences

If the decedent dies after the term, the property is not included in his gross estate. If the decedent dies within the term or has a life estate, the property is includible unless the decedent received full and adequate consideration for the remainder interest during his life (in the case of a sale of a remainder interest) or paid no more than the value of his interest (in the case of a joint purchase). The amount includible is reduced by consideration received. In *Gradow v. United States*,[53] the Federal Circuit held in one situation that full and adequate consideration is the value of the entire property, not merely the value of the remainder interest.[54]

5. Installment sales and private annuities

Description

A freeze also may be achieved through sale of the property in return for an installment note or annuity.[55] The note may cancel upon the transferor's death.[56] In conjunction with the sale, the transferor may lease back the property and pay rent or make annual gifts that are used to make the installment payment.[57]

Gift tax consequences

A private annuity is valued pursuant to Treasury tables. The failure to pay an amount owed under a note generally is treated as a gift.

Estate tax consequences

Sale of property for a private annuity or installment note generally does not result in such property being included in the estate unless the annuity effectively results in the decedent's retention of an interest in the sold property (sec. 2036(a)). The U.S. Supreme Court has suggested that the transaction will not be treated as a transfer with a retained interest if "the promise is a personal obligation of the transferor, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made." [58]

[53] No. 89-1377 (Fed. Cir. March 1, 1990), *aff'g.* 11 Cl. Ct. 808 (1987).

[54] The decision in *Gradow* has been criticized. *See* P. Weinbaum, "Are Sales of Remainder Interests Still Available in Light of a New Decision," 14 Estate Planning 258 (Sept./Oct 1987)

[55] A sale would result in recognition of gain that might be deferred as an installment sale (sec. 453). Once sold, the property does not receive the step-up in basis that would have occurred had such property been retained until death (sec. 1014).

[56] *See* D. Freeman at sec. 4.11; W. Blum, "Self-Cancelling Installment Notes," 60 *Taxes* 183 (1982).

[57] *See* D. Freeman at sec. 5.06.

[58] *Fidelity-Phila Trust Co. v. Smith*, 356 U.S. 274, 280 n. 8 (1958). *See also Lazarus v. Commissioner* 513 F.2d 824 (9th Cir. 1975); *Lane v. Commissioner* 37 T.C. 188 (1961).

IV. TRANSFER TAX CONCERNS RAISED BY ESTATE FREEZES

Estate freezes raise three basic transfer tax concerns. First, because frozen interests are inherently difficult to value, they can be used as a means of undervaluing gifts. Second, such interests entail the creation of rights that, if not exercised in an arm's-length manner, may subsequently be used to transfer wealth free of transfer tax. Third, "frozen" interests may be used to retain substantial ownership of the entire property while nominally transferring an interest in the property to another person.

A. Undervaluation of Initial Transfer

Estate freezes provide an opportunity for undervaluation of the initial gift. Because gift tax adjustments do not generally result in additional tax (due to the unified credit) and because the Internal Revenue Service has limited audit resources, such undervaluation may go unchallenged.

Undervaluation may occur because the transferor claims a value for the transferred property lower than the amount a willing buyer would pay for the interest.[59] This undervaluation is difficult to detect because of the inherent difficulty in valuing interests created in a freeze.

The discounted cash flow method depends upon proper valuation of the preferred interest.[60] Such interests pose substantial valuation difficulties. Even if the features of the closely held preferred interest are identical to those found in public markets, differences between the two types of securities make comparison difficult. Much publicly traded preferred stock is held by corporations, which, because of the dividend received deduction (sec. 243), are willing to accept a dividend yield lower than individual investors. Also, the need of publicly traded companies to have continued access to the capital markets creates an incentive to pay dividends on preferred stock that may be absent for the closely held company. Further, publicly traded preferred stock is inherently more liquid than is comparable stock of a closely held company. Finally, publicly traded companies are more likely to be in more than one line of business, which may effect the variability of the firm's earnings (or cash flows).

Moreover, the features of a preferred stock issued in a freeze often vary substantially from features contained in publicly traded

---

[59] Indeed, the very application of the willing buyer, willing seller standard to certain property rights held by related parties may be problematic. In most families, family relationships rather than contractual rights determine how and when property will pass.

[60] Since the option and the discounted cash flow methods are both sound, they theoretically reach substantially the same result. The existence of a substantial difference in the values determined by each method may suggest inaccurate application of one or both methods.

BEST AVAILABLE COPY

stocks. Stock issued in a freeze may lack features common to publicly traded comparables (such as a cumulative right to dividends) or contain features missing from such comparables (such as discretionary capital call rights).

These valuation difficulties create the possibility that inconsistent valuation assumptions will be used to value a preferred interest. Taxpayers may use favorable assumptions in valuing the retained preferred stock at the time of the freeze and unfavorable assumptions in valuing such stock at death.

Undervaluation also may result from the failure to value correctly restrictions or options to buy property. Fixed price and book formula options may be used without considering the likely appreciation in the property. Options granted in exchange for services may be valued on a mistaken assumption that the parties are dealing at arm's length. Bilateral options exercisable at death may be valued without regard to the different life expectancies of the parties.

Further, undervaluation may result from the use of Treasury tables valuing annuities, life estates, terms for years, remainders and reversions. Those tables are based on assumptions regarding rates of return and life expectancy that are seldom accurate in a particular case, and therefore, may be the subject of adverse selection. Because the taxpayer decides what property to give and when to give it, use of tables, in the aggregate, more often results in undervaluation than in overvaluation.

B. Subsequent Transfers

Creation of a frozen interest in property also permits the transfer of wealth free of transfer tax through the subsequent exercise or nonexercise of rights with respect to the enterprise. Even if the transferred property is properly valued at the time of the initial transfer under the willing buyer, willing seller standard, wealth may be transferred thereafter if the rights are not exercised in an arm's-length manner. This may occur if, after the transfer, either transferor or transferee acts or fails to act or causes the enterprise to act or fail to act. It is unclear under present law whether such exercise or nonexercise results in a gift. Even if it does, it is virtually impossible for the IRS to monitor all post-transfer action or inaction with respect to such rights.

Closely held businesses provide many opportunities for subsequent transfers of wealth. Such transfers may occur through legal rights created at the time of the freeze transaction. For example, wealth may pass from a preferred shareholder to a common shareholder if the corporation fails to pay dividends to the preferred shareholder. Even if the preferred stock is cumulative, such failure results in a transfer equal to the value of the use of the money until the dividend is paid. Or, by exercising conversion, liquidation, put or voting rights in other than an arm's-length fashion (or by not exercising such rights before they lapse), the transferor may transfer part or all of the value of such rights.

Subsequent action or inaction may transfer wealth even in the absence of a preferred interest in a closely held company. For example, failure to revise a dated sales price contained in a buy-sell agreement can transfer wealth from the party who would benefit

from such revision. Similarly, the failure of a life tenant to exercise his rights to use the property can have the effect of transferring wealth to the remainderman. Conversely, improvements by a life tenant can enrich the remainderman.

C. Disguised Testamentary Transfers

Third, the retention of a frozen interest may be used in order to retain enjoyment of the entire property. Enjoyment may be retained through a voting right, a preferred interest in a partnership or corporation, an income interest in a trust, a life estate in property, or a right to use property. In such cases, the transfer is, in reality, incomplete at the time of the initial transfer and, if the frozen interest is retained until death, the transfer is testamentary in nature.

Failure to treat a testamentary transfer as such gives the donor the advantage of favorable rules applicable only to gifts—such as the annual exclusion and tax-exclusive gift tax base. In addition, early utilization of the unified credit increases its present value. These benefits are appropriate only when the transferor has parted with substantial ownership of the transferred property.

V. PRESENT LAW: CODE SECTION 2036(c)

In the Omnibus Budget Reconciliation Act of 1987 (1987 Act), the Congress addressed the estate freeze transaction by including the value of the appreciating interest in the decedent's gross estate and crediting any gift tax previously paid (Code sec. 2036(c)). Such inclusion effectively treats the transfer as incomplete for transfer tax purposes during the period of the freeze. Thus, section 2036(c) addresses the possibilities of initial undervaluation, subsequent transfer of wealth, and retention of substantial ownership by postponing a final determination of transfer tax until the frozen interest passes.

Since its enactment, section 2036(c) has been amended and interpreted. In the Technical and Miscellaneous Revenue Act of 1988 (1988 Act), the Congress enacted safe harbors for the retention of debt and agreements to provide goods and services for fair market value. The Internal Revenue Service provided additional guidance in Notice 89-99, issued on August 31, 1989.

A. General Description of Section 2036(c)

Section 2036(c) generally provides that if a person in effect transfers property having a disproportionately large share of the potential appreciation in an enterprise while retaining an interest, or right in, the enterprise, then the transferred property is includible in his gross estate. For example, if a person who owns all the preferred and common stock in a corporation transfers the common stock while retaining the preferred stock, the common stock is includible in his gross estate.

Section 2036(c) does not apply if the sale is to an unrelated person for full and adequate consideration or the transferor and his family own less than 10 percent of the income or voting power of the enterprise. If the family member provides consideration not originally received from the transferor, a portion of the enterprise is excluded from the estate under section 2036(c). Dispositions of either the transferred or retained property prior to the transferor's death result in a deemed gift equal to the amount that would have been includible had the transferor died at the time of the transfer.

Section 2036(c) applies only if an interest is retained in an enterprise. The legislative history of section 2036(c) describes an enterprise as including a business or other property which may produce income or gain.[61] In its notice, the Internal Revenue Service stated that an enterprise is an arrangement that has significant business aspects. The notice excluded from the definition of enterprise personal use property, such as a principal residence or a life insurance contract.[62]

---

[61] *See* H. R. Rept. No. 100-495 at 996 (100th Cong., 1st Sess.)
[62] *See* Notice 89-99, 1989-38 I.R.B. 4 at 7

The statute and notice contain safe harbors for common business transactions that pose only limited possibility for the transfer of wealth outside the transfer tax system and do not resemble retained life estates. Failure to comply with the precise requirements of these safe harbors does not necessarily cause section 2036(c) to apply to a transaction.[63] The IRS also has solicited comments on the desirability of a safe harbor for transactions in which a significant number of unrelated parties participate.[64]

B. The Effect of Section 2036(c) on Specific Estate Freeze Transactions

1. Preferred interests in corporations and partnerships

Section 2036(c) generally applies to freezes involving the transfer of common stock coupled with the retention of preferred stock in a corporation. The provision also may apply if the parent exchanges common stock for preferred stock in a corporation in which the child also owns common stock,[65] or if the parent loans or contributes capital to a corporation in which the child owns a disproportionate share of the appreciation.[66] Creation of a holding company can cause section 2036(c) to apply even if the underlying property consists of stock in an enterprise in which the parties lack a 10 percent interest. The provision also applies to similar transactions using partnership interests.

Section 2036(c) applies only to transfers of a disproportionately large share of appreciation. The provision does not apply if the transferred and retained interests have the same rights, or if the only difference between the two interests is with respect to voting or managerial powers.[67]

Several safe harbors may apply to transactions involving preferred interests in corporations or partnerships. These safe harbors provide that section 2036(c) will not apply simply by reason of the retention or receipt of certain interests. One safe harbor exists for "qualified debt" held by the decedent. Qualified debt generally is debt that requires the payment of a sum certain in money at a fixed time and lacks equity features.[68] Such debt is excepted because it is easily valued, presents limited opportunity for the subsequent transfer of wealth and does not constitute retained enjoyment of the enterprise.[69]

In addition, there is a safe harbor for certain debt or preferred stock received in exchange for a cash loan to an enterprise engaged in an active trade or business so long as the holder of the debt or preferred stock did not, within three years, transfer property (including goodwill) or other business opportunities to the enter-

---

[63] *See id* at 11.
[64] *See id.* at 8.
[65] *See id.* at 9, Example 13.
[66] *See id.* at 10, Example 15.
[67] *See id.* at 10.
[68] *See* sec. 2036(c)(7)(c). An unconditional debt to pay a sum certain on demand incurred in return for cash used to meet normal business needs of the enterprise need not have a fixed maturity date or be payable on one or more specified dates *Id.*
[69] See H.R. Rept. No. 100-795 at 424.

prise.[70] This safe harbor relaxes the requirements generally imposed upon qualified debt because of the increased likelihood that appreciation in start-up enterprises is attributable to the transferee's labor and not to disguised transfers of wealth from the transferor.[71]

Another safe harbor provides that section 2036(c) generally will not apply solely because of 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 if the agreement (1) is an arm's-length agreement for fair market value and (2) does not otherwise involve any change in interests in the enterprise.[72] This exception is provided because such agreements do not present an opportunity for transferring wealth free of transfer tax and do not involve the retention of enjoyment of the enterprise.[73]

These safe harbors do not exhaust the transactions excluded from section 2036(c). For example, the provision does not apply simply because a person provides *de minimis* amounts of property or services to be used in the child's business or because such person, in the ordinary course of business, provides goods or other property for use in the business.[74]

2. Grantor retained income trusts

Section 2036(c) generally applies to a grantor retained income trust (GRIT).[75] An exception exists for transfers to a trust in which the transferor retains a right to receive amounts determined solely by reference to income from the trust property if the term of the income interest does not exceed 10 years and the transferor is not a trustee of the trust (sec. 2036(c)(6)). This exception does not apply if the transferor retains an interest that is not determined solely by reference to income from the trust. Thus, it does not apply if the transferor retains an annuity interest.[76] In addition, the exception does not apply if the grantor retains a contingent reversion or power of appointment with a value in excess of 25 percent of the retained income interest.[77]

3. Options and buy-sell agreements

Section 2036(c) applies to an option or buy-sell agreement because such an arrangement creates two classes of interests, with differing rights to appreciation.[78] The effect of section 2036(c) is to

---

[70] In addition, the retained interest cannot be voting or convertible to another interest. If the interest is debt it must unconditionally require the payment of a sum certain in money. If the interest is preferred equity, it must have a cumulative dividend preference with a fixed rate of return, a nonlapsing liquidation preference for capital plus accrued dividends and not be redeemable for less than such preference. *See* sec. 2036(c)(7)(D); Notice 89-99 at 12-13.

[71] *See* H. R Rept. No. 100-795 at 426.

[72] Sec. 2036(c)(7)(A)(ii). The safe harbor does not apply to any amount determined in whole or in part by reference to gross receipts, income, profits, or similar items of the enterprise or to agreements to provide services over a period greater than three years after the transfer. *See* sec. 2036(c)(7)(B).

[73] *See* H. R. Rept. No. 100-795 at 426.

[74] *See* Notice 89-99, at 7.

[75] *See id* at 5. An irrevocable trust is an enterprise even if the property held in trust would not constitute an enterprise if held directly. *See id.* at 6.

[76] *See* H.R. Rept. No. 160-1104 at 74 n. 1.

[77] *See* Notice 89-99, at 11-12.

[78] *See id.*

include the value of the option or restriction in the transferor's gross estate.

Section 2036(c) does not generally apply to an arm's-length buy-sell agreement between unrelated persons.[79] There is a statutory safe harbor for an option or other agreement to buy or sell property at fair market value determined as of the time the option is (or rights under the agreement are) exercised. In recognition of the expense and administrative difficulty involved in determining fair market value, the IRS considers an agreement as falling within the safe harbor if the sale price is determined by application of a formula that reasonably can be expected to produce a result that approximates the fair market value of the property when the sale is consummated.[80]

4. Sales of remainder interests and joint purchases of interests in property

Section 2036(c) applies to the sale of a remainder interest and the joint purchase of an income and remainder interest in property.[81] The value of the entire property is included in the term-holder's estate, with an adjustment for the consideration provided by the term-holder.

5. Installment sales and private annuities

Section 2036(c) may apply to an installment note or private annuity if the installment note or annuity constitutes a retained interest in the enterprise.[82]

Even if it constitutes a retained interest in an enterprise, an installment note or private annuity may qualify for the safe harbor for qualified debt. Because such safe harbor requires an unconditional obligation to pay a sum certain in money, a note or annuity for which the payments are contingent on future events, such as the survival of the transferor, does not qualify.[83]

---

[79] *See id.*
[80] See *id.*
[81] *See id.* at 5, 10 (Example 16).
[82] *See id.* at 5, 10-11.
[83] *See* H. R. Rept. No. 100-795 at 425; Notice 89-99, at 12.

VI. GENERAL CRITICISMS OF SECTION 2036(c)

A. The Merits of an Incomplete Gift Approach

One criticism of section 2036(c) regards the merits of using an incomplete gift rule for estate freezes. Critics of such an approach argue that regardless of the possibilities for initial undervaluation and subsequent transfer, the gift tax assessed when the transfer is made should finalize the transfer tax consequences of the transaction. They also argue that frozen interests should be regarded as separate property rather than the retention of substantial ownership of the enterprise. Further, they argue that section 2036(c) does not adequately implement an incomplete gift rule because it only credits the gift tax on the initial transfer rather than eliminating such tax entirely. Thus, the donor has in effect prepaid his estate tax without interest.

Proponents of an incomplete gift approach argue that estate tax inclusion is the surest means of providing a proper valuation and avoiding problems attendant to subsequent transfers. They note that such a rule achieves roughly the same effect as treating the transaction as a gift initially—taxation of appreciation is offset by the benefit derived from deferral of tax. They stress that an incomplete gift rule is the only means of addressing the problem of inherently testamentary transfers. Some suggest modifying section 2036(c) to eliminate the initial gift tax while others justify the initial tax on administrative grounds.

B. The Breadth of Section 2036(c)

Critics of section 2036(c) note that the section extends far beyond the preferred stock freeze to a wide variety of family transactions. They argue that such breadth creates uncertainty and hampers planning by family members. They note that section 2036(c) can trap unwary taxpayers undertaking common business transactions such as the lending of money or the provision of services. They believe that further modification of the statute would create undue complexity.

Others counter that freezes may be performed through a wide variety of devices—partnerships, trusts, options and interests in property—and argue that a broad scope is necessary to reach these devices. They note that in the family context many common business transactions operate to transfer wealth. They assert that present-law safe harbors protect most common business transactions with limited transfer tax avoidance potential and that additional safe harbors could be enacted if necessary.

C. Effect on Small Business

Critics of section 2036(c) observe that the provision makes it more difficult to transfer a closely held business between generations. They note that a family is sometimes forced to sell the business in order to pay estate tax. They argue that the creation of special rules for family transfers is unfair and that entrepreneurs play an important role in our society.

Supporters of section 2036(c) note that the provision does not discriminate against small businesses, but in fact treats all transfers of assets alike. They also argue that the donative character of many intrafamily transactions justifies the application of a special standard to them. They argue that all types of wealth should be subject to the same transfer tax.

Supporters of section 2036(c) also note that the unified credit exempts estates of up to $600,000 (potentially $1,200,000 for a married couple) and that small business owners already receive estate tax relief through the unified credit, special valuation rules for real property, sales treatment of redemptions to pay death taxes, and rules allowing deferred payment of estate taxes. They argue that additional relief for family businesses is better granted to small business generally through modification of these provisions rather than limiting relief to persons engaging in estate freeze transactions.

VII. ALTERNATIVES TO SECTION 2036(c)

Generally, there are three points of time for subjecting property to transfer tax. Alternatives to section 2036(c) might modify the law with respect to any of them.

First, gift tax can be imposed on the initial transfer. This approach predominated under pre-1987 law. Valuation at the time of the initial transfer might be improved by requiring notice and information reporting to the IRS, expanding the use of qualified appraisals, creating valuation assumptions for discretionary rights, and extending the statute of limitations.

Second, gift tax can be imposed on subsequent transfers. This approach is similar to the Dickman case and section 7872. This approach might be bolstered by clarifying the gift tax consequences of the failure to convert stock, declare a dividend, or exercise other rights with respect to property.

Third, gift or estate tax can be imposed on the transferred interest when the transferor disposes of the frozen interest. This hard to complete approach was implicit in sections 2036 through 2042 of pre-1987 law and was extended by section 2036(c). Even if section 2036(c) were replaced, the hard to complete approach could be retained for certain transactions such as transfers to trusts, or retentions of rights that lapse on death.

Five proposed alternatives to section 2036(c) are described below.

A. Repeal of Section 2036(c) Without Replacement

During March and April of 1989, Senators Boren, Daschle, Heflin and Symms introduced bills proposing repeal of section 2036(c) without replacement.[84] Repeal without replacement would reinstate pre-1987 law.

B. Proposal of the Task Force of the American Bar Association and American College of Probate Counsel

1. General description of Task Force Proposal

In 1989, an ad hoc Task Force of the American Bar Association and the American College of Probate Counsel formulated a two-part replacement for section 2036(c) ("Task Force Proposal").[85] The first part is a valuation assumption made for gift tax purposes. Under that assumption, nonpublic stock and partnership interests are valued in order to maximize the value of the gift by assuming that any discretionary liquidation, conversion, dividend or put

[84] *See* S. 659 (Senator Symms) (March 17, 1989), S. 838 (Senator Heflin) (April 18, 1989), and S. 849 (Senators Daschle, Heflin, Boren, and Symms) (April 19, 1989) *See also* H.R. 60 (Mr. Archer) (January 3, 1989).

[85] *See* letter of Irwin L. Treiger, L. Henry Gissel, Jr. and Geraldine S. Hemmerling to Ronald A. Pearlman (July 27, 1989) (enclosure).

rights retained by the donor or the donor's spouse will not be exercised in a manner adverse to the interest of a member of the donor's family. The effect of the first part is to value the transfer without regard to discretionary rights retained by the transferor. Accordingly, the value of the transferred interest is increased.

The second part is a safe harbor, which would, in valuing a gift of a residual equity interest, value certain retained preferred interests at their liquidation preference. The safe harbor applies only if (1) the preferred interest carries a cumulative return equal to the applicable Federal rate, compounded semiannually; (2) the failure to pay income for 36 months results in the preferred interest having voting control of the corporation or partnership; and (3) the sum of all preferred interests does not exceed 80% of all equity interests in the corporation or partnership.

2. Application of Task Force Proposal to specific transactions

a. Preferred interests in corporations and partnerships

The Task Force Proposal affects gift tax valuation by placing rights retained by the transferor into one of three categories. First, certain preferred interests bearing a cumulative compounded return equal to AFR are valued at par. Second, discretionary liquidation, conversion, dividend or put rights retained by the donor or donor's spouse are assumed not to be exercised in a manner adverse to the interest of a family member. Third, all other rights are valued under present law. A cumulative preferred stock lacking discretionary rights that is not within the safe harbor continues to be valued under present law.

The Task Force Proposal does not affect estate tax valuation.

b. Other transactions

The Task Force Proposal is limited to preferred interests in corporations and partnerships. Thus, under the Task Force Proposal grantor retained income trusts, options and buy-sell agreements, sales of remainder interests, joint purchases, installment sales, and private annuity transactions would be governed by pre-1987 law.

C. Discussion Draft Released March 22, 1990

1. General description of Discussion Draft

Overview

In a Ways and Means Committee press release dated March 22, 1990, Ways and Means Committee Chairman Dan Rostenkowski announced the release of a Discussion Draft relating to estate freezes ("Discussion Draft"). The Discussion Draft would repeal section 2036(c) and enact in its place a set of rules generally intended to modify the gift tax valuation rules so as to more accurately value the initial transfer. Such rules operate by adopting valuation assumptions that take into account the likelihood that related parties will not exercise rights in an arm's-length manner.

The Discussion Draft would repeal section 2036(c), under which the transfer is incomplete until the freeze ceases. Rejecting the characterization of freeze transactions as testamentary, the Discussion Draft generally substitutes for section 2036(c) a set of rules in-

tended to modify the gift tax valuation rules in such a way as to more accurately value the initial transfer. Such rules operate by adopting valuation assumptions that take into account the likelihood that related parties will not exercise rights in an arm's-length manner.

Assumptions in valuing gifts

The Discussion Draft assumes that the value of a residual interest in an entity is determined by reducing the value of the whole by the value of retained preferred interests. In determining whether a gift has been made, and the amount of the gift, the Discussion Draft provides rules for valuing rights retained by the transferor and members of his family (other than the transferee). Such rights fall into one of three categories.

The first category consists of qualified fixed payments (QFPs), which are generally rights to payment that are fixed both as to time and amount. Such payments are assumed to be made as provided in the instrument. Payments under instruments lacking a fixed termination date are assumed made in perpetuity.

The second category consists of voting rights and retained rights in the same or a junior class. Such rights continue to be valued as under present law.

The third category of retained rights consists of all other rights. Such rights are valued at zero in recognition of the uncertainty that they will be exercised in an arm's-length manner. Certain rights which would otherwise fall into this category may, under certain circumstances, be valued as though they were qualified fixed payment rights.

These categories can be illustrated by considering the following example: a person holding cumulative preferred stock that can be put to the corporation for its par value and common stock gives one half of the common stock to a family member. In valuing the gift, dividends are assumed to be paid as provided in the preferred stock, the put right is valued at zero, and the retained rights under the common stock are valued as under present law.

Rules governing late payment of QFP or transfer of retained rights

The failure to make a QFP within a specified period of time, generally 3 years, results in a gift. This consequence is a corollary of the favorable assumption made in valuing QFPs at the time of the gift. If the QFP is made after the deemed gift, the Discussion Draft would refund the gift tax paid on the deemed gift.

The Discussion Draft adopts special rules for the transfer of retained rights previously valued under these rules. In order to avoid double taxation, the Discussion Draft reduces the value of any right previously valued at zero by the amount of the increase in the original gift resulting from valuing such right at zero. To ensure consistent use of the favorable valuation assumption, the later transfer of a QFP is treated as giving rise to an additional transfer equal to the excess of the value of the QFP determined with the statutorily mandated assumption that QFPs would be paid over the value determined without regard to that assumption. Additional transfer tax is not imposed on a transfer of a retained in-

terest to a spouse; however, the spouse is treated as the transferor in the future for purposes of these rules.

Scope

The valuation rules apply to transfers of an interest in a corporation, partnership or trust of which the transferor and his family own more than 10 percent. A debt instrument or lease is treated as an interest in an entity. The rules apply in valuing donative transfers and all transfers to a spouse, to lineal descendents and descendents of the spouse, to parents or grandparents, to parents and grandparents of the spouse, and to spouses of the foregoing. The rules also apply to a recapitalization, redemption or contribution to capital that has the effect of a transfer.

Statute of limitations

The gift tax statute of limitations is extended from three years to six years for transfers subject to the Discussion Draft. In addition, the statute of limitations is unlimited for transfers subject to the Discussion Draft which are not reported, regardless of whether a gift tax return was filed, or required to be filed, for the year in which the transfer occurred.

Effective date

The Discussion Draft would repeal section 2036(c) retroactively to the date of its enactment. The Discussion Draft does not contain an effective date for the substitute valuation rules.

2. The effect of the Discussion Draft on specific estate freeze transactions

a. Preferred interests in corporations and partnerships

Valuation of initial transfer

QFPs

QFPs from a corporation or partnership include a cumulative preferred dividend (payable on a periodic basis and at a fixed rate), or any other payment or distribution which is fixed both as to time and amount.[86] The transferor may elect to treat non-cumulative preferred stock dividends and partnership distributions which are contingent on cash flow or income as QFPs.

As under present law, QFPs from corporations or partnerships are valued by determining the value of the fixed payments, using appropriate market discount rates. Taxpayers are free to set the rate of the QFP at whatever rate they wish. For example, if preferred stock with a par value of $1,000 carried an 8 percent cumulative dividend, and 8 percent was the appropriate market rate, the value of the stock would be approximately $1,000 (its par value). On the other hand, if the taxpayer chose a 4 percent dividend rate, but the appropriate market rate were 8 percent, the value of the stock would be less than par value.

---

[86] QFPs could have a variable interest rate if the rate were tied to a specified market rate. Payments subject to a life contingency would not be QFPs.

These special rates could not reduce the value of the common stock of a corporation or the non-preferred interests of a partnership below a minimum value. Thus, the total value of the common stock or non-preferred partnership interests could not be less than 20 percent of the sum of the total equity in the corporation or partnership and any debt which the corporation or partnership owed to the transferor or members of his family. This minimum value is intended to reflect the "option value" of the right of the common stock or non-preferred interest to future appreciation.

Other rights

The Discussion Draft does not apply where the transferor transfers preferred stock and retains common stock or where he transfers and retains only stock of the same class (even if the transferred and retained stock differs with respect to voting rights). Such transfers are valued without regard to the valuation rules of the Discussion Draft. Conversion, liquidation, redemption and other capital call rights lacking a fixed payment date are valued at zero.

Example

Assume a holder of a partnership interest gives to a family member a partnership interest that has income rights that are junior to those of the retained interest. Unless the donor elects otherwise, the retained income rights are valued at zero. If the donor elects to treat the income right as a QFP, such right is valued on the assumption that the payment will be made as scheduled.

Subsequent treatment of retained rights

To make allowance for natural changes in the business cycle, no gift is deemed for failure to make a QFP from a corporation or partnership until three years after the year in which the QFP is due. In addition, there is no deemed gift if the instrument under which the payment is to be made provides that the unpaid QFP will bear compound interest at the discount rate used to determine the value of the initial gift.

A transfer of a retained QFP right results in a transfer equal to the excess of (1) the value of the gift determined with the statutorily mandated assumption that QFPs would be paid over (2) the value determined without such assumption.

Bankruptcy or insolvency

Special rules apply to corporations and partnerships in bankruptcy or insolvency. Under these special rules, the three-year grace period for deemed gifts is extended by the period of insolvency or bankruptcy; QFPs which are discharged in bankruptcy are not treated as deemed gifts; and no deemed gift occurs if the transferor transfers his retained interest during insolvency or bankruptcy. The bankruptcy exception does not apply if one purpose for commencing the bankruptcy suit was to avoid these rules. Insolvency is defined as the excess of liabilities over the fair market value of the assets. For this purpose, liabilities owed to the transferor or a member of the transferor's family are not taken into account.

b. Grantor retained income trusts

Valuation of initial transfers

For trusts, a QFP would either be (1) a fixed amount payable at least annually, (2) an amount payable at least annually which is a fixed percentage of the trust's assets (valued annually), or (3) a non-contingent remainder interest if all the other interests in the trust are QFPs. These interests are similar to those permitted in charitable split interest trusts. Such interests would be valued under the appropriate Treasury tables.

Other interests in trusts are disregarded. Thus, a person who makes a completed transfer of an interest in property in trust and retains an interest determined by reference to the income of the trust (or a contingent reversionary right to trust corpus) is treated as making a transfer equal to the value of the whole property.

Subsequent treatment of retained right

Failure by a trust to make a QFP within 65 days of the end of its taxable year results in a deemed gift by the transferor.

Personal residences

The Discussion Draft does not apply to transfers of interests in a personal residence to be used by the holder of the term interest.

c. Options and buy-sell agreements

Under the Discussion Draft, the value of property is determined without regard to options, rights of first refusal and leasehold rights held by family members. An exception to the rule is provided for property that lacks a readily ascertainable fair market value and is sold pursuant to a price determined under a formula which was reviewed within three years of the sale and which, at the time of the review, was reasonably expected to produce a price approximating fair market value at the time of exercise. The effect of an option falling within this exception on estate tax value would be determined under pre-section 2036(c) law.

d. Sale of remainder interest and joint purchase of interests in property

Under the Discussion Draft, the retention of a term interest (including a life estate) in property is treated like the retention of an interest in trust. Moreover, a joint purchase of property is treated as an acquisition of the entire property by the holder of the term interest, followed by a transfer of the remainder interest. Thus, the Discussion Draft effectively treats the purchaser of a life estate pursuant to a joint purchase as making a gift of the entire property less the amount of any consideration paid by the purchaser of the remainder.

A special rule applies to a term interest in tangible property where the non-exercise of the term-holder's rights does not substantially affect the value of the property passing to the holder of the remainder interest. In that case, the value of the term interest is not zero, but the amount for which the term interest could be sold to an unrelated third party (not determined under the Treasury tables). For example, the rule could apply to the joint purchase of a

painting or undeveloped real estate (the value of which primarily reflects future development potential). On the other hand, the rule would not apply to a joint purchase of depletable property.

e. Installment sales and private annuities

The Discussion Draft only applies in valuing an interest in a corporation, partnership, or trust. Thus, the Discussion Draft generally does not apply to an installment note or private annuity for which an individual is the obligor. In the case of a note or annuity which is an interest in an entity, the note or annuity would be treated as a QFP, so long as payments on it were fixed as to time and amount and not subject to a life contingency.

D. Proposal of the Section of Taxation of the District of Columbia Bar Association

1. General description of D.C. Bar Proposal

On April 17, 1990, the section of taxation of the District of Columbia Bar Association issued a report containing a proposed alternative to section 2036(c) ("D. C. Bar Proposal").[87] The Proposal contained two sets of rules governing transactions that generally would be subject to section 2036(c), i.e., those involving an enterprise in which the transferor owns more than 10% before the transfer and in which he retains an interest after the transfer.

The first set of rules relates to valuation. Under one rule, the value of property transferred to a family member is determined as if it were associated with property retained by the transferor. The effect of this rule is to permit a discount for lack of control only if the retained and transferred property together constitute a minority interest.

Another valuation rule permits departure from the Treasury tables if the income or mortality assumption of those tables is likely to be substantially different from that actually experienced. Failure of the tables to reflect the subsequent experience of the transferred property would be evidence that their use at the time of the initial transfer was inappropriate, unless the deviation is due to circumstances not foreseeable at the time of the transfer and is attributable to factors beyond the reasonable control of the parties.

The second set of rules in the D.C. Bar Proposal concerns disclosure and the statute of limitations. The Proposal requires reporting of all section 2036(c) transactions regardless of whether the transaction gives rise to a taxable gift. In addition, the gift tax statute of limitations generally is extended to six years. Failure to adequately disclose the transaction tolls the gift tax statute of limitations. Even if the transfer is adequately disclosed, the Internal Revenue Service could, at donor's death, prove that the gift was undervalued and collect additional transfer tax attributable to the gift.

The D.C. Bar Proposal also gives the taxpayer the right to petition for an audit. Such audit permanently forecloses the Internal Revenue Service from subsequently revaluing the property. Failure of the IRS to audit within the later of (1) six years of the disclosure

[87] *See* letter of Jane E. Bergner to Ronald A. Pearlman (April 19, 1990) (enclosure).

or (2) two years after filing the request for audit results in the taxpayer's value being treated as conclusive. Upon the donor's death, the Commissioner could not challenge the value for purposes of determining either the tax due on the gift or the appropriate estate tax bracket and credit.

2. The effect of the D.C. Bar Proposal upon specific estate freeze transactions

The disclosure and statute of limitations component of the D.C. Bar Proposal applies to the specific estate freeze transactions described below. In addition it makes the following substantive changes.

a. Preferred interests in corporations and partnerships

Under the D.C. Bar Proposal, the gift and estate tax consequences of the transfer of common stock, coupled with the retention of preferred stock is governed by pre-1987 law except that a discount for lack of control is permitted only if the retained and transferred property together would be entitled to such a discount.

Subsequent events have potential transfer tax consequences. The failure to pay dividends or exercise other rights with respect to the retained preferred stock would be evidence of undervaluation of the transferred interest at the time of initial transfer. In addition, the D.C. Bar Proposal would retain present law gift tax treatment for the failure to exercise retained rights.

b. Grantor retained income trusts

The D.C. Bar Proposal modifies the valuation of a retained income interest in a GRIT to permit valuation without regard to the Treasury tables if either the Internal Revenue Service or the taxpayer establish that the actual income or mortality experience is likely to be different from those contained in the tables. The failure of the tables to predict the actual experience may be used to establish the inaccuracy of the original valuation unless the deviation is due to circumstances not foreseeable at the time of the transfer and is attributable to factors outside the reasonable control of the transferor or transferee.

c. Options and buy-sell agreements

Under the D.C. Bar Proposal, the estate or gift tax treatment of options and buy-sell agreements is governed by pre-1987 law.

d. Sale of remainder interest and joint purchase of interests in property

The D.C. Bar Proposal treats a sale of a remainder interest and a joint purchase in property the same as a GRIT. Thus, departure from Treasury tables is permitted if the Internal Revenue Service or the taxpayer establishes that the actual income or mortality experience is likely to be different from that assumed in the tables.

e. Installment sales and private annuities

The D.C. Bar Proposal treats a private annuity the same as a retained income interest in a GRIT. Thus, departure from Treasury tables is permitted if the Internal Revenue Service or the taxpayer

establishes that the actual income mortality experience is likely to be different from that assumed in the tables. Under the D.C. Bar Proposal, an installment sale is governed by pre-1987 law.

E. Proposal of the U.S. Chamber of Commerce

1. General description of Chamber of Commerce Proposal

In its testimony before the House Ways and Means Committee on April 24, 1990, the U.S. Chamber of Commerce supported the "core concept" of the Discussion Draft and offered a modified draft ("Chamber of Commerce Proposal).[88]

Assumptions in valuing gifts

Like the Discussion Draft, the Chamber of Commerce Proposal divides retained rights into three categories.

One category consists of qualified non-discretionary payments, which are generally payments that are non-discretionary both as to time and amount. It also includes any dividend payable on a preferred stock to the extent that the dividend is determined at a non-discretionary rate. Such payments are assumed to be made as provided in the instrument. Payments under instruments lacking a non-discretionary termination date are assumed made in perpetuity.

A second category consists of rights valued under present law. These include: any interest of the same class as the transferred interest; any discount for minority interest or lack of marketability with respect to the transferred junior interest; any rights with respect to the retained preferred interest which have no preference over any rights under the transferred interest; any option, buy-sell, cross-purchase, redemption or other agreement to buy or sell property interests; employment agreements, debt, leases and other non-equity interests; rights of first refusal agreements and other transfer restrictions; and a payment or right which is (i) a function of any published index, (ii) directly related to sales or production, or (iii) otherwise not subject to the discretion of the transferor, his or her spouse or the 50 percent owned entity.

The third category consists of discretionary rights, defined as any liquidation, conversion, put, call or other right to a payment or distribution the payment of which is at the discretion of the transferor or entity. Such rights are valued at zero.

Rules governing late payment of qualified non-discretionary payment or transfer of retained rights

As under the Discussion Draft, the failure to make a qualified non-discretionary payment within three years generally results in a gift. The gift tax paid is refunded if the payment is subsequently made.

The later transfer of a qualified non-discretionary right is valued under the same assumptions made in the initial transfer. The value of any discretionary right previously valued at zero is reduced by the amount of the increase in the original gift resulting from valuing such right at zero.

---

[88] *See* statement of David R. Burton to House Ways and Means Committee (April 24, 1990)

Scope

The Chamber of Commerce Proposal is limited to preferred interests retained in a partnership or corporation. It applies only to rights retained by the transferor or a spouse in a corporation or partnership in which the transferor directly or indirectly owns 50 percent or more. The definition of family is the same as the Discussion Draft except it excludes donees who are not otherwise related to the transferor.

Statute of limitations

The Chamber of Commerce Proposal does not change the gift tax statute of limitations.

2. The effect of the Chamber of Commerce Proposal upon specific freeze transactions

a. Preferred interests in corporations and partnerships

Valuation of initial transfer

Qualified non-discretionary payments

A qualified non-discretionary payment includes cumulative and noncumulative dividends. Such payments are valued by appropriately discounting future payments. Under the Chamber of Commerce Proposal, the value of all preferred interests determined under the special valuation rules is limited to the value of the entire business, and the value of the retained preferred stock is limited to its proportionate share of such value. Unlike the Discussion Draft, the Chamber of Commerce Proposal attaches no minimum value to the common interests.

Other rights

The Chamber of Commerce Proposal does not affect any nonequity interest; any right in the same or junior class; a minority discount or lack of marketability discount; or any payment or right that is (1) the function of a published index, (2) directly related to sales or production, or (3) otherwise not subject to the discretion of the transferor, his or her spouse, or the 50-percent or more owned entity. Discretionary liquidation, conversion, put and call rights are valued at zero.

Subsequent treatment of retained rights

Failure to make a qualified nondiscretionary payment within three years of its due date does not result in a gift if the instrument provides for compounding of interest. In addition, no gift occurs if the failure occurs when the company is bankrupt or insolvent (determined by taking into account liabilities owed the transferor). Finally, failure to make a qualified non-discretionary payment does not result in a gift if the sum of the entity's annual earnings and profits plus compensation to family members allocable to the retained interest is less than the qualified non-discretionary payment payable under the instrument. This exception applies only if, for the three years prior to the initial transfer, such sum

exceeded 150 percent of the average qualified non-discretionary payment payable.

b. Other transactions

The Chamber of Commerce Proposal is limited to preferred interests in corporations and partnerships. Thus, grantor retained income trusts, options and buy-sell agreements, sales of remainder trusts, joint purchases, installment sales, and private annuity transactions would be governed by pre-1987 law.

APPENDIX: DATA ON FEDERAL ESTATE AND GIFT TAXES

Federal estate and gift taxes compared to total Federal revenues

Federal estate and gift taxes raised $8.7 billion towards total Federal receipts in fiscal year 1989. As indicated in Table 1, estate and gift taxes generally have provided increasing revenues over the past 50 years. Throughout the postwar period, the United States has experienced substantial growth of real per capita income and wealth. In the absence of changes in Federal transfer taxes, increasing wealth would generate increases in the real value of revenues generated by estate and gift taxes. In addition, the exemption levels and tax rate brackets of the estate and gift taxes have not been indexed for inflation. Consequently, inflation also would lead to increased revenues from the estate and gift taxes. The reduction in transfer tax revenues experienced after 1977 and again after 1982 primarily results from the increase in the exclusion amount (phased in), expanded marital deduction, and reduction in the highest marginal tax rates enacted by the Tax Reform Act of 1976 and the Economic Recovery Tax Act of 1981.

Adjusting for inflation, the revenue collected from Federal transfer taxes in 1988 is more than 80 percent greater than the revenue collected from Federal transfer taxes in 1955. However, adjusting for inflation, the revenue collected from Federal transfer taxes in 1988 is less than 80 percent of the value of the revenue collected from transfer taxes in either 1965 or 1975.

While the more than $8 billion collected from the transfer taxes is significant, Federal transfer taxes in percentage terms provide only a small fraction of total Federal revenues. In the postwar era, Federal transfer taxes have only rarely provided revenues in excess of two percent of total Federal receipts. As Table 1 documents, revenues from the transfer taxes as a percentage of total Federal receipts have declined since the mid-1970s. Since 1982, transfer taxes have never accounted for more than one percent of total Federal receipts. The growth of other revenue sources accounts for at least some of the decline in the share of Federal receipts provided by the transfer taxes.

Table 1.—Revenue from the Federal Estate and Gift Taxes, Selected Fiscal Years 1940–1989

[Dollar amounts in millions]

Fiscal year	Revenues	Percentage of total Federal receipts
1940	$357	6.9
1945	638	1.4
1950	698	1.9
1955	924	1.4
1960	1,606	1.7
1961	1,896	2.0
1965	2,716	2.3
1966	3,066	2.1
1970	3,644	1.9
1973	4,917	2.1
1975	4,611	1.7
1976	5,216	1.7
1977	7,327	2.1
1978	5,285	1.3
1979	5,411	1.2
1980	6,389	1.2
1981	6,787	1.1
1982	7,991	1.3
1983	6,053	1.0
1984	6,010	0.9
1985	6,422	0.9
1986	6,958	0.9
1987	7,493	0.9
1988	7,594	0.8
1989	8,745	0.9

Sources: Joint Economic Committee, *The Federal Tax System: Facts and Problems,* 1964; Joseph A. Pechman, *Federal Tax Policy* (Washington: Brookings Institution), 1987; and U.S. Office of Management and Budget, *Budget of the United States Government Fiscal Year 1991.*

Scope of the Federal estate tax

Relatively few decedents incur a Federal estate tax liability. Since the revisions made to the estate tax as part of the Economic Recovery Tax Act of 1981, generally less than two percent of decedents incur an estate tax liability. In 1988, less than one percent of decedents incurred an estate tax liability. Never have as many as 10 percent of decedents incurred an estate tax liability. Table 2 presents data for selected years on the number of returns taxable under the estate tax compared to the number of adult deaths in the United States.

As discussed above, in the absence of changes in the estate tax, inflation and the growth in per capita wealth in the United States over the past 50 years would cause more decedents' estates to incur an estate tax liability. This was the case until 1977. The increase in

the estate tax exclusion enacted in the Tax Reform Act of 1976 and the Economic Recovery Tax Act of 1981 removed a substantial number of estates from Federal estate taxation.

Table 2.—Number of Taxable Federal Estate Tax Returns Filed as a Percentage of Adult Deaths, Selected Years 1940-1988

Year	Deaths	Taxable estate tax return filed [1]	
		Number	Percent of deaths
1940	1,237,186	12,907	1.04
1945	1,239,713	13,869	1.12
1950	1,304,343	17,411	1.33
1955	1,379,826	25,143	1.82
1961	1,548,665	45,439	2.93
1966	1,727,240	[2] 67,404	3.90
1970	1,796,940	[2] 93,424	5.20
1973	1,867,689	[2] 120,761	6.47
1977	1,819,107	[2] 139,115	7.65
1982	1,897,820	[2, 3] 41,620	2.19
1983	1,945,913	[2, 3] 35,148	1.81
1984	1,968,128	[2, 3] 31,507	1.60
1985	2,086,440	[2, 3] 30,518	1.46
1988	[4] 2,171,000	[2] 18,948	0.87

[1] Estate tax returns are not necessarily filed in the year of the decedent's death. Consequently, the data for taxable returns may not correspond to the same year as the data for deaths.

[2] Not strictly comparable with pre-1966 data. For 1966 and later years, the estate tax after credits was the basis for determining taxable returns. For prior years, the basis was the estate tax before credits.

[3] Although the filing requirement was for gross estates in excess of $225,000 for 1982 deaths, $275,000 for 1983 deaths, and $325,000 for 1984 deaths, the data are limited to gross estates of $300,000 or more.

[4] Preliminary estimate.

Sources: Joseph A. Pechman, *Federal Tax Policy* (Washington, Brookings Institution), 1987; Internal Revenue Service, *Statistics of Income;* and U.S. National Center for Health Statistics.

Summary data from Federal estate tax returns

Data from Federal estate tax returns filed in 1988 show that more than one quarter of the value of gross estates comes from corporate stock, both publicly traded and non-traded, held by the decedent. Real estate represents another fifth of the value of gross estates. Deductions exempt from tax nearly one half of the value of gross estates. However, one third of the value of estates is excluded from tax under the marital deduction, which generally only provides a deferral of tax until the death of the surviving spouse. Table 3 provides a more detailed presentation of summary data on the composition of estates for estate tax returns filed in 1988.

36-968 0 - 91 - 5

Table 3.—Data on Federal Estate Tax Returns Filed in 1988

[Dollar amounts in millions]

Item	Returns	Percent	Value	Percent
Gross Estate	**43,683**	**100.0**	**$70,625.4**	**100.0**
Real estate	35,077	80.3	13,564.8	19.2
Corporate stock	34,333	78.6	19,638.8	27.8
Bonds (total)	26,803	61.4	8,077.5	11.4
Federal savings	6,255	14.3	243.3	.3
Federal other	9,239	21.2	1,539.2	2.2
State and local	19,521	44.7	5,823.1	8.2
Corporate and foreign	9,391	21.5	471.9	.7
Cash	42,345	96.9	7,614.4	10.8
Notes and mortgages	12,568	28.8	1,708.7	2.4
Life insurance	23,741	54.3	2,150.0	3.0
Annuities	11,985	27.4	1,692.3	2.4
Noncorporate business	10,916	25.0	2,519.4	3.6
Household assets	39,374	90.1	2,547.4	3.6
Lifetime transfers	9,382	21.5	11,112.1	15.7
Deductions (total)	**43,596**	**99.9**	**33,523.9**	**47.5**
Funeral expenses	40,274	92.2	197.5	.3
Admin. expenses (total)	31,846	72.9	1,700.6	2.4
Executors	15,408	35.3	632.6	.9
Attorneys	25,702	58.8	604.9	.9
Other	30,762	70.4	463.1	.7
Debts and mortgages	35,514	81.3	3,238.2	4.6
Charity	8,376	19.2	4,822.1	6.8
Marital	20,593	47.1	23,539.6	33.3
ESOP	[1]	[1]	[1]	[1]
Taxable estate	**39,480**	**90.4**	**37,250.2**	**52.7**
Adjusted taxable gifts	4,582	10.5	918.2	1.3
Adjusted taxable estate	39,551	90.5	38,168.4	54.0
Estate tax before credits	**39,551**	**90.5**	**14,588.7**	**20.7**
Credits (total)	**39,550**	**90.5**	**8,187.3**	**11.6**
Unified	39,550	90.5	6,559.5	9.3
State death taxes	21,900	50.1	1,567.5	2.2
Other	919	2.1	60.1	.1
Estate tax	**18,948**	**43.4**	**6,299.2**	**8.9**

[1] Information not disclosed.

Source: Internal Revenue Service.

PREPARED STATEMENT OF RICHARD L. DEES

My name is Richard L. Dees, and I am a partner in the Chicago office of the national law firm of McDermott, Will & Emery. In May 1989 I was an invited witness to testify to the full Committee on why current Section 2036(c) should be repealed. Since that time I have given technical advice to members of the Business Coalition to Repeal Section 2036(c) and was named as a technical expert by the National Grocers Association and the Small Business Legislative Council to work with Treasury on a replacement to Section 2036(c). My comments today, however, are my own and not necessarily those of the NGA, the SBLC, of any other business group or those of any firm client.

Since last year's hearing the Finance Committee has consistently viewed the Section 2036(c) solution as a bigger problem than the "estate freeze" which the section was supposed to resolve. That is now the consensus view. Thus today's focus on possible replacements to Section 2036(c).

The process underway in the House to find a replacement to Section 2036(c) is one of the best in recent memory. Input from affected groups was sought. Draft statutory language and an explanation were released for comment [1] followed by hearings. Those hearings solicited a wide variety of opinions and a revised draft is being crafted with technical input from experts. While there is no assurances that the final draft will be acceptable, I am committed to the continuation of that process.

However, this process sometimes obscures the broader policy issues. Indeed, Section 2036(c) was enacted as a technical loophole closer to avoid an important policy debate. These hearings can complement that process by addressing the broader policy issues implicated in the replacement of Section 2036(c) and by urging a revised draft which fits within that framework.

ESTATE AND GIFT TAX VALUATION ISSUES

Any business consists of many forms of financial capital. The lender loans money in return for interest payments and the expectation of return of principal. A lessor lends an asset in exchange for lease payments and the expectation of the return of the asset. The preferred stockholder holds stock for a steadier dividend and the expectation of a definite interest on liquidation. The common shareholder seeks future dividends and appreciation, but recognizes that both depend on the business's success. More subtly, the suppliers and customers have a financial investment in the business and the employees, managers and others have a human investment.[2]

It is presumed for tax purposes (income, transfer and other taxes) that the market appropriately values these investments, *i.e.* the interest rate is sufficient for the risk involved, that the compensation paid equals the value of the services provided, that goods exchange hands at their market value. If the transactions are between family members, that assumption may not be valid. Nonetheless, for tax purposes a consistent hypothetical buyer-seller test has been applied to family member transactions.[3]

> "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

Section 2036(c) discarded this hypothetical fair market value test in the context of "estate freezes." It denied family members the opportunity to substitute greater income and security for appreciation, despite ample market proof that unrelated parties would engage in the same transactions. The justification for this discrimination was the *potential* for valuation abuse. Although the statute and legislative history suggested a limited application to Section 2036(c) consistent with its technical loophole closing origin,[4] eventually every business transaction had potential as an

---

[1] Statutory language and explanation released March 22, 1990, by Committee on Ways and Means of the House of Representatives. Technical aspects of the proposed statute (referred to below as the "discussion draft") are discussed in my April 24, 1990, testimony to Ways and Means.

[2] The estate tax is particularly harsh as it requires the liquidation of capital in order to pay the estate tax. That capital requirement has to come from one or more of these constituencies unless the family business is sold.

[3] The estate tax test is described in Treasury Regulations Sec. 20.2031-1(b) as follows:

[4] Of the 27 transactions to which the Committee Reports stated Section 2036(c) was to apply, 24 involved the following prototypical recapitalization. A wholly owned corporation or partnership is recapitalized into two classes of stock or partnership interests: A preferred class which had a preference for dividend or income payments and on liquidation and a common class which

Continued

"estate freeze." In order to avoid the application of Section 2036(c), therefore, it was necessary for each transaction to fit within an exception which supposedly permitted an arms-length comparison.[5] This cookie cutter approach produced anomalous results. An accurately valued gift could result in a million dollar increase in estate tax while an inaccurately valued gift might result in no increase. Business owners with more than one entity or business arrangement could not make any transfer without the risk of Section 2036(c) applying. Paying too little compensation was not caught by Section 2036(c), but an agreement with the potential to do so was caught even if adequate compensation actually was paid.

IMPORTANT POLICY OBJECTIVES IN REPLACING SECTION 2036(C)

The Section 2036(c) mistake was to allow the broader policy issues to be obscured by technical issues. It is important that this not be repeated with the Section 2036(c) replacement. Let me offer my view of the three most important policy objectives:

1. Treat Business Owners Fairly
2. Narrowly Target the Abuse
3. Ensure the Survival of Family Businesses

The discussion draft offers a framework for replacing Section 2036(c) which could satisfy these policy objectives. A consensus exists on the following items:

A gift tax solution to a gift tax problem. Section 2036(c)'s approach of including property subject to a "freeze" in the decedent's estate has been discredited. Rather, the focus is on an appropriate valuation for gift tax purposes. If the gift is appropriately valued, then appreciation on the gift can escape estate tax. The discussion draft adopts this approach.

An elimination of the "strings" concept in family businesses. One aspect of Section 2036(c) is that it impacted smaller family businesses more heavily than the very wealthy. This is due to the requirement that the transferor retain an interest in the enterprise before Section 2036(c) applies. It was unnecessary for the very wealthy to retain that "string." The string concept also is inconsistent with the valuation approach which acknowledges that those strings have value which offset the right to loss of appreciation. The discussion draft appropriately discards the "strings" concept.

Value Discretionary Rights at Zero. Everyone agrees that discretionary rights to convert or liquidate should be ignored in valuing preferred stock. The discussion draft tries to list the rights which have value and value all others at zero. This produces a statute which is too unpredictable and too complicated. This is demonstrated by the fact that the discussion draft, unlike Section 2036(c), unintentionally applied to gifts of non-voting stock.

Value Payments by Discounting. The discussion draft reflects the view that the value of a frozen equity interest is attributable primarily to dividend and other payments, and that these payments can be valued by discounting. The draft appropriately grants business owners flexibility to establish their own arrangements and also permits a election to specify a payment schedule or gift tax valuation purposes where it is not specified under the instrument.

Deemed Gift Treatment Where Payments are not Made. The *quid pro quo* for non-payment of dividends or other payments would be deemed gift treatment after three years for the unpaid amounts to the extent non-payment enriches family members. Unlike Section 2036(c) the discussion draft continues to apply when the gifted interest is conveyed outside the family. Change is needed on this point.

The discussion draft was roundly criticized by business groups in the April 24 House hearings. However, those criticisms primarily related to matters where the

---

was junior, but had a right to appreciation over the stated value ("frozen value") of the preferred. The owner then gave away the common while retaining the preferred. The dividends or other payments on the preferred may never have been paid, but the value of the preferred was artificially supported by a redemption right, a conversion right or a power to liquidate. These rights were never actually exercised so that over time the value of the preferred was frozen at its initial stated value. Moreover, the unpaid dividends or income payments accumulated in the entity to the benefit of the common owners. Using time value of money concepts, if the payments were deferred into perpetuity, their present value approached zero. The actual present value was never that low as the life expectancy of the parent was often short and the frozen value of the preferred would be taxed in the parent's estate.

[5] These exceptions were contained in the "safe-harbors" in Section 2036(c)(7) and in Notice 89-99, 1989-38 I.R.B. 4,7, issued by the Internal Revenue Service. Despite the stated purpose many of the exceptions required difficult valuations, such as Section 2036(c)(7)(A)(ii)(1) which required an arms-length agreement for fair market value.

discussion draft failed to apply the valuation approach consistently. In my view it is possible to produce an acceptable Section 2036(c) replacement within the discussion draft's framework. The Chamber of Commerce proposal corrected a number of these criticisms.

SECTION 2036(C) REPLACEMENT ALTERNATIVES

Disclosure Alternative

At the end of last year's hearing Senator Daschle asked for proposed solutions to eliminating the abuses which Section 2036(c) targeted. My solution at that time was fuller gift tax return disclosure combined with appropriate penalties and IRS audit incentives. This recommendation was based on viewing the problem of valuation of freeze transactions as a part of a larger valuation issue.

Whatever the merits of this approach, the consensus is that disclosure alone is insufficient. Moreover, any disclosure approach presents a dilemma: the penalties for failing to disclose must be substantial to encourage disclosure and yet it is the least sophisticated taxpayers who are likely to be penalized. This is unfair and the mitigation of the penalty in the unfair cases weakens the disclosure alternative.

It has been suggested by some that disclosure might be combined with a study to better define the abuse at which Section 2036(c) was directed. While I agree that defining the problem by drafting a solution is backwards, I do not believe that a consensus exists for disclosure combined with a study either.

Of the disclosure alternatives proposed, I like the D.C. Bar's the least because it continues the unworkable concepts of "enterprise" and "disproportionate appreciation." Considering that normal arms-length business transactions could require disclosure under this alternative, penalizing business owners for failing to report a "gift" seems harsh.

Finally the disclosure alternatives do nothing to identify with certainty the types of preferred stock freezes which are not abusive. Any disclosure provision should be coupled with a preferred stock freeze safe harbor.

ABA Approach

A task force of the American Bar Association ("ABA") has proposed an alternative replacement to Section 2036(c) which is much simpler than the discussion draft. However, several aspects of the Task Force Proposal are troubling. First, it establishes a discriminatory test for the valuation of family member discretionary rights which presumes that the rights "will not be exercised . . . in a manner adverse to the donee's interest if the donee is a member of the donor's family." Although this rule is narrowly crafted in the ABA Proposal, its logical extension could eliminate marketability or minority discounts, increase control premiums by ignoring the fiduciary duty owed a minority shareholder and result in valuing continuing businesses as if liquidated.

The ABA approach couples its "adverse valuation" rule with a safe harbor for a certain type of preferred stock. A safe harbor always represents a failure to adequately define the policy objectives. Unlike the discussion draft the ABA proposal requires the business owner to set the dividend rate at a fixed minimum. While the discussion draft permits a three year window to pay passed dividends to account for business exigencies, the ABA proposal requires the cumulation of passed dividends. Finally, the safe harbor approach penalizes those taxpayers who are ill-advised.

The treatment of cumulative dividends under the ABA proposal is unclear. Although failure to pay cumulative dividends over time can result in a substantial shift in value from the preferred shareholder to the related common shareholder, it appears that the Task Force would handle the gift tax consequences of such failure by a *Dickman*-like rule. This would leave to resolution by the courts the difficult issue of whether the failure to pay was based on "business" or "donative" reasons. This creates uncertainty for both taxpayers and the IRS.

SHORTCOMINGS OF THE DISCUSSION DRAFT

The major shortcomings of the discussion draft are set forth below. These shortcomings can be overcome within the discussion draft's valuation framework:

1. Treat Business Owners Fairly

Any replacement to Section 2036(c) should treat business owners fairly. Section 2036(c), although cast in technical terms, represents a policy that the potential for a family business owner to exploit the uncertainties of valuation outlined above justifies a rule which penalizes all family business owners. This discrimination must not be a part of any replacement.

Buy-Sell Agreements. The discussion draft's treatment of buy-sell agreements fails this fairness test. Section 2702 ignores rights of first refusal and leases in a family corporation in determining value for transfer tax purposes. Rights of first refusal and other transfer restrictions are always present in privately-held businesses. These rights do not fix value for estate tax purposes so that there is no "freeze" potential. However, like other aspects of ownership of stock in a private business, such as SEC restrictions, minority voting and lack of marketability, these restrictions depress value. It is discriminatory to ignore the value depressant effect of these rights when held by close family members, but to recognize that effect when held by others.

In other words, under the discussion draft the possibility that the restrictions may sometimes have an estate tax motive is a sufficient motive for taxing the same interests at a higher estate tax value in a family business than in a public corporation. This discriminatory treatment is never justified. Moreover, it is unnecessary in light of Treasury Regulations Section 20.2031-2(h) which set forth rules which appropriately balances the legitimate business objectives of family business owners against the needs of the Federal fisc. The regulation provides:

> the option or contract price, . . . will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

The Regulation permits Treasury to ignore options in buy-sells which have an estate planning motive rather than a business motive.[6]

80/20 Rule. The discussion draft unfairly limits the value of the common to no less than 20% of the value of all equity interests in the entity combined with all family debt. This rule is arbitrary and without merit. Although the stated purpose of the replacement is to tax 100% of a business in the transferor's transfer tax base, this rule actually taxes 120% of the business in that base. This rule further discriminates against family businesses in favor of an investor with cash who could lend 100% to a child to purchase a family business while the business owner can provide only 80% of the capital to his child.

By including family debt in the computation of the family business, the discussion draft requires financing to avoid application of the rule. It was precisely this discrimination that led to the creation of the qualified debt safe harbor under Section 2036(c). The safe harbor recognized that family member debt structured in the same way as arms-length debt presented no abuse opportunities. The 80/20 rule's retreat from that self-evident proposition is discouraging.

No change in the computation of the 80/20 rule can resolve its inherent unfairness. Its justification is that the value of the common has a minimum value equal to its option value or future appreciation in the business. Accordingly, it should be replaced with a provision that permits the IRS to determine a separate value for the "option" value of the common stock.

Liquidation Value. A family business should always be valued for estate tax purposes as an on-going enterprise rather than at its liquidation value. Otherwise, the estate tax requires the liquidation of the business to pay the estate tax. One aspect of the preferred stock freeze was an attempt by taxpayers to mismatch values by

---

[6] This regulation was upheld in *Saint Louis County Bank* v. *United States,* 674 F.2d 1207 (8th Cir. 1982), and *Dorn* v. *U.S.*, 828 F.2d 177 (3d Cir. 1987). The tax court, on the other hand, had interpreted the regulation as expressing two alternatives, rather than a conjunctive, two part test. In light of the recent appellate court decisions, the tax court is revising its position. *Compare Bischoff,* 69 T.C. 32 (1979) *with Obering,* ¶84, 407 P.H. Memo TC (1985). However, the results of the tax court decisions might not change under the Regulations. For example, in *Seltzer Estate* which is sometimes cited as a decision which demonstrates the estate planning potential in current law the price was tied to book value without regard to goodwill. While it is true that the sales price in the buy-sell was less than the sales price which might be obtained without the agreement, the price was not motivated by estate planning. First, the sale to the corporation benefitted not only family members but non-family members. The proposed Section 2702 gives no guidance as to how to sort out family members, but non-family members rights when the corporation has the right to purchase. Second, the agreement permitted only directors and employees to own stock. Thus the decedent's family was limited in its ability to continue ownership of the stock. Finally, the agreement bound all shareholders equally both during life and at death. The presence of non-family members again demonstrates the arms-length nature of the agreement. Under proposed Section 2702 the family owners in the business would pay a higher estate tax than the non-family owners on the same stock.

valuing the business at its cash flow value while valuing the preferred stock at its higher liquidation value. The mismatch was inappropriate if the business did not liquidate. The Discussion Draft, on the other hand, mandates a cash flow or going concern approach for valuing the preferred stock. Accordingly, the IRS should not be permitted to value the business using a liquidation approach and then mandate the valuation of the preferred at cash flow value when its liquidation value is much higher. This mismatch is equally inappropriate.[7]

2. Narrowly Target the Abuse

In my previous testimony to the Committee I compared Section 2036(c) with trying to give directions to my house by describing everywhere in America I don't live. The Discussion Draft adopted Section 2036(c)'s cookie cutter approach of listing certain rights as having value, and valuing all other rights at zero. The zero valuation results in a gift equal to the actual fair market value of the rights. It is drafted broadly out of a concern that some tax savings device may not be caught. The result is an unnecessarily complicated statute which needlessly impacts business transactions. It is important to return to the notion of targeting the abuse and relying on regulations and the courts to end schemes which are designed to avoid the statute. Probably less than 5% of all family business owners and farmers engaged in preferred stock freezes, yet Section 2036(c) impacted 100% of those owners and farmers. An acceptable replacement should require consulting the complicated valuation rules in Chapter 14 only for a preferred stock recapitalization (or its partnership equivalent) and no other business transaction.

Targeting Preferred Stock Only. As discussed above, the Section 2036(c) replacement should be narrowly targeted at preferred stock "freezes" (and the partnership equivalent), the discussion draft instead applies to all kinds of rights. Section 2036(c) currently applies only when the underlying financial capital is severed from the appreciation right. The proportionality rule limits estate inclusion to that portion of the capital of the business retained by the transferor which correlates with the appreciation rights to the capital which are transferred. The discussion draft lacks a similar concept. Indeed, Section 2701(b)(3) of the discussion draft requires a family member of the transferor to elect treatment of his interests as a QFP in order to value those interests at other than zero the non-active sibling who holds preferred stock is given a veto over gifts of common to the active sibling. This rule goes further than current Section 2036(c).

Debts and Leases. The discussion draft broadly applies both the debts and leases. Section 2703(e)(3) of the discussion draft treats leases and debt as equity interests (and corresponding provisions in other parts of the statute, such as the inclusion of indebtedness in the computation of the 80/20 rule and the application of the trust entity rule to debt and lease payments) should be removed. Section 2703(e)(3) is particularly hard to understand. It appears to favor taxpayers because it allows debt and lease payments to reduce the value of the entity without requiring a gross up in value for the indebtedness (except for purposes of the 80/20 rule). If that is the implicit result, then why is the result explicit for debt under the 80/20 rule and for leases under Section 2702? Debts and leases must be removed from the scope of the Section 2036(c) replacement, otherwise the complexities of Chapter 16 will apply to our businesses. Treasury has indicated that its concern in including debt and leases in Chapter 14 is that a deemed gift rate is needed to ensure the payment of family member interest and rent payments, such is not the case. Dividends represent a special problem because "business reasons" may justify non-payment. These business reasons may preclude a gift from occurring and are difficult for the IRS to police. On the other hand, "business reasons" are insufficient for rent or interest non-payment. Only insolvency or bankruptcy would permit the avoidance of a gift. As the discussion draft notes, these tests are sufficiently objective to permit adequate policing by the IRS. Thus no reason exists for extending Chapter 14 to family debt and lease arrangements where a sufficient arms-length analogue exists.

"In Effect" Transfers. At some point in the drafting of Section 2036(c), it was decided that the words "in effect" when added to transfer somehow both met the constitutional requirement of a "transfer" and eliminated its meaning. In Alice's Wonderland these words must be paid *triple*. The stated purpose of Chapter 14 is to arrive at a fair valuation of a preferred equity interest. To this end, "bells and whis-

[7] An example of the differences in valuation of the two approaches is evident in *Harrison Estate*, 52 T.C.M. 1978-8 where the liquidation value was $59,555,020 and the going concern value was $33,000,000. The court adopted the going concern value because a hypothetical purchaser would have been unable to liquidate the business. The court relied on a lapsing rights theory to reach the right result in this case. This indirect route should have been unnecessary.

tles" are disregarded and payment rights are discounted to determine value. Yet the 80/20 rule could still result in a gift if a business owner exchanges common stock for preferred stock of equal value under Chapter 14. Indeed, the recapitalization rule in the discussion draft may result in a gift on the buy-out of common stock for cash. The authors of the statute continue to see tax avoidance in a transaction which results in the exchange of assets having equal value, a view thoroughly discredited under Section 2036(c). This position must be discarded to arrive at a statute which does not discriminate against business owners and which is based on an analogue to the arms-length valuation rules.

3. Ensure the Survival of Family Business

Although the preferred stock freeze was a pretext for the enactment of Section 2036(c), most business groups have avoided using the Section 2036(c) replacement as a pretext for estate tax relief. The search is for a replacement which applies neutral tax rules to address the abuse. The groups recognize that a replacement which leaves loopholes to be exploited in the future is likely to invite Congress to reenact Section 2036(c). Nonetheless, the estate tax has a substantial adverse effect on family businesses and farms. The estate tax is a tax on capital. Private businesses are at a disadvantage in raising capital when compared to large public and foreign corporations. Capital invested in a private business is not committed to personal use, but to the payment of employees, suppliers, contractors and others, including other taxes. It is invested in job creation and growth. The estate tax converts that capital from productive uses to unproductive ones. Moreover, the estate tax is imposed at a time when the business is least able to pay the tax. The death of the owner creates its own disruptions. Without that owner's commitment and with a looming estate tax burden, a sale to a public corporation becomes an attractive alternative. This is especially true where the loss of capital from paying the estate tax makes the business less competitive with those public corporations and more likely to fail. This is a double burden for family businesses. The Committee should ensure the survival of America's family businesses.

Discount Rate. The discussion draft contains no mechanism for determining the market testing rate. However, to be fair the rate should not be higher than the AFR which is the required rate on intrafamily loans. First, the discussion draft assumes that the stated dividends will be paid. This eliminates any need for a higher rate to account for risk, dividend coverage, or lack of marketability. The AFR represents a safe taxable rate of return. Second, a higher rate would discriminate against family businesses in favor of investors. A wealthy individual can loan cash to a child to buy a business (or growth stock) and need only receive interest at the AFR. Third, a higher rate suggests an attempt to go after the presumed greater return from families which work and invest together. This attempt is frequently phrased as an "attack on hidden giving." Finally, the current non-deductibility of dividend payments should indicate a lower rate. "Blue Chip" corporate preferred stock often carries a rate lower than AFR.

Going beyond simple fairness, a lower testing rate than the AFR encourages the use of preferred stock as a means of business succession. It further allows the conservation of capital by family businesses so that these businesses are more productive, more competitive and ultimately pay more taxes. The ideal market testing rate would account for these factors and would be less than 66% of AFR, a reflecting reduction for the Federal corporate tax rate.

4. GRIT's and Remainder Valuations

GRIT's and other trust devices present different issues than the valuation of frozen equity interests. It is illogical to mix the two concepts as the discussion draft does. GRIT's are an anomaly of the rates employed in the Treasury Tables and the method required thereunder for the valuation of the gifted portion. The IRS has long misvalued GRIT's and similar devices. This misvaluation and the safe harbor in Section 2036(c) for certain statutory GRIT's is the sole reason for the current popularity of these devices. If valued properly, GRIT's offer no advantage over other types of gifts.

A GRIT is an immediate irrevocable gift of a remainder interest in a trust. The remainder interest vests in fee at the end of a specified term of years during which the grantor/donor retains the income. Long ago, the IRS adopted an "easy to complete" rule which held that a gift to a GRIT or other trust would be deemed a gift of the donor's entire interest, except to the extent that the donor's retained interests were susceptible to valuation. Accordingly, the IRS requires that the gift portion of a GRIT be determined by subtracting the value of the donor's retained income interests from the value of the property transferred to the GRIT.

GRIT's can be used to reduce estate taxes because the 1988 tax act established a floating discount rate that overvalues the retained income interest by at least 20% (the discount rate is set at 120% of the applicable Federal rate). This discount is a taxable rate of return. A taxable rate of return is an acceptable benchmark as a substitute for a taxable interest rate. It also is an acceptable discount for valuing income interests and annuities which are substitutes for taxable income. However, it is not an acceptable rate for valuing remainder interests. An after-tax or tax-free rate should be used.

The IRS subtractive approach obscures this distinction between the valuation of the income and remainder interests. The distinction meant very little when the discount rate was 3% at the inception of this approach, but is significant now as the discount rate is 10%. The real value of the remainder is the amount which must be invested now at the discount rate to produce a value at the end of the term equal to the present value of the property gifted to the GRIT. This is why the discount rate should reflect a tax-free or after-tax rate of return. Thus the discount rate should be 72% of the applicable Federal rate, not 120%. (The 72% reflects a reduction by the 28% top Federal rate. An alternative rate would be an average of tax-exempt rates. I would propose a rate equal to 66 2/3% of the mid-term rate.) The discussion draft's approach of leaving the rate untouched while creating a new valuation scheme is illogical, unnecessarily complicated and without merit.

Of course, the actual value of the property at the end of the term might be higher or lower than the present value of the gifted property. This would be true if the donor had made an outright gift of cash equal to the discounted present value which the donee then invested for the term. Similarly, actual income payments to the donor may be more or less than the discounted value of the income interest. This would be true if the donor retained cash equal to the discounted value of the income interests. The problems with Section 2036(c) proves that gift tax value should not depend on the appreciation of the gifted property.

The retention of a reversion to further reduce the value of the GRIT also has drawn criticism. The need for the reversion is based solely on an inconsistency between the gift and estate tax rules applicable to GRIT's. If the grantor dies during the term, the entire GRIT, even the remainder previously subject to gift tax, is subjected to estate tax. The reversion mitigates this double taxation by excluding from the gift tax the value attributable to the possibility of dying early. Again, if the reversion is valued properly, no abuse occurs.

If this bifurcated discount rate is used, GRIT's would be valued properly and no further changes in tax treatment would be warranted. In addition, the generation-skipping tax and estate tax rules should be unified by repealing Section 2036(a) and making the allocation of the GST exemption effective. This would eliminate the use of reversions to reduce value as death within the term would continue to result in inclusion in the estate. The alternative method of unifying the transfer tax system, the adoption of a hard to complete rule, would lose revenue and be inconsistent with property law concepts and 40 years of tax law.

PREPARED STATEMENT OF E. JAMES GAMBLE

Mr. Chairman and Members of the Committee: My name is E. James Gamble, and I am a tax and estate planning lawyer who practices in Detroit, Michigan. I am pleased to be here today on behalf of the American College of Trust and Estate Counsel with my colleagues, Waller H. Horsley and Thomas P. Sweeney, who are, respectively, the President and Vice-President of the College. I represent the College in my capacity as the Chairman of its Estate and Gift Tax Committee and of its Section 2036(c) Task Force.

The membership of the College is composed of more than 2600 lawyers who specialize in the practice of trust and estate law and related tax matters. A major and continuing effort of the College since it was organized over 40 years ago has been the improvement and reform of probate and transfer tax laws with the ultimate goal of simplifying the disposition of property and the administration of estates in this country. The College is grateful for the opportunity to appear before this distinguished Committee to express its views concerning the repeal of Section 2036(c) and the Discussion Draft containing the proposed new Chapter 14. We welcome and accept once again the challenge of working with the Congress to find additional ways to improve and simplify the nation's transfer tax laws.

THE COLLEGE SUPPORTS THE COMMITTEE'S GOAL TO ELIMINATE ABUSIVE VALUATION FREEZES

The College shares the Committee's concerns about taxpayers who avoid the Federal estate and gift tax laws through the use of abusive valuation freezes, and we support the Committee's objective to eliminate abusive freezes, but the College has been deeply concerned about the complexity and breadth of Section 2036(c). The College feels that section 2036(c) has many flaws, the worst of which it has described in "Section 2036(c)'s Little Chamber of Horrors," which is attached as Appendix A. The College enthusiastically supports the Committee's proposal in the Discussion Draft to repeal Section 2036(c) retroactively.

The College agrees with the Committee that the abusive freeze problem is really a valuation problem, and we believe the Discussion Draft correctly treats abusive freezes as a gift tax valuation matter. We would much prefer to have the Committee adopt the approach set forth in the report of the Joint Section 2036(c) Task Force that is attached as Exhibit A to the testimony of Jere D. McGaffey because we think that proposal will produce a more narrow and simple solution to the problem without any loss of revenue. Nevertheless, we are pleased to have the opportunity to offer our comments on the Discussion Draft.

The College feels the scope of Chapter 14 is broader and more complex than is necessary to solve the valuation problem, and as a result it would unnecessarily intrude in many routine business transactions without thereby solving the abusive valuation freeze problem. We believe that Chapter 14 can be narrowed and simplified without diminishing its effectiveness in eliminating abusive freezes and without losing any revenue; and that the adoption of our suggestions would reduce the time and cost that taxpayers, their advisors, and the Internal Revenue Service personnel will have to spend to understand and administer the law, and would thereby increase compliance with the law.

THE SPECIAL VALUATION RULES IN SECTION 2701 ARE BROADER THAN NECESSARY TO ELIMINATE ABUSIVE VALUATION FREEZES

1. *Chapter 14 should not apply to businesses that are not controlled by the transferor's family.* The person who creates an abusive freeze does so because he believes he can cleverly shift a major part of the future appreciation in the business into the common stock that he plans to give away. Believing this, he is not about to share the benefits of such a value shift with nonfamily members who also own common stock. For this reason, virtually all of these transactions occur in businesses that are owned solely by the members of one family. As a result, we feel it is unnecessary to apply the special valuation rules to entities in which a family may own as little as 10 percent. The 10 percent test should be increased to more than 50 percent. If the Committee is concerned about a business that is owned by several families who might act in unison in a recapitalization (a situation we believe is rarely encountered), Chapter 14 should apply only to the members of those families whose combined ownership would exceed 50% of the corporation or partnership.

2. *Section 2701 should not apply to equity interests for which a fair market value is readily available.* The special valuation rules in Section 2701 prescribe how a preferred interest in a corporation or partnership must be valued in order to determine a value for a nonpreferred equity interest in a corporation or a partnership that is transferred to a member of the family. However, there are several situations in which market values are already available and in these cases using the special valuation rules would be unnecessary and would produce an incorrect and unfair result.

(a) *Publicly traded securities.* When either the preferred stock or the common stock is publicly-traded, special valuation rules are not needed because market values are readily available and should be used.

(b) *Negotiated sales prices.* If a person who owns preferred stock decides to sell his common stock to a group of buyers composed of both unrelated persons and family members; and if a substantial portion of the stock is sold to the unrelated persons for a price that is negotiated at arm's length, the special rules in Section 2701 should not apply to the stock sold to a family member for the same price. If the special valuation rules are applied in this case, the seller would be liable for a gift tax on the stock that he sold to his family members at the same arm's-length price he negotiated with the unrelated persons, and in order to avoid a patently unfair gift tax in this situation he must eliminate the family members from the purchasing group and sell only to unrelated persons. Today, this may well mean a sale to an entity that is not owned by U.S. citizens, with the result that the value of the business (and its future growth) will disappear entirely from our transfer tax system. This adverse tax result is also one of the

defects in Section 2036(c), and is described in "Section 2036(c)'s Little Chamber of Horrors" (Appendix A). It should be eliminated.

(c) *Sales to ESOPs.* The sale or contribution of stock to an employee stock ownership plan (ESOP) is closely regulated and subject to Department of Labor rules that set forth requirements for determining the fair market value of stock acquired by a qualified plan. If shares in the same class of stock are sold to family members as an integral part of an ESOP transaction, the transferor should be permitted to use the value determined for ESOP purposes rather than having to use the special valuation rules.

3. *Indebtedness and leases should not be "interests" to which Section 2701 may apply.* It is not clear to us how an abusive valuation freeze of an equity interest in a corporation or a partnership can be accomplished by using indebtedness or leases. It is difficult to identify a fact situation in which the existence of debt owed to the transferor or a member of his family, or a lease of property by the transferor to the entity, could cause the value of a corporation's common stock or of a partnership's equity to be diminished for gift tax purposes. If it were possible to diminish nonpreferred equity values through these devices, we believe it would simply increase the value of the transferor's right to receive payments under the indebtedness or the land subject to the lease. If the provision regarding indebtedness is in the Discussion Draft to deal with so-called "self-cancelling installment notes" (SCINs), we recommend that a specific provision be placed in the statute to deal just with this kind of obligation. Including indebtedness and leases in Chapter 14 increases unnecessarily the scope, complexity and intrusiveness of section 2701 because it is so common for one or more owners of a business to lend money or to lease property to the business. This provision will make it much more difficult for the business owner who owns no preferred equity in the entity (and his advisors) to determine when and how the special rules in Section 2701 might apply.

4. *An unrelated person should not be considered a member of the transferor's family just because the transferor has made a prior gift to that person.* Section 2703(a)(2) provides that if a transferor has made a gift of any kind to someone who is not a member of his family, that person automatically becomes a member of his family for purposes of Chapter 14, apparently forever. Under this rule, if any employee of a corporation who has received stock through a bonus or stock purchase plan is married and receives a wedding gift from the corporation's principal owner, the donee becomes a member of the principal owner's family. The common stock the employee owns would be attributed to the principal owner of the corporation, and any subsequent stock that is awarded to, or purchased by, the employee may become subject to the special valuation rules of Section 2701, thereby exposing the principal owner to all of the valuation and gift tax consequences of Chapter 14. This "adoption by gift" provision makes it necessary for a business owner and his advisors to search the owner's history for the names of all of the persons to whom the owner has ever made a gift, no matter how small and no matter of what kind or nature, in order to determine if and to what extent Chapter 14 may apply to a transfer of stock. We fail to understand how this rule will prevent an abusive valuation freeze. Its usefulness in the general scheme of Chapter 14 is so tenuous that there is no way to justify the extraordinary complexity it will add to the administration of Chapter 14.

CHAPTER 14 IS MORE COMPLEX AND INTRUSIVE THAN IS NECESSARY TO ACCOMPLISH ITS OBJECTIVE TO ELIMINATE ABUSIVE VALUATION FREEZES

1. *Much of Chapter 14's complexity comes from its scope.* The provisions described in the preceding paragraphs (the 10% rule, the failure to permit use of readily available market values, the inclusion of indebtedness and leases, the "adoption by gift" rule), increase the scope of Chapter 14 unnecessarily and thereby increase unnecessarily the complexity of the statute and its intrusion into routine transactions that in no way relate to abusive valuation freezes.

2. *Trust transactions should be placed in a section separate from the section that applies to corporations and partnerships.* The College understands that the purpose of the trust provisions in Chapter 14 is to deal primarily with grantor retained interest trusts (GRITs), joint purchases, and private annuities. However, the trust provisions are inserted as exceptions to the rules that apply to corporations and partnerships, which makes it very difficult to sort out the provisions that apply to trusts. We believe it is possible to segregate the provisions that deal with trusts in a separate section and to sharpen the focus of these provisions so that they apply clearly to the perceived abuses at which they are directed. Making these changes

would considerably simplify the statute and increase the ability of taxpayers and their advisors to understand and to comply with these rules.

GRANTOR RETAINED INTEREST TRUSTS (GRITS) SHOULD BE GO BY THE STATUTORY PROVISIONS ENACTED IN 1988

GRITs have received much attention from the Committee and its staff. After extensive study, special rules for a so-called "statutory GRIT" were placed in Section 2036(c)(6) in 1988. We believe the Committee considered those provisions satisfactory to control the use of GRITs. The College has no information on the number of statutory GRITs that may have been adopted since the 1988 amendment that specifically authorized their use, but we submit there is no good policy reason to reverse the decision made in 1988 and now adopt still another rule. The Discussion Draft does not indicate what effect the new rules will have on GRITs that have been adopted in reliance on existing law, and the College sees no useful purpose in making another change in an area we thought had been settled.

NO PROVISION IS NEEDED FOR OPTIONS, BUY-SELL AGREEMENTS AND RIGHTS OF FIRST REFUSAL

Section 2702 changes significantly the present law that applies to provisions now commonly found in buy-sell agreements. These agreements are not typically undertaken for estate planning purposes, nor are they used to achieve abusive valuation freezes. They are so routinely used by business owners, and the concepts used in them are so commonly understood, that it is not unusual for small corporations and partnerships to enter into buy-sell agreements without even consulting their legal counsel. The usual business purposes of these agreements are to assure a continuation of the business upon the death or withdrawal of one of the owners; to provide a market for the equity interest of the owner who dies or wishes to withdraw by specifying the price and terms on which that interest will be purchased by the person who continues to operate the business; and to prevent the transfer of an interest to a person who might not be acceptable to the continuing owner as a compatible and competent participant in the business. There is now a substantial body of law governing the use of these agreements that is contained in judicial opinions and in the Internal Revenue Service regulations and rulings. In fact, the estate tax regulations specifically provide that an option or contract price will be disregarded unless the agreement represents a bona fide business arrangement and not a device to pass corporate shares to the natural objects of the taxpayer's bounty for less than an adequate and full consideration. To create a new set of rules to govern these arrangements will completely disrupt and adversely affect the legitimate business arrangements of the vast majority of small businesses in this country. New rules are unnecessary because these agreements are not normally used as abusive valuation freeze devices—to the extent they are so used, existing law is adequate to prevent the abuse.

THE PROPOSED CHANGES TO THE GIFT TAX STATUTE OF LIMITATIONS ARE UNNECESSARY

An unnumbered section on page 24 of the Discussion Draft would amend Code Section 6501 to provide for a 6-year statute of limitations instead of a 3-year statute whenever the value of property is determined under Section 2701; and to provide for no statute of limitations if such property is not shown on a return.

1. A 6-year statute of limitations is unnecessary

The College believes it is not necessary to extend the statute of limitations from 3 years to 6 years, for these reasons:

First, Section 6501(e) (2) now provides for a 6-year statute of limitations if a taxpayer omits gifts from his return whose value exceeds 25 percent of the total amount of gifts stated in the return. This provision will cover any substantial omission of value with respect to a transfer to which Section 2701 applies.

Second, the Internal Revenue Service should be able to identify any Section 2701 transfer and flag it for audit without having to extend the limitations period from 3 years to 6 years.

Third, human nature being what it is, the incentive to proceed with a gift tax audit on a timely basis will be reduced significantly. If there are three years to get the job done, its completion will take three years; if there are six years to get the job done, it will take six years. If more than three years really is required in a particular situation, the Service can, and regularly does, request the taxpayer to extend the statute of limitations. It is only in rare situations that

the taxpayer refuses to extend the statute. In short, a 6-year limitations period is unnecessary.

2. An unlimited statute of limitations is also unnecessary

There are several reasons why the unlimited statute of limitations proposed in the Discussion Draft is unnecessary:

First, Section 6501(a) already provides for an unlimited statute of limitations if no gift tax return is filed, because the limitations period does not begin until the return is filed.

Second, if a taxpayer files a return and deliberately omits a transfer to which Section 2701 applies, Section 6501(c)(1) now provides for an unlimited statute of limitations if the return is false or fraudulent with the intent to evade tax.

Third, if the amount of the omission is greater than 25% of the amount of the reported gifts, the present 6-year statute would apply.

Fourth, the proposed addition to the Code of Section 6501(c)(9) would not apply to any item disclosed in the return or a statement attached to the return "in a manner adequate to apprise the Secretary of the nature and amount of such item."

This narrows the application of 6501(c) (9) to situations in which a taxpayer unintentionally (and probably unknowingly, because of the statute's breadth and complexity) omits a transfer. There is no valid policy reason to treat this in the same manner as a fraudulent return by providing for an unlimited statute of limitations.

3. If the provision for an open statute of limitations is retained, an amended return should start the running of the statute.

The proposed unlimited statute of limitations seems to apply only when a return has been filed and a Section 2701 transfer has been omitted for a reason other than fraud. If that provision is enacted, it should be changed to provide that the limitations period will begin with respect to any such transfer when an amended return is filed that adequately reports the transfer. If this change is not made, the person who files no return at all is in a more favorable position than the person who files a return but unintentionally omits a Section 2701 transfer. The person who has filed no return can always start the limitations period by filing a late return because Section 6501(a) provides that the limitations period begins to run upon the filing of a return even though it is filed after the due date.

4. A forum should be provided to resolve disputes

Under present law, there is no way for either the taxpayer or the Service to obtain a binding resolution of a valuation dispute if the available unified credits of the taxpayer (and of a married taxpayer's spouse who elects split-gift treatment) exceed the amount of the gift tax liability proposed by the Service. It is unfair to the taxpayer to be forced to argue a valuation case many years after the initial transfer occurred. A judicial determination of any dispute should be permitted as soon as possible after the time of the gift so the taxpayer's lay witnesses will be available, as well as expert witnesses who are familiar with the economic considerations and valuation techniques employed at the time of the transaction. Such a judicial determination would enable both the Service and the taxpayer to resolve any question about how much of the taxpayer's unified credit is to be used in situations in which no gift tax is required to be paid.

PROVISIONS THAT SHOULD BE ADDED TO CHAPTER 14

There are several other provisions that should be added to in the Discussion Draft:

1. The Discussion Draft contains a provision that would repeal all of Section 2207(B) even though only 2207(B)(b) specifically applies to 2036(c). The other parts of 2207(B) apply to 2036(a) and (b), and they set forth what we consider to be an acceptable rule. We suggest that only 2207(B)(b) be repealed.

2. Persons who took corrective action at the end of 1989 in an effort to comply with Notice 89-99 should be permitted to rescind those actions without adverse tax consequences.

3. The Summary of the Discussion Draft states that qualified fixed payments from corporations or partnerships would be valued "by determining the value of the income stream, using appropriate market discount rates." In the case of trusts, the Summary says that QFPs "would be valued (as under current law) according to the appropriate Treasury Tables." The Draft itself does not contain any provision that sets forth these rules, and we believe it should.

4. A provision should be added that states:

"Nothing in this Chapter shall be construed to change existing law with respect to the valuation of property for purposes of Chapter 11, 12 or 13 except as expressly provided in this Chapter."

5. A provision should be added to the separate section on trusts that says:

"Nothing contained in this section shall be construed to cause section 2036 to apply to any transfer to which it would not otherwise apply."

TECHNICAL DRAFTING SUGGESTIONS

The College has prepared a separate description of drafting suggestions that it believes represent a constructive effort to help create a "user friendly" statute that will accomplish the Committee's objective of stopping abusive valuation freezes. These suggested are in Appendix B.

THE COLLEGE BELIEVES THAT NO REVENUE WILL BE LOST IF ITS RECOMMENDATIONS FOR THE RESTRICTION OF CHAPTER 14'S SCOPE AND COMPLEXITY ARE ADOPTED

In determining the revenue impact of repealing Section 2036(c), we believe the Committee should regard the revenue gain from Section 2036(c) since December 1987 as a permanent gain (because we believe that abusive valuation freezes have been neutralized since that time), and it should assume that Chapter 14 will continue to produce the same long-term revenue gain that Section 2036(c) would produce if it were not repealed. Chapter 14 will generate near-term gift tax revenue and, in addition, when taxpayers engage in nonabusive recapitalizations for valid family planning purposes, they will increase the revenue from income taxes on qualified fixed payments that are permitted under Chapter 14. Our recommendations, if adopted, should not cause any reduction in that revenue picture.

APPENDIX A—SECTION 2036(c)'s LITTLE CHAMBER OF HORRORS

The impact of Section 2036(c) falls primarily on people who own small businesses. Much wealthier owners of liquid assets can give their growth stocks to their children and keep their bonds and preferred stocks without any fear of 2036(c); and the owner of several unrelated small businesses can give away those with growth potential and keep the "cash cows" without concern. But the farmers and other small businessmen who operate a single business are the primary targets of an excessively broad estate tax provision that singles them out for unusually harsh treatment.

The worst flaws in Section 2036(c) are illustrated by these examples:

—You sell 50% of the common stock in your corporation to your son and the remaining 50% to his business school classmate, and they take over the full management of your corporation. You retire, but you retain all of the preferred stock. They each pay you the fair market value for the common stock. When you die, your son's common stock is included in your estate in addition to your preferred stock, but none of his classmate's stock is included in your estate because the statute treats sales to family members different from identical sales to non-family members. (There is no way to explain the policy reasons for imposing an estate tax on a person who sells his business to a family member for a fair price but exempting that person from the tax if he sells his business to a stranger for the same fair price.)

—Your son and his classmate transform your sleepy little corporation into a hot property by adding new lines of business and transforming it into a key supplier to the computer industry. The common stock's value rises to ten times what they paid you for it solely because of their new business activities. When you die, your son's stock is included in your estate because you still own the preferred stock. You can subtract from the common stock's value an amount attributable to the cash your son paid you for the stock, but all of the remaining value that his efforts added to the stock is taxed in your estate.

—The value of your son's common stock is so large that the estate tax on that stock exceeds the value of your own assets. Your will says that all estate taxes due as a result of your death must be paid from your estate, and this wipes out all of your assets that your spouse expected to live on. The Internal Revenue Code permits your estate to recover the tax from your son. Your spouse (his mother) doesn't want to do this, but economic necessity forces her to do so, and your son winds up paying an estate tax on value he added to the business even

though he's still very much alive and hasn't transferred his stock to anyone else.

—If before you die your son and his classmate decide to sell the company to IBM for ten times its original value, you are stuck with a gift tax on the increase in the value of your son's stock. Not to worry—the statute gives you the right to compel your son to pay you the amount of the gift tax, and this will put him in the happy position of paying a capital gain tax on the increase in value and also a gift tax on the same increase in value even though he kept the sales proceeds and didn't make a gift to anyone. Depending upon the income tax and gift tax brackets that apply, the combined income and gift taxes could represent 75- or more of the increase in value.

APPENDIX B—TECHNICAL DRAFTING COMMENTS ON DISCUSSION DRAFT OF MARCH 22, 1990 RELATING TO ESTATE TAX VALUATION FREEZES

"Interests" and "Rights"

The terms "interest" and "right" are used interchangeably throughout the Draft, which is confusing. The problem affects the following sections:

—Section 2701(a)(2)(A) refers to: "[t]he value of any retained *interest* which is not a *right* to receive qualified fixed payments . . . " This implies that an interest and a right may be the same thing.

—In 2703(b) "interest *or* right" is used, which suggests someone may own a right without owning an interest.

—Section 2703(c)(2) refers to "an interest in such entity" but not to a right in an entity.

—Section 2703(e)(3) says that any "right" to receive payments from a 10-percent owned entity under any indebtedness or lease shall be "treated" as an interest (suggesting that rights are not interests and are not to be treated as interests without specific statutory authority).

—The definition for a "specially valued retained interest" in 2703(e)(2) refers to an interest (but not a right) that was valued under 2701(a)(2)(A) or (B). Section 2701(a)(2)(A) deals with the valuation of an "interest," and 2701(a)(2)(B) deals with the valuation of the "right" to receive a QFP.

—"Interest" is not defined, but "equity interest" is defined in 2701(a)(3)(B)(ii) to mean "stock or *any* interest as a partner." (Section 2703(e)(1)(A)(ii) contains a more limited reference, to the "capital or profits interest" in a partnership.)

—"Right" is not defined, but "specially valued fixed payment rights" are defined in 2701(d)(4) as the right to receive qualified fixed payments under a "specially valued retained interest." (We suggest it would be easier to eliminate the reference to a "specially valued retained interest," and simply say that a specially valued fixed payment right is a qualified fixed payment that has been valued under Section 2701(a)(1)(B), thus preserving the idea that the term doesn't apply to a QFP if the transferor elects out of special valuation treatment for that QFP.)

—"Instrument" is also used as a substitute for "interest" in 2701(a)(2)(C) the lead-in language speaks of "the following retained *interests," two of which are called "instruments."*

In the overall scheme of 2701, it seems clear that an owner of an "interest" in common stock may have several rights, but only one interest in that stock. The same is true of a preferred stockholder, a general partner or a limited partner. However, 2701(a)(2)(A) says that the value of an "interest" that is not a right to receive QFPs shall be valued at zero. What if a preferred stock owner is entitled to receive $100 per share on a fixed date in the future (which is a QFP under 2701(b)(1)(A)(i)), and dividends that are not determined at a fixed rate? The preferred stock is an "interest" (it falls within the definition of "equity interest"), but is it valued at zero because it is not a right to receive a QFP; or will the value of the interest be the special QFP value for the right to receive the $100 plus the zero value for the right to receive dividends that are not QFPs? The answer should be that some "rights" that are part of an "interest" may be valued at zero under 2701(a)(2)(A); some rights that are part of the same interest will be valued under 2701(a)(2)(B) if they are described in that section; those rights that are described in 2701(a)(2)(C) will be valued under pre-Chapter 14 law; and the sum of the values thus determined for all of the "rights" will be the value of the "interest."

The distinction between an interest and a right is also important under 2701(d)(1) and (2), which requires that we revalue particular "rights" rather than the interest itself. However, while 2701(d) deals with the revaluation of "rights," 2701(d)(5) provides that the termination of an "interest" is to be treated as a transfer, leaving

open the possible interpretation that the termination of one of several "rights" under a particular interest will not be a transfer unless the entire interest terminates at the same time.

Trust Interests. We understand that Section 2701 is not intended to apply to a beneficiary's assignment of his interest in the income or principal of a trust, and our discussion of this section leads us to believe that section 2701(a)(4) should be modified to refer to the "transfer of an interest in trust" instead of "in a trust." Unfortunately, including a trust in the definition of a 10-percent owned entity, and having Section 2701 apply to transfers in those entities, means that the references in Chapter 14 to transfers in a 10-percent owned entity become references to transfers in a trust; and the problem is compounded by specific references to transfers in a trust such as the one in 2701(a)(4). The provisions in Section 2703(e)(4) (which deals with "a transfer of an income or remainder interest with respect to a specified portion of the property in a trust") can apply both to a transfer of property to the trust and to a transfer by a beneficiary of his interest in the trust. For this reason, and also because there are special provisions for trusts that are scattered throughout sections 2701 and 2703, we submit that all trust provisions should be placed in a separate section. We have tested the possibility of doing this from a drafting point of view and are convinced that it is possible to segregate the trust provisions without damaging any of the Committee's objectives for Chapter 14.

General Drafting Suggestions

We suggest that any reference in the Draft to the transfer, retention or valuation of an "interest" should instead refer to a particular kind of interest. In the case of a corporation or a partnership, the term "equity interest" should be used, and the definition of equity interest in 2701(a)(3)(B)(ii) should be expanded to pick up the language in 2703(e)(1)(A)(ii), so that it would read:

> "The term 'equity interest' means stock in a corporation or any interest in the capital or profits of a partnership.

If indebtedness remains in the statute as an "interest" there should be a separate definition for a "debt interest;" and if an interest as a lessor remains in the statute, there should be a separate definition for a "lessor interest." This distinction is important because, if our understanding is correct, debt and lessor interests are significant only in valuing the transferred equity interest and for deemed transfer and valuation-on-death purposes, and 2701(a) is not intended to apply to the transfer of a debt interest or a lessor interest to determine if there is a gift or the amount of the gift.

The Summary of the Discussion Draft states that employment agreements are not to be affected by these rules, but nothing in the Discussion Draft says so. The definition of "equity interest" (and of "debt interest," if there is one) should state that such an interest does not include any contractual right or claim against the entity that arises because the entity employs the transferor or a member of his family. However, any stock acquired as compensation would be treated as an equity interest once it has been reduced to the employee's possession.

If the concept of a lessor interest is not eliminated, the definition should make it clear that a lessor/lessee relationship with the related entity is not a "partnership" and thus an "entity" in which an interest may be transferred.

A lessee's interest in leased property also comes within the definition of a "term interest" as defined in 2703(d)(3), which could cause all leasehold arrangements to be treated as a transfer of an interest in trust. And the interest of a borrower in the borrowed money is also arguably "an interest in property for a term of years," and thus a term interest. The definitions of a debt interest, a lessor interest or a lessee interest should state that these relationships shall not be treated as a partnership or a trust.

Specific Drafting Proposals Related to "Interests" and "Rights"

We suggest that the sections that rely on "interest" or "right" be revised to read as follows:

2701(a)(1)

"(1) IN GENERAL—

(A) If a transferor transfers an equity interest in a 10-percent owned entity to a member of the transferor's family; and

(B) If the transferor (or a member of the transferor's family other than the transferee) retains an [equity interest] [equity, debt or lessor interest] under which the owner of the retained interest possesses a right that has preference over any right under the transferred equity interest,

then, solely for the purposes of determining whether such a transfer is a gift (and the amount of such gift), the value of each retained interest described in subparagraph (B) shall be determined as provided in paragraph (2).

Comments

(1) The suggested language differentiates between an "interest" and a "right." It reflects the notion that an interest is what the transferor owns and either transfers or retains; but that a "right" is something that attaches to the interest and is normally not transferred or retained separate from the transfer or retention of an interest. The only "right" that is sometimes transferred or retained separate from the transfer or retention of an interest is a voting right (as in the case of revocable or irrevocable proxies, stockholder agreements with respect to voting rights, etc.), but the Discussion Draft provides that voting rights are to be disregarded in determining the value of a retained interest to which they attach.

(2) The bracketed material in subparagraph (A) indicates a decision that must be made about whether the retained interest that is to be specially valued will be confined to an "equity interest" or will include indebtedness or leases as now provided for in the Draft.

(3) Subparagraph (A) speaks in terms of the transfer of an "equity interest" to make it clear that, if a debt interest or a lessor interest remains in the statute, the transfer of the debt interest or the lessor interest is not a transfer that triggers the application of 2701(a).

(4) Subparagraph (B) picks up the concept set forth in 2701(a)(2)(C)(iii), which we regard as an indirect definition of a preferred interest, i.e., any "instrument" ("interest") under which its owner possesses at least one right that has a preference over any right possessed by the owner of the transferred interest.

2701(a)(2)

We suggest that the first part of subparagraph (A) be revised to read:

"The value of any *right under a* retained interest . . .

and that subparagraph (B) on page 2 of the Discussion Draft, lines 22 and 23 (carried over to the top of page 3) be modified as follows:

"For purposes of determining the value of the right to receive qualified fixed payments under any instrument *that sets forth the rights under the retained interest,* it shall be assumed that . . ."and that subparagraph (C) be modified to read as follows:

(C) Valuation of Certain Other *Interests* [Rights]—The value of the following retained interests *or rights under such retained interest* shall be determined without regard to this section:

(i) Any [instrument] *retained interest* of the same class as the transferred interest.

(ii) Voting rights.

(iii) *Any interest created by* any instrument none of the rights under which have a preference over any rights under the transferred interest.

Comments:

(1) In the Discussion Draft, the caption for 2701(a)(2) is "Valuation of Retained *Interests.*" However 2701(a)(2)(C) refers to "rights" in the caption, "retained interests" in the text, and 'any instrument" in (i) and (ii). No definition of these terms tells us if they are equivalent to one another or what the differences are. The approach of the suggested language is that a "right" is possessed by virtue of owning an "interest," and an "instrument" is a document that describes the nature and scope of the right.

(2) Section 2701(a)(2)(C)(iii) is probably unnecessary if the suggested language for 2701(a)(1)(B) is used because the concept in (C)(iii) is incorporated in subparagraph (B). A negative inference embedded in 2701(a)(2)(C)(iii) as it appears in the Discussion Draft is that, if the transferor retains an interest in "any instrument" that has one or more rights that are preferences over any right under the transferred interest, the value of such a retained interest shall be determined *with* regard to 2701. This can be read as a definition of a retained "interest" that would include debt, leases and any other contractual right of any kind, and is one of the reasons for transferring the concept in (C)(iii) to 2701(a)(1)(B).

(3) The suggested language omits the provision that subparagraph (C) does not apply to a trust because we would like to see all provisions that apply to trusts in a section separate from the one that deals with corporations and partnerships.

2701(a)(3)

We suggest it is not necessary to define "junior equity interest" It is used only once in the substantive provisions of the Draft, in 2701(a)(3)(A), and is defined in 2701(a)(3)(B) only "for the purposes of this paragraph." (However, the term is also used in 2703(f)(1) with no further definition, but that language can be revised.) If the definition is deleted, Section 2701(a)(3)(A) would be changed to say:

> "The application of paragraph (1) to any transfer of common stock in a corporation or of a partnership interest that is not preferential shall not result. . ."

Comments:

(1) All definitions should be grouped together rather than being scattered throughout the Draft (as are the definitions in 2701(a)(3)(B)); if a cross-reference is desirable, place it where needed, e.g., as the Draft does at the end of 2701(a)(4)(B) at the top of page 5.

(2) Compare the language used to describe preferential rights in 2701(a)(3)(B)(i) on page 4 of the Draft to the description of "other rights" in 2701(a)(2)(C)(iii) on page 3. The former provision refers to any partnership interest which is not "preferential," and the latter provision refers to "any instrument none of the rights under which have a preference over any rights under the transferred interest." The language in the second provision should be used either in place of "preferential" or as a definition for "preferential." If short reference terms are desired (and they probably would be useful), use the terms "preferred interest" and "nonpreferred interest."

2701(d)(1)

It seems unlikely that the "right" to a specially valued fixed payment will be transferred separate from the specially valued retained "interest" of which the payment is a part. Section 2701(d) (5) of the Draft reflects the same idea because it provides that the termination of an "interest" (not a right) shall be treated as a transfer. Section 2701(d)(1) should read:

> If the transferor transfers any specially valued [fixed payment rights] *retained interest,* the transferor shall be treated as having made a transfer of property by gift (on the date of such transfer) in an amount equal to the excess (if any) of—
>
> (A) the fair market value of [such rights] *the retained interest* as of the time of the transfer determined with regard to the rules of subsection (a)(2)(B), over
>
> (B) the fair market value of [such rights] *the retained interest* determined without regard to the rules of subsection (a)(2)(b).

Comments:

(1) Similar changes should be made to 2701(d)(2).

(2) We read 2701(d)(1) and (d)(2) to say that upon the transfer of an interest that includes a QFP as one of its rights, or upon death of the transferor, the portion of the interest's value attributable to the QFP shall be the greater of (1) the value at the time of transfer or death under a normal valuation approach, or (2) the value at the time of transfer or death based on the special QFP assumptions (payments will be made as provided in the instrument; payments will be made in perpetuity if no fixed termination date). Section 2701(d) (1) should be rewritten to say this:

> If the transferor transfers any specially valued [fixed payment rights] *retained interest, the value of the transferred interest for purposes of Chanter 12 shall be the greater of:*
>
> (A) the fair market value of [such rights] *the retained interest* as of the time of the transfer determined with regard to the rules of subsection (a)(2)(B), or
>
> (B) the fair market value of [such rights] *the retained interest* retained interest determined without regard to the rules of subsection (a)(2)(b).

Section 2701(d) (2) should be revised in a similar manner.

(3) We believe it is possible for more than one QFP to exist under a single interest, some of which may have a lower value under normal rules than under the special QFP assumptions, and some of which may have a higher value than under the QFP assumptions. The statute should say that the interest shall be valued by combining the value of all of these rights for the purpose of this section

BUY-SELL AGREEMENTS THREATENED BY PROPOSED TAX LEGISLATION

High on the nightmare list of most business owners is the prospect of an aggressive IRS agent successfully placing too high an estate tax value on the business. As the nightmare unfolds, the family is forced to sell the business to pay the estate tax, the business is sold for much less than the estate tax value, and the amount received for the business just barely covers the taxes. This grim scenario suddenly dissolves with the realization that someone told you that the company's buy-sell agreement eliminates this problem—but does it?

For many years, business owners have commonly used buy-sell agreements to assure the continuity of the business when an owner dies, to provide a market for an owner's interest in the business at what all of the owners think is a fair price, and to give them the assurance that an interest can't be transferred to someone who will not be compatible with the other owners. In most cases, these agreements have also had the happy side effect of fixing the value for estate tax purposes and preventing your nightmare from becoming a reality. However, after section 2036(c) became effective on December 17, 1987, this began to change.

Before Congress enacted section 2036(c) in 1987 (the valuation freeze legislation), the IRS and the courts agreed that buy-sell agreements would usually fix the value for estate tax purposes if the agreement was a bona fide business arrangement and not a device to pass the business interest to natural objects of the owner's bounty for less than its fair value, and if the agreement restricted lifetime transfers of the business interest, the estate was obligated to sell at the price in the agreement, and the price was reasonable at the time of the agreement. Agreements that were binding before December 17, 1987 (and not amended since then) are still governed by those rules, but agreements that were entered into or amended after December 17, 1987 are subject to section 2036(c), and that section could cause some or all of the interests in the business that others own to be included in your estate if you die before they do.

Chairman Rostenkowski's Discussion Draft of the proposed legislation to replace section 2036(c) would eliminate the section 2036(c) problems that apply to buy-sell agreements, but it would replace them with a new and equally troublesome set of problems if a family member holds rights under the agreement, either directly or through a corporation, partnership or trust. If that legislation is adopted, the sales price required by a buy-sell agreement will be disregarded for estate tax purposes unless specific conditions are met. One condition is that the interest must actually be sold pursuant to the agreement (under present law, an unexercised option to buy will fix the estate tax value); another is that the sales price must be determined pursuant to a formula that is reviewed by the parties within three years before the sale; and when the parties review the formula, it must be reasonably expected to produce a price which would approximate the fair market value of the property during the following three years.

If the proposed legislation is enacted, you may find yourself locked into an agreement that was entered into primarily for business reasons but that is not binding for tax purposes, and this will lead to a prolonged and expensive battle with the IRS over the value of the business to prevent the nightmare about being taxed on a value higher than the sales price from becoming stark reality.

The proposed legislation also provides that rights of first refusal held by a family member are to be ignored in all cases, and that property leased to a family member is to be valued without regard to the terms of the lease. Moreover, the Discussion Draft does not exempt agreements that are now binding on all of the parties even though few existing agreements can meet the requirements set forth in the proposed legislation.

PREPARED STATEMENT OF MICHAEL J. GRAETZ

Messrs. Chairmen and Members of the Subcommittees: I am pleased to have this opportunity to present the views of the Administration on proposals to repeal and to replace section 2036(c), relating to "estate freeze" transactions.

BACKGROUND

"Estate freezes" take many forms, but have as their common objective limiting or reducing the value of an interest in a business or other property for estate tax purposes. Typically, this is accomplished by having an older-generation transferor

retain a non-appreciating interest in a business while transferring the interest that will appreciate to a younger-generation transferee.[1]

The Treasury Department does not object to the use of techniques that freeze value in a transferor's estate so long as the value of the transferred property for gift tax purposes is *properly* measured. This is because, if the value of the gift is properly measured, this value will take into account the value of the right to future appreciation of the business or other property. Before enactment of section 2036(c), however, taxpayers were using techniques which resulted in improper valuations for gift tax purposes, which in turn effectively eliminated gift tax on a significant portion of the fair market value as of the transfer date.

These techniques typically involved the use of rights which the transferor had discretion to exercise. In reality, in the family context many of these rights were likely not to be exercised at all since to do so would undermine the transfer tax benefits of the freeze transaction, if not undo the freeze completely. Nevertheless, standard transfer tax valuation rules dictated that fair market value normally be determined according to what a willing buyer would pay an unrelated willing seller. Under this approach, appraisers would ignore the fact that these discretionary rights were held by members of the same family and would assign value to them for transfer tax purposes on the assumption that they *would* be exercised as if held by an unrelated third party. This caused estate planners to advise the older generation transferors to retain as many of these rights as possible in order to maximize the value of the interest they retained and to minimize the value of the transferred interest and the gift tax consequences of the transfer. Thus, virtually the entire value of the business would be "soaked up" by the discretionary rights retained by the transferor. For this reason, these features are often referred to as "soak-up features." [2]

The cumulative effect of these valuation techniques was significant understatement of the value of the transferred interest for gift tax purposes. As a result, when the transferred interest was assigned to the younger generation, little or no transfer tax would be due, even though all future appreciation in the value of the business would inure to the transferred interest. Moreover, soak-up features retained by the transferor often escaped subsequent transfer tax because of lifetime events, expiration at death, or inconsistent valuation for estate and gift tax purposes. It is the transfer tax avoidance due to this discontinuity between the assumptions used in valuing the transferred interests and the likely behavior of the family members that the Internal Revenue Service and the Treasury Department consider to be abusive.

SECTION 2036 (C)

These abuses motivated Congress to enact section 2036(c) in 1987.[3] Under section 2036(c), the entire value of an enterprise is included in a transferor's estate (or treated as a deemed gift) if the transferor transfers a disproportionately large share of the potential appreciation in the enterprise while retaining an interest in the income of, or rights in, the enterprise. Thus, section 2036(c) is not directed specifically at the valuation abuses previously outlined, but instead returns the entire value of the property, including future appreciation, to the transferor's estate.

Serious concerns have been raised about the possible overbreadth of this result, as well as about the uncertain operation of section 2036(c).[4] The Treasury Department shares many of these concerns. We strongly believe, however, that these valuation abuses should not be allowed to return, and that repeal of section 2036(c) without a replacement would cause that result. We therefore support repeal of section 2036(c)

---

[1] Illustrations of a variety of freeze transactions appear in the Appendix.

[2] For example, a common technique in a corporate freeze involved the use of "noncumulative" dividends. Noncumulative dividends are dividends which, if not paid in a particular year, never have to be paid by the corporation in a later year. Because the older generation often retained control over whether or not to pay dividends, the dividends frequently would not be paid at all. By keeping the dividends in the corporation, the value of the common stock held by the younger generation would be enhanced without payment of any gift tax. On the other hand, at the time the freeze was done, this right to receive non-cumulative dividends which the older generation retained would be assigned substantial value for gift tax purposes on the assumption that these dividends would be paid, notwithstanding the likelihood of non-payment in a family context.

[3] Section 2036(c) was enacted as part of the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203), and was amended in the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647).

[4] The Internal Revenue Service issued Notice 89-99 to provide guidance as to how the Service would interpret section 2036(c). This notice has allayed some of the concerns about how the section will be administered. However, the notice does not address all the underlying concerns about the potential scope of the section, which can be addressed only through legislation.

only if coupled with enactment of a replacement provision adequate to prevent the valuation abuses previously discussed.

DISCUSSION DRAFT

On March 22 of this year, the House Ways and Means Committee released a discussion draft of a possible replacement for section 2036(c). A hearing on the discussion draft was held before that committee on April 24.

We stated at that hearing our belief that a replacement for section 2036(c) should be judged on whether or not it eliminates the abuses described above while, at the same time, permitting flexibility in intra-family transfers consistent with this objective. Stated another way, does the proposed replacement for section 2036(c) permit businesses to be transferred to younger-generation family members and, at the same time, result in the various interests being valued appropriately for gift tax purposes on the date of the freeze transaction? Does it also assure that the subsequent behavior of the various parties will not cause that value, once determined, to be undermined? Judged by those standards, we believe that the discussion draft circulated by the Ways and Means Committee offers the most constructive and workable approach for such a replacement.

The basic mechanism of the draft is straightforward. It does not affect how the business as a whole is to be valued. Rather, the draft sets forth rules as to how that value once determined is to be allocated among the various interests in the business.

The draft provides that in valuing the interest retained by the transferor, generally only rights to receive "qualified fixed payment rights" ("QFPs") will be valued.[5] Discretionary rights, such as put or call options, generally will be disregarded, because these are the kinds of "soak-up features" that have so frequently been used in cases of valuation abuse. Voting rights will continue to be valued as under current law, so that minority discounts can still be claimed where appropriate. The discussion draft may need clarification with regard to this point.

QFPs are essentially rights to receive payments in specified amounts at specified times.[6] The discussion draft assumes that QFPs will be paid on schedule for valuation purposes. The necessary corollary to this rule is that if the payments are not so paid, the transferor will be considered to have made a "deemed gift" in the amount of the missed payment.[7]

After valuing the right to receive QFPs retained by the transferor, the value of the interest *transferred* generally is determined by subtracting the value of the retained interest from the value of the business as a whole. However, the draft also provides a minimum valuation rule to ensure that the appreciating equity interest (such as the common stock or a non-preferred partnership interest) cannot be valued for gift tax purposes at less than 20 percent of the total equity in the business, which for this purpose includes debt owed by the business to the transferor.[8]

In summary, the discussion draft attempts to deal with the abuses which existed prior to enactment of section 2036(c) by assigning value only to those rights which are likely to actually carry value in an intra-family transfer—rights to receive payments from the business. Discretionary rights (*i. e.*, soak-up features) generally are not given value since those are the rights which a transferor is not likely to exercise in the intra-family context. To ensure that the valuation of QFP rights cannot be undermined subsequently by transferors, the draft treats the failure to pay QFPs as deemed gifts. Finally, the minimum value rule prevents taxpayers from undervalu-

---

[5] The draft defines a qualified fixed payment as any payment or distribution (other than a dividend) with respect to any interest in the entity to the extent the payment or distribution is fixed as to both amount and time for payment. We understand that employment agreements, such as deferred compensation or other types of compensation agreements, are not intended to be treated as interests in the entity except to the extent such agreements involve payments or distributions of stock or other forms of ownership interests in the entity.

[6] Generally, the valuation of the right to receive QFPs, such as guaranteed payments from a partnership, will be made using the standard technique of discounting the payment or payment stream to present value, using the market rate of interest or return appropriate for the particular business. Transferors would be free to set the interest or dividend rate at whatever rate they choose, including variable interest rates, recognizing that if the rate selected is below the market rate for that business, the value of the QFP right will necessarily be lower as a result.

[7] We understand that the "deemed gift" rule will not result in the transferor being treated as having received a constructive dividend for income tax purposes.

[8] If only a portion of the appreciating equity interest were being transferred, the minimum value rule would require that a pro rata share of the minimum value be allocated to the transferred shares. Any appropriate discount on account of a transfer of a minority interest could then be applied.

ing the transferred interest by ensuring that the right to future appreciation is appropriately taken into account.

The discussion draft also contains certain other rules intended to assure that these basic rules operate appropriately and to give taxpayers as much flexibility as possible. For example, explicit rules are included to prevent the same value from being taxed twice for estate and gift tax purposes.[9] In addition, transferors may elect to apply the QFP rule to transactions which will not otherwise qualify (such as noncumulative preferred stock or real estate partnerships in which payments are dependent on income or cash flow)[10] The deemed gift rule also provides a three-year grace period for corporations and partnerships so that the failure to make QFPs due to temporary cash flow difficulties will not trigger a gift. Finally, the rule provides that no deemed gift will occur if the QFP right provides for compound interest and the fully compounded amount is accounted for when the retained interest is transferred or if the corporation or partnership that fails to make QFPs is insolvent or bankrupt.

The discussion draft will not apply to transfers of the same class of stock which the transferor retains,[11] nor will it apply to transfers of interests none of the rights of which are junior to the retained interest.[12]

The discussion draft also addresses three related problems: trusts in which the transferor has retained an interest, joint purchase transactions in which the transferor purchases a life or term interest while a family member purchases a remainder interest, and buy-sell agreements.

The primary focus of the trust rule is the grantor-retained income trust ("GRIT") A GRIT is a trust in which the transferor has retained an income interest for a term of years, while transferring the remainder interest to another person (usually a family member) The various interests in a GRIT are valued according to tables published by the Internal Revenue Service which assume a rate of return specified by statute.[13] Frequently, however, the property placed in a GRIT either does not generate any income or does not generate income equal to the rate of return assumed in these tables. We believe this presents the same potential for abuse as in the corporate or partnership context; i.e, that the interest transferred to the younger generation remainderman will have been undervalued, which in turn means that the gift tax paid will have been too low.

Consistent with the approach for corporations and partnerships, the discussion draft provides that the only interest in such a trust that is assigned value for gift tax purposes is a QFP.[14] In the trust context, a QFP is generally[15] defined as the right to receive a fixed annual payment or an annual payment based on the value of the assets in the trust (determined annually).[16] If the trust fails to pay out the

[9] The discussion draft also provides that if a missed QFP is treated as a deemed gift on which gift tax is paid, the transferor is entitled to a refund of gift tax to the extent the missed QFP is paid subsequently.

[10] We understand that partnership distributions which are contingent on cash flow but not specifically fixed as to time are also eligible for this election. In addition, we understand that the favorable valuation assumption that payments will be made as provided in the instrument will also apply to payments for which such an election is made.

[11] We understand that this provision is intended to apply to situations in which a transferor retains voting common stock and transfers common stock which is identical except that it has no right to vote.

[12] At present, the discussion draft does not provide rules as to how rights which lapse on the occurrence of a specified event (such as death) or temporary restrictions which are designed to depress value for transfer tax purposes will be treated. Therefore, it is not clear how the discussion draft would affect a transaction such as that sanctioned in *Estate of Harrison* v. *Commissioner*, 52 T.C.M. (CCH) 1306, T.C.M. (P-H) Par. 87,008 (1987). In *Harrison*, the Tax Court concluded that liquidation rights which lapsed upon the death of a limited partner could not be taken into account for purposes of estate tax valuation even though the value represented by those lapsing rights effectively escaped the transfer tax system entirely. The Treasury believes this result is not appropriate and supports changes to the discussion draft to clarify that it prevents a result such as in the Harrison case.

[13] *See* IRC Section 7520.

[14] We understand that these QFP rights would continue to be valued under the valuation tables published pursuant to IRC Sec. 7520.

[15] QFPs for trusts also include non-contingent remainders if all other interests in the trust are QFPs.

[16] These trust rules are derived from the rules governing charitable remainder trusts, which were enacted to address related problems of incorrect valuation of the various interests in such trusts. *See* IRC Section 664.

required amount, the transferor is treated as having made a deemed gift (just as the failure by a corporation or partnership to make a QFP is treated as a deemed gift)

The discussion draft also applies to certain joint purchases of property since joint purchases can be structured to work the same way as a GRIT. Joint purchases subject to the rule are purchases of a life or term interest by one family member and the purchase of the remainder interest by another. The discussion draft therefore does not apply where the family members purchase property either as tenants in common or as joint tenants with right of survivorship.

The discussion draft generally treats joint purchases in the same way it treats GRITs. Thus, only rights to receive QFPs are valued, and failure to make the required payments to the term holder results in a deemed gift.

The draft also contains a provision concerning buy-sell agreements. Although buy-sell agreements are widely used in closely held businesses and often have legitimate non-tax purposes, they also have potential for suppressing the value of a business interest for transfer tax purposes. The discussion draft provides a mechanism intended to prevent the abuses with buy-sell agreements similar to those that no longer could be accomplished through other freeze mechanisms.

TESTIMONY ON THE DISCUSSION DRAFT BEFORE WAYS AND MEANS

The Treasury has benefitted substantially from the opportunity to discuss the draft with interested members of the public. We believe that the dialogue that has been established on this issue will result in a better legislative product than otherwise would be the case. The hearing before the Ways and Means Committee also produced many constructive comments for improvement of the draft.

First, and most importantly, the testimony before the Ways and Means Committee revealed a consensus that estate freezes present a serious potential for tax abuse. Many small business organizations, as well as professional organizations such as the American Bar Association, the American Institute of Certified Public Accountants, and the American College of Trust and Estate Counsel, agreed that a provision to replace section 2036(c) was necessary and that outright repeal would not be appropriate. As I previously stated, the Treasury Department concurs in that assessment. We also believe that the discussion draft provides the most satisfactory and workable approach to such a replacement—by attempting to obtain the appropriate valuation of the various interests at the time of transfer.

We also agree with those who have commented that many improvements can and should be made in the draft. We are prepared to support proposed modifications that improve the draft in terms of taxpayer flexibility and ease of administration and compliance. We will oppose, however, changes that effectively would undermine the fundamental premise of the discussion draft—proper valuation at the time of the gift.

The following represents a partial list of comments we have received with which we concur and modifications to the discussion draft that we would suggest in response:

- *Debt and Leases.* Several commentators have suggested that it is not appropriate to treat debt and leases as interests in the business which are subject to the rules in the discussion draft. We have reviewed this issue and have concluded that the problem posed by debt and leases in the context of freezes is not their effect on valuation of the transferred interest, but rather the failure of debtors and lessees to perform according to the terms of the particular agreement. The treatment of such failures is not specifically set forth in the Internal Revenue Code, nor are the obligations of taxpayers to report such a failure clearly defined. We support changes in the discussion draft limiting its application in the case of debts and leases to providing specific rules detailing the effects of modifications or failures to perform under a debt instrument or lease in the intra-family context and requiring reporting of such events.
- *Publicly Traded Stock.* Some commentators have suggested that the discussion draft should not apply to transfers of publicly traded stock, because the value of such stock is readily ascertainable through stock quotations. We believe this is a reasonable conclusion and support a change in the draft which generally would leave stock traded on a public securities exchange subject to the current valuation rules.
- *Increasing the Ownership Threshold.* The discussion draft applies to any transfer of an interest in an entity 10 percent or more of which is owned by the transferor, after application of family attribution rules. It has been suggested that this threshold should be increased. We support such an increase, provided that the level is not set too high and that appropriate attribution rules are provided.

• *QFP Election.* Several comments were made to the effect that the election into the QFP regime for rights that would not otherwise qualify should be broadened to apply to particular types of interests, such as percentage leases. Rather than attempting to specify in the statute the particular rights to which an expanded election would apply, we support broadening substantially the types of rights which taxpayers can elect to treat as qualified fixed payments to include most rights to receive income or payments from a business.

• *Generation skipping transfers.* Comments have correctly indicated that it is unclear how the rules set forth in the discussion draft would affect the taxation of generation skipping transfers. We support clarification of this issue.

• *Trusts.* The rules concerning trusts in the discussion draft are integrated with the rules concerning partnerships and corporations. It has been suggested that the trust rules should be separated for the sake of clarity. We support this change.

• *Voting vs. Non-voting Stock.* We understand that the discussion draft was not intended to apply in cases of the transfer of non-voting common stock where the retained stock is identical except that it carries voting rights. The discussion draft should be clarified to reach this result.

• *Option to Avoid Deemed Gift Rule.* The discussion draft currently provides that the failure to make a QFP will not result in a deemed gift when the instrument provides that the missed QFP will bear compound interest until paid. We support increasing the flexibility of taxpayers to defer payment of QFPs without causing a deemed gift to occur, if such deferred payments bear compound interest, by also allowing a company to create the legal right to the compound interest at the time the payment is missed rather than requiring that it be provided in the original instrument.

• *Election by Non-Transferor Family Members.* The discussion draft presently provides that interests held by family members other than the transferor at the time of the transfer will not be treated as QFPs unless the family member consents. This provision has been criticized for effectively giving a veto power to non-consenting holders when the interests of the holder may be adverse to those of the transferee. In response to this concern, we are developing an alternative which attempts to limit the application of the provision to generations above that of the transferee.

• *Limitations on Value for Subsequent Transfer Tax Purposes.* In cases in which QFPs have not been made but no deemed gifts have occurred because such QFPs bear compound interest, the value of such QFP rights for subsequent transfer tax purposes will reflect not only the value of the QFP right itself but also any compound interest which has accrued to that point. This could result in the value of the QFP right, together with the compound interest, exceeding the value of the underlying business. We believe it is generally appropriate in this situation to limit the fair market value of the QFP right for transfer tax purposes to the value of the underlying business.

• *Rights Valued at Zero.* The discussion draft presently provides that rights other than QFP rights will be valued at zero, except in limited circumstances. None of the comments to date have cited examples of other non-income rights which should be given value. Nevertheless, we believe it would be appropriate for Treasury to be given regulatory authority to expand those non-income rights which are given value under the discussion draft.

• *Non-Family Members Treated as Family Members.* The discussion draft provides that if a transfer would be treated as a gift for gift tax purposes without regard to the rules in the discussion draft, the transferee will be treated as a member of the transferor's family. The effect of this rule is to make certain transfers to non-family members subject to the discussion draft. This rule has been criticized, and we support narrowing the rule so that it applies only in the context of the transfer to the non-family member to which the discussion draft applies and not to any subsequent transactions.

• *Statute of Limitations.* The discussion draft extends the statute of limitations which would apply to transfers subject to the rules of the discussion draft from three years to six years. This change has been criticized. We believe that with appropriate modifications to accommodate the deemed gift rule, a three-year statute of limitations could be retained in the context of the discussion draft.

• *Right of Recovery.* The portion of the discussion draft which repeals section 2036(c) also repeals a related provision, section 2207B, which provides for a right of recovery of estate taxes paid on account of the value of property which is included in a decedent's estate by reason of section 2036 (relating to transfers with a retained life estate). It has been pointed out that this right of recovery applies to portions of section 2036 other than section 2036(c), and that it should be retained for purposes of those other provisions. We agree.

• *Coordination of Discussion Draft with Section 2036(a).* Comments have suggested the need to coordinate the rules of the discussion draft dealing with joint purchases with section 2036(a). We agree and support such a change.

• *Effective Dates.* Many commentators have suggested the need for clarification as to the way in which transactions occurring before enactment of a replacement provision would be treated if current section 2036(c) is repealed retroactively. We are very sympathetic to the need for this clarification on the part of estate planners. We would be pleased to work with the members of the Finance Committee to provide this clarification as quickly as possible.

In addition, we understand that there have been serious objections raised to the provision of the discussion draft concerning buy-sell agreements. We have not yet developed a satisfactory alternative to the provision now in the draft. We are continuing to discuss the problem, both with Congressional staff members and with interested groups. We are optimistic that an alternative can be developed that does not inhibit the use of buy-sell agreements that are arms-length in nature.

We are also considering other modifications suggested by the Ways and Means testimony and in our discussions with interested groups. We are certain that we will receive additional beneficial suggestions today.

OTHER PROPOSALS

The press release announcing this hearing requested comments on other proposals to replace section 2036(c), specifically proposals submitted by the District of Columbia Bar Association, the U.S. Chamber of Commerce, and a task force made up of two sections of the American Bar Association and the American College of Trust and Estate Counsel ("Task Force")

a. District of Columbia Bar Association Proposal

The District of Columbia Bar Association ("D.C. Bar") proposal would make two significant modifications to current law valuation rules. First, the ability of a transferor to claim a minority discount in a freeze transaction would be limited to situations in which the transferred interest, together with the retained interest, represented a minority interest. The second rule would permit taxpayers and the IRS to value partial interests in property without regard to the IRS actuarial tables if it can be shown that the income or mortality assumptions are likely to be substantially different from the actual income stream or mortality expectation.

The balance of the D.C. Bar proposal is designed essentially to enhance the ability of the Internal Revenue Service to audit freeze transactions. The proposal would accomplish this by lengthening the gift tax statute of limitations from three to six years, providing an open statute of limitations for unreported freeze transactions, and increasing the reporting requirements for gifts (including annual exclusion gifts and transfers for consideration). The statute provides a mechanism by which transferors could request that a gift tax valuation be audited by the IRS. If such an audit took place, the IRS would thereafter be precluded from challenging the valuation. If no such audit had occurred, the IRS could revalue such gifts in the context of an estate tax audit.

We believe that the primary problem presented by estate freezes is manipulation of the current valuation rules. These rules provide that fair market value is to be determined by what a willing buyer would pay an unrelated willing seller in an arms-length transaction. Freeze transactions between family members, however, are fundamentally not at arms-length. Consequently, the normal fair market valuation rules simply do not assure a correct valuation in the context of an intra-family transfer utilizing soak-up features.

The D.C. Bar proposal would not change the willing buyer-willing seller standard, and therefore does not address what we regard as the primary problem in estate freezes. Instead, it would merely enhance the IRS's ability to audit transactions without changing the valuation standards by which those transactions are audited. We do not believe this approach is adequate.

b. U.S. Chamber of Commerce Proposal

We view the proposal of the U.S. Chamber of Commerce as a variation of the discussion draft. While we believe that the Chamber's proposal is unduly narrow in scope, both in terms of its threshold for application of the proposal and in the types of transactions affected, we also believe that the proposal contains worthwhile ideas that should be seriously considered in drafting a replacement proposal.

As an example of our concerns about the scope of the proposal, only entities 50 percent or more owned by the transferor and certain members of his family would be covered. We believe this threshold is too high. Second, the proposal provides that

non-discretionary payments would be valued under normal valuation principles, but would not treat the failure to make such payments as deemed gifts. Third, the draft lacks specificity as to those rights which would not be given value. Fourth, the proposal would permanently excuse taxpayers from treating missed payments as deemed gifts under circumstances we do not believe to be appropriate. Finally, the proposal would not apply to certain transactions, such as GRITs and joint purchases which, as discussed earlier, present opportunities for abuse.

c. Task Force Proposal

The proposal of the task force seems to be the conceptual precursor of the discussion draft. It attempted to deal with the primary abuse in estate freeze transactions—misvaluation of the initial transfer.

We believe, however, that the Task Force proposal is far too limited. It does not deal adequately with discretionary rights retained by the transferor. First, the proposal would alter the valuation treatment of only a very narrow class of discretionary rights. In addition, the way these rights would be treated under the proposal is to assume that they would not be exercised in a manner adverse to the donee's interest. We believe such a rule would complicate rather than simplify valuations, because the effect of this assumption on valuation is not clear, and would be confusing to all but the most sophisticated estate planners. By complicating the valuation rules, the problem of misvaluation will likely be exacerbated rather than reduced. Third, by specifically listing the types of rights which would be given no value, the draft would invite planners to develop new rights (or variations of old rights) not dealt with by the statute which could be misvalued.

Moreover, the proposal provides no rules to deal with the failure to make dividend or other payments. As discussed above, we believe this was one of the most pervasive abuses prior to enactment of section 2036(c), and the failure of the Task Force proposal to deal adequately with this abuse makes the proposal unacceptable. Finally, the proposal would only apply to corporate and partnership transactions, and would not deal at all with other potentially abusive transactions, such as GRITs and joint purchases.

REVENUE CONSIDERATIONS

The Treasury's Office of Tax Analysis estimates that repeal of section 2036(c) would reduce revenues during the period 1991-95 by $1.021 billion. (See the attached Table).

The revenue loss from repeal of section 2036(c) arises because the provision effectively prevents taxpayers from engaging in freeze transactions. Therefore, interests which otherwise would have been subject to freeze transactions will be retained and continue to appreciate in value in the hands of the older generation. As members of the older generation die holding such appreciated interests, their gross estates will be correspondingly larger, thereby increasing revenues. If section 2036(c) were simply repealed, freezes would resume (including abusive freezes which eliminate current value from the transfer tax base) and the appreciation that would otherwise be includable in the estates of the older generation will not be subject to tax.

Treasury also estimates that, if the discussion draft in its current form were enacted to replace section 2036(c), revenues during the period 1991-95 would be reduced by $50 million from current law. (See the attached Table).

CONCLUSION

The Treasury Department looks forward to working with the Congress and interested members of the public to develop a fair and workable replacement for section 2036(c). To retain our support, any proposal must prevent abusive valuations in estate freeze transactions. We are encouraged by the progress made to date.

APPENDIX—ILLUSTRATIONS OF COMMON FREEZE TECHNIQUES

Corporate Recapitalization. In this transaction, the older generation, owning all or a significant portion of the common stock, recapitalizes the corporation, exchanging its common stock for both preferred and common stock. The preferred stock is structured with non-cumulative dividends and with discretionary features, such as puts, conversion features, rights to compel liquidation, etc. The preferred stock is typically valued assuming that dividends will be paid and that discretionary rights will be exercised in an arms-length manner, even though in the family context it is often unlikely that such rights will ever be exercised. This results in the value of the common stock being understated. The common stock is then transferred to the younger generation subject to little, if any, gift tax. The older generation retains the

preferred stock. All subsequent appreciation in the value of the business inures to the common stock, effectively freezing the value of the business in the older generation's estate as of the date of the transfer of the common stock.

Partnership Freeze. The partnership freeze resembles the corporate freeze, and can be accomplished either by forming a new partnership or by restructuring an existing one. In the typical freeze, the older generation receives a limited partnership interest, which provides for a preferred return on the partner's undistributed capital (analogous to dividends on preferred stock). As with preferred stock, discretionary features are added to the limited partner's interest in order to maximize its value and minimize the value of the general partnership interest, which is then transferred to the younger generation subject to little, if any, gift tax. These discretionary features are not likely to be exercised by the older generation, but nevertheless generally are valued as if they were. Because the limited partnership interest does not appreciate, it has effectively been frozen for estate tax purposes, and all future appreciation would inure to the younger generation.

Grantor Retained Income Trust ("GRIT"). A GRIT is a trust in which the grantor has retained an interest for a term of years. On expiration of the term, the property passes to the remainderman (typically a younger generation family member) The grantor will typically retain a reversionary interest or general power of appointment which becomes effective if the grantor dies during the term. The value of the retained interest is determined according to tables provided by the IRS which assume a rate of return equal to 120% of the applicable Federal rate. This typically results in a very small value being assigned to the transferred interest (and thus a very small gift tax) Frequently, the property placed in the GRIT is of the type that produces little or no income but will appreciate in value (such as growth stock) Since the income from the trust is less than the rate of return assumed in the valuation tables, the grantor's retained interest will have been overvalued and the transferred interest will have been undervalued. Since no further tax is due when the term expires, this means that a portion of the initial value will have been transferred to the younger generation without gift tax.

Joint Purchases. A joint purchase can be structured to work the same way as a GRIT. However, instead of transferring property that the older generation already owns, the older generation will purchase a term interest in property while the younger generation purchases the remainder interest in the same property. The property is often the type that pays little if any income, but which instead appreciates in value. The values of the respective interests are determined according to the same valuation tables used in the case of GRITs. Thus, in such circumstances the interest of the older generation will be overvalued while that of the younger generation will be undervalued. When the term expires the property passes to the younger generation without transfer tax.

Buy-Sell Agreements. A buy-sell agreement is an agreement among shareholders or partners (or between such individuals and the corporation or partnership) The agreement generally provides for the purchase of the person's stock or partnership interest on the occurrence of some event, such as death. These agreements often have legitimate non-tax purposes. They typically work by fixing the price at which the person's interest will be purchased, either at a set price or according to a formula. However, this price is sometimes set far below what a willing buyer would pay for the interest *absent the buy-sell agreement.* In some instances, courts have permitted these agreements to set value, notwithstanding Treasury regulations which provide that such agreements will not be taken into account if the agreement is being used as a testamentary device to suppress estate tax values.

Self-Canceling Installment Note. A common use of this device involves an older generation which owns all the common stock of a corporation. The older generation gives a small portion of the common stock to the younger generation, and then causes the corporation to redeem its remaining common stock for an installment note. This would freeze the value of the business in the hands of the older generation. The installment note could provide that any payments due after the death of the older generation are canceled. If the note had not been fully paid by the death of the older generation, a portion of the corporation's value would have passed to the younger generation free of tax. A similar result could be achieved by use of a private annuity which expired at death.

Table 1.—ESTIMATES RELATED TO ESTATE FREEZES

Item	Fiscal Years (Millions of dollars)						
	1990	1991	1992	1993	1994	1995	1990–1995
Repeal Section 2036(c)	0	−3	−58	−176	−314	−470	−1021
Discussion Draft Proposal	0	75	123	14	−83	−179	−50

Department of the Treasury, Office of Tax Analysis, April 23, 1990

PREPARED STATEMENT OF HARRY L. GUTMAN

Messrs. Chairmen and Members of the Subcommittees: I am pleased to appear today as an invited witness to offer comments on two specific aspects of the "estate freeze" issue. I shall discuss with you "buy-sell" agreements and "joint purchases" of property.

BACKGROUND

Before discussing these specific issues, it is appropriate to put them in context. Over the years, a number of techniques have been developed to exploit the transfer tax structure by taking advantage of valuation uncertainties, manipulating valuation table and creating devices to transfer wealth in ways that are difficult for the Internal Revenue Service (the "Service") to detect. In part these techniques have been successful because lack of adequate notice, manpower and other administrative problems have prevented the Service from finding and questioning doubtful transactions. Thus, one part of the solution is to provide the Service with adequate notice and manpower to deal with these issue. Another part of the problem has been the court response to cases brought by the government. Here, in a significant number of instances, strict adherence to the "willing buyer/willing seller" test has led to results that permit transfer tax avoidance. The solution to this part of the problem is substantive legislation mandating a different result in appropriate cases.

In the classic "estate freeze," corporate or partnership interests are rearranged with the objective of fixing the value of a retained portion of a business in the transfer tax base of the transferor while transferring the future growth potential to another (in many cases the natural object of the transferor's bounty). This is usually done by creating a preferred interest with a fixed value (the "frozen interest") which is retained while the interests which represent the remaining present and all the future value of the entity are transferred. If the retained and transferred interests are properly valued, there is no transfer tax problem. However, if the interests are designed to facilitate overvaluation of the retained interest, with a corresponding undervaluation of the transferred interest, there is a problem. Moreover, it is important to understand that the objective of freezing value in the transfer tax base of the transferor while transferring future growth to the transferee, can be achieved through manipulation of the business entity's capital structure, sales of stock for notes, buy-sell arrangements, options, and the provision of property or services to the entity through lease or employment arrangements.

There seems to be little dispute, that the classic—and easily recognized—situation that I have just described should be corrected by appropriate legislation. There is less agreement that other methods of achieving the same substantive results should be subject to similar rules. In the buy-sell area, in particular, the reluctance is in part premised upon the view that existing law is sufficient to control any abuses. I believe that a sound legislative solution must apply not only to the classic case, but also to any transactional forms that accomplish the same result. Accordingly, I am uncomfortable with a statutory regime that fails to deal with the abuse I believe is possible if a note, buy-sell agreement or option is substituted for the classic frozen interest.

BUY-SELL AGREEMENTS

A buy-sell agreement is an arrangement pursuant to which, upon a specified event (such as an *inter vivos* offer to purchase, a desire to transfer, or death) the holder of property subject to the agreement must offer to sell, or sell, the subject property to the other parties to the agreement at a price and upon the terms specified in the agreement. Buy- sell agreements serve important and legitimate business

functions. They are commonly used to control the devolution of ownership of a closely-held business, to avoid expensive appraisals in determining purchase price and to determine and provide for liquidity needs in advance are all legitimate concerns.

On the other hand, as illustrated by the following example, a buy-sell may be used to pass wealth without the payment of transfer tax. Assume X, age 60, and X's daughter Y, age 30, own all the common stock of a business in the proportion of 80-20. X enters into an agreement with Y, which provides that no shares in the corporation can be sold without first offering them to the other at a price equal to the company's book value on the date the agreement is signed. The agreement further provides that upon the death of one of the shareholders, the other will purchase the shares of the deceased shareholder at the same book value price.

The agreement, if upheld for Federal transfer tax purposes, will fix the value of the stock at book value. In substance, the agreement has the same effect as a preferred stock recapitalization. The value of the retained interest is frozen in the hands of the transferor and the post-execution increase in value passes to the transferee with no transfer tax imposed. Given the age disparities in the example, it is more likely that the father will predecease the daughter. Thus the post-execution growth in the value of the common stock owned by the father will inure to the benefit of the daughter. It is unlikely that unrelated third parties of these ages would enter into such an agreement. Unrelated third parties would be likely to want to capture the full fair market value of their ownership interest for the benefit of their families.

Despite this example, the inclusion of buy-sell arrangements, and their equivalents, in legislation directed at the estate freeze problem has provoked considerable controversy.

Some have viewed the inclusion of buy-sell arrangements as an unfair attack on closely-held family businesses. In my view, this charge is unjustified. It is true that the existing and proposed legislation dealing with the estate freezes has focused on closely-held family businesses. However, that focus, rather than indicating an intention to discriminate against closely-held family businesses, represents a candid acknowledgment of the fact that more opportunity for manipulation exists in that context and therefore greater scrutiny is required.

In testimony before the House Ways and Means Committee, representatives of the American Bar Association and the American College of Trust and Estate Counsel opposed legislation in this area. Jere McGaffey, testifying on behalf of the American Bar Association, stated, "We believe that the existing regulation [Regulation, section 20.2031-2(h)] issued prior to enactment of Section 2036(c) which prevents the use of buy-sell agreements as substitutes for testamentary devices is adequate to deal with any abuses in this area." My fellow panelist, James Gamble, testifying on behalf of ACTEC, stated, "New rules are unnecessary because these agreements are not normally used as abusive valuation freeze devices; if anyone attempts to use them for this purpose, existing law is adequate to prevent the abuse." John Wallace, testifying on behalf of the American Bar Association, stated that the standard set forth in Regulations Section 20.2031-2(h) "has been successfully applied by the courts to prevent abuses of the normal valuation rules." However, Mr. Wallace did note "If there is a concern that this test is uncertain or not being interpreted properly, then the test could be clarified."

I have enormous respect and admiration for these gentlemen, but I must disagree with their conclusion that existing law is adequate to deal with potential abuse of the buy-sell agreement. The Regulation they have cited provides that the price set in a buy-sell agreement will fix value if the agreement is a

> bona fide business arrangement and not a device to pass the decedent's shares to the natural object of his bounty for less than adequate and full consideration in money or money's worth.

This Regulation, which could be read to say that an agreement will be disregarded if there is any donative element involved, has instead been interpreted in the opposite manner. Courts have held that the price set in a buy-sell will establish value despite an acknowledged donative element so long as some business purpose can be shown. Moreover, maintaining family control of a business has invariably been accepted as a bona fide business purpose, the existence of which essentially trumps the existence of a donative element.[1]

---

[1] See *Estate of Seltzer*, 50 T.C.M. (CCH) 1250, 1252 (1985); *Estate of Reynolds*, 55 T.C. 172, 179 (1970); *Slocum* v. *U.S.*, 256 F.Supp. 753, 755 (S.D.N.Y. 1966), 66-2 U.S.T.C. P12,410.

When examining buy-sell agreements, courts have asked three basic questions to determine whether an arms-length business transaction has occurred. They examine the relationship of the parties, the circumstances surrounding the execution of the agreement, and whether the agreement serves a bona fide business purpose.

As to the first inquiry, the relationship of the parties, the courts seem to examine the question whether arms-length bargaining existed only when the parties involved in the transaction are solely parents, or grandparents, and children on good terms.[2] Agreements between siblings [3] or the participation of a third party [4] appears to be sufficient to satisfy this test.

Second, the courts examine the circumstances surrounding the creation of the agreement. Unless the restrictions cover all transfers both during life and at death, the striking price will not fix value.[5] While courts appear to show some interest in whether the owner of stock is in failing health, in one case where a shareholder was near death due to cancer, the court still viewed the transaction as a business transaction, not as a testamentary transfer.[6] In two other cases in which the decedent was in ill health when the agreement was executed, the courts refused to enter summary judgment against the taxpayer.[7] Negotiations at the creation of the buy-sell agreement are helpful to establish an arms- length bargain, but generally, this is a low hurdle to overcome.[8] The revision of an agreement several times is evidence of arms-length negotiations.[9] Finally, the closer the value under the agreement to the actual fair market value, the more likely the court will find that arms-length negotiating occurred.[10] If the seller in the agreement is a majority shareholder and the corporation itself is involved in the buy-sell agreement, the courts are more suspicious of the arrangement. However, even here, courts have sustained agreements on the ground that the majority shareholder has a fiduciary duty to minority shareholders.[11] While it is not possible to generalize, it is certainly the case that courts have upheld agreement prices for estate tax purposes that are far below fair market value.[12]

---

[2] See *Dorn Estate* v. *U.S.*, 828 F.2d 177 (3d Cir. 1987), 87-2 U.S.T.C. P13,732 (Gift of options from grandmother to grandchildren on her stock void as testamentary). See also *May* v. *McGowen*, 194 F.2d 396 (2d Cir. 1952), 52-1 U.S.T.C. P10,839 (Option from father to son to purchase family business valid as arms length agreement); *Bensel and Driver* v. *Comm'r*, 36 U.S.T.C. 246 (1937) (Gift of options to son valid where father and son estranged personally but worked together in father's business).

[3] See *Estate of Littick*, 31 T.C. 181 (1958) (Agreement valid despite that entered when one sibling had terminal cancer, and that agreement was for 77% of market value). See also *Novak* v. *U.S.*, 87-2 T.C.M. (CCH) P13,728 (Allowing agreement between siblings to define the value at $1,000,750 when fair market value was $1,657,465), but see *Estate of Hoffman*, 2 T.C. 1160 (1943) (Gift of option to buy on death given to brother invalid as he was natural object of bounty).

[4] See *Seltzer*, 50 T.C.M. (CCH) 1250. See also *Weil* v. *Comm'r*, 22 T.C. 1267, 1272 (1954), acq. 55-2 C.B. 10 (Where one of four general partners was unrelated to the other three, the court allowed estate tax value of $172,000, when the fair market value was $710,000, over 400% higher); *Slocum*, 256 F.Supp. 753 (S.D.N.Y. 1966), 66-2 U.S.T.C. P12,410 (Summary judgment for I.R.S. denied where dying father enters agreement with his wife, son, daughter, and an unrelated individual); *Wilson* v. *Bowers*, 572 F.2d 682 (2d Cir. 1932) (valid agreement when one or more participants not in the same family).

[5] See *Estate of Caplan*, 33 T.C.M. 189 (1974) (where decedent could dispose of stock inter vivos with no restrictions, little weight given to option price for estate tax purposes); *Matthews* v. *U.S.*, 226 F.Supp. 1003 (E.D.N.Y. 1964), 64-1 U.S.T.C. P12,222; *U.S.* v. *Land*, 303 F.2d 170 (5th Cir. 1962), 62-1 U.S.T.C. P12,078 (applied to a partnership).

[6] *Littick*, 31 T.C. 181 (1958) (decedent sibling was terminally ill with cancer when agreement made).

[7] *St. Louis County Bank* v. *U.S.* 674 F.2d 1207, 1210 (8th Cir. 1982), 82-1 U.S.T.C. P13,459 (decedent had given some shares to children and grandchildren, but only after suffering two heart attacks did he ask them to enter a stock sale restriction); Slocum, 256 F.Supp. 753, 755 (S.D.N.Y. 1966), 66-2 U.S.T.C. P12,410 (decedent father in failing health).

[8] See *Littick*, 31 T.C. 181 (1958) (Mutuality of agreement enough even though one party terminally ill).

[9] *Bensel*, 36 T.C. 246, 253 (1937).

[10] See *St. Louis County Bank*, 674 F.2d 1207 (8th Cir. 1982), 82-1 U.S.T.C. P13,459 (rejecting summary judgement where option gave stock value of $0, and book value is $200,000). See also *Estate of Curry*, 706 F.2d 1424 (7th Cir. 1983) (Option to buy at book value valid for estate tax purposes as book value greater than market value); *Roth* v. *U.S.*, 511 F.Supp. 653 (E.D.Mo. 1981), 81-1 U.S.T.C. P13,406 (Option price based on formula of recent years' profits acceptable estimate of value); *Dorn Estate* v. *U.S.*, 828 F.2d 177 (3d Cir. 1987), 87-2 U.S.T.C. P13,732 (rejecting option valuation of $20 and $24 for stock publicly traded at $31.44).

[11] See *Curry*, 706 F.2d at 1430-31.

[12] See *Davis* v. *U.S.*, 5 A.F.T.R. 1901, 1903 (Allowing father and son to value father's share of a partnership at 50% of the share's assets). See also *Weil* v. *Comm'r*, 22 T.C. 1267, 1272 (1954),

Continued

Finally, the courts attempt to determine whether a valid business purpose exists. As noted above, maintaining family control of a business has invariably been accepted as a valid business purpose. Because this is virtually always a reason for a buy-sell agreement in a family business, this test is virtually always satisfied. Indeed, a recent district court case held that buy-sell agreements amongst close family members are presumptively valid and the government bears the burden of showing invalidity.[13]

I believe the foregoing cases do not clearly indicate that buy-sell arrangements cannot be used to transfer wealth free of transfer tax. Accordingly, Congress should take this opportunity to clarify the applicable law. In so doing, it should keep the following in mind. There is no inherent evil in a buy-sell agreement pursuant to which the striking price is the fair market value of the property subject to the agreement. When the striking price is less than the fair market value, a transfer for less than full consideration is taking place. The question is whether that increment of value should be subject to the transfer tax. In general, if that striking price has been negotiated in an arms-length transaction between unrelated parties, it represents a bona fide business arrangement and neither will, nor should, be subject to transfer tax. When that increment arises in the context of a transaction among family members, it is suspect and should have to be justified as the equivalent to an arms- length transaction.

In my view, both Section 2036(c) and the Discussion Draft are too stringent. A more flexible rule would provide that agreements or options to acquire property that are entered into between related parties will be ignored presumptively for purposes of determining the value of that property. Any property subject to such an arrangement would be valued at its fair market value determined without regard to the arrangement. The taxpayer would have the opportunity to demonstrate, to the satisfaction of the Commissioner, that the terms of the agreement were similar to those that would obtain in an arm's length bargain. If that were the case, the value determined under the agreement would be sustained.

I recognize that the foregoing rule introduces an element of uncertainty into the planning process. However, that uncertainty is an inevitable by-product of the need to make factual determinations. Moreover, it does not seem an excessive price to pay. One must remember that the tax question arises only because the price under the agreement is below fair market value. If the test can be satisfied, that increment of value will pass to the purchaser free of transfer tax.

The rule also needs to have a number of critical elements fleshed out. For example, the relationships that trigger the presumption must be defined. The effect of unrelated parties must be specified. The effect of a formula that is honestly designed to determine fair market value must be addressed. However, I believe that there will be less pressure on the immediately foregoing factors if the general rule is presumptive and the Treasury is reasonable in exercising its discretion to treat an agreement between related parties as substantially equivalent to an arms-length transaction.

Finally, I would like to make an observation that goes beyond how buy-sell arrangements should be treated. The rule I have just proposed should apply not only to contractual arrangements and options but also to partnership arrangements and corporate capital structures that have the effect of reducing value. Thus, the partnership technique sustained in *Estate of Harrison* v. *Commissioner,* 52 TCM 1306 (1987), would no longer be effective to reduce value artificially. Similarly the value reductions attributable to specialized capital structures, such as those encountered by the Tax Court recently in *Estate of Hall* v. *Commissioner,* 92 TC 312 (1989), and *Estate of Newhouse* v. *Commissioner,* 94 TC 19 (1990), might not be sustained. There is no question that those cases should be addressed in legislation designed to remedy valuation abuses.

---

acq. 55-2 C.B. 10 (Where one of four general partners unrelated, allowing estate tax value of $172,000, when the fair market value was $710,000, over 400% higher). See also *Reynolds,* 55 T.C. 17, 194 (1970), acq. 71-2 C.B. 3 (In family agreement, allowing $100/share valuation when Over-the-Counter market price was $250/share); *Novak* v. *U.S.,* 87-2 T.C.M. (CCH) P13,728 (Where parties were siblings, allowing agreement value of $1,000,750 when fair market value was $1,657,465); *Littick,* 31 T.C. at 187 (1958) (Where parties were siblings, allowing agreement valuation of $200,000 when fair market value was $257,000); *Slocum,* 256 F.Supp. 753 (S.D.N.Y. 1956) (Where one party unrelated to the others, allowing fixed price valuation agreed upon 40 years prior); *May* v. *McGowen,* 114 F.2d 396 (2d Cir. 1956) (In father-son agreement, allowing formula which produced $0 valuation of the business).

[13] *Roth,* 511 F.Supp. 653 (E.D.Mo. 1981), 81-1 U.S.T.C. P13,406.

A LIQUIDITY RELIEF PROPOSAL

As I noted above, one of the principal purposes for a buy-sell agreement is to fix value so that liquidity needs can be anticipated. The planning problem under current law is exacerbated by the uneven relief presently granted to illiquid estates. There seems to be no compelling reason why an illiquid estate (no matter what the source of the illiquidity, be it investment real estate, art works or closely-held business interests) should not be able to elect to defer the estate tax attributable to the illiquid assets, so long as the interest rate charged on the deferred tax is sufficient to equate the present value of the deferred tax liability with the amount of tax that would otherwise be due immediately. The knowledge that illiquidity relief is readily available might alleviate some of the pressure on buy-sell agreements.

JOINT PURCHASES

A joint purchase or property can arise when two or more individuals jointly purchase undivided current interests in property or sequential temporal interests in property, such as a life estate and a remainder. This portion of my statement is devoted to a brief examination of the latter technique, in which the valuation tables may be exploited to enable the full value of property subject to the joint purchase to pass to the remainderman without the payment of an appropriate amount of transfer tax. The technique is also troublesome because the income tax rules governing joint purchases are incorrect and encourage the transaction I am about to describe.

Assume that F and his daughter D want to purchase Blackacre, a parcel of non-income producing investment property, for $1,000,000. F agrees to purchase the income interest for his life and D agrees to purchase the remainder. At the time of the purchase, F's life estate is worth 75% of the value of the entire property and D's remainder is worth 25%. F contributes $750,000, D contributes $250,000 and they purchase the property. The property never produces any current income and at F's death after 10 years it is worth $2,000,000. The entire value of the property passes to D, who has paid $250,000 without the payment of any income tax by D or transfer tax by F. That is quite a transaction.

The transfer tax issue is easy to see. The value of the respective interests of F and D at the time of the purchase were determined by assuming that F would receive an annual return on his investment. In fact he never received a penny. All the economic income from the property was reflected in unrealized appreciation that accrued for the benefit of D. The transfer tax issue could be cured by providing that the annual difference between the assumed yield of the Tables and the actual amount included in F's income would be a gift from F to D. Alternatively, the transaction could be treated as it is under the Discussion Draft.

The income tax issue is also easy to see. The value of D's remainder interest increases each year as the actuarial probability of possession increases. Yet, under current law that increase in value is not taxed as it accrues or when D comes into possession of the property. This narrow problem could be cured by applying the rules of section 1286 to the transaction. The joint purchase is, in economic effect, analogous to a stripped bond. The life income interest is the equivalent of the coupon and the remainder interest is the equivalent of the bond. The stated redemption price at maturity would be the original purchase price of the jointly purchased property. The term of the "bond" would be the term of the income interest (if a life estate, it would be the life expectancy of the holder). The effect would be to tax D under the OID rules for the increase in value of her remainder interest attributable solely to the passage of time. The increase in value attributable to market forces would be taxed under normal realization principles when D disposes of the underlying property.

CONCLUSION

To the extent Congress now chooses to address transfer tax valuation issues, all methods of exploiting valuation rules should be examined. Any legislative solution must encompass business capital structures as well as contractual arrangements that potentially exploit those rules. The overriding difficulty in crafting a solution to abusive valuation techniques is to distinguish between those arrangements that serve legitimate business purposes and those that do not. This is especially important in the context of closely-held family businesses where the usual mechanisms to deal with legitimate concerns also contain the seeds for abuse. One must be scrupulous in devising rules that do not discriminate against closely-held businesses when the activity undertaken by those entities is similar to that undertaken by unrelated third parties.

I will be pleased to answer any questions.

PREPARED STATEMENT OF MARK S. HAYWARD

Dear Mr. chairman and Members of the Finance Committee: I am pleased to appear before you as the Acting Chief Counsel for Advocacy, U.S. Small Business Administration, to testify on the replacement proposals to Section 2036(c) of the Internal Revenue Code (2036(c)). I am accompanied by the Assistant chief Counsel for Tax Policy, Office of Advocacy, Dan Mastromarco. As you know, the Treasury Department is the spokesman for the Administration on tax issues. My views are those of the Chief counsel for Advocacy and do not reflect those of the Administration.

This Committee's continuing interest in 2036(c) confirms the view of small business that the case for replacement has been well established. Section 2036(c) has made the estate and gift tax laws unworkable in the family business context, and there is a need for more than technical correction. In addition to achieving its objective of quashing the possibility of estate planning abuses, 2036(c) prohibits common transactions for transferring business assets, favors families whose wealth is represented by marketable securities over those who own small businesses and farms, discourages childrens' involvement in family businesses, and dramatically increases the costs of transferring ownership.

Perhaps more than any other tax issue this legislative year, 2036(c) has commanded the full attention of small business. We are no longer confronted with the question of whether or not the law needs changing: we are confronted with the question of how best to strike a balance between enforcement and business concerns.

I commend the Finance Committee, the Ways and Means committee and the Department of Treasury for working to fashion a replacement proposal. This process is readily distinguishable from the process by which 2036(c) was originally developed. In the absence of meaningful opportunity for debate, the business community often finds itself before the tax-writing committees, seeking change in laws which had unforeseen effects. And this committee must then work towards modification, with the attendant time and budgetary considerations, after initial damage is done.

It is my hope that the good faith efforts which have characterized the development and consideration of these replacement proposals thus far are instructive of future policy debates.

I. THE ANTI-FREEZE RULE OF I.R.C. 2036(C)

Section 2036(c) was enacted as section 10402(a) of the Omnibus Budget Reconciliation Act of 1987 and was broadened by section 3031 of the Technical and Miscellaneous Revenue Act of 1988. Its purpose was to prevent circumvention of the estate and gift taxes through the misvaluation of assets.

Technically, 2036(c) applies if a business owner "in effect" transfers an interest having a disproportionately large share of the potential appreciation in the business while retaining an interest in the income or rights of the enterprise. Section 2036(c) then serves to pull the value of the appreciated interest back into the estate, potentially many years after the rights to future appreciation were transferred. If the transferor continues to hold the retained interest until death, the value of the transferred property will be included in the transferor's estate. If the transferor's retained interest terminates or if the transferred property is disposed of outside the transferor's family, the value of the transferred property will be treated as a deemed gift. The effect of 2036(c), in either case, is to tax the post-transfer appreciation from the time of such transfer to the time of the terminating event.

In general, in order for 2036(c) to apply four conditions must be met. An individual must: (1) own, directly or indirectly, at least 10 percent of the voting power or income stream in an enterprise; (2) effectively transfer a disproportionately large share of appreciation in the enterprise; (3) retain a disproportionately large share of the income of, or rights in, the enterprise; and, (4) own the retained interest at death or transfer that interest within three years of death.

In an attempt to stop valuation abuses, many common estate planning devices, such as stock recapitalizations, were the target of 2036(c). In a typical stock recapitalization, a portion of the parent's common stock was converted into preferred and the remaining common stock was given or sold to the children. The common stock, which was given or sold to the children, was assigned all future appreciation in the business; the preferred was assigned fixed liquidation and dividend rights. If the transaction were properly executed, upon the parent's death, the preferred stock would be redeemed for liquidation value, the children would obtain control and appreciation would be received without tax consequence. Under 2036(c), however, the

value of the appreciation after the transfer will be taxed as part of the decedent's estate, regardless of the hand of the children in generating that appreciation.

Stock recapitalizations and other "estate freezes" had favorable tax implications, since they allowed appreciation of the business after the recapitalization to avoid estate and gift tax. These taxes could be imposed at a rate of between 18 percent to 60 percent. "Freezes" also were popular because preferred stock provided retirement security, the parents retained legal control through voting rights, children were given an incentive of appreciation attributable to their efforts, and estate taxes were determinable in advance.

There was nothing illegal about these transactions. The Unified Transfer Tax Act and subsequent case law had long permitted shifts in future appreciation. The straightforward "freeze" offered businesses a legitimate tool for estate planning. However, there was a perception that many "freeze" transactions were abusive in other than arms-length contexts because the gifted or retained interest, if improperly valued, could evade notice until a significant time after the transaction took place. More specifically, limited preferences, discretionary rights and other "bells and whistles" could be utilized to undervalue property for transfer tax purposes. The potential for "abuse" also existed because discretionary action or inaction by the transferor with respect to the retained interest might shift wealth without estate or gift tax consequence. For example, the failure to issue dividends on noncumulative stock would enhance the value of the corporation—its future appreciation.

II. SECTION 2036(C) EFFECTS: EXISTING DATA

The exact impact of the provision on businesses is difficult to quantify from existing data sources. In order to measure the number of businesses affected by the provision in a given year, we would need to know at a minimum: (1) the number of businesses with more than $600,000 in assets; (2) that are family run; and (3) that are intended to be passed along to family members. A look at the number of businesses likely to be affected by the estate-taxes, and the number of family-owned businesses helps us to understand the impact of 2036(c). And what we do know suggests that the potential effects of the provisions are substantial.

First, we know that there were about 283,000 partnerships and 133,000 non-farm sole-proprietorships in 1986 with greater than $500,000 in assets. Additionally, there were about 302,000 corporations with greater than $1 million in assets in 1986. Hence, as of 1986 there were, as a rough approximation, 718,000 businesses with assets substantial enough to be subjected to estate taxes. The number of businesses within these asset classes are expected to be greater today, given normal growth assumptions and the failure of current law to index an exemption for estate taxes. Moreover, because the estate tax laws apply to the devolution of all wealth, the personal assets of a business owner must be combined with the business assets to determine if the estate tax threshold is exceeded. This would cause our estimates to increase greatly.

Second, recent data derived from the National Survey of Small Business Finances, sponsored by the Board of Governors of the Federal Reserve and the Small Business Administration, indicates that about 57 percent of all partnerships and about 80 percent of all corporations in the Dun's Market Identifier file of 3.5 million firms are family-owned. Applying these percentages to the approximations of affected corporations and partnerships, we estimate that 164,000 partnerships and 242,000 corporations are potentially affected by 2036(c).[1]

III. A REPLACEMENT PROPOSAL: BROAD CONSIDERATIONS

Before this Committee undertakes the task of developing a replacement proposal, it should recognize the nature of the problems which have led us to this point. The grass roots efforts to repeal 2036(c) by the business community have not been grounded in a desire to merely resurrect a tax avoidance device. The issues before this Committee are more fundamental, and go to the heart of tax policy debate over the imposition of estate taxes on business assets.

The question over the proposed structure of the replacement provision to 2036(c) should appropriately be divorced from the more philosophical question concerning the concentration of family wealth. The principal justification of estate and gift taxes is not to raise revenue, but to place limitations on the concentration of wealth upon the taxable event that separates that wealth from its owner. The effect of imposing estate taxes on active trade or business property is inherently different from the effect of imposing such taxes on personal assets. Unlike taxing the devolution of

---

[1] These figures are derived from the 1986 IRS Statistics of Income.

wealth in the for of collectibles, publicly traded securities or cash, the taxation of businesses can affect the ongoing concern of the business and it can dismantle a successful economic unit that has succeeded in innovating, generating jobs and last but not least—paying taxes.

At a minimum, four broad considerations should guide the Committee in the development of the replacement proposal. First the replacement must be limited to areas of known abuse. Revenue considerations do not justify expansion of an anti-abuse mechanism to transa tions which are not abusive. Second, the replacement mechanism must be flexible, and should strike the balance between enforcement and business concerns with regard to the preeminence of neither. It should not require businesses to forgo sound business and family planning in order to comport with onerous or complex tax rules. Third, the proposal must be equitable as applied to businesses in different industries, in different growth phases and of different sizes. Finally, the Committee must recognize that the ability of a firm to transfer future appreciation must remain intact: it is often the only way a business entity can be transferred from one generation to another.

IV. THE SCOPE AND OPERATION OF THE REPLACEMENT PROPOSALS

The proposals before this committee will be analyzed fully by the Treasury Department, which is the spokesman for the Administration on Tax Policy matters. However, I would like to briefly outline the scope of the proposals from the small business perspective, with special emphasis on the Way and Means proposal.

A. The Ways and Means Replacement Proposal

In sum, the Ways and Means Committee proposal is broad, encompassing trust and buy-sell agreements, in addition to recapitalizations. The basic purpose of the proposal is to require all value to be run through the transfer tax system, by the application of either gift or estate taxes. To accomplish this, the proposal creates a system for immediately valuing the amount of a gift, and for ensuring that the assumptions leading to the valuation of that gift are adhered to throughout the time the transferor retains the interest. The operation of the proposal as applied to recapitalizations, Grantor Retained Income Trusts and typical freezes encompassed by 2036(c) can best be understood when broken down into three levels: (1) determination of the gift at the time of the original transaction; (2) determination of estate or gift tax treatment during the firm's existence; and (3) reconciliation of the interests at death. At the outset of the transaction, the amount of the gift commonly referred to as (the residual interest) is valued as the difference between the retained interest and the value of the business.

In determining the value of the retained interest, voting rights or rights in the same or junior class of stock will be considered; however, all discretionary rights will be assigned a zero value. Only the value of the income stream to "qualified fixed payments" (QFPs) will be considered to have positive value if the retained interest has preference rights over any rights under the transferred interest. QFPs in a partnership or corporate context would include payments or distributions fixed as to time and amount, such as cumulative dividends. In the case of trusts, QFPs are a fixed amounts payable at least annually and which are either a fixed percentage of the trust's assets or a noncontingent remainder interest if all other interests in the trusts are QFPs. All discretionary rights retained by the transferor, therefore, will be assumed to be worthless under the proposal, and will not enhance the value of the retained interest. One purpose of this rule is to ensure that the value of these rights escape transfer tax.

The proposal would permit the business to fix the QFP rate of return. Allowing the firm to fix the rate of return is not an invitation to abuse because the assignment of a low rate of return on the retained interest will reduce the value of the retained interest and increase the value of the transferred interest, with greater gift tax consequences. Alternatively, the assignment of a high rate of return on preferred will cause the value of the preferred to be greater than the gift, with greater estate tax consequences.

Assuming there is no fixed period of redemption, the QFP income stream will be valued as if it were payable in perpetuity. The value of the residual interest will be the relative value of the firm which the rate of the qualified fixed payment bears to a benchmark rate. The benchmark rate, which is not established in the proposal, is supposed to approximate the opportunity cost of the residual interest, i.e. what that interest would fetch in the open market for a similar investment. However, the lower this rate is set, the more possible it is to maximize the transfer of the future appreciation. For example, if a condition of the transfer of future appreciation by the transferor was that the transferor would receive a 5 percent cumulative divi-

dend, and the benchmark rate were 10 percent, the transferor has gifted an interest equivalent to 50 percent of the value of the firm. In no event can the transferred value be less than 20 percent of the sum of the total equity in the corporation or partnership and any debt which the corporation or partnership owed to the transferor or members of the transferor's family. This is meant to establish the minimum "option value," reflecting the amount an arms-length purchaser would pay for the right to receive future appreciation.

The second level of the proposal ensures that the firm or the trust actually pays out the QFP at the assumed rate. The approach will permit a partnership or corporation to pass (not to pay) QFPs for three years after the due date, as long as the firm makes those payments up. If the fir fails to make the payment upon the expiration of three years, the transferor will be treated as making a gift of the unpaid QFP, unless the instrument provides that the missed payment will bear compound interest at the assumed discount rate or unless the fir is insolvent or bankrupt. A trust will have 65 days from the end of the trust year to make the QFP.

At the third level, the proposal provides rules for reconciling the value of the interests upon disposition to a third party. If the rights that were previously valued at zero are later transferred, the value of the later transfer will be reduced by the amount by which the original gift was increased. In the case of dispositions of the rights to receive QFPs for greater value than assumed under the special valuation method, the excess will be treated as a gift.

The proposal would provide special rules in the case of buy-sell agreements. For buy-sell agreements the option price would have to be determined under a formula which had been reviewed within three years of the exercise of the option. Moreover, the value of property subject to other options, rights of first refusal and leasehold rights held by family members would be determined without regard to such options of rights.

B. The Chamber of Commerce Proposal (June 27, 1990)

The Chamber of commerce (chamber) proposal generally follows the core of the Ways and Means proposal by providing for Qualified Nondiscretionary Payments, similar to QFPs. However, the Chamber proposal is more narrow in scope and more liberal in important respects. The Chamber proposal, for example, (1) permits a ten percent option value; (2) an exception from the deemed gift rule for firms which have insufficient profit to make a dividend.

Among its salient features, the Chamber proposal would limit the application of special valuation rules to transfers of interests in a 50 percent-owned entity,[2] not a ten percent-owned entity. With regard to transfers of preferred interests in a 50 percent-owned entity, the Chamber proposal would determine the value of the preferred interest by assuming that discretionary rights, such as liquidation, conversion, put, call, or other rights to payment or distribution which are at the discretion of the transferor, would be worthless. In addition to listing rights that are given a zero value, the Chamber proposal lists rights which are to be valued under existing principles; including, interest in the same class, minority discounts, junior rights, buy-sell options, employment agreements, debts or leases and payment rights subject to exogenous factors, such as profit or market rates.

The term "qualified nondiscretionary payment" under the Chamber proposal means any payment or distribution nondiscretionary as to both time and amount or any dividend payable under cumulative or noncumulative stock to the extent the rate is nondiscretionary.[3]

As under the Ways and Means proposal, a waiver mechanism is provided under the Chamber proposal. A transferor may elect to treat any payments as not qualified nondiscretionary payments. Additionally, however, the transferor or his or her spouse may elect to treat payments as nondiscretionary by specifying the amounts and times at which such payments or distributions shall be made.

As under the Ways and Means proposal, the Chamber proposal would generally require payments which are missed (here nondiscretionary payments) to be deemed gifts to the junior interest holders unless: (1) the payments are made within three years following the calendar year in which such payment was due; or, (2) the firm is

---

[2] A 50 percent or more-owned entity means an entity under Subchapter C that has 50 percent or more of the stock in such corporation or taxed under Subchapter K that has 50 percent of more of the value of the capital or profits. The transferor is treated as holding any interest held by the transferor's spouse, or lineal antecedent, but will not include an entity for which market quotations are readily available on an established securities market.

[3] Note: An amount subject to a life contingency is not a qualified nondiscretionary payment. This restriction may be unnecessary under IRC 2036(a).

insolvent or bankrupt. Additionally, however, the Chamber proposal would allow the firm to miss such payments without gift or estate tax consequence if the firm had inadequate earnings and profits. Inadequate earnings and profits are defined to be earnings and profits plus compensation paid to family members.[4]

C. The District of Columbia Bar Association Proposal

The District of Columbia Bar Association (D.C. Bar) proposal, which has not been reduced to legislative language, would generally apply procedural rules to all transactions covered under current 2036(c) (i.e. where the transferor or the transferor's family owned before completion of the transfer more than 10 percent of the enterprise) The salient features of the proposal are to: (1) require greater disclosure by the taxpayer of "freeze" transactions; (2) provide certain valuation procedures; (3) extend the statute of limitation for audit; (4) provide a mechanism for taxpayer requested IRS review of valuations; and, (5) provide for an undervaluation penalty.[5] More specifically, the proposal would require inter-vivos transfers to be contemporaneously reported by the transferor on an annual return; and such transfers would also be required to be reported on the estate tax return.

As it applies to valuation rules, the proposal would add two features. First it would not permit minority discounts for family transfers, unless the retained and transferred interests combined would have qualified for minority discounts. Second, it would allow taxpayers and the IRS to ignore Treasury actuarial tables in the event the income or mortality tables do not substantially comport with experience.

The Service will also have until the later of (1) six years after the date the gift tax return was to be filed, or (2) two years after a taxpayer request for reviews, in which to make an assessment. If the Service fails to do so and was adequately informed of the transaction, the Service will be precluded from challenging the value for gift tax purposes and will have the burden of proof in challenging estate tax values. To provide taxpayers certainty as to tax results, the proposal would allow the taxpayer to request an audit of the transaction within one year of a 2036(c) freeze transfer.

D. The ABA and The ACPC Proposal

The American Bar Association and the American College of Probate Counsel (ABA-ACPC) proposal, which has also not been reduced to legislative language, provides for: (1) certain valuation assumption rules; and (2) a safe-harbor for small business transfers.

The ABA-ACPC proposal will be limited to nonpublic [6] corporate and partnership interests in the family context; [7] not to "enterprises" as under current law. Under the proposal's valuation assumption rules, discretionary rights, such as discretionary conversion, liquidation or dividend rights, are valued in order to maximize the gift. These discretionary rights will be assumed not to be exercised in a manner disadvantageous to the donee.

Under the proposal's safe harbor, a junior interest will not have a value less than its stated liquidation amount if: (1) it bears a cumulative compound dividend with a rate not less than the relevant Applicable Federal Rate (AFR) at the time of the gift. However, the preferred must have a stated liquidation amount that is less than 80 percent of the value of all outstanding preferred. There must be a stipulation that if there is an arrearage of the preferred income for 36 months, the preferred interest shall obtain voting-control, but the proposal differs from the W & M proposal in not requiring deemed gifts.

V. POSITIVE ATTRIBUTES OF THE WAYS AND MEANS PROPOSAL

The W & M discussion draft has several advantages over 2036(c). Most importantly, the proposal recognizes the legitimacy of transfers of future appreciation; it does not eliminate the use of recapitalizations. To the extent the value of the common stock can grow at a rate exceeding that paid out in QFPs, appreciation will be removed from the estate without transfer tax consequence. The proposal also correctly recognizes that the problem which has given rise to 2036(c) was one of valuation. In the effort to solve the valuation problem, the proposal advances a gift tax solution

[4] However, provided the firm in each of the three years prior to the creation of the instrument on which the nondiscretionary payments are based, has earnings and profits equal to 150 percent of the qualified nondiscretionary payments.

[5] Comparable to that of IRC Section 6622(g).

[6] Suggested definition would exclude those regularly traded on an established securities market or held by 500 or more persons throughout the taxable year.

[7] Issue of the donor or the donor's spouse and issues.

to a gift tax problem—not an estate tax solution as current law. Assuming some guidance is forthcoming on the market testing rate, it would be possible under the proposal to determine gift tax liability the moment a recapitalization or other transaction effecting a traditional "freeze" is consummated.

Additionally, the proposal would permit the favorable assumption, as applied to QFPs, that such payments will be made, and made in perpetuity. This will serve to increase the value of the retained interest and decrease any gift tax liability. The proposal also provides some leniency for a business which is having difficulty meeting the QFPS: it permits a grace period of three years in which to pay out the cumulative dividend and forgives businesses in insolvency or bankruptcy from payment of the QFP.

VI. REMAINING PROBLEMS WITH THE WAYS AND MEANS PROPOSAL

Despite the W & M proposal's advantages, however, several problems remain. First, the proposal is overly broad. The IRS has not made clear from disclosed Taxpayer Compliance Measurement Data or other audit indicia exactly what types of transactions have afforded the greatest abuses, whether these transactions involved personal assets or business, and the extent of the abuses. Nevertheless, the proposal is premised on the assumption that a significant and growing problem exists in the business context, and that this problem extends to buy-sell agreements as well as traditional recapitalizations. The proposal should be limited to those transfer devices which IRS compliance data affirmatively indicate are the crux of the problem. The use of buy-sell agreements, for example, is common among small businesses; not because they are necessarily motivated by tax avoidance, but because they have allowed families to fix the value of transferred interests at an early stage, and plan in advance for the imposition of estate taxes. Insufficient evidence has established that substantial abuses exist in the utilization of buy-sell agreements which would not be attackable under pre-Section 2036(c) law.

Second, a firm is not given sufficient leeway to avoid the payment of a dividend in cases where no increase in the value of the residual interests results. The three exceptions provided under the deemed gift rule: first; for firms in bankruptcy or insolvency; second, for firms which pay the dividend within three years; and third, for firms which provide that the dividend be compounded, is a good attempt to address the problem, but not a solution. The arbitrary deemed gift rule is still problematic because it assumes that the failure to pay a "QFP" automatically results in the transfer of equivalent value to the residual interest, when this assumption may not hold true.

For publicly traded securities, cash or other liquid assets placed in trust, a mandatory payment rule may not present great problems. However, downturns in the economy, downturns in the industry, the loss of a significant customer and other factors can cause firms to have difficulty adhering to their fixed payment rate. And the problem is not just a question of equity; it is a question of efficiency: A firm may need working capital to meet competition or to grow into new markets.

Third, the proposal assumes an arbitrary value of a junior equity interest—the value of the residual interest—at 20 percent of the sum of the equity of the business plus any debt owed by the business to the transferor. This 20 percent floor reflects the assumption that the option to receive future appreciation in a company is always worth at least 20 percent of the value of the company. There are at least three problems with this assumption: (1) it ensures that a firm will gain no benefit from approximating the market testing rate (whatever that is) as closely as possible; (2) it sets an arbitrarily high price for the option value; and, (3) it improperly includes debt in the calculation.

As noted in an earlier section, the determination of the relevant percentage share of the residual interest is determined by permitting a firm to fix a rate of return for QFPs and by assuming that QFPs will be paid in perpetuity. Under this approach, the ratio of the value of the retained interest to the transferred interest will reflect the ratio the QFP bears to the yet-to-be-determined market testing rate. The purpose in setting this ratio is to reflect the opportunity cost of the slower income stream when compared with a reasonable market rate of return.

However, the establishment of a minimum option value at 20 percent may be inconsistent with the theoretical basis of the proposal: that no gift occurs if the return on the retained interest reflects the market rate of return. The closer the firm gets to the appropriate market testing rate, the more the transaction is arms-length; something which ought to be encouraged. Under the 20 percent arbitrary rule, though, a firm will gain no benefit from setting the QFP any closer than 80 percent of the market testing rate. Moreover, the arbitrary floor for firms with high earnings and low appreciation rates will be set too high. This is the converse of the prob-

lem experienced by firms with low asset to earnings ratios which must approximate the market testing rate to avoid the imposition of substantial gift taxes. The inclusion of debt in the calculation does not appear to be desirable. Since small firms routinely have family debt, this provision may prohibit recapitalizations in ordinary circumstances.

Fourth, the proposal fails to define the parameters of an acceptable market testing rate, which, if too high or if inflexible would be punitive for some small firms. The rate which is assumed to be the testing rate can regulate the ability of a firm to use QFPs and transfer future appreciation. Imposing an inflexible benchmark rate can lead to serious inequities, depending upon the differential between the firm's assumptions of an acceptable QFP rate and the market testing rate. Under the proposal, the amount of the gift determined at the time of the initial transaction will be based on the relative ratio of the assumed pay out rate to some benchmark rates: the larger the differential between the two, the greater the immediate gift. If the potential pay-out of earnings is low, the gift will be high, irrespective of the ability of the firm to approximate the benchmark rate or of the firm's liquidity at the time of the transaction. Indeed, firms least likely to pay-out a high QFP (and therefore more likely to be subject to an immediate gift tax) may be doubly disadvantaged: they may be the firms most illiquid and least able to survive a heavy gift tax.

Many external factors can influence the firm's ability to pay QFPs at a specified rate. These factors, as noted, include economic conditions and the firm's individual health. Additionally, the earnings rate will be influenced by firm size, location and industry. Indeed, our data suggests substantial fluctuations in earnings rates across firm sizes and industries. For example, by taking certain industries at random, we determined that manufacturers of food and kindred products and fabricated metal products averaged a return on equity of approximately 10 percent in 1984.[8] This differed from industries such as manufacturers of electrical and electronic equipment, which averaged a return on equity of 12 percent. Also within the electrical and electronic equipment manufacturers industry, wide discrepancies existed across firm sizes. Firms with between $500,000 and $1 million in assets indicated a return on equity of negative 4 percent, whereas firms with between $25 million and $50 million in assets posted a return of 21 percent.[9]

These fluctuations in earnings rates are merely illustrative of those found across firm sizes and industries.[10] owners of small businesses with low earnings to asset ratios who wish to pass their business along to the second generation will be faced with an ultimatum; (1) pay an immediate gift tax which represents a significant portion of the estate; or (2) pay a dividend above the rate sound business planning would dictate. Payment of the dividend at a higher rate may detract the firm's ability to expand and to compete.

VII. SUGGESTED MODIFICATIONS TO THE WAYS AND MEANS PROPOSAL

First, the proposal should be narrowed to address areas of known abuse. The proposal, for example, should not propose a separate valuation system for buy-sell agreements and should not extend to joint purchases. It should merely provide that buy-sell agreements are one factor which may be taken into consideration to establish value, but are not conclusive as to value. This approach would be consistent with the existing regulations. The Chamber proposal and the ABA-ACPC proposal sufficiently limit the application of the anti-estate freeze provision by excluding joint purchases and buy-sell agreements. These proposals address only standard recapitalizations. Moreover, the Chamber proposal is limited to 50 percent-owned C corporations and partnerships. We favor this more limited approach.

Second, the proposal must provide greater leeway for a firm to avoid a QFP in the case of business exigencies. The ABA-ACPC proposal does not contain a deemed gift rule, but would require payment at the AFR, sanctioned by a change in voting rights. The District of Columbia Bar proposal does not contain a deemed gift rule, and therefore does not address this issue.

A mechanism could be developed that would allow limited exceptions from the arbitrary rule in the W & M proposal, without jeopardizing the integrity of the pro-

---

[8] According to the 1954 Statistics of Income.

[9] Lesser fluctuations can be seen in the data on food and kindred products, where a firm with between $500,000 and $1 million in assets had a return on equity of less than 2 percent while firms with $50 million to $100 million had a return of 14 percent.

[10] These fluctuations are indeed recognized by IRS Rulings as a reasonable basis for determining differing valuations of business based on cash flow. See, Revenue Ruling 68-609; Revenue Ruling 59-60.

posal.[11] The approach might contemplate a mechanism whereby a firm can pass upon a QFP for valid business reasons, as it might do in an arms-length transaction. One possible solution, as advanced in the Chamber's proposal, would be to permit the firm to pass on a QFP if insufficient profit would enable the payment of a dividend. The Chamber proposal offers a favorable solution by proposing that the deemed gift rule not apply if the sum of the entity's earnings and profits plus compensation paid to family members is less than the QFP.[12]

Third, the proposal should not establish an arbitrary option value of 20 percent and should not include debt in that calculation. The option should not be assigned an arbitrary floor value at all, or in the very least the floor should be lowered to 10 percent. Reducing the assumption of the arbitrary value of the residual interest from 20 percent to 10 percent will not solve the theoretical inconsistency; however, it will reduce the practical problem. As noted, the ABA-ACPC proposal does contain a 20 percent arbitrary floor. However, the Chamber of Commerce would reduce the option value to 10 percent and exclude debt, while the D.C. Bar proposal would assign no arbitrary minimum value.

Fourth, the proposal must define the parameters of an acceptable market testing rate in a flexible manner, and should establish those rates at the lowest acceptable levels given revenue considerations. One possibility, would be to publish a table of acceptable rates on a yearly basis, that would differ by broad industry classifications. Another solution might be to permit a variable market rate by allowing firms to reference the prime rate or other published rate. In any event, market rates should be discounted due to the nondeductibility of the payments at the firm level. The W & M and Chamber proposals do not address the issue of a market testing rate. However, the ABA-ACPC would set that rate at the AFR, which is an example of the inflexibility that should be avoided.

Fifth, the replacement proposal should make necessary strides towards simplification. This can be accomplished in several ways. As indicated earlier, the proposal is too broad, and should be narrowed by excluding joint purchases and buy-sell arrangements along the lines of the Chamber and ABA-ACPC proposals. If the Committee wants to address joint purchases or buy-sells, it should do so in a separate proposal. Also Section 2703(c)(2) continues the "in effect transfer" concept of Section 2036(c) and enlarges its scope. The meaning of this clause is unclear and will generate much case law. Last, the proposal Creates new family attribution rules. These attribution rules are different from that specified in Sections 318 and 267 and other areas of the Internal Revenue Code. The proposal could be simplified if the attribution rules of Section 318 are applicable, as under the Chamber proposal.

CONCLUSION

Section 2036(c) should be seen by this Committee for what it was intended to be: a device to assist the IRS in correcting valuation abuses in recapitalizations. It should not seek to accomplish this objective by prohibiting common sense transactions; or, by invoking a legislative panacea to enforcement concerns.

Again, Mr. Chairman, I greatly appreciate the opportunity to discuss this important issue. I commend this Committee for working to seek an alternative to 2036(c). I am hopeful that these efforts will be reflected in the solution to IRC Section 2036(c) and be representative of the method by which solutions to other potentially divisive issues are found.

PREPARED STATEMENT OF IDELLE A. HOWITT

I. INTRODUCTION

Mr. Chairman and Members of the Committee, on behalf of American Appraisal Associates, Inc. ("AAA"), we thank you for the opportunity to testify before you

---

[11] We appreciate the administrative difficulty the Service anticipates in enforcing a broad exception to the deemed gift rule. Moreover, we recognize that the concept of a QFP is integral to the proposal since it is the means by which the proposal ensures that the initial payout assumptions that determined the gift amount are followed. Nevertheless, we believe that the inequities and inefficiencies that would result from an arbitrary rule justify further efforts towards an escape mechanism.

[12] It should be noted in connection with the Chamber's suggestion that a related solution has been contained in the proposal because the proposal already permits the income stream of a QFP to be determined by specific reference to the sales, profit, production or output of a business, so long as the payment is nondiscretionary.

today. For the benefit of those who may be unfamiliar with AAA, I would like to introduce our firm and its representatives who are here with me today.

My name is Idelle Howitt, and I am the National Director of ESOP Services for American Appraisal. With me today is Michael S. Megna, Senior Vice President and Chief Operating Officer of American Appraisal. Also present are Kenneth O. Miller and William F. Pittock from our Wall Street office who collectively have over twenty-five years of experience in the valuation of closely held securities. The Wall Street office has been dedicated primarily to the valuation of closely held securities for almost sixty years.

AAA was founded in 1896 and is based in Milwaukee, Wisconsin. Today AAA is the world's largest and oldest valuation firm with offices in thirty two cities throughout the United States and in nineteen other cities throughout the world. Each year AAA values more than $100 billion in assets for over a thousand clients. A significant number of these valuations have involved closely held businesses and blocks of securities in connection with estate and gift tax purposes, including estate freezes, ESOPs and many other transaction related purposes.

We are very pleased that the staff of the Committee invited us to testify before you today. We hope that sharing our views based on day-to-day business experience will be helpful to you in your analysis of estate freeze valuation issues.

We agree that Section 2036(c) should be abolished, and we believe that the discussion draft under consideration represents a positive step toward developing an alternative. We wish to share with you specific concerns that we have with selected portions of the draft that address valuation. For purposes of today's hearing, we shall highlight the following three issues: (1) the treatment of omitted dividends as deemed gifts, (ii) the 20 percent minimum rule for the retained common interest, and (iii) the formula approach for valuing securities subject to a buy/sell agreement.

II. EFFECTIVENESS OF DISCUSSION DRAFT

A. Deemed Gift Issues

1. Omitted Dividend

The characterization of deemed gifts does not recognize legitimate business purposes for which dividend payments to shareholders are omitted or postponed. In light of increasingly adverse economic conditions and the limited availability of credit for business, some companies may need to conserve cash to keep their businesses afloat. Such conditions are not necessarily limited to three years as provided in the deemed gift provision—especially for cyclical companies. Indeed, the Bible recognized extended business cycles when it spoke of seven lean years following seven fat ones.

Attached to my testimony as Appendix A are recent examples of publicly owned corporations whose dividends payments on their cumulative preferred stocks have been suspended for more than three years.

This list includes Chrysler Corporation which you may recall suspended dividends on its cumulative preferred stock for a period of four years from December 1979 through September 1983. No one would claim that the preferred shareholders of these corporations such as Chrysler made gifts to their common stockholders. In fact, to have suggested the application of such a rule as this one would have caused more than a little disruption on Wall Street and on Main Street.

2. Compounding Issue

We also have serious reservations about the proposal to compound accrued, but unpaid, "qualified fixed payments" (QFP's).

The potential negative impact of characterizing omitted dividends as gifts is magnified when such unpaid dividends are accumulated at a compound interest rate. This proposed rule would impose a particular hardship on the common stockholders who would, in effect, be subsidizing these fixed payments to the extent of any compounding. AAA feels that family owned corporations should not be singled out and subject to such onerous rules.

3. The Ten Percent Rule

We also are concerned that a threshold of ten percent is too low for the purpose of defining a family corporation that is subject to these valuation rules. For example, there are many public corporations of which more than ten percent of the stock is owned by a single family. Among the corporations listed on the New York Stock Exchange whose names begin with "A," there are 19 such examples. (See Appendix B)

Although a ten percent owner of a public company may have control because of the dispersion, diversity, and actual number of other shareholders, a ten percent owner of a closely held business is rarely in a position to wield control over general corporate matters, much less to implement an abusive recapitalization.

The proposed ten percent rule is particularly unfair because it includes debt in the calculation of an interest. AAA believes that the threshold percentage should be based on equity alone and should correspond to the percentage required for corporate control defined by applicable state law, always in excess of 50 percent.

III. THE 20 PERCENT RULE

The 20 percent value rule, limiting past recapitalization of common equity to a minimum of this amount, is unreasonable. Since it applies to the total of both equity and debt, it is inherently fraught with the potential for mischief since an entity could otherwise control contribution limits merely by borrowing money. If a lower limit of value needs to be imposed on junior equity, it should be based on a percentage of equity alone.

IV. BUY/SELL AGREEMENTS

The draft permits the use of a valuation formula for buy/sell agreements if it is reviewed every three years.

At the risk of sounding self-serving, a valuation formula will not yield as accurate a determination of value as an independent appraisal. Moreover, a valuation performed contemporaneously with the valuation/transaction date is more accurate than a valuation calculated on the basis of a formula devised three years previously.

We believe that reference to the process for valuing closely held securities in connection with ESOPs would be instructive. As a result of consideration by the Congress, the Internal Revenue Service and the Department of Labor, annual valuation updates by an independent appraiser are required.

Congress also requires appraisals for the valuation of closely held stock with respect to charitable contributions. Under Section 170, an independent appraisal is required in order to claim a deduction for a charitable contribution of closely held securities. Moreover, the value must be determined within 60 days of the transaction date.

The valuation requirements for closely held securities should be consistent throughout the estate and gift tax provisions of the Internal Revenue Code. The establishment of different methodologies undercuts the concept of fair market value, necessitating multiple valuations, and making tax planning unnecessarily difficult and costly.

V. VALUATION OF STOCK

I would like to illustrate the application of appraisals to estate planning by describing how closely held securities are valued.

In the context of estate freeze transactions, valuation of preferred and common interests are interrelated. The exercise usually begins with the valuation of all the equity in the firm. The client may suggest the desired amount of common equity to be converted into preferred, and the appraiser determines the feasibility of the recapitalization. We historically have discouraged a conversion of more than approximately three-quarters of total equity value into preferred, in part because of the dividend burden on the recapitalized business.

In general, the valuation of preferred stock is performed in a manner similar to other fixed-income securities. The IRS, in Revenue Ruling 83-120, discussed factors that bear on preferred stock value. Two crucial factors are dividend coverage and asset coverage; that is, the ability of the earnings of the company to cover the dividend requirements, and the ability of the assets of the company to cover the liquidation preference. Once these parameters are known, comparisons are made with similar publicly-traded securities in order to determine an appropriate yield for the subject stock, taking into account the deductibility of dividend income to corporate investors in preferred stocks. Application of the yield to the annual dividend directly determines the price of the security.

Other rights add or subtract value so as to lower or raise the required yield. Voting, redemption, liquidation, and conversion rights are among such features. Such features may work with other characteristics of the stock to create value, or may establish practical minimum values for the stock. For example, voting control adds great value to the holder of noncumulative preferred by permitting the holder to enforce the payment of dividends. Redemption or conversion features serve to establish "floor" values for the stock, depending on the terms of the feature.

The value of the common equity is determined by subtraction, and is further reduced by a discount for lack of marketability. Once the residual common value is determined, tests are made to ascertain whether it represents a reasonable result. In the event that the preferred interest is allocated more than approximately three-quarters of the equity value of the entity, then the residual common interest may have more than a strictly proportional value, due to the enhanced speculative (option) value of such an interest.

VI. CONCLUSION

We have taken some time to explain the process of valuation to you. We hope this explanation will put in context the principles contained in the discussion draft. We believe strongly that the better your understanding is of the appraisal methodology, the better you will be able to draft legislation.

In conclusion, let me again express my appreciation for being permitted to express the views of American Appraisal here today. We are available to you and members of your staff in the coming weeks and months as the discussion draft undergoes revision.

APPENDIX A—SELECTED CUMULATIVE PREFERRED STOCKS WITH DIVIDENDS IN AREARS FOR MORE THAN THREE YEARS

Chrysler Corporation—C Rating

$2.75 cum pfd—last dividend 9/15/79; resumed 12/15/83

Long Island Lighting—C Rating

5.75% cm Cv I pfd—last dividend 8/10/85; resumed 9/1/89
$2.47 cm O pfd—last dividend 8/1/85; resumed 9/1/89
$2.43 cm P pfd—last dividend 9/1/85; resumed 9/1/85
$3.31 cm T pfd—last dividend 6/15/85; resumed 9/15/89
$4.25 cm U pfd—last dividend 7/15/85; resumed 10/15/89
$3.50 cm V pfd—last dividend 7/1/85; resumed 10/1/89
$3.52 cm W pfd—last dividend 7/1/85; resumed 10/1/89
$3.50 cm X pfd—last dividend 8/1/85; resumed 9/1/89

LTV Corp—D Rating

$3.06 cm Cv B pfd—last dividend 9/1/85; no resumption
$5.25 cm Cv pfd—last dividend 7/15/85; no resumption
$1.25 cm Cv D—last dividend 8/15/85; no resumption

Todd Shipyards—D Rating

$3.08 cm Cv Exch A pfd—last dividend 2/1/87; no resumption

Ratings:
C—Non-paying issue
D—Non-paying issue with issuer in default on debt instruments

APPENDIX B—SELECTED NEW YORK STOCK EXCHANGE COMPANIES WITH FAMILY OWNERSHIP OF TEN PERCENT OR GREATER

AMRE, Inc.
S.D. Bedowitz—34%
R. Levin—16%

Albany International
J.S. Standish—55%

Alberto Culver
Levin Family—49% of Class B; 16% of Class A

Alexander's, Inc.
D.J. Trump—27%

Alleghany Corporation
Kirby Family—40%

Amerada Hess Corporation
Leon Hess—15%

American Building Maintenance Industries, Inc.
T&S Rosenberg—30%

American Business Products, Inc.

Curtis Family—26%

American Heritage Life Investment Corp.
Davis Family—51.8%

American Shipbuilding Company
G.M. Steinbrenner III—14%

American Stores Company
L.S. Skaggs—11.5%

Ampco-Pittsburgh Corporation
L. Berkman—16%

Anixter Brothers, Inc.
Anixter Family—11%

Aon Corporation
P.G. Ryan—14%

Apple Bancorp, Inc.
S. Stahl—31%

ARTRA Group, Incorporated
P. Harvey—13%

Atlanta/Sosnoff Capital Corporation
M.T. Sosnoff—73%

Augat, Inc.
E.H. Augat—13%

Aydin Corp.
A. Hakimoglu—24%

RESPONSE TO A QUESTION SUBMITTED BY SENATOR DASCHLE

Question. If Congress addresses the 20 percent requirement and the deemed value issue, would it really in essence deal with the issues effectively and in a focused way?

Response. Regarding the 20 percent requirement, we believe that 20 percent is a bit high, and a minimum range of 10 to 15 percent provides more flexibility. However, more significant than the actual number is the need to clarify the law that the percentage applies to equity only, not the sum of debt and equity.

Regarding the deemed gift issue, we believe that a standard is needed to decide if the company is not paying a dividend because of legitimate business reasons versus an intent to circumvent the law.

As a first step, one needs to determine if the company has the financial ability to pay the dividend on its preferred stock.

One method to measure the financial ability of the company to pay the dividends is to compute the preferred dividend coverage, namely: funds available to pay all fixed charges including the preferred dividend divided by those fixed charges. This ratio can be computed either on a pre-tax or on an after-tax basis.

PREPARED STATEMENT OF DAVID E. LAJOIE

Mr. Chairmen and Members of the Subcommittees, I am pleased to provide our analysis on the issue of repealing IRC §2036(c) and replacing it with special valuation rules. I am submitting this statement on behalf of my firm, Coopers & Lybrand, an international accounting firm. This testimony is based on the extensive practice our firm has in estate and financial planning for businesses and individuals. I have personally practiced in this area for over 35 years and presently Chair the AICPA's Committee on Income Taxation of Estates and Trusts.

We commend you, Mr. Chairmen and your Members, for recognizing the misguided approach of current §2036(c) and for seeking to develop a new approach that will be more reasonable and responsive to valuation concerns in the estate freeze area. We wholeheartedly endorse the repeal of §2036(c) and its replacement with gift tax valuation rules aimed at determining a fair and realistic value for transferred interests at the time the transfer is made.

The problems with §2036(c) stem, in part, from an overreaction to past freeze techniques and a desire to stamp out all possible avenues for avoiding transfer taxes in

the family context. This desire to enact an all-encompassing provision has resulted in a situation where all family businesses are in jeopardy of having common business transactions and transfers of property to relatives produce unexpected and disastrous consequences upon the death of the business owner.

With the experience of §2036(c) in mind, we offer the following analysis of key provisions of the Ways and Means discussion draft proposal and our analysis of other valuation concerns.

1. The Ways and Means discussion draft proposes special valuation rules that would apply to family transfers of interests in 10-percent owned entities. The potential for abuse is minimal where an element of control is not present. The threshold for application of these rules should be increased to a more objective ownership level of 50-percent.

The ability to cause a change in the capital structure of an entity (i.e., recapitalization, redemption, etc.) is not present in real life without some element of control. The element of control is also necessary to accomplish any type of discretionary payments (i.e., noncumulative preferred dividends, etc.). The discussion draft establishes an arbitrary 10-percent threshold that has no correlation with control, particularly when considered in conjunction with the family attribution rules and the indirect ownership rules. In a situation where a 10-percent total interest in an entity is owned directly by an individual, his family members (including siblings, parents, children, and spouses), and indirectly through entities in which these persons own an interest, the individual simply is not in a position to impose his will on the unrelated and sometimes adverse owners of the remaining 90-percent interest.

We note that the Chamber of Commerce proposal suggests a 50-percent ownership level, and that testimony given before the House Ways and Means Committee on April 24 by the American College of Trust and Estate Counsel, the American Bar Association, and the Small Business Legislative Council all support an increase in this 10-percent threshold.

In addition, the inclusion of siblings and their spouses in the definition of family for attribution purposes in determining the 10-percent ownership threshold is not reasonable. Typically, parents and children will have similar interests and concerns that are not present in a brother and sister context. Each brother and sister typically has the interests of themselves and their own family (spouse and children) as a primary concern. Therefore, it is not reasonable to presume that they will act in concert when, in fact, they may have adverse interests.

This sibling rule is also inconsistent with other definitions of family in the Code. Although the §267(c)(4) definition of family includes siblings (but not spouses), it is a related party rule, dealing with disallowance of certain losses and expenses, that has nothing to do with control. Section 318 of the Code deals with constructive ownership of corporate stock in the context of control and does not include siblings in the definition of family.

We would urge that any replacement for §2036(c) be less pervasive. One clear avenue would be to increase the 10-percent requirement to a more objective 50-percent threshold. Fifty percent is not arbitrary and control would be a real consideration. In addition, the inclusion of siblings and their spouses in these attribution rules should be eliminated.

2. The proposed Ways and Means valuation rules would create serious cash burdens upon a typical family business.

a. The requirement in the discussion draft that 20-percent of the equity be represented in the appreciating portion of the business is an arbitrary rule. As was noted in the testimony at the Ways and Means hearing, there is no need for a minimum valuation rule. If a fair value for retained and transferred rights is utilized, this added requirement serves no useful purpose. In addition, the gift tax cost associated with transfers subject to this rule could make legitimate transfers unreasonably costly. Selection of 20-percent as the minimum value has no real-world basis.

b. The Ways and Means proposal provides that a qualified fixed payment (QFP) will be attributed a value determined on the basis of its relationship to an appropriate market rate of return. We share the concern of many commentators that the rate set may be artificially high. This could create serious cash-flow problems for the typical family business.

Market rates do not necessarily take into consideration the financial realities of a closely-held business. These types of entities typically are successful because earnings and profits are put back into the business for capital expansion and capital improvement. Cash for dividends often is not available. Less successful businesses and even successful businesses during lean years will have even less cash available for these purposes and may even require borrowings to sustain the business. Requiring

a high dividend pay-out in the typical family business environment is counterproductive and unreasonable.

As an illustration of these concerns, we currently are advising one of our clients on the projected consequences of the proposal contained in the Ways and Means discussion draft. The numbers dramatically illustrate our cash-flow concerns. In our situation, Dad owns a family business worth, we will assume, approximately $32 million. The estate tax on the value of Dad's stock would be in excess of $17 million. Dad is approaching retirement and would like to ease out of the business over a period of years in favor of his children. A recapitalization plan provides for preferred stock with a QFP that would be attributed a value of at least 80-percent of the total value of the company. Under this plan the minimum 20-percent value attributed to the common stock would require a gift transfer of $6.4 million to his son. Gift tax would be about $3.0 million—an upfront cost of the transaction.

The annual dividends required in connection with Dad's preferred stock QFP dramatically illustrate the cash flow problems for the business. These required dividend payments raise the question of whether our client's business can generate sufficient cash to pay taxes plus the dividends while retaining enough cash profits to secure the future of the business. The market rate to be applied is very crucial to these considerations.

The business in our example will be required to pay Dad an *annual* dividend based upon his $25.6 million of preferred stock (this is the value of the business of $32 million minus the required minimum value attributed to the common stock of $6.4 million). If we compute dividends at a 9%, 12%, 15%, or 18% market rate, the source of our concern becomes obvious. The annual dividend payments required would vary from $2.3 million to $4.6 million depending on the rate used. Assuming Federal and state taxes of 37.4% (34% Federal +3.4% state) the following table illustrates that the required before tax profits and rates of return are exceedingly high, leaving nothing to invest in the company. Based upon these facts, we question whether our client can sustain the success of his business after such a recapitalization.

CASH PROFITS REQUIRED TO FUND PREFERRED STOCK QFP

[Dollars in millions]

	9%	12%	15%	18%
Cash profits (before taxes)	$3.7	$4.9	$6.1	$7.4
Less Federal and state taxes	(1.4)	(1.8)	(2.3)	(2.8)
Cash profit after tax	2 3	3.1	3.8	4.6
Preferred dividend (QFP)	(2.3)	(3.1)	(3.8)	(4.6)
Amount available to reinvest	0	0	0	0
Rate of return before taxes to pay preferred dividends and taxes	11.5%	15.3%	19.1%	23.0%

It is clear that additional profits are necessary in order to sustain and grow the business. The production of additional profits could be an unrealistic goal.

c. Deferred or extended payment schemes should be considered to alleviate cash-flow problems. It is suggested that a deferred gift tax payment provision, similar to §6166, be included. In many circumstances the transferor will have only one major asset, that is the family business, with resulting cash-flow problems. A redemption exception similar in purpose to §303 is also suggested.

The goal in the "trust" area should be to obtain a more reasonable allocation of value between what is retained and what is given away.

The potential for abuse associated with GRITs (Grantor Retained Income Trusts) split interest purchases (purchase of life and remainder interests by separate parties), and sales of remainder interests could be simply erased by using valuation tables that reflect what can be realistically expected to be earned from a prudent investment.

In past times, split interest vehicles such as Clifford Trusts (generally 10-year term interests) were popular as income tax savings devices (not as estate tax savings devices) Estate tax planning based on such split interest arrangements was not popular because the IRS valuation tables were based on low rates of interest (3½-per-

cent and later 6-percent) For example, the 3½-percent tables assigned 29-percent of the value to the 10-year term interest and 71-percent of the value to the remainder interest. The 6-percent tables assigned 44-percent of the value to the 10-year term interest and 56-percent of the value to the remainder interest.

However, in 1984 the IRS valuation tables were adjusted to 10-percent which then assigned 61-percent of the value to the 10-year term interest and 39-percent to the remainder. Estate planning based on giving away the remainder interest and keeping the income interest suddenly became a very popular technique. GRITs, split purchases, and sales of remainders took advantage of the fact that so much of the value was being attributed to the retained income interest. This resulted in a significant discount in determining the value attributed to the gifted remainder. Presently we have monthly changes to the rates based on 120-percent of the mid-term AFR. This produces an even higher value for the income interest and creates even more popularity for GRITs and similar arrangements.

The solution is *not* to eliminate this type of planning since there is nothing inherently abusive in giving away interests in property. The solution is to arrive at a proper valuation that is fair to the taxpayer and fair to the government. A more realistic rate needs to be determined periodically which reflects real-life returns on prudent investments made in trust. Interests of both the remainder beneficiaries and the income beneficiaries must be treated equally in determining such a prudent investment. Rates could be adjusted on an annual basis, rather than monthly, to allow for continuity and certainty in planning.

4. Effective dates for any new valuation rules should not be prior to the enactment of any replacement provision.

There is a significant concern among our clients relative to any effective date that would be retroactive to a prior event such as the release of the Ways and Means discussion draft. We strongly urge you to consider that this will un-fairly deprive taxpayers of the ability to plan major transactions without full knowledge of what rules will be applied. It is important that a public statement be made so that taxpayers and their advisors can plan with some degree of certainty based on existing law which will not be undermined by an unannounced retroactive effective date for a replacement provision.

5. We recommend that a practitioner group be organized to work with the Committee, and other interested parties, to develop a workable solution.

There are a number of unresolved issues, both major and minor that require attention. Because of the complexity and critical need to establish workable rules in this area of the law, we recommend that the Committee establish a practitioners' working group to work with you in developing a final proposal.

Prepared Statement of M. Mark Lee

INTRODUCTION

As an expert in the valuation of businesses for estate freezes, both for taxpayers and the Internal Revenue Service, I have been asked to present my views as to the advisability of repealing United States Internal Revenue Code Section 2036(c) and replacing it with the House of Representatives' Ways and Means Committee proposed Chapter 14, regulating estate freezes (the "House Proposal").

Simply put, repealing Code Section 2036(c) is a good idea. Properly formulated estate freezes can encourage business growth and can increase national capital investment and employment.

The House Proposal of establishing the concept of a QFP (Qualified Financial Payment) is clearly a step in the right direction for tax-based freezes in that it: (1) establishes a reasonable (but not completely accurate) method to determine the value of a junior equity interest in a business (such as common stock or a general partnership interest) by first establishing the fair market value of its total equity and then subtracting the present value of distributions required to service the senior equity interest (such as preferred stock or a limited partnership interest); (2) recognizes that the appreciation potential of the junior equity interest has significant value; (3) provides for the ability to defer cash payments up to three years up without being deemed gifts; and (4) provides that if payments are not made on the senior equity interests but bear interest no gift will be deemed to be made to the junior equity interest. Nevertheless, the House Proposal is too complex and leaves some major questions unanswered, including:

1. Why is the maximum amount that can be frozen in a business equal to 20% of the value of total family related debt plus equity?
2. What is the appropriate rate of return on a frozen interest?
3. What should be done about the reverse freeze concept, that is, retaining the junior equity interest and gifting the senior equity interest?
4. Why should a passed payment on the senior interest be deemed as a gift to the junior interest as opposed to an increase in the value of the senior equity interest?
5. What, if anything, should be done if a freeze back fires—that is, the value of the business declines or does not increase as fast as the preferences of the frozen interest, resulting in an unintended reverse gift?
6. Why must non-QFP interests of family members (employment agreements, demand notes, license agreements, percentage leases, etc.) and QFP interests held by family members who do not elect QFP treatment be treated at zero cost for valuation purposes?
7. Considering that an option analysis was used in establishing the 20% minimum value of junior equity securities of a company, why should options generally be prohibited?

THE NATURE AND HISTORY OF THE CORPORATE OR PARTNERSHIP FREEZE

In a typical corporate or partnership freeze, the common stock or general partnership interests owned by an older member of a family is exchanged for common and preferred stock (in the first case) or general and limited partnership interests (in the second case) and then the junior or appreciation interests (the common stock or general partnership interests) are gifted to younger family members and the senior or frozen interests (the preferred stock or limited partnership interests) are retained by the older generation. This tax free exchange usually is executed for two reasons: (1) to induce younger family members to participate in and grow a family's business and (2) to reduce estate taxes.

Financial planners know that if a business can be expected to appreciate at 10% to 15% a year or more and the required market yield on a senior interest of in this business is 6% to 9%, then this tax-free exchange reduces the growth in senior family member's interest by as much as 9% per year, and increases the value of junior family members interest by the same amount tax free.

The 10% to 15% equity appreciation rates and 6% to 9% rates of return on senior interests were not atypical in the 1950's and 1960's. The relatively low preferred stock or limited partnership yield requirements meant, at least in the lower return case, that many businesses could afford to pay the preference yield in cash. As result of this environment, estate freezes became a device that encouraged the creation of family wealth and national capital investment and employment. Active senior family members were motivated to continue building their businesses without fears of confiscatory estate taxes, and junior family members could expand the business without worrying that estate taxes would take, upon the death of the senior generation, most of the appreciation the junior members created.

In the early 1980's, the prime rate, i.e., the rate that commercial banks in the United States post as the interest demanded from their best corporate customers, exceed 20%. In addition, the stock market was depressed and trading at low price-earnings ratios. Given the low value of businesses generally, there was a desire for estate freezes to transfer potential long-term appreciation. However, given the high interest rates that prevailed at the time, most companies faced much tighter debt service requirements and could not on afford to pay normal preferred dividends or distributions in cash.

Several techniques were developed to reduce the need for cash payments on senior freeze securities including: (1) put rights (the ability of the of holder of the senior interest to require its redemption at a specified value); (2) withdrawal rights (the ability of the holder to withdraw certain assets from the company or partnership on demand); and, (3) fixed-dollar conversion rights (the ability of the holder of a senior equity interest to convert it into a specified dollar value of junior equity interest). All of these rights existed in the marketplace and could be assumed to be exercisable by a third party under adverse conditions to limit risk of the senior equity interest, thus reducing the need for as great a cash return.

Other techniques that were developed included (1) combining noncumulative income preferences on the senior security with voting control over the payment of the dividend or distribution and (2) the 99% freeze. The assumption in the first technique is that a hypothetical willing buyer would value the noncumulative feature almost as highly as a cumulative right because of the potential buyer's ability to force payment. However, in reality, there was no assurance that a senior family member would act in his or her own economic self-interest and pay the dividend or

distribution. Often, even though the business could afford to pay the dividend in some form, e.g. either cash or in-kind securities, these distributions were omitted or were set at below-market rates, resulting in the de facto passing of appreciation.

This passage of appreciation is complicated to explain to laymen and the Courts. While the Tax Court, in *Snyder* v. *Commissioner*, recognized that a passed noncumulative dividend is a gift if it could be paid, it did not address the issue that the noncumulative dividend was set well below both the borrowing costs of the business and interest on U.S. Government securities at the time the freeze was instituted. Thus, annual appreciation in the value of the business, equal to the differential between the noncumulative dividend and the business's borrowing cost (or the United States Government's borrowing cost), was transferred tax-free to the junior equity securities.

The 99% freeze technique was the result of some experts stating that, even without an immediate withdrawal right, conversion right or put right, almost all of the value of a rapidly appreciating business can be locked up in a relatively low-yielding senior security, with the result that all of the appreciation could be transferred without any economic gift to the holders of the junior interests. To the sophisticated freeze participants, this is rubbish. To the extent that a business can be expected to meet the asset and income claims of a senior equity interest and have appreciating value left over, the junior equity interest will have considerable option value. That is, it has the right to all of the growth in the value of the business. Nevertheless, it was not possible for the Internal Revenue Service to establish that common stock had this option value in Tax Court (*Snyder* v. *Commissioner*).

Given some of the estate freeze techniques employed in the 1980's it is clear why Section 2036(c) was adopted. However, the effects of these provisions are draconian. All inter-generational freezes are essentially prohibited even though many would promote the creation of national investment and greater employment. Unfortunately, the Snyder case shows why Section 2036(c) of the Internal Revenue Code cannot simply be repealed.

RECOMMENDATIONS

The House Proposal can be greatly simplified and still accomplish much of the desired effects both in terms of national tax policy and estate tax planning. Seven relatively straight forward adjustments that can be made are:

1. Establish the minimum value of the junior equity of a business at 10% to 15% of the equity value of the business, perhaps including as an addition to equity for this calculation only the *unsecured debt* of the transferor's family.

The generally accepted minimum value for common stock in a freeze of business whose equity value is appreciating is between 10% and 15% of the pre-freeze equity value of the company. Technically, it is possible to freeze more of the value, but this can be done only if all or almost all of the growth potential of the business is absorbed by the senior interest. If we assume that a business as the potential of equity appreciation of 12% per year, and the rate of return requirement on the senior security is 12% or more per year, then the appreciation remaining for the junior interest is small. However, in most cases, the rate of return projected for the business is significantly greater than the rate of return for the senior security. Thus, the value of the junior interest can be large.

Secured debt of family members is backed by particular assets and may represent legitimate reductions in the value of the business equity interests held by other family members. It is not a proxy for equity and should not be included in this calculation.

2. Establish a statutory rate of return reference rate, either fixed or variable, for a QFP or senior equity interest based upon some public rate.

Reasonable reference rates include Applicable Federal Rates (AFR), or the yields of straight cumulative preferred stocks rated BBB by Standard & Poor's having similar maturities and similar variable or fixed dividend rates. These rates reflect the basic economic and inflation risks of this country as well as, in the latter case, some estimate of business risk. If a business can grow faster than these rates the nation should benefit from increased investment and employment. The family will get the benefit of being able to pass on the extra appreciation tax free to the younger generation.

It must be noted that these rates of return may not provide sufficient relief for farmers and other business owners the value of whose interests cannot keep up with inflation. Special relief for these groups would be required.

3. Require the use of the statutory rate of return reference rate to reduce the effectiveness of the reverse freeze.

A reverse freeze is a recapitalization of the business in which older family members retain the junior equity interests and gift the senior interests. The senior interests of many businesses recapitalized in estate freezes would be considered, at best, speculative grade, as the companies would be considered small by public market standards and very highly leveraged. In addition, the dollar amount of the issue would be considered much too small to provide adequate liquidity. The market rates of return on these speculative securities could easily range from 12% to over 25%. The upper part of this range is well in excess of the growth rate of many of these businesses. The reverse freeze allows a low-value senior interest to increase rapidly in value, and to reduce the value of the junior interest, as a result of preference payment arrearages accumulating at very high rates of return. The use of the suggested statutory rate of return limits the effectiveness of this technique.

4. Require that, if a distribution on a senior equity interest is not paid out with in a specified time (perhaps the three years of the House Proposal), the unpaid amount is added to the principal amount of the senior equity, but not to its basis, and bears the same rate of return.

Essentially the concept of a deemed gift would be eliminated. Either a distribution would be paid out within a specified time and taxed as ordinary income or retained as capital appreciation of the senior interest entitled to the same preference return and subject to estate and capital gains taxes. There would be no need to file gift tax returns if preferred distributions were passed. As retention of the capital appreciation by the senior equity holder simply restores the capital appreciation that would have been realized without the freeze, there is no need for the current taxation of the retained distributions.

5. Provide a safe harbor so that if the value of the equity of a business does not grow faster than the statutory rate of return on the senior equity interest, the freeze can be unwound.

People often freeze their businesses near the top of the business cycle when economic conditions are good and are expected to improve well into the future. They expect the value of their businesses to appreciate rapidly with corresponding increases in the value of the junior interests. Unfortunately, after the top of the cycle comes the recession, or depending on the industry or geographic area, the depression, in which the business may actually shrink in value directly at the expense of the junior interest.

For example, assume that at the time of a freeze a business is worth $10 million, which is then divided into $6 million of preferred stock and $4 million common stock, all of which is owned by the younger generation, $2 million of which was received in the freeze and $2 million of which was previously owned. Let us also assume that a prolonged recession now occurs which causes a 30% decline in the value of the business. The business is now $7 million. The common stock is now worth $1 million, about 15% of the total equity value based on the minimum value requirement, and the preferred stock is still worth about $6 million. The loss of $3 million in the value of the business eliminated all of the equity value received by the younger generation in the freeze plus half of their original holdings as well.

There should be a safe harbor to unwind this result—that is, the ability, with the consent of the parties, to restore the family's ownership interests, assuming no intervening transactions, to their pre-freeze positions without any further tax consequences, and with the ability to use any gift taxes paid as a credit against future estate and gift taxes. If this safe harbor is created, the minimum value of a junior equity interest can remain at 20% as some of its downside risk has been eliminated.

6. Non-QFP interests of family members (demand notes, license agreements, percentage leases, etc.) and QFP interests held by family members who do not elect QFP treatment should be deducted for valuation purposes based upon their arm's-length cost for similar services on their contract dates or the actual cost or arm's-length cost on the valuation date.

The House Proposal appears to assume that all non-QFP interests of family members are suspect of potential manipulation for transferring wealth untaxed and that these interests can be ignored at the time of the freeze. Under this assumption expenses associated with potentially rights are ignored, but the revenues they help create are included, thus artificially increasing the profits of the business, its value, and the value of any junior interests resulting from a freeze. A better approach would be to have the business owners show the valuation experts at the time of the

freeze to what extent these non-QFP payments reflect the arm's-length nature or fair market value of the transfers either at the contract date, if based on a contractual agreement, or at the valuation date, so that the information can be incorporated in valuation of the business.

Assuming the elimination of deemed gift provisions, family members should not be required to consent to QFP treatment of QFP interests because zeroing out these values will result in the overvaluation of the business.

> 7. Option freezes should be permitted if the valuation formula for the value of the option is: the fair market value of the equity security obtainable with the option minus the sum of (1) the present value, at the statutory rate of return, of the exercise price over the life of the option, and (2) the present value at the same rate of return of any dividends or cash flow expected to be paid on the security obtainable with the option before its exercise.

The above formula is the textbook calculation for determining the minimum value of an option. It also is virtually identical to the House Proposal for valuing junior equity interests. Instead of the value of the equity of the business, we have the value of optioned security. Instead of having the prior claims of the QFPs, we have the prior claims of the exercise price and the dividend or cash flow payments to the current holder. Considering this similarity, this formula should be permitted for tax purposes.

PREPARED STATEMENT OF E. FLETCHER LORD, JR.

Mr. Chairman, my name is E. Fletcher Lord, Jr., and I am President and CEO of Crow-Burlingame Company of Little Rock, Arkansas. I am here on behalf of the National Federation of Independent Business (NFIB), and I ask that their statement be attached to my own and made a part of the permanent record.

My grandfather and a partner started our company in 1919. The two men were not related and together controlled 75% of the stock. The rest of the stock is owned by the families of the original investors plus many employees who bought stock at one time or another through the 71 years of the company's existence. My family holds a little over 52% of the company stock. My grandfather's partner's family sold much of his stock late in his life, and the family which bought the stock still controls about 22%.

My grandfather died at 84, 45 years after founding the company. The entire time he was active in the company, most of its earnings were plowed back to finance future growth.

Auto parts businesses require a lot of capital to support the large inventories required to provide parts coverage in the automotive aftermarket. The size of the inventories greatly inflate the value of our business for estate tax purposes.

My grandfather's best friend was a tax accountant. They played golf and traveled together for years. Because of this relationship, my grandfather was very aware of tax laws and how to structure the company and his estate. He used the best advice available at the time. Despite the best advice, between the time a will was written and the results are measured, the laws change so much that the best of plans work out in ways you could never have dreamed.

Although my grandfather split his stock into three parts and used generation skipping to give part to me and my brother, I still ended up paying a huge amount of estate taxes.

When my grandfather died, it was thought that my grandmother might live several years past him, and his estate left enough to her to provide for her needs. She died 11 months later. All that was left to her was taxed twice.

Although my grandfather planned well and was frugal, after paying the taxes on both of my grandparents' estate, the family had virtually nothing left but company stock. Everything else had to be sold to pay the estate taxes.

The family had now moved control of our business to a second generation.

My dad had been working for the company over twenty years when my grandfather died. Today he is 82, and my mom died last Christmas. Unfortunately, Dad did very little estate planning and although he will pass less than one third of the stock that my grandfather did, it will take all of his assets, his pension (lump sum), his investments, and his home to raise enough money to pay estate taxes. The best guess is that my brother and I will still need to chip in some of our own money to pay the taxes in order to keep the stock in the family.

Today, it's my generation's turn to try to pass our business on to the next generation. My brother and I pay ourselves modest salaries, and our total compensation is in line with norms for our kind of business and other distribution companies of our size. There is not much room for additional salaries to plan for estate taxes.

Our company is an above average performer for our type of private business. We have been at it for a long time and kept putting the investment in year after year. Here is how our company's assets are divided:

Assets:	
Cash	2 50%
Inventory	44 30
Accounts Receivable	16 40
Prop Plant & Equip	36 80
Total	100 00%
Profit on sales	5 00
Tax as of Pretax Income	38 00
AfT Income as of Sales	3 05

As can be easily seen, the company is very capital intensive with inventory requirements growing at almost 10% a year because of all the new types of parts entering the workplace. Because of this inventory growth, the company must maintain a sales growth large enough to support the inventory. Our ability to maintain a large inventory and carry the slow moving items makes us valuable to the market place and is an important part of our success. Unfortunately, estate tax law does not differentiate between cash on hand and inventory. Our large inventory gives us a competitive advantage, but it also greatly increases the amount of estate taxes owed when a family member dies. The failure of current estate tax law to differentiate between liquid assets and assets of an operating family business will destroy many family businesses.

I have three children ages, 18, 14 and 10. The first one starts college this fall. My house is less than half paid for, and my wife needs a new car. She drives an Olds wagon that's over eight years old with over 100,000 miles on it. It is not possible for us to put enough aside to help pay the estate tax bill that will be due when my children take over the company.

My company carries a $1,500,000 life insurance policy on me so that if I die before I retire, there is money to buy back half of my stock. This will take the ownership of our business away, but will allow my family to have some security and income past any early death. This protection ends on my 65th birthday.

I personally carry around $600,000 of life insurance.

With the current tax laws there is no way for my family to move our ownership of our business to the next generation. I cannot afford to carry any more insurance to protect my stock, and I cannot afford to save enough over the years to pay the tax. My family will lose our majority control of our company if my children have to redeem stock to pay the estate taxes.

If either my brother or I die prematurely, it is entirely possible that the company will be in jeopardy of survival at that time, let alone pass to a new generation.

I feel that our family has been a responsible member of the community, managed our business affairs well, been one of the more successful companies of our type in the country, but unfortunately that is not enough to survive estate taxes.

Congress needs to make up its mind whether capital formation and the preservation of small family farms and businesses is more or less important than current income gained through estate taxes. My feelings are that by confiscating the assets of small farms and businesses, the country is eating its own seed corn. In the longer term, the country is better served by helping small business pass from generation to generation and encouraging their growth through its tax laws, than the short term effect of raising more revenue up front. When the seed corn is eaten, what are we going to use for next year's crop? Capital is all businesses' seed corn. The one thing small business is short on is capital. It's not hard work, or the willingness to take risk, or doing a good job, it's capital. Congress knows this, but it sure is hard to read the tax laws and realize that most of Congress is in support of small business.

One of the other problems small business faces is the tax laws changing almost every year. The IRS hasn't even printed guidelines or the courts ruled on any cases before the law changes again, almost in a 180 degree direction. Most of the time when the Congress changes its direction, it takes away all it set in place in previous laws. Congress should not change the way the law works after someone has made a decision which they cannot change or get out of for years. Tax laws change and dis-

rupt plans which were put in action sometimes years before. This is not in anybody's best interest, small business, individuals, farmers, large business or government.

Statement of the National Federation of Independent Business

The National Federation of Independent Business (NFIB) appreciates this opportunity to explain the problems small family businesses are having trying to cope with estate tax laws, especially section 2036(c). NFIB is the nation's largest small business advocacy organization, representing the interests of more than 500,000 small and independent business owners throughout the country.

ESTATE TAX PROBLEMS SMALL BUSINESSES ENCOUNTERED BEFORE SECTION 2036(C)

The present debate over section 2036(c) and its potential replacement raises some very interesting questions about the effects estate taxes have on small, family businesses. Although section 2036(c) has created a great deal of trouble for small business owners, it has only exacerbated a problem that already existed for parents that wanted to pass along their business to their children. Even before the arrival of section 2036(c), the owners of small family businesses were forced to take drastic actions to prevent the sale of some or all of the business upon their death. This Committee should use this opportunity to reexamine the public policy reasons for estate taxes and whether or not we should continue to treat small family businesses as if they are purely personal wealth and nothing else.

Under current law, the owner's share of a business is valued when he dies, and the estate has to pay taxes on that value even if very few of the business's assets are liquid. If the business owns land, buildings or a large amount of inventory, the taxes on these non-liquid assets can only be paid by selling part or all of the assets. Although owners of closely held businesses are currently allowed to spread their estate tax liability over fourteen years, these payments still take a great deal of the business's operating capital and severely limit its potential growth.

Small businesses are particularly vulnerable to the intricacies of estate tax law. Small business owners spend very little time with estate planners because most of their energies are directed towards keeping the business running. Unfortunately, unless a small business owner carefully plans ahead, estate taxes will very likely ruin his business when he dies.

Small businesses are the engine that has pulled the American economy through the last decade of economic growth, and the entrepreneurial spirit of the founders of family businesses should not be undermined through unreasonable estate tax laws. Heirs of small business owners should not be forced to sell the family business to pay the estate taxes due when the owner dies for three reasons: (1) the thought of building a business to pass onto the next generation serves as a great incentive for business owners to make sure their business succeeds; (2) forcing the sale of business assets to pay estate taxes does economic damage to the business and to the local economy that business is helping support; and (3) a small family business is worth more than just the sum of its parts. There is something special about a family business that gives it a value that cannot be appraised.

THE EFFECT OF SECTION 2036(C) ON SMALL BUSINESSES

Section 2036(c) has had a devastating impact on small family businesses primarily because of its broad impact on virtually every intra-family transaction.

Estate freezes were an extremely useful tool in preserving family owned businesses. They allowed small business owners to pass along their live's work to their children, while still remaining involved in the business at some level. Estate freezes helped small family businesses smoothly transfer the operation of the business from one generation to the next.

There have been abuses of estate freezes in the past, but section 2036(c) did not stop at eliminating abusive estate freezes. Section 2036(c) applies to even arm's length transactions between family members. For example, even for a child that purchases the future growth of a parent's business for its fair market value, section 2036(c) applies. It is the scope and reach of section 2036(c), not its purpose, that is most disturbing to small business owners.

Section 2036(c) is so complex and its effects so broad that NFIB wholeheartedly agrees with the first step taken by the "Discussion Draft" —outright repeal. The compliance problems 2036(c) was designed to alleviate may be addressed in a number of different ways, but any solution to 2036(c) must begin with its repeal.

REPLACEMENT OF SECTION 2036(C)—THE "DISCUSSION DRAFT"

The discussion draft starts out on the right foot by repealing section 2036(c) and beginning anew. In addition, focusing solely on valuation greatly simplifies current law. Finally, valuing what is transferred at the time of the transfer seems more equitable than waiting until the death of the parents to find out how much the children owe.

The discussion draft continues in the right direction, by valuing the business upfront and then using a gift tax to ensure that it was properly valued. Unfortunately, valuing a closely held business is not any easier than it was when section 2036(c) was drafted, and the discussion draft uses a number of valuation assumptions and monitoring requirements to ensure that the value of the business is approximately what the taxpayer says it is. NFIB is very concerned about how these valuation assumptions and monitoring requirements will affect small family businesses.

The discussion draft also includes language that could lead to the same overly broad effect that plagued section 2036(c). The greatest concern NFIB members have with section 2036(c) and its potential replacement is that they could apply to everyday transactions between family members that are not intended to be an abusive avoidance of the estate tax system. A replacement for section 2036(c) should focus only on eliminating abusive estate freezes.

Concerns with Valuation Methods and Monitoring Requirements in the Discussion Draft

The discussion draft contains the simple premise that when a parent transfers part of the business to a child nothing retained by the parent has any value except Qualified Fixed Payments (QFPs) and voting rights. The effect of this is to maximize the value of the business interest given to the younger generation and to maximize the amount of gift tax that will be owed.

- *Limiting the Value of Qualified Fixed Payments*

Qualified Fixed Payments (QFPs) are payments that are fixed as to amount, time of payment, and interest rate. This strict definition of a QFP ensures that the older generation will not undervalue what they transfer to their children by including in the deal discretionary dividends that are not paid. The problem with this definition of a QFP is that it is underinclusive. Too few rights in a business are given value under this definition. There are ownership rights that do have value on an open market that would be considered as having absolutely no value in calculating a QFP. For example, some developers that build shopping centers charge rent to the stores and also get a percentage of gross sales. On an open market, the right to receive a percentage of gross sales from a shopping center would have value. Yet, this right would not be a QFP and would have no value when calculating the value of the property transferred to the younger generation because it is not a fixed payment. Similar problems arise with royalties. Lowering the value of a QFP lowers the value of the portion of the business retained by the parents, thereby increasing the value of what is transferred to the children and increasing the amount of gift tax that will be owed on this transaction.

- *Valuation Premise*

The discussion draft assumes that nothing can be deducted from the value of the business interest transferred to the children outside of an enumerated list of exceptions. This greatly increases the value of the children's interest in the business, and it may be the wrong approach. Small business owners who retain valuable rights in a business should not be penalized because what they retain is not on the list of what counts toward a QFP. A better approach may be to list what will not have value, and leave the assumption that rights retained by the older generation will have value unless stated otherwise.

Tightening the valuation rules and maximizing the value of the children's retained interest in the business may limit abuses in this area of the law, but it will also result in some very inequitable cases in which taxpayers are forced to pay too much in gift tax. The discussion draft's definition of a QFP may value the interest transferred to the younger generation above its fair market value. This is a particular problem for small businesses that do not have the capital up front to pay the higher gift tax.

- *No Legitimate Business Reasons for not Paying a QFP*

If the younger generation fails to pay a QFP within three years, the discussion draft will consider that failure to pay to be a gift from the older generation to the younger generation, and it will be taxed as such. The purpose of this provision is to

ensure that the parents are not giving the children gifts over time by not accepting the QFPs. The problem with the discussion draft approach is that it forces the younger generation to pay dividends to the older generation when, for legitimate business reasons, they should not do so. According to the discussion draft, the only way a business can skip a QFP and not have it taxed as a gift is if the business is insolvent or in bankruptcy. This requires businesses to make QFPs even if they are on the verge of insolvency. Requiring these payments not only makes little sense in a business context but it also may run counter to state corporate statutes, some of which prohibit corporations from making dividend payments if they are on the verge of insolvency. In addition, this requirement may require business owners to violate loan agreements they have with banks or suppliers that these creditors will be paid before others.

- *The 20 Percent Requirement*

The discussion draft also requires that at least 20 percent of the value of the business be reflected in the common stock when a business owner performs a stock recapitalization. Again, this increases the value of what is transferred to the younger generation. This requirement is also unnecessary because the other valuation rules in the discussion draft will ensure that the transfer is properly valued.

- *Effect of the Valuation/Deemed Gift Rules*

Taking together what the discussion draft does not consider to be a valuable right retained by the parent and the QFPs the parents must receive from their children, small businesses owners are going to face an increased gift tax when they transfer the family business to the next generation. If this Committee wants to continue to support family businesses, something will have to be done to assist small businesses in dealing with the increased gift taxes, either by changing the valuation rules for gifts of business assets to a family member or by allowing small business owners to pay the gift tax liability over a number of years. Current law allows closely held businesses to pay estate taxes over 14 years. Similar treatment of gift taxes would allow more family businesses to survive a transfer from one generation to the next.

Concerns with the Scope of the Discussion Draft

NFIB is most concerned about the type of transactions that will fall under the rules proposed by the discussion draft. For example, in the very first sentence of the discussion draft, it mentions regulating the transfer of interests in an "entity" and not the transfer of an interest in a business. The term "entity" could include a great deal more than just part of the family business.

In addition, the discussion draft also affects buy-sell agreements which are commonly used by family businesses. In a buy-sell agreement the parties agree to transfer the business for a set price at a point in the future. These agreements and rights of first refusal are usually reserved by a family that owns part of a business, and they want to keep that ownership within the family.

Buy-sell agreements are not in the same league as estate freezes, and either the discussion draft's application to buy-sell agreements should be modified or they should be dropped from the draft altogether.

Concerns with Confusing and/or Complicated Provisions of the Discussion Draft

In order for a payment to the older generation to be counted as a QFP, the discussion draft requires the consent of other family members who own stock in the business. This could create a problem if there are intra-familial problems that extend beyond the ownership of the business.

The discussion draft extends the statute of limitations from three years to six years. NFIB sees no reason to break from the standard three year statute of limitations under these circumstances. Three years allows the IRS sufficient time to find and audit those attempting to abuse the system, and it limits the amount of time small business owners have to worry about being hit with unexpected gift tax liability.

Any final replacement of section 2036(c) should allow business owners the flexibility to set a rate of interest that corresponds to that business' rate of return. Businesses that traditionally have a low rate of return should not be penalized because they cannot afford to pay the same rates as businesses with greater rates of return.

NFIB is also concerned that the valuation rules used for determining the gilt tax due on the day of the freeze will not be the same rules used when determining the estate tax due when the owner of the business dies. The discussion draft does have some language indicating that items valued for gift tax purposes should be given the same value for estate tax purposes. This provision should be clarified so that taxpayers are not taxed twice.

In the search for something to replace section 2036(c), the discussion draft is a good first step. Several major problems with its approach to valuation and monitoring, however, have to be addressed before it will be acceptable to small family businesses.

REMAINING PROBLEMS WITH ESTATE TAXES AND POSSIBLE SOLUTIONS

By eliminating many of the common methods to limit estate tax liability for small family businesses, section 2036(c) highlighted the devastating impact estate taxes have on these businesses. Narrowing the focus of section 2036(c) would be helpful, but it still leaves small business owners with the question of how to deal with a 55 percent tax on the current value of a business they want to pass along to their children. The estate tax is so high and the law so complicated family businesses probably pay more in fees to estate tax planners than they do in tax to the Federal Government.

Competing policy goals conflict when estate tax laws are applied to small, family businesses. Estate taxes are designed to prevent the pooling of too much wealth in too few families. Yet, we want to encourage the creation and growth of family businesses. Obviously, family businesses will not survive long if they are subject to estate taxes every time a new generation takes over. NFIB firmly believes that the public policy goals of an estate tax can be met without prohibitively high estate taxes.

Estate tax laws can be modified so that they still serve their public policy purpose of preventing the pooling of wealth in a few families without, at the same time, causing the dissolution of family businesses upon the parent's death. A few ways to do this would be to:

—increase the unified credit from $600,000 to $2 million. This would neatly reduce the amount of estate taxes paid by smaller family businesses.
—change the estate tax tables so that they are the same as income tax rates. A top estate tax rate of 55 percent is outrageously high. Lowering the top rate to 28 percent would make estate taxes more reasonable and tax the estate at the same level as other income.
—change the valuation rules for small, closely held businesses. Valuing these businesses below their highest and best use value would limit the amount of tax the next generation has to pay.

Although those changes in law would greatly benefit family businesses, NFIB realizes that the current budget deficit makes it difficult for this Committee to argue for lowering taxes on business owners. For this reason, we suggest allowing family farms and businesses to be able to defer their estate taxes until the farm or business is sold outside of the family.

NFIB ESTATE TAX REFORM PROPOSAL

Allowing family farms and businesses to defer their estate taxes until the farm or business is sold outside of the family prevents farmers and small business owners from having to sell off their life's work to pay estate taxes. At the same time, their estate tax rates are not lowered or forgiven, and they still must pay their full share if the business is sold outside the family. The tax bill need only be paid, however, when the owners of the business have the cash available to pay the tax.

Outlined below is a brief summary of a proposal that NFIB considers adequate to address the concerns of both those that believe the transfer tax system is an important part of the tax code and those who believe small family businesses ought to be able to survive that system. This proposal is presented in its conceptual stage and further input will be necessary to develop legislative language.

SMALL FAMILY BUSINESS AND FARM SURVIVAL PROPOSAL

Family Members—Only members of the business owner's family are permitted to defer estate tax liability.
Multiple Transferees—Upon the death of the owner, the estate is relieved of any tax due on "trade or business" assets owned by a family business that are passed on to a family member. Each family member assumes responsibility for the deferred tax liability that is due on the assets they inherit.
Property—All "trade or business" assets that are owned by a business that has been in the family for at least five years.
Deferral—Estate tax owed on the value of "trade or business assets" held by a business that has been in the family for at least five years is deferred until sold outside of the family.

Triggering Event—The estate tax is due when the holder of the property sells a majority of their share of the business outside of the family. Sale of assets by other family members will affect those family members only.
Interest—The amount of tax due will be increased annually according to the rate of inflation or the applicable Federal rate, whichever is lower.
Cap on Liability—The amount of tax owed may never exceed the value of the business.

Small businesses do not have the resources to do advanced estate tax planning. Very few BIB members ever engaged in estate freezes. Allowing family businesses to defer their estate taxes would prevent the breakup of small, family businesses that have extremely high estate tax bills because the owner did not take the time to hire an estate planner soon enough.

The benefits of this proposal are: (1) it is an equitable solution to the problem that small business owners face when trying to pass the family business on to the next generation; (2) small business owners still have to pay their share of estate taxes so that the revenue impact is minimal; and (3) families of small business owners that cannot afford high-priced estate planning advice will not lose the business when the owner dies.

The high rates and complex issues involved in estate taxes make it—very difficult for small, family businesses to survive. The Small Business and Farm Survival Proposal offers a great amount of protection for family farms and businesses at a minimal cost to the Federal Government.

CONCLUSION

Section 2036(c) has highlighted the problems estate taxes present family businesses. Without complicated estate tax planning techniques like estate freezes, it is very difficult for family businesses to survive the transfer from one generation to the next.

In addressing the problems section 2036(c) has created for family businesses, the Senate Finance Committee should take the opportunity to look at the underlying cause of the problem—that estate taxes remove huge sums of money from the family business as soon as the older generation dies. Deferring estate taxes would prevent the removal of the very lifeblood of these family businesses and allow them to continue to operate.

Prepared Statement of Donald C. Lubick

I. SUMMARY OF POINTS

1. The problem attacked by Section 2036(c) is one of difficulty of valuation. It should be addressed by increasing the ability of the Service to determine correct valuation. Solutions imposing artificial valuations on transferred or retained interests are inordinately complex and unfairly penalize many legitimate transfers.
2. Most abusive valuations can be deterred or discovered by requiring full disclosure. Accordingly, the D.C. Bar Proposal would require reporting of all Section 2036(c) type transfers, at both the time of transfer and subsequent death of the transferor. Cases today for which there is no reporting, e.g., where the transferor claims the transfer is a sale or a gift falling within the annual $10,000 exclusion, would be covered. Specific disclosure rules would be prescribed by Treasury.
3. The Proposal would extend the statute of limitations to 6 years for transfers within the Section 2036(c) ambit, and indefinitely if disclosure of the transfer was inadequate, thereby providing the Service with sufficient time to marshall its facts on valuation on a retrospective basis. Taxpayers who want finality would be allowed to file a request for audit at any time after a Section 2036(c) transfer. The Service then would have until the later of the expiration of the 6 year period or 2 years after the request to audit the transfer. Failure to audit would bar the Service from revaluing the transfer at any time.
4. The Proposal permits the Service to revalue at the time of death (with the burden of proof) a Section 2036(c) transfer that has been disclosed, but not audited, by including the proper value of the property in the transferor's estate in making the tentative estate tax computation, while limiting the gift tax offset to the actual gift tax paid.
5. For Section 2036 transfers that are not properly reported at the time of transfer, the statute of limitations would remain open indefinitely, and the Service may subsequently revalue the transferred property both for gift tax purposes and for the purpose of making the tentative estate tax computation at death.

6. Valuation rules would be corrected in specific situations where taxpayers have been able to misuse them, such as minority discounts and the use of tables that do not reflect actual facts. The Proposal would expressly confirm the ability of the Service to take post-transfer conduct into account retrospectively to determine intent at the time of transfer. It also would expressly confirm that a transfer resulting in gift tax liability may result from subsequent action or inaction by the transferor that is inconsistent with the assumptions on which the original valuation was based.

II. INTRODUCTION

Section 2036(c) was enacted in 1987 to enable the Internal Revenue Service to deal with avoidance of transfer taxes through devices generically referred to as "estate tax freezes." These devices permit a transferor to retain his interest in the current benefits of ownership of a business, such as management and control and its current income stream, yet pass increases in its underlying value to his beneficiaries without transfer tax. In the abusive cases, the transferor overvalued the retained interest and valued the donated interest at zero or at a grossly inadequate value. The classic preferred stock recapitalization and many complex variations on that theme have caused avoidance of transfer taxes, either because the valuation rules without Section 2036(c) are inadequate to deal with them or because the Service has inadequate means to detect undervaluations of transferred interest.

Instead of dealing with valuation abuse, Section 2036(c) changed the substantive rules of transfer taxation by a sweeping inclusion, generally at death, of interests transferred during lifetime by an individual who retains an interest in an underlying "enterprise" apart from property unconditionally and irrevocably transferred. The new law extends well beyond the principal abuse that prompted its enactment, namely undervaluation of the transferred interest in future growth, and almost all agree that, at the least, it must be replaced with an approach focusing on valuation.

III. DISCUSSION OF PROPOSAL IN SUBSTITUTION FOR SECTION 2036(C)

A. Limitation of Changes to "Section 2036(c) Situations."

Our Proposal would only apply to transactions currently within Section 2036(c) ("Section 2036(c) situations"). As under Section 2036(c), we apply the new rules where (a) the transfer involves an enterprise, (b) the transferor retains an interest in the enterprise post completion of the transfer and (c) the transferor and the transferor's family own before completion of the transfer more than 10 percent of the enterprise.

We recognize that, thereby, we have retained some of the imprecision that justifiably subjected Section 2036(c) to criticism as causing hardship for legitimate planning. The critical difference is that we are retaining in our Proposal the scope of Section 2036(c) definitional terms as a procedural matter only. No taxpayer's substantive liability is changed. Our tolerance for giving latitude in definition is, therefore, significantly greater than is the case under either Section 2036(c) or the Ways & Means Discussion Draft.

Further, we suggest new review and disclosure procedures that will enable taxpayers to determine with certainty the effects of their transactions and will give the Service adequate tools and time to effectively evaluate the transactions, thereby forcing both taxpayers and the Service to place their cards on the table.

B. Valuation Procedure.

1. *Minority Interest Discount.* In a Section 2036(c) situation, valuation of property transferred to a family member (as is currently defined in Section 2036(c)(3)(B)) will be made without any reference to a discount for lack of control inherent in the transferred property. Taxpayers have frequently avoided taxation of a transfer, in substantial part, by looking only at the property transferred and claiming a discount for its status as a subordinate minority interest. Since the transferor in a Section 2036(c) situation has retained an interest associated with the transferred property, it is logical to value the transferred property as if it were associated with the retained property, instead of as a minority interest.

2. *Artificial Valuations by Application of Treasury Actuarial Tables.* Taxpayers have frequently taken advantage of actuarial tables, set out in the Treasury Regulations and Notice 89-60, to justify artificially low valuations of property transfers involving split interests such as life estates and remainders. The actuarial tables assume both a standard interest rate and consistent mortality experience. If, for example, a transfer of a remainder in appreciating, *nonincome-producing* property is valued from the tables, there will be a serious undervaluation of the remainder.

a. *Right to Ignore Tables.* Either the Service or a taxpayer may value a transfer without regard to actuarial tables if the proponent of the nontabular valuation establishes that the income or mortality assumption of the tables is likely to be, or, in certain cases, was in fact, substantially different from the actual income produced or mortality factor experienced in connection with such transfer. Thus, solely on the question of use or deviation from the actuarial tables, the retrospective use of the pertinent actual facts may be applied in a Section 2036(c) situation as evidence of the reality of the original assumptions at the time of the transfer, *unless* the factual deviation from the tabular actuarial assumption is due to circumstances not foreseeable at the time of the transfer and is attributable to factors beyond the reasonable control of the transferor or transferee.[1]

b. *Procedural Rules in Cases of Disregard of Tables.* The actuarial tables will continue to carry the presumption of correctness in a Section 2036(c) situation, and the party valuing a transfer on the basis of a different assumption will carry the burden of proof on that issue. Furthermore, a taxpayer who values a transfer of a split interest in property without regard to the actuarial tables will be required to disclose such disregard of the tables in order for the statute of limitations to run with respect to such transfer.

C. Disclosure, Reporting and Statutes of Limitation.

The general principle supporting the aspects of our Proposal in respect to disclosure and extended statutes of limitation is that the Service must be given notice and opportunity to audit a transfer in a Section 2036(c) situation. Too many taxpayers have relied upon their own valuation, without the Service having a reasonable chance of review, to take a position that a transfer is either within the Federal gift tax annual-exclusion amount (i.e., under $10,000 per donee) or supported by an adequate, yet nominal, consideration. Statute-of-limitations questions arise with respect to each inter-vivos transfer, as well as with respect to inclusion of lifetime gifts, to ascertain the decedent's transfers (during lifetime and at death) reportable on the estate tax return of a deceased taxpayer as the basis for determining the estate tax.

1. *Disclosure Requirements.* In a Section 2036(c) situation, a transfer must be reported contemporaneously by the transferor, regardless of whether the taxpayer claims the transfer to be either within the annual gift-tax exclusion amount or a sale supported by adequate consideration. The Proposal contemplates that Treasury may prescribe by Regulations the information required to be reported in any such situation. In addition to such annual reporting, all Section 2036(c) situation transfers made by a decedent during his or her lifetime must be reported on the transferor's estate tax return after death.

2. *Statute of Limitations—Gift Tax.* A critical facet of our Proposal is a new statute of limitations with respect to gift tax in Section 2036(c) situations. In such situations, the Service will have until the later of either (i) six (6) years after the date the gift tax return for the year of the transfer is filed (treating a return filed before its due date as if filed on such due date) or (ii) two (2) years after the date of a taxpayer request for review of a gift tax return, a proposed new procedure described in III.D., below. A gift tax statute of limitations longer than the historic three years is necessary because the Service currently does not have adequate time to properly evaluate gift transfers in Sections 2036(c) situations.

The gift tax statute of limitations will not run and, therefore, will not preclude the Service from revaluing a Section 2036(c) situation transfer (i.e., determining its fair market value at the date of transfer), for gift-tax purposes, unless there has been adequate disclosure of the transfer in accordance with Regulations, or there has been a determination of value after an audit by the Service, including an audit under the new review procedure described in III.D.

Thus, the Service will not be precluded from asserting liability by a taxpayer's failure to inform it of an audit opportunity. On the other hand, if there has been adequate reporting of a Section 2036(c) transfer by a taxpayer within the statutory period, once the statute of limitations has run, the Service will be precluded from

---

[1] The Proposal confirms that, under existing law, if the transfer of common stock is reported, dividends are paid during the applicable statute of limitations period, the transfer is audited by the Service and the taxpayer's valuation is sustained, then, any failure to pay dividend to the holder of the retained interest in a year subsequent to the expiration of the statute of limitations—because of factors within the reasonable control of the transferor—may be a *gift* to the holder of the transferred interest in the year of such failure and may be included in the transferor's estate for the purpose of determining the estate tax at the transferor's death based on the value of all lifetime *and* testamentary transfers. Of course, if the statute of limitations has not run, the Service can use the fact that no dividends were paid during the statutory period as evidence of undervaluation of the originally transferred interest on the gift tax return.

adjusting, *for gift tax purposes*, the value of a gift in a Section 2036(c) situation, and it will have the burden of proof with respect to an estate tax adjustment.

In addition, if there has been an actual gift-tax audit of the value of the transferred property, the Service will be precluded from adjusting, *for estate tax purposes*, the value of such a gift in connection with the estate tax return filed at the transferor's death. The termination date with respect to the gift-tax valuation of Section 2036(c) transfers will provide taxpayers with a degree of certainty, thereby promoting compliance. By the same token, the longer, six-year statute of limitations assures the Service that the comfort given taxpayers by such possibility will not be granted at the expense of its adequate audit opportunity.

Both Section 2036(c) and the Discussion Draft are considerably more complicated than our Proposal because of their respective "look-back" requirements. The Discussion Draft would *require* such a "look-back" on the first to occur of (i) a subsequent transfer of the transferor's retained rights in circumstances where such rights originally were valued, under the Discussion Draft, at zero, and (ii) the death of the transferor.

3. *Statute of Limitations—Estate Tax Return*. The statute of limitations will not preclude the Service from revaluing a Section 2036(c) situation transfer (i.e., again, determining the transferred property's value at the time of transfer) in connection with the tentative tax computation performed for purposes of computation of a deceased taxpayer's estate tax, unless there has been a prior determination of value after audit by the Service, including under the new review procedure proposed in III.D., below. Moreover, where there has not been a gift tax audit (even if, for example, a taxpayer thought the transfer to be an annual-exclusion gift when made), the tentative estate tax computation will be made pursuant to Section 2001(b)(1), based on the sum of the decedent's inter-vivos taxable gifts and the gross estate otherwise reportable at the decedent's death, but *without* subsequent revision, in connection with the applicable estate tax computation, of valuations in determining the tax on the prior gifts under Section 2001(b)(2). This will increase the tax due at death.

Once the Service has audited a taxpayer's return and has determined a gift-tax value for a Section 2036(c) situation transfer, it is foreclosed from subsequently revaluing the transfer subject to the prior audit, either for gift or estate tax purposes. In addition, if the gift was not properly reported, the Service may adjust the value of the gift on a gift tax audit without regard to the six-year statute. Under all circumstances, the offset under Section 2001(b)(2) to the estate tax will include only gift tax actually paid with respect to a Section 2036(c) situation transfer.

4. *Undervaluation Penalty*. The Service may assess a substantial undervaluation penalty comparable to that of Section 6622(g) of the Code, either in a gift tax proceeding or in the estate tax proceeding, if not barred by the statute-of-limitation rules of III.C.2. and III.C.3., above, but *not* in both such proceedings.

Because the Service has been left with power to redetermine valuation in the estate tax proceeding, even though there may have been full return disclosure of the earlier Section 2036(c) transfer, but no audit, (a) the undervaluation penalty will not apply in the gift tax context after expiration of the gift tax statute of limitations, and (b) in the estate tax proceeding, the burden of proof on valuation will be on the Service if there was prior disclosure of the transfer by the taxpayer. The rules as to retrospective use of post-transfer facts with respect to deviation from the valuation tables, described above in III.B.2.a., will apply in the estate tax proceeding. The expanded reporting and disclosure requirements and the lifting of the statute of limitations in the absence of disclosure to the Service will discourage taxpayers from playing roulette to avoid tax. Requiring disclosure will give the Service information to curb abuses, but without the changes in substantive rules effected under current Section 2036(c).

D. Taxpayer Request for Review

Because Section 2036(c) situations have historically resulted in transfer tax avoidance abuses, we have recommended revision in the statute of limitations and reporting and disclosure rules, along with changes in valuation standards, in order to eliminate abuses. At the same time, taxpayers have a right to certainty of the tax results of their transactions. Accordingly, our Proposal provides that a taxpayer may request that the Service review the taxpayer's valuation of the property transferred in a Section 2036(c) situation. Such a proceeding will be treated as an audit under III.C., above, to secure the benefits of the statute of limitations for both gift and estate tax purposes.

A taxpayer may petition the Service at any time following the year of a Section 2036(c) situation transfer to audit the valuation on the transfer. The Service will have until the expiration of the later of either (i) six years after the date of filing of

the return reporting the transfer (treating a return filed before its due date as if filed on such due date) or (ii) two years after the date of such request within which to audit the taxpayer's valuation of the transferred property. During such period the gift tax statute of limitations will remain open or may be reopened. The Service will have the opportunity during such period to review post-transfer facts, to determine if assumptions made by the taxpayer (such as, for example, the regular payment of dividends) in determining the reported value of the transferred interest were reasonable. The Service may adjust the valuation where post-transfer actions, within the reasonable control of the taxpayer, are not consistent with the initial assumptions, but unforeseen post-transfer events not within such control of the taxpayer may not be used to alter a taxpayer's initial valuation. If the Service fails to audit after the taxpayer's request, the taxpayer's valuation will be accepted as if audited. The audit will be judicially reviewable as under existing rules for gift taxes. This new procedure will give a taxpayer the opportunity to achieve finality with respect to a Section 2036(c) situation transfer, but only if the Service first has been provided adequate disclosure and an opportunity to audit.

IV. COMPARISON OF THE PROPOSAL WITH THE DISCUSSION DRAFT

The chief difference between our Proposal and the Discussion Draft is that the latter imposes fictional values on interests involved in many transactions. Because it imposes fictional values in the initial transaction, the Discussion Draft is obliged to provide elaborate rules to trace those interests and make certain they are valued consistently throughout the life of the transferor, as well as at the transferor's death. Those rules, contained in §2701(d) and (e) of the Discussion Draft, are very complicated, and their application to any but the simplest of cases is uncertain.

Even though the values imposed on an interest in property by the complicated rules of the Discussion Draft may sometimes be approximately the same as the interest's true value, the Discussion Draft's inherent imprecision in this regard is weighted against the taxpayer. The arbitrary minimum value of twenty percent on the transferred interest is a punitive where the transferred interest truly has only nominal value.

The Discussion Draft imposes certain structures—"qualified fixed payments"— on taxpayers who desire a satisfactory result, while our Proposal permits parties to choose the structure that best meets their nontax needs and requires only that they value interests accurately at the time of transfer.

While our Proposal provides the Service with a final opportunity to detect and correct gift tax valuation abuses, through increases to adjusted taxable gifts under Section 2001(b)(1)(B), without a corresponding gift tax credit offset under Section 2001(b)(2) beyond the gift tax actually paid, this feature operates only to implement the correct valuations *when* made. In our view, one of the most frustrating elements of current Section 2036(c), which is retained in the Discussion Draft, is unavoidable uncertainty. The uncertainty may be caused by a mandated undervaluation of a retained interest that requires compensation at the time of death or by the lack of a procedure to achieve finality of a gift-tax valuation.

V. CONCLUSION

Our concern is in providing an appropriate alternative to Section 2036(c) that addresses the legitimate valuation concerns of the Congress and the Treasury while, at the same time, providing taxpayers with a measure of finality. We believe that the changes to pre-1987 law contained in our Proposal are sufficient to impose taxation based on appropriate and traditional legal concepts of property and tax law, while, at the same time, eliminating the procedural and audit advantages that taxpayers have had over the Service.

PREPARED STATEMENT OF STEVE MASSIE

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms. The construction industry is dominated by small, family-owned firms.

The broad statutory language contained in Section 2036(c) makes estate planning and orderly business succession very difficult. The problems are worsened by the IRS' broad ability to write regulations. Parents and children working in the family business may carry out, a transfer only to have the IRS decide later that Section 2036(c) applied. AGC therefore supports the proposal to repeal Section 2036(c). AGC also supports the abandonment of taxing future increases in value by including it in

the transferor's estate. That approach ignores the contribution the next generation has made in building up the business.

In considering any replacement for Section 2036(c), the main goal should be preserving the family business, because they are the foundation of the entrepreneurial system. The next generation should not be penalized for spending a lifetime working to build the business. The next generation is contributing to the business's growth, increased equity and increased value. They should not be taxed more harshly than strangers.

The Treasury proposal substitutes a gift tax approach for the estate tax approach. It contains several excellent provisions for flexibility. There is some concern that the proposal could worsen the effect of business cycles. It could also harm the ability of the business to accumulate capital for expansion.

It poses a particular problem in that construction contractors must leave equity in the business to ensure adequate bonding capacity so that they can bid on jobs. The equity that must be left in the business will cause the gift taxes to be higher.

Ally substitute proposal should target the problem of appropriate valuation of businesses. It is not clear that the transfers should then be subject to higher gift tax rates.

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,000 of America's leading general contracting companies, which are responsible for the employment of more than 3,500,000 employees. These member construction contractors perform more than 80% of America's contract construction of commercial buildings, highways, bridges, heavy-industrial and municipal-utilities facilities.

The construction industry is composed predominantly of small, family-owned firms competing in local geographic markets. Eighty-five percent of AGC's membership has average annual gross receipts of less than $10 million; ninety percent qualifies under the Small Business Administration's definition of a small business.

AGC appreciates this opportunity to present its views on the estate valuation rules of Section 2036(c). AGC would like to express its appreciation to the Chairman and to the Committee for circulating the discussion draft on reforming the valuation rules and requesting comments.

HISTORY

Section 2036(c) was added to the Internal Revenue Code in 1987. If an individual holds a substantial interest in an enterprise and after December 17, 1987 in effect transfers property having a disproportionately large share of potential appreciation in the enterprise while retaining an interest in the income of or rights in the enterprise, the retention of that interest is considered a retention of the enjoyment of the transferred property. The value of the transferred property comes back into the parent's estate, at its value as of the time of the parent's death.

Section 2036(c) eliminated the traditional corporate and partnership estate freezing techniques. Section 2036(c) went beyond those transactions to cover a variety of other everyday business transactions. The 1988 Tax and Miscellaneous Revenue Act (TAMRA) added several safe harbors, but also added a "deemed gift" rule. IRS Notice 89-99, published on September 1, 1989, gave the first guidance on how the IRS intends to enforce the statute.

PROBLEMS WITH SECTION 2036(C)

The broad statutory language contained in Section 2036(c) makes estate planning and orderly business succession very difficult. Congress also granted the IRS unusually broad authority to write regulations in this area and to expand the types of distributions to which it applies. This broad ability to interpret the statute means that taxpayers may carry out a transaction that is not subject to Section 2036(c) when it is designed, but the IRS may decide several years later that the transaction is actually subject to Section 2036(c). It took two years to get the first guidance on the statute.

For example, Section 2036(c) as presently interpreted by the IRS applies not only to transfers of interest in a business but transfers of passive investments as well. If parent transfers a bond to a child but retains the right to the interest payments, that transaction is subject to Section 2036(c). That was an extremely broad and unexpected interpretation.

Transfer. Section 2036(c) applies if an individual "in effect transfers" property. That phrase is extremely vague. IRS Notice 89-99 states that it includes the creation of trusts, intra-family sales (including installment sales, private annuities and sales of remainder interests), transfer and leaseback arrangements and joint pur-

chases of income and remainder interests. Transfers may include gifts, sales or trades of property.

"Potential Appreciation." Neither the legislative language nor the notice defines "potential appreciation" or explains how to estimate it. IRS Notice 89-99 established an extremely broad test. The taxpayer is required to assume that any combination of circumstances that would maximize the potential appreciation of the interest would take place.

"Enterprise." Section 2036(c) applies to the transfer and retention of interests in an "enterprise." The legislative language does not define enterprise, but the conference report states that it includes a business "or other property which may produce income or gain." The definition is extremely broad and creates a great deal of uncertainty as to what transactions are covered.

The recent IRS notice states that Section 2036(c) covers passive investment activity as well as the operation of a business entity. Until the guidance was issued, life insurance policies and sales of personal residences were believed to be covered by Section 2036(c). The clarification on those two issues is helpful, but it also indicates the confusion surrounding the scope of Section 2036(c).

Sale to Family Member. Generally, Section 2036(c) does not apply to a transaction if the individual receiving the asset pays fair market value for it. However, Section 2036(c) states that its rules apply to sales to family members, even if the family member pays fair market value for it. If the parent retains an interest in the business or asset, the asset that was sold will be included in the parent's estate.

The only exception is if the family member purchaser can prove that he or she had enough money from other than family sources to purchase the assets. Income from gifts the parent has given the child would not be considered an "outside" source of money.

AGC supports the repeal of Section 2036(c). The repeal removes a great deal of uncertainty as to which transfers are covered and will help family businesses plan an orderly succession.

DISCUSSION DRAFT

AGC supports the abandonment of taxing future increases in value by including it in the transferor's estate. Valuing interests more accurately at the time of the transfer is a better approach. AGC also appreciates the flexibility of the approach contained in the Chairman's draft proposal. AGC would like to offer several points for consideration.

In considering any replacement for Section 2036(c), one goal should be preserving the family business. If the next generation is working to build the business, they ought not be penalized for doing so. Family members should not be taxed more harshly than strangers. Family members working in the business are contributing to its growth and increased equity and to the increase in value of the common stock. They should not face a gift tax as well as income taxes on those efforts.

The draft proposal substitutes a gift tax approach for the estate tax approach. If the company is unable to pay the preferred stock dividends, the company pays a gift tax on the unpaid dividends. If the preferred dividends are not set at a "current market rate," that decreases the value of the preferred stock and increases the value of the common stock. That would lead to higher gift taxes.

The proposal would subject the transfers to additional levels of taxation. The dividends that must be paid is taxed. It limits the ability of the company to grow. If the parent can't transfer the business, it's taxed within the parent's estate. The child is taxed on the value of the business he or she is helping to build.

In the construction industry, insurance and bonding capabilities are directly impacted by the business's capital structure. Construction contractors must maintain equity in the business to ensure adequate bonding capacity to be able to bid on jobs. The equity that must be left in the business to ensure its viability will cause the gift taxes to be higher than they would otherwise be.

The draft proposal could worsen the effect of business cycles. If the company is cash-poor or encounters problems with operating capital, paying taxes would worsen the financial problems. If the financial problems are large enough to force forgone dividends, then paying a gift tax will worsen the problem.

The draft proposal would also reduce the ability of the business to accumulate capital for expansion. It would force certain payments regardless of whether the timing would help or hurt the business. There is some flexibility in the proposal which is helpful, but further consideration ought to be given to this issue.

The "current market rate" set in the proposal takes insufficient account of business problems. A national current market rate wouldn't reflect regional economic

downturns and the problems faced by businesses. This provision should be eliminated.

The regulatory authority granted to the IRS in this area should be restricted. If the statute of limitations is to be unlimited for transfers subject to the rules that are not reported, then taxpayers should be told what transfers are subject to the rules. Given the current backlog of regulations at the IRS, it would be unfair to subject taxpayers to any uncertainty. The statute should be very specific as to the transactions covered or the statute of limitations should be put back into place.

The statute of limitations should not be unlimited. There can be bonafide disputes as to the application of the statute. Good faith actions should not be penalized years later.

Section 2036(c) was added to the Internal Revenue Code in response to concerns that family businesses were being incorrectly valued. Options that were unlikely to be exercised were thought overvalued. To correct that problem, the draft proposal sets certain valuation rules, as follows:

The total value of the common stock could not be less than 20% of the sum of the total equity in the corporation and any debt owed to the transferor's family. Only certain rights in the corporation would be value. Other discretionary rights not likely to be exercised in an arm's-length manner would not be permitted to reduce the value of the business.

AGC believes this is a sensible approach to the problem Congress identified and resolves it in a simple manner.

CONCLUSIONS AND RECOMMENDATIONS

AGC believes incentives for entrepreneurship and capital growth are vital for a healthy, growing and competitive economy. To foster competitive and innovative businesses, which in turn provide economic growth and jobs, tax policy must provide incentives for hard work and entrepreneurship. Section 2036(c) penalizes family businesses by making it more difficult for them to financially survive the transfer of ownership. It penalizes efforts to encourage younger generations to join the business, and discourages efforts to sell the business to company employees.

For small businesses to thrive, the founders need to leave capital in the business. In the construction industry, insurance and bonding capacity are directly impacted by the business's capital structure. Construction contractors must leave equity in the business to ensure adequate bonding capacity so that they and their successors may bid on jobs.

Not only does Section 2036(c) affect orderly succession planning, it affects the basic viability of business. If equity is taken out of the construction company, its bonding capacity is reduced. If equity is left in the company, the founder may die and leave so much valuable equity in the business, the next generation cannot raise enough money to buy the business or pay estate taxes on it. The business would have to be sold to pay the estate taxes.

This is particularly inequitable when the next generation has been working to build the business. At least part of the buildup of the business has been due to their efforts. As the construction company grows, the increased equity left in the business will make it that much harder for the next generation to take it over. However, under Section 2036(c), the next generation is so hampered by constraints that it often makes economic sense for them to work elsewhere than to stay with the business.

Individuals need incentives to take risks. One of the incentives in forming a family business is the opportunity to pass something on to the next generation. Without incentives, the financial risks that must be faced early in the business's formation are not worthwhile.

The interaction of the estate valuation rules with the other recent tax code changes are hurting small businesses. For example, the 1986 Tax Reform Act repealed the *General Utilities* doctrine. Previously, a single tax was paid at the shareholder level on liquidating sales and distribution of a business. The proceeds were not taxed at the corporate level. Under current law, if the owner retires and liquidates the business, the double taxation reduces the amount the owner will realize on the sale of the business.

The proceeds from the sale of the company are further reduced by the repeal of preferential tax treatment for long term capital assets. The 1986 Act's repeal of preferential treatment for capital gains means that an owner that had invested for the long term instead of spending for the short term is penalized.

The 1988 tax act further reduced the ability of the owner to sell the company to employees or third parties. Sales of property are restricted in their use of the installment sales method of reporting income.

In effect, the tax code penalizes the owner of a business at the end of his or her career no matter how the transfer is accomplished or to whom the business is sold.

When these provisions are taken together with the estate freeze rules, the consequences to small family businesses are very severe. Owners of construction companies who have taken financial risks and who have devoted a lifetime to building equity in a business and who transfer it to the next generation, transfer it to employees or even sell it to strangers cannot dispose of that business at the close of their careers without being subjected to confiscatory tax rates. This is a great disincentive to entrepreneurship and penalizes investment. AGC believes the most innovative and productive sector of the economy deserves better. AGC recommends that Section 2036(c) be repealed. Any replacement ought to focus on the question of valuation of the business. The next generation, which has been working to build the business, ought not to be treated more harshly than strangers.

PREPARED STATEMENT OF JERE D. MCGAFFEY

Good afternoon. My name is Jere McGaffey. I am Chair-Elect of the Section of Taxation of the American Bar Association. I am here today speaking on behalf of the American Bar Association at the request of L. Stanley Chauvin, President.

I wish to explain the alternative to Section 2036(c) developed by a Task Force of not only the Section of Taxation, but also the Section of Real Property, Probate and Trust Law of the American Bar Association and the American College of Trust and Estate Counsel.

I am pleased to be able to testify today on alternatives to the present Section 2036(c). Repeal of Section 2036(c) is the position of the American Bar Association. I believe there is general agreement that Section 2036(c) is too broad and ambiguous. Its scope has extended to too many transactions that not only are not abusive but have no estate planning intent. Detailing these problems does not seem necessary at this time. The experience with Section 2036(c) demonstrates the large number of taxpayers and transactions that can be affected by legislation in this area.

We recognize that there were abusive freeze transactions prior to the enactment of Section 2036(c). We thus realize that a substitute for Section 2036(c) is necessary to prevent such abusive transaction. The substitute, however, should not interfere with other non-abusive transactions.

We want to compliment all those involved on the government side in considering alternatives. The tax writing committee staffs and the Treasury have been interested in our views on alternatives. Providing statutory language in a Discussion Draft made it possible to analyze an alternative in light of a variety of transactions that it might affect. Holding hearings provides a formal means of providing comment. We thank all those involved for this procedure.

Too often in the past, it has seemed to me, that major revisions in the estate tax area have been viewed by both sides as part of some "cold war." The approach to revision of Section 2036(c) has caused confrontation to be reduced and more recognition of common goals. I hope both sides can recognize the goodwill being expressed by the other side.

The action of the American Bar Association and the American College of Trust and Estate Counsel has been balanced and thoughtful. We recognized the extreme intrusiveness of Section 2036(c) and illustrated that it was not workable. The American Bar Association called for its repeal. We commenced early to work on an alternative to deal with the abuses and developed a Report recommending an alternative. The Discussion Draft approach is related to our Report. The Discussion Draft was carefully analyzed. In my testimony before the House Ways and Means Committee on April 24, 1990, I submitted 34 specific suggestions for improvement. Even though we had some problems with the approach of the Discussion Draft and believe it was too broad certain areas, we have continued to make technical comments to improve the Discussion Draft even in areas in which we disagree. I believe it is the obligation of the bar to attempt to improve proposed legislation by pointing out its application to transactions. We have offered our assistance in reacting to revisions of the Discussion Draft and we look forward to seeing a second version. Our willingness to cooperate and our appreciation for the process followed to date, however, does not lessen our belief that there are some significant problem areas.

The Task Force Report is as follows:

Report of the Section 2036(c) Task Force, July, 1989

[Prepared by a Task Force of the ABA Section of Real Property, Probate and Trust Law, Section of Taxation, and The American College of Probate Counsel].

The Task Force recommends that Section 2036(c) be repealed and an alternative legislative response to the "estate freeze" problem be substituted for it.

The Task Force has analyzed the transfer tax avoidance problem which Section 2036(c) was attempting to address and proposes certain legislative alternatives in order to deal with this problem. The Task Force is mindful of the concern for adequate enforcement of the estate and gift tax laws and the limited resources available for this purpose. Its proposals, therefore, recommend substantive changes in the estate and gift tax law, rather than merely urging more stringent enforcement efforts by the Internal Revenue Service. The Task Force is also mindful of revenue concerns. To the extent there are any significant revenue implications, the Task Force proposals should increase revenue in the short term, because the emphasis of the proposals is on the gift tax payable at the time of the transaction rather than on the estate tax payable on the transferor's later death.

THE PROBLEM: The Task Force believes the "estate freeze" problem was one of valuation. In the classic case of a preferred stock recapitalization, the common stock was valued by subtracting from the value of the business the value of the preferred—typically valuing the preferred at face although it did not bear a cumulative dividend at a market rate. Instead, various "features" were included in the preferred to justify a valuation at face. These features were usually rights given to the holder to protect the economic position of the preferred stockholders that were not expected to be exercised. Further, the transaction was often not reported as a gift. Consequently, neither the initial transaction nor the later failure to pay dividends were drawn to the attention of the Service for audit.

Some have suggested that there are other policy reasons for having Section 2036(c). These have yet to be clearly articulated. They seem to relate to the concept of retention of "strings." Such a rationale is consistent with Section 2036(a) (retention of the "string" of income) and Section 2036(b) (retention of the "string" of voting). "Strings" may include the extension of compensation, interest on loans, and lease payments. To the extent these payments are only reasonable and adequate compensation for services rendered, market interest rates, and arm's length rental payments, they are not retained "strings" on the gift of capital, but instead represent quid pro quo payments in exchange for valuable rights. To the extent such payments are excessive (note this problem is the opposite of the valuation problem in a preferred freeze where the dividend is inadequate) various income tax sections and doctrines (e.g., unreasonable compensation and Section 482) can adequately deal with any problems. To the extent the "string" retained is the preferred dividend, this issue is a valuation issue.

If the "string" retained is the control of a closely held enterprise because of the ability to obtain various benefits from the enterprise, the definition of "string" is too broad. Such a definition would logically apply to all gifts of any minority interest in a closely held enterprise. Tax policy should not unduly discourage the closely held business owner from transferring part of an interest to the owner's children during the owner's lifetime.

PROPOSAL

PART I—VALUATION ASSUMPTION: For gift tax purposes only, nonpublic stock and partnership interests shall be valued in order to maximize the value of the gift by assuming any discretionary liquidation, conversion, dividend or put rights retained by the donor or the donor's spouse will not be exercised by them in a manner adverse to the donee's interest if the donee is a member of the donor's family.

This proposed valuation assumption rule is confined to nonpublic corporation and partnership interests because the past "estate freeze" abuses have occurred with respect to interests in business entities and there is no potential for valuation abuse with transfers of publicly traded interests.

The attempt in Section 2036(c) to encompass all "enterprises" caused great uncertainty as to the limits of that Section's application. The Section 2036(c) requirement of a 10% interest indicates the intent to apply the current "estate freeze" limitation only to business entities. If there is more than one person interested in an enterprise, it will be conducted either in corporate or partnership form.

In recapitalizations, the common stock was often valued by assuming that the discretionary conversion, liquidation or dividend rights of the retained preferred stock would be exercised in a manner which would be disadvantageous to the common

stock owner. However, in many cases the donor was not likely to exercise those discretionary rights to the disadvantage of the donee's interests.

The proposed gift tax valuation assumption rule is intended to value the transferred common stock interest without lowering that value with the discretionary "bells and whistles" often placed on the preferred. Thus, a cumulative preferred dividend would decrease the value of the donated common stock for gift tax purposes because such right is not discretionary, but a noncumulative dividend rate would not decrease the value of the transferred common stock for gift tax purposes as there could be no assurance it would be paid.

This change in the substantive law of valuation would mean that a taxpayer could not claim compliance with the law by use of "bells and whistles." The discretionary rights listed are intended to include all rights which may be used in aggressive recapitalizations or other potentially overreaching transactions. It is not intended to make any change in pre-1988 law with respect to voting rights. It, therefore, does not propose to change the law as to valuation of nonvoting or minority stock.

The Service has attempted to challenge these devices by treating noncumulative preferred dividends not paid in any one year as a gift under the rationale of the Dickman case. See Ltr. Rul. 8403010; TAM 8723007; and TAM 8726005. This proposed valuation rule, the Task Force believes, is a more effective deterrent to such transactions than attempting to tax each year's failure to exercise the rights as gifts. The proposal is similar to Section 7872 which, when dealing with term loans, treats the gift as made at the time the loan is made, not annually. Also, if the gift is deemed made annually, annual exclusions may diminish the effect.

Public corporations or partnerships might be defined as those for which market quotations are readily available on an established securities market. This definition accords with that in Section 170(e)(5)(B)(i) relating to charitable contributions of qualified appreciated stock.

The proposed valuation assumption rules would have no application to nonfamily transfers. It is suggested that "family" be defined as issue of the donor or the donor's spouse and spouses of such issue.

PART 2—A SAFE HARBOR: For purposes of valuing any gift of a junior or residual equity interest in a nonpublic corporation or partnership ("common interest"), which interest is subject to one or more senior or preferred equity interests in such corporation or partnership ("preferred interest"), any such preferred interest shall be deemed to have a value not less than the amount which such preferred interest would receive if the corporation or Partnership were liquidated on the date of such gift ("the liquidation amount"), provided that

> *(a) such preferred interest is entitled to a cumulative dividend or preferred income right not less than the liquidation amount multiplied by the applicable Federal rate on the date of such gift determined under IRC §1274 compounded semiannually; and*
>
> *(b) in the event of any failure of the corporation or partnership to pay dividends or make cash distributions in the amount stipulated in (a) above for 36 months, the preferred interest shall be entitled to voting control of the corporation or partnership: and*
>
> *(c) the sum of all such preferred interests does not exceed 80% of all of the equity interest in such corporation or partnership.*

Through the concept of qualified debt and qualified start-up debt in Section 2036(c), Congress has authorized a division of the capital structure of a nonpublic corporation or partnership into debt and stock. There are, however, many situations where a preferred stock or preferred partnership interest would be preferable either as a substitute for debt or in addition to debt. The Task Force believes that such preferred interests should be authorized if there are adequate provisions against valuation abuses. Congress has authorized use of the applicable Federal rate for the valuation of debt for gift tax as well as income tax purposes, even though the credit of the individual or nonpublic business is certainly less than that of the Federal Government and thus a higher interest rate would be economically justified. The Task Force is of the view that it would create unnecessary administrative complexity to use varying rates for different types of debt and equity interests. Therefore, we suggest use of the applicable Federal rate for any preferred interest, whether it be debt, stock or a preferred partnership interest.

Safe harbors have an advantage in obtaining compliance. The experience of practitioners is that many taxpayers will structure their transactions to fit within them, if they are reasonable.

It essential in defining a safe harbor preferred to provide that the preferred returns are cumulative. An outsider would purchase a preferred stock which was not

cumulative only in rare and unusual circumstances. Although the cumulative feature of preferred is normally not compounded, compounding is believed desirable in the family context. In the nonfamily context, other factors assure payment of dividends. In the family situation, even cumulative dividends may well not be paid. If the rate does not compound, a significant advantage to the common interests can be obtained. The recent emphasis on "time value of money" indicates the wisdom of including compounding. Furthermore, the market is utilizing paid-in-kind preferred dividends in the case of highly leveraged enterprises to obtain the compound effect. A paid-in-kind provision should be considered as satisfying the compounding requirement.

The dividend or compounding rate selected is the relevant applicable Federal rate. Usually the long-term Federal rate would be used, but if it is a preferred with a variable or reset rate provision, the short or midterm rate may be appropriate. Taxpayers should be able to elect the rate from any one of a specified number of months before the gift in view of the time required to plan and effectuate the transaction.

If all the value of a corporation or partnership is placed in the preferred, no matter what the dividend rate, it understates the value of the common. The common always has at least the value of an option that may obtain value if the business does better than the return on the preferred. Therefore, some minimum capitalization in common stock should be required. The Task Force believes that requiring at least 20% of the equity capitalization to be in common stock or non-preferred partnership interests should solve this problem.

The interest rate and capitalization requirement must be met at the time of gift rather than just when the preferred is issued. This limits the safe harbor's usefulness in the case of annual gifts. However, consideration should be given to valuing preferred (that otherwise meets the capitalization requirement) by the use of the applicable Federal rate tables in a manner similar to valuing debt instruments with inadequate interest under the OID rules. The lack of a maturity date for preferred complicates the problem, but this may be dealt with by assuming that preferred stock will be redeemed in 40 years.

A shift of voting control after a 36-month default in preferred contributions is provided to ensure that such a preferred, for estate tax purposes, would have a value equal to its stated liquidation value (including cumulative distributions) adjusted for changes in interest rate, if the corporations or partnership's assets have at least such value. Because dividends may not be paid, it is important to assure that such value is not diminished. There is considerable question as to whether alternative provisions such as mandated estate tax valuation should be used.

CONCLUSION: It is believed that enactment of the foregoing proposals in place of present Section 2036(c) will permit legitimate business transactions and give the Service the tools necessary to prevent unjustified tax avoidance devices.

Detailed comments on the Discussion Draft were given by all three organizations that compose the Task Force before the House Ways and Means Committee. Pending a revision of the Discussion Draft, such detailed analysis does not seem appropriate. Rather, I will confine my remarks to comments concerning the differences in approach of the Task Force Report and the Discussion Draft.

The Task Force report relies upon a determination of past abuses and defining them as "bad" rights that cannot give value to a preferred interest. We believe that defining what is bad is a more appropriate approach to the problem than defining what is "good." It prevents past abuses. If it is feared that new devices will be developed, there could be added to the list of rights some general language referring to "similar rights." There are so many transactions in this area, that some flexibility needs to be left to individual facts or the statute will sweep innocent transactions into its scope. In my testimony before the House Ways and Means Committee, I gave various examples of the unintentional breadth of the language of the Discussion Draft.

The Task Force Report does give some indication of what is good by its safe harbor. This safe harbor has been quickly dismissed by some. I suggest that safe harbors are very helpful in obtaining compliance under a self-assessment system. They have two practical effects: (1) Many taxpayers will want the assurance of safe harbors and will comply; (2) They imply a question as to transactions outside the safe harbor. For example, the concept of a 20% minimum common capital as a safe harbor implies that some minimum capital is required, but yet permits a lower amount of common capital for businesses that can justify such a position. Abuses in

this area are not based on whether the common capital is 10% or 30%, but on 1% or less.

An additional advantage of the Task Force Report is that it automatically deals with the issue of third parties holding common interests in the corporation, and does not necessitate a decision upon the minimum level of ownership required before applying the new rule. The Discussion Draft's 10% threshold level raises the problem of how to deal with the situation when more than 50% of the common, and thus the benefit from the non-QFP preferred, is held by non-family members.

One of the more difficult areas of distinction between the Task Force Report and the Discussion Draft is cumulative, but not compounded, preferred on which dividends are not paid. This situation is one of the major reasons for the Discussion Draft's deemed dividend provisions which have the potential of applying in an inequitable way and, in all cases, result in much complexity. The Task Force Report, in its safe harbor, indicates the importance of the preferred having terms which deal with that issue. It requires both compounding and a voting shift after three years of non-payment of dividends. It, thus, implies that the lack of these terms must be considered in valuation and, if they are not supplied, other facts or circumstances must show at least the intent to pay dividends.

I am particularly concerned as to how a broader approach may affect partnerships. The various rights that may be included in partnerships are much broader than in corporations. I believe defining what is bad is quite possible, but attempting to define what should be permitted in partnerships is very difficult.

Our Task Force did not consider Grantor Retained Income Trusts because of the present Section 2036(c) statutory exception. I would favor limiting them by rules similar to the strict and specific rules which govern the charitable contribution in the charitable area. It may be, as the Discussion Draft suggests, that joint purchases other than of residence should be dealt with similarly. Structurally, this should be a separate provision from that dealing with corporations and partnerships.

CONCLUSION: We have given careful consideration to the approach taken by the Discussion Draft. All three groups that compose the Task Force testified before the House Ways and Means Committee on the Discussion Draft. We find much merit in it. On reflection, however, we sincerely believe our Report is a better approach. We believe it is significantly less intrusive and complex and equally able to deal with the historic abuses in corporation and partnership freezes. More important than our differences with the Discussion Draft, however, is our similar view that Section 2036(c) should be repealed and a substitute enacted this year.

Prepared Statement of James O. Roberts

Mr. Chairman and Members of the Committee: Thank you for the opportunity to make this statement before the Committee. My name is James O. Roberts; I am president of Management Planning, Inc. of Princeton, New Jersey. We are a firm of financial analysts specializing in the valuation of closely held corporations for various shareholder and corporate planning purposes. Since our founding in 1939, we have valued thousands of family and closely held companies and have counseled on many preferred stock recapitalizations or "estate freezes."

When Section 2036(c) was enacted by the Revenue Act of 1987, I could not believe that the section meant what it said. In our experience of over 50 years in the valuation business, we have seen virtually no IRS challenges to the preferred stock freezes in which we were involved. Therefore, it was inconceivable to me that Congress would subject all family owned businesses and farms to the punitive rules of 2036(c).

The owners of thousands of closely held and family companies that I and my associates talk to each year are desperately concerned about their inability ever to pass on the business to their children. In most cases, they have spent their lifetimes, and committed virtually all their assets, to developing the businesses; the preferred stock recapitalization had proven to be one of the fairest and most appropriate methods of allowing the senior generation to retire with some security of their investment while providing the next generation with the incentive to build the business on a sound and secure basis.

First of all, it might be helpful to give you a little background on the closely held or family owned business and the place that it holds in our national economy. There are something like 20 million business enterprises in this country and, with the exception of about 15 to 20 thousand that are publicly owned, the rest are all privately owned. These range from single employee business to extremely large and vital pri-

vately owned companies that rival in size the largest 100 publicly owned enterprises.

The importance of the family and closely held business in the national economy cannot be over-emphasized. It is this segment that produces the most new products, the greatest productivity increases, the most new jobs, and the greatest capital accumulation. Indeed, it has been the lynchpin of the free enterprise system since our country's founding. The driving force of the founding family is often what guarantees the continued success of a company. The truly damaging effect of Section 2036(c) is that it creates financial disincentives to continue the family business into the next generation.

The constraints of this legislation have forced all too many owners to reach the frustration level that triggers the decision to sell out. It has also been my experience that the primary beneficiaries of this decision are foreign financial interests who have been able to buy up a major segment of America's family owned business enterprises due to this inability to continue ownership within the family.

All businesses have a need to plan for the orderly succession of both ownership and management. This is a far more complicated transition for the private businessman than it is for a public company due to family, liquidity, and estate tax considerations. The transition of management and ownership in a public company is normally an orderly process with the successor being a few to maybe 10 years younger than the senior executive contemplating retirement. In the family owned business, the successor son or daughter is not 5 or 10 years younger than the senior, but rather 25 to 40 years younger. The time horizon for ownership and management planning represents an extraordinary problem for the closely held or family held company. To be repeatedly battered with the deluge of tax legislation and regulation that the owners and their advisors have encountered in recent years has been devastating to this orderly succession planning process.

Since 1976, 15 major laws have been enacted by Congress dealing with income or estate taxation. With rare exception, they have negatively influenced the ability of the small business to provide continuity of ownership. Section 2036(c) was perhaps the most devastating of all this legislation. Without a means by which the family business can provide for the orderly succession within the family, the business will be taxed out of independent existence. I urge you to repeal this confiscatory statute.

The question following repeal is probably: To what? To regulations and legislation already on the books, or to something else? The solution lies, I believe, in reliance on in-place legislation and regulation. Internal Revenue Service Ruling 83-120, for instance, provides guidelines for valuing preferred stock recapitalizations. Unfortunately, this regulation did not go far enough, but I believe that guidelines can be developed to fairly value these securities without a negative revenue flow. Since many of the problems arising from 2036(c) legislation are valuation problems, I believe that the solution lies within the valuation industry and the IRS. Together, we can target the abuses and develop guidelines on how to correct them without a loss of revenue; I then encourage the IRS to enforce these guidelines.

I. ESTATE FREEZES PRIOR TO THE 1987 ACT

A. Valuations of Preferred Stock

By definition, the basic provisions of standard preferred stocks call for a fixed dividend rate that is cumulative in its payments. Traditionally, they have been issued to owners of closely held companies in modest amounts. In more recent years a number of market factors have changed bringing about more complicated valuation problems in determining the value of the preferred stock to be issued. It should also be understood that in virtually every corporate recapitalization, someone is turning in common stock and receiving preferred stock, and the value of what he turns in must be equal to the value of what he gets. It is essential, therefore, that you also know the value of the common stock.

A normal, straight preferred stock is not especially difficult to value if the company has sufficient assets to provide added security for the preferred issuance and sufficient earnings to cover its annual dividend requirements.

Two major valuation problems in estate freeze transactions developed in the 1970's and 1980's. The principal of these was the double-digit yield of standard fixed dividend preferred stocks necessary to make them of market quality and the limits of the total amount of preferred stock which a company can realistically issue. By far the largest percentage of preferred recapitalizations were a straightforward and practical solution to a family company's needs; which are, secured investment and an adequate income stream for the senior generation and an opportunity for appreciation for the younger generation family members who were either active or inac-

tive in managing the growth of the business. The younger generation would be motivated to build the overall value of the business, and therefore, creating his or her own rewards through growth and increased profitability.

B. Background on the Closely Held Business

It's important to understand the complexity of planning for the family owned business. There are many factors unique unto the particular business itself, including such things as: individual needs of the family and the competitive needs within their industry. Family matters are of particular concern in planning for this type of situation due to the fact that transition of ownership and management must take place over an extremely long period of time due to the difference in age between the senior generation and the next generation. This can be up to 25 to 40 years. The parent is seldom sure of just how the whole thing will work out. The family needs can be broken down by parents needing security and income in their senior years and children having various income and appreciation needs depending on their age, involvement in the company, abilities, parent/child relationships and others. To ignore the needs of either generation results in poor planning. The result is that the business languishes or is eventually sold.

C. Valuation Problems Encountered in Recapitalizations

Because of the high yields expected in standard fixed dividend preferred stocks, a number of special features, also known as "bells and whistles" were added to justify a lower dividend rate. These included:

(1) adding voting power to the preferred
(2) giving them a put or an opportunity for the shareholders to demand redemption
(3) making them convertible

Another problem encountered was that preferred stocks were issued in quantities which were much too great for the underlying equity in the company. The valuation of these special features became major stumbling blocks for the Internal Revenue Service.

D. Revenue Ruling 83-120

In 1983 the IRS came up with guidelines for valuing preferred stock and, in a minor way, common stock in recapitalizations. The ruling was a good one, as far as it went, however it dealt with relatively simple concepts on a fundamental basis. There was little attention to some of the more sophisticated "bells and whistles" that were being developed for the business owner at the time. This ruling did not include any comments on such features as convertibility and "leaks."

E. Regulation and Enforcement

Valuation cases involving the Internal Revenue Service were handled on a case-by-case basis and as the use of special features or "bells and whistles" increased, the expertise needed to value these features increased proportionately. This created an understaffed situation for the IRS and in many cases they were "outgunned" by the taxpayer and his advisors. Undoubtedly there were abuses in the system, but a few got the publicity and the whole system became tainted.

II. THE ENACTMENT OF SECTION 2036(C)

The enactment of 2036(c) relieved the Internal Revenue Service of responsibility to enforce the fairness of these varying and, occasionally, abusive plans. Unfortunately, the ability of countless thousands of family companies to plan for the future continuity of ownership on a fair and equitable basis went out with that legislation. The baby thrown out with the bath water, if you will.

The principal concerns were alleged abuses in preferred stock recapitalizations, particularly the misvaluation of appreciation transfers. The particular abuses singled out included:

(1) Inadequate dividend rates and payments
(2) The failure to pay dividends on a cumulative basis
(3) Excessive amount of company value transferred to a preferred stock.

III. AFTER REPEAL OF 2036(C)

A. Improved Enforcement of Existing Rule

The IRS has developed a significant level of expertise in valuing closely held businesses over recent years and there is already in place an IRS Revenue Ruling 83-120 which was developed to amplify Revenue Ruling 59-60 by specifying additional

factors to be considered in valuing common and preferred stock of a closely held company for gift tax planning, and other purposes. Whereas 83-120 was late in being developed and somewhat inadequate for the types of preferred stocks already in existence, it nevertheless provides a basis on which fair and firm valuation standards for both common and preferred stocks in these reorganizations. Also, significant valuation penalties are in existence to assist the IRS in this effort.

The durability of strong guidelines in the valuation process is a well recognized fact dating back to Revenue Ruling 59-60. Originally introduced in 1959, this ruling has stood the test of time in valuation questions for everything from gift and estate tax planning to ESOPs, to all types of corporate and personal transaction needs. A valuation work ignoring this rule and its guidelines, does so at peril. There is no reason why revised and strengthened guidelines for "freezes" cannot serve the IRS, tax planners and the closely held business owner fairly.

B. Revising Revenue Ruling 83-120

This ruling established basic guidelines for valuing preferred stock recapitalizations and there is a definite need to update and strengthen these guidelines and there is significant incentive for all parties to work toward this end. I would suggest a panel of experts from the American Society of Appraisers (Business Valuation Discipline) be appointed to work with representatives from the Internal Revenue Service toward this end. Since it is recognized that the deficiencies of 2036(c) are basically valuation problems, new guidelines should be developed to provide for ready recognition of valuation questions, a fair market basis for valuation and solutions within an easily enforceable range.

Particular issues to be covered would be:

(1) A Market Yield as measured by the quality of the asset and earnings coverage should be the basis for value. A yield lower than that of BBB, the lowest investment grade preferred stock would indicate a preferred stock value of less than par unless compensated for by other defined rights such as vote, convertibility or other factors.

(2) Cumulative versus noncumulative dividends: The use of a cumulative dividend provides for a far stronger preferred stock than does the noncumulative. There are times when a company is unable to pay all of the preferred dividends and in these cases, there should be "narrow safe harbors" developed to handle them. Where the preferred shareholder has the voting control to declare the dividend, that shareholder or shareholders could be forced to pay an annual gift tax on that portion of the dividend that they did not declare. This could be in the form of either a paid tax or allocated from the individual's unified gift credit or their annual exclusion.

There are circumstances in all companies, both large and small, when it becomes necessary to invest significant capital to maintain the competitive nature of the business. This quite often creates a serious problem for the closely held small business and some provision should be made for that. Many companies taking this route would normally have invested their capital over a relatively short period of time (say, one to three years). An exclusion from the dividend payment could be justified with sound documentation.

(3) The maximum equity value represented by preferred stock. A common misconception is that nearly all of a company's equity value can be represented by preferred stock. This is not the case in sound valuation practice. The strength of a preferred stock issue depends upon its asset and income protection. The person giving up common stock in exchange for preference security and income should expect fair exchange. If a preferred stock is entitled to nearly all of the company's net assets and earnings, the preferences of this stock will actually give it very little protection because the margins of its coverage will be limited. It will be a preferred stock which has most of the risks of the common stock without the potential rewards of appreciation. Without a fair percentage of at least 20% in the common stock equity, the value of such a preferred stock would be well below its par value. Guidelines for accepting this should be developed.

(4) Voting Power. The provision for voting power, often in control blocks, has been a characteristic of many preferred stock recapitalizations. Voting power does improve the value of the preferred stock. The effect of this improvement is modest if the preferred is a minority block. If the block has voting control, the value is bolstered considerably because it empowers the owner to have the stock called for redemption, declare dividends, exercise conversion rights, etc.

(5) A stock redemption "put." If the preferred stock has a "put" that would require the company to redeem the stock, then this has value that can be defined. Again, if the block does not represent voting control, this increased value would be modest.

(6) Convertability. If you make the preferred stock convertible into a number of shares of common stock or into dollars of common stock, it will increase the preferred's value.

(7) Other features. There are a number of other, features including the partial participation in appreciation in the increased value of the company (called a "leak"), a high call price compared to issue price and other features. Each of these can be dealt with with firm guidelines and limits.

The key on developing special and appropriate features for the preferred stock of a closely held company is that the preferred stock accepted and exchanged for common must have defendable and documentable equality if it is to be valued at par. When you take away the upside potential of common stock in a growing company, you must also take away the downside risks for those receiving preferred stock. This is very much in line with interests of most older generation owners. Their interest is in the security of their investment and a current income to satisfy their needs. The younger generation, at least those involved in the business, are more keenly interested in the upside potential for their abilities and management skills and the ability to expand the business beyond its present level.

Repeal of 2036(c) in coordination with clear, strong and enforceable guidelines for valuing preferreds will allow for fair and equitable planning without a loss to the taxing authorities.

Prepared Statement of Senator Steve Symms

SYMMS INTRODUCES BILL TO SAVE FAMILY FARMS AND BUSINESSES

(WASHINGTON)—After months of research, preparation and "jawboning," Senator Steve Symms and seven of his colleagues today introduced the "American Family Enterprise Preservation Act," a law Symms says will stop tax collectors from forcing family farms and small businesses to be sold at estate sales to pay "death taxes."

"It's crushing the backbone of America, the family business," Symms said on the floor. "Family businesses should not have to be sold, Mr. President. They should not have to be sold in order to pay off the death tax!"

Symms, a member of the Senate Finance Committee where the bill will most likely get its first hearing, was joined by the ranking Republican on the Senate Committee on Small Business, Senator Rudy Boschwitz, (R-MN) and Senator Malcolm Wallop (R-WY) another member of the Small Business Committee.

Also joining Symms as original cosponsors were Republican Whip, Senator Allan Simpson (R-WY), Senator Orrin Hatch (R-UT), Senator Don Nickels (R-OK), Senator Conrad Burns (R-MT), Senator Thad Cochran (R-MS), and Senator Gordon Humphrey (R-NH).

The American Family Enterprise Preservation Act is a comprehensive reform of the controversial and penalizing estate tax provisions enacted in 1986 as part of "tax reform" which cause thousands of family enterprises to be sold at estate sales. Especially hard hit are family farms, 90% of which Symms estimates are family operations. Farms are often "land rich and cash poor, according to Symms and are forced to be liquidated to pay the taxes when the elder generation passes away.

Essentially, Symms' bill will repeal Section 2036(c) of the IRS code, commonly known as the "estate freeze. The so-called estate freeze does not recognize legitimate transfers of ownership between family members, either by purchase or gift, prior to the death of the elder family member. Consequently, a son or daughter is taxed as though they have inherited the entire business, not just that portion that they had not previously acquired either by purchase or by gift.

Other provisions of the Idaho Republican's bill increase the tax credit so as to allow family enterprises worth less than $1 million to be transferred between family member without tax penalty, and indexes that credit for inflation.

Symms also wants to simplify the process of transferring property between family members. There are currently 17 tax brackets the top being in excess of 55 percent. Under Symms' bill these are reduced to two—15 and 28 percent—the top one being equal to the top income tax. These brackets would also be indexed for inflation.

Finally, Symms' bill would make it easier to pay taxes due at the time of transfer by extending the four percent interest rate currently charged on the first $153,000 of tax due, after which the rate goes up, over the entire amount of tax due.

In addition to the support of his colleagues, including two members of the influential Small Business Committee, the National Federation of Independent Businesses (NFIB) and the newly formed advocacy group for family businesses, "Family Businesses of America" have endorsed the bill.

Vol. 136 WASHINGTON, TUESDAY, JUNE 26, 1990 No. 83

Congressional Record

Senate

S. 2783.

AMERICAN FAMILY ENTERPRISE PRESERVATION ACT

Mr. SYMMS. Mr. President, I rise today to introduce the American Family Enterprise Preservation Act. I think it is no secret to Members of the Senate, and to Americans in general, that a high percentage or our population earn their living working in or for small businesses in this country, and that most of the small businesses in the country are owned by families.

Family-owned businesses are the essence of the American dream. Hard work, resourcefulness, and pride in doing the job well are typical characteristics that we find in family businesses. Family businesses are an attractive venture of Americans to enter into and try to work for their own benefit, pleasure, and sense of accomplishments.

I assert to you today, that it has been families and their businesses that have been the bedrock of a strong economy in the United States since the very beginnings of this Nation.

Mr. President, due to the present tax laws however, a family's business accomplishments are heavily taxed upon the death of the majority owner of the business, which exposes many of these small businesses to what can lead to financial collapse, particularly in the agricultural community.

I would venture to guess that well over 90 percent of the farms in America are operated as family businesses. Most of those farms are land rich and cash poor. So if someone dies in the family, and if the farm is of any value and substantial size, it forces liquidation or heavy debt in order to pay off the tax collector.

One of the reasons that we have seen such a concentration of newspaper ownership in America, is because of the death tax laws in this country that have forced families to sell local newspapers to bigger corporations so they can pay off the debt taxes.

Family-owned businesses are not an American institution that Congress should contemplate taxing into extinction. Family businesses provide jobs, revenues to the Treasury, and products and services that are essential to the well-being of America. It is by no means easy that a family business can be built. And what is really tragic is that Congress has, through its infinite wisdom, created a taxing system we now have that imposes death taxes in this country. It is crushing the backbone of America—the family business. Family business should not have to be sold in order to pay off the death tax.

Mr. President, if American Government has evolved to the point of destroying such a fundamental part of society, I feel one of the most important and vital legacies we possess will be lost forever. Extremely high estate taxes strike at the heart of the American dream. More than half of all businesses qualify as family businesses. As I said earlier, in agriculture it is a much higher percentage.

Incredibly, as the citizens in this country are clamoring for tax relief across the board from the income tax system and from property taxes, the Federal Government continues to impose no less than 17 different tax rates on estates. They range from 18 to 55 percent. This often causes the family of the deceased business owner to sell the assets of the business just to pay the Federal taxes.

The legislation I intend to introduce today, which I call the American Family Enterprise Preservation Act, will do several things. I fell these are all essential to help ensure the survival of thousands of family businesses in the country, and not only the survival for the business, but the survival for the people that work in those businesses, who enjoy working in a small company where they have direct contact with the owners, and can become part of a team, with a family that operates a business.

First, this bill would repeal section 2036(c) of the IRS Code by eliminating the estate tax freeze. That means that the heir will only pay taxes on the portion of the estate that is actually inherited. They will not have to pay capital gains taxes on the growth of the company from the time that they assumed ownership until the owner is deceased, in the interim period.

For example, if a father would give or sell a business to his children, during the interim period of, 25 years before the time the father might be deceased, and the business were to enjoy a great deal of growth and expand in its value, under current tax law, upon the death of the original owner of the business, they will have to go back, recoup, and pay taxes on the growth that took place even after that person moved out of the business.

I feel this estate tax freeze will be received favorably. I am confident that at least this portion of this bill will be passed this year.

Second is to reduce the number of tax brackets from 17 tax brackets down to 2. This is the same as the top income tax bracket. It would be indexed for inflation, and the top bracket would be 28 percent. Why we tax people at 55 percent on an estate is beyond my imagination. It is pure confiscation of property to tax anyone at 55 percent, particularly if they have worked, been thrifty, reinvested in their business, and paid taxes on the profits of that business throughout the years of building it. To have the heirs upon their death pay at 55 percent tax rate is absolutely outrageous, and should be stopped. We should not have this inequity taking place in the United States. My legislation would lower the estate tax rates to either 15 or 28 percent, same as the income tax rate.

Third, it would increase the "unified credit" to a higher amount equivalent to a $1 million estate and index it for inflation. The unified credit is currently $600,000. This bill would raise it to $1 million finally; this will extend the 4 percent interest rate to the entire amount of tax due, instead of being increased after the first $153,000 is paid.

Mr. President, this bill does not go all the way. I know many people in the Congress and in the country believe that the estate tax should be repealed

CONGRESSIONAL RECORD

entirely—I do not argue with that philosophy—because those people have already paid taxes on it. But this is a modest step to moderate the destructive damage done to the businesses, jobs and to the economy of this country by these very confiscatory taxes.

The advantages of these provisions are easily seen. Repeal of these onerous, laws returns to law prior to the Tax Reform Act of 1986, and reinstates the expectation of fairness and simplicity in estate planning that families running a business had come to depend on.

What incentive is there, Mr. President, to establish a business owned and operated by the family, only to have up to 55 percent of it taken away by estate tax payments when the majority owner dies? In fact, precisely because of 2036(c) and the resultant high estate taxes, there is no incentive to keep a family business going. The purpose of a family business is to provide for the family; yet, our present estate tax laws discourage this, discourage the basic backbone of the American dream for most people.

Mr. President, unfair tax laws stand as a barrier to the hopes and dreams of the American people. Estate taxes discourage normal intrafamily transactions which prevent the passage of the family farm or business to the next generation. We have an opportunity to do something to correct this error in our taxing system. I urge all my colleagues to support this legislation. I say to my colleagues that the National Federation of Independent Business supports this legislation, along with the Family Businesses of America. I ask unanimous consent to have printed in the RECORD at this point a letter from Mr. John Garvey to Senator BOB DOLE encouraging his support of this legislation.

There being no objection, the letter was ordered to be printed in the RECORD, as follows:

FAMILY BUSINESSES OF AMERICA,
Wichita, KS, June 20, 1990.

Hon. BOB DOLE,
U.S. Senate, Hart Senate Office Building, Washington, DC.

DEAR SENATOR DOLE: We are grateful for your past and continuing support of S. 849 to repeal section 2036(c) of the Internal Revenue Code.

Family Businesses of America, formed in 1990, already represents family businesses and their advisors from all regions and most states and many industries.

We aspire to represent many of America's 20 million family businesses, which represent an estimated 40–60% of U.S. GNP, at least ½ the U.S. population, including owners, investors, employees and dependents of American family businesses.

As a Kansan and as a founder of FBA, I solicit your consideration and support of Senator SYMMS' "Family Enterprise Protection Tax Act" which will be announced on or around June 21, 1990

Sincerely,

JOHN K. GARVEY.

Mr. SYMMS. On behalf of myself, Mr. BURNS, Mr. WALLOP, Mr. NICKLES, Mr. HUMPHREY, Mr. SIMPSON, Mr. COCHRAN, Mr. HATCH, Mr. BOSCHWITZ, and Mr. HELMS and any other Senators who would like to join in this effort, I invite their participation, and I hope that they will cosponsor this. I think it is going to have a very minimal impact on the Federal Treasury in terms of costs to the Treasury. In my view, if we look at a dynamic model, I think we can make the case that this bill will, in the long run, generate income and revenue to the Federal Treasury, because it will generate the desire for people to own and operate their own profitable small businesses.

Current Law

If the amount with respect to which the tentative tax to be computed is: If the amount with respect to which the tentative tax to be computed is:	The tentative tax is The tentative tax is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41 percent of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43 percent of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45 percent of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49 percent of the excess of such amount over $2,000,000.
Over $2,500,000	$1,025,800, plus 50% of the excess of such amount over $2,500,000.

If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53% of the excess over $2,500,000.
Over $3,000,000	$1,290,800, plus 55% of the excess over $3,000,000.

STEVE SYMMS
IDAHO

United States Senate
WASHINGTON, DC 20510

SECTION BY SECTION ANALYSIS
[bill to be introduced in June]

Section 1. Short Title
"American Family Enterprise Preservation Act"

Section 2. Repeal of Section 2036(c)
The effect of this section is the same as S.659, introduced by Senator Symms on March 17, 1989, to restore prior law -- effective date December 17, 1987. Repeals IRC section 2207B and 2501(d)(3).

Section 3. Reduction in Estate and Gift Tax Rates
New rates would be 15% for estates of one million dollars or less; 28% for estates over one million dollars. Effective date after December 31, 1990. IRC section 2001(c).

Section 4. Increase in Unified Estate and Gift Tax Credit

(a) Establishes a credit of $150,000 -- equivalent to an estate of one million dollars under the new tax rates. Indexes the credit according to cost of living adjustments.

(b) Does the same for gifts.

(c) Amends IRC section 6018(a)(1) to apply only to estates over one million dollars, and indexes this amount.

(d) Effective dates after December 31, 1990.

Section 5. Rate of Interest on Deferred Estate Tax Attributable to Closely Held Business

(a) Estate tax extended under IRC section 6166, and any deficiency prorated to installments, shall be 4%.

(b) Effective date after December 31, 1990.

PREPARED STATEMENT OF DEBORAH WALKER

Mr. Chairman, I am Deborah Walker, a member of the Federal Taxation Executive Committee of the American Institute of Certified Public Accountants. With me is William T. Diss who chairs our Estate and Gift Tax Committee. The AICPA is a national organization representing 296,000 CPAs. It's Tax Division represents 23,000 tax practitioners.

Mr. Chairman, we thank you for giving us, and others, the opportunity to present our views on a matter of intense interest to our membership, the difficulty in making lifetime transfers of family business interests. We recognize that the Senate Finance Committee included repeal of Internal Revenue Code (IRC) §2036(c) in the tax legislation which was reported out of the Committee last year. We appreciate that. We also appreciate the continuing discussion which the House Ways and Means Committee has promoted through issuance of the discussion draft. The draft obviously reflects many hours of careful deliberation by many interested parties.

Transfer taxes affect the founding and perpetuation of American businesses, the backbone of our economic system. Changes to the transfer tax system should be carefully considered and change should be undertaken only after deliberation by all interested parties and a thorough understanding of the effect the changes will have on the development of new businesses within this country.

We have testified a number of times concerning the repeal of IRC §2036(c). We continue to believe that IRC §2036(c) should be repealed because it inappropriately tees property which a taxpayer no longer owns. To impose estate and deemed gift taxes, Congress adopted a system far too intricate and complicated for efficient enforcement by the Internal Revenue Service or compliance by most taxpayers and practitioners. A subsection which was one of the few transfer tax provisions included in the 1987 legislation has caused such concern that the entire valuation system within the transfer system is being examined. This is an appropriate response to IRC §2036(c).

Discussion of estate and gift tax values must include an understanding of two interrelated goals—preservation of the integrity of the transfer tax system and continuation of family owned businesses and farms. Taxes should not be so onerous that the existence of a business is threatened. With rates of up to 60% of a company's value, this often occurs. American business simply cannot accept a tax burden equal to 60% of value and continue to survive in family ownership. At the same time, unrealistically high discount factors in the actuarial tables, which are based on applicable Federal rates, should not permit the manipulation of value of partial interests in investment instruments.

The adoption of the adjusted taxable gift rule with the unification of gift and estate tax rates, the ability to pay estate tax in installments, sometimes at favorable interest rates, the safe harbor stock redemption privileges for estate tax payments, and, more recently, the estate freeze rules, result in a transfer tax system which favors intergenerational transfer of assets at death rather than by gift. However, in many instances, transfer by gift before death would provide incentive to younger generations to further develop a family business. The transfer tax system should encourage transfers by gift, not penalize such transfers with marginal 60% tax rates and the required immediate payment of taxes. The transfer tax system needs a number of incentives to encourage the transfer of ownership.

Prior to adoption of IRC §2036(c) the preferred stock redemption was an acceptable, and in some cases, a very beneficial means of encouraging such transfers. The lifetime transfer of common stock in a family business or farm could provide an inducement to attract the younger generation and to reward them for their efforts. The estate freeze was a reasonable means of alleviating the transfer tax problem of the family business. However, other measures to encourage lifetime transfers should also be considered. These include lower transfer tax rates, a significant exemption for family held businesses, special valuation techniques and a delayed payout of estate and gift taxes, perhaps at a lower interest rate.

The transfer of businesses should be encouraged and the valuations used for the transfer of a business interest should be the same rules that apply to other property: fair market value, as embodied in the willing buyer, willing seller concept. The value of any transfer should be supportable in an IRS audit. We support an expanded reporting requirement, which will inform the Internal Revenue Service when transfers are made, irrespective of whether or not the transfer results in current income or gift taxation. The reporting should include a detailed analysis of the valuation and computation method used. For transfers in excess of a certain amount, an appraisal could be required.

Even with increased reporting, concerns with abusive valuations may still exist. Congress should not legislate a valuation system with a conclusive presumption. Our society is far too diverse and complicated, for any valuation system to properly reflect the true fair market value of an asset, as reflected in our free market system. However, some taxpayers would be well served with a safe harbor methodology for valuing property. The safe harbors should be elective, binding on both the taxpayer and the Service and not materially different than actual fair market value. Safe harbors could be developed statutorily, or could, with adequate guidance from Congress, be outlined in regulations. The safe harbors should be developed in consultation with professional appraisers. We believe that proposed Chapter 14, as outlined in the discussion draft, could perhaps be modified to include some valuation safe harbors.

Having determined the total fair market value of a business entity, the transfer tax system next needs to consider how that value is to be adjusted when an individual transfers only an interest in the entity. This is the specific issue that IRC §2036(c) and the proposals to replace IRC §2036(c) address.

We support the application of a special valuation approach for transfers of family businesses, as we believe such an approach can be a means of encouraging the transfer of property by gift. A simpler and more fair system would perhaps be one that valued the transferred property, rather than one valuing the retained property and subtracting that amount from the taxpayer's total interest in the property. At the same time the subtraction method with some adjustments can probably work. Such a system developed through deliberation by many interested parties, as is now occurring with the development and release of the discussion draft and this hearing.

Turning for a moment to the discussion draft, we want to emphasize our concerns regarding the market interest rate used to value a stream of payments. While we believe it is appropriate to use a market discount rate, the rate of return demanded by a closely held business is not equivalent, and cannot even use as a model, the market rate for traditional or portfolio investments.

Our experience has shown that many closely held businesses and farms realize a much lower rate of return for the risk assumed than that commensurate with the return demanded by the capital markets for the equivalent risk. Many entrepreneurs and small business owners traditionally evaluate the decision to remain in business or provide a service much differently than the capital markets—in fact, these businesses could not go to the market and raise capital since the marketplace would demand far too high a risk premium. The valuation system incorporated into the transfer tax system must consider this inability to go to the capital markets, and the reason this inability exists.

It is ironic that the businesses which are most burdened by the transfer tax system are those that cannot go to the capital markets for funds and yet the use of a market discount rate, as we understand the current discussion draft, effectively forces taxpayers unable to go to the market to value, for transfer tax purposes, their property as if they had gone to that market. The resultant value is not only far too burdensome, it does not truly reflect the market within which these businesses operate.

To adjust for this, we recommend a series of elective safe harbor rates which can be used by the taxpayer to discount a stream of payments. The safe harbors, when applied appropriately, should protect the taxpayer against revaluation. One safe harbor which we especially urge you to consider is the discount rate based on an internal rate of return calculation, a cash flow calculation. This calculation can be made with the information reported on annual income tax returns. A second safe harbor could contemplate a discount rate based on industry norms for the industry in which the business operates. The safe harbors should be elective, and should protect the taxpayer against future revaluations. Also, there should be a tolerance rule or range when the market rate is redetermined on examination. This will avoid significant unexpected gift tax consequences as a result of judgmental disputes on the market rate.

Whatever rate is used, it is absolutely mandatory that the rate consider the deductibility of interest and the nondeductibility of dividend payments. In many cases a business cannot structure a stream of payments as interest, even though this is preferable for income tax purposes, and the rate of return should consider this disparity.

In determining the valuation of transfers where an interest is retained, other possible implications within the Internal Revenue Code need to be considered. Specifically, for example, if a special type of interest is given priority status, such as that given to a qualified fixed payment in the discussion draft, those types of interests should be compatible with corporations operating as S Corporations. Similarly, the

benefits of IRC §303 redemptions and installment payment of estate taxes should be incorporated into the gift tax system. Thus, if an individual makes a significant gift of a closely held business, the gift tax should be able to be paid over a number of years, perhaps at a lower interest rate. Proposals need to adequately focus on various other transfer techniques that could become as abusive as certain estate freezes have become. Specifically, legislation should also prevent abusive reverse freezes.

The replacement for IRC §2036(c) and any new valuation rules which Congress adopts should be sure to consider the myriad of existing arrangements which often cannot be altered or modified. Taxpayers entering into arrangements years ago, including various trust arrangements, rights of first refusal and certain buy-sell agreements, should not be adversely impacted by any new valuation system. With regard to buy-sell arrangements, Congress should be aware that many buy-sell arrangements are usually entered into for non-tax purposes.

We are pleased that the discussion of a review of IRC §2036(c) is focused on the larger question of valuations within the transfer tax system and the impact on American business. It is most important that IRC §2036(c) be repealed. Any replacement to eliminate the valuation abuses which sometimes occur should be focused narrowly on those abuses and not involve sweeping changes which result in significant disruption and misunderstanding. Increased detailed reporting will significantly curtail these abuses. Valuation cannot be legislated, but a number of safe harbors could be made available to taxpayers, so that those who desire certainty in the taxation of a transaction can achieve it. Adjustments to the valuation for the retained interest should truly reflect the market in which these individuals operate.

We are pleased that the proposals being discussed tax the value of the transfer today and do not attempt to tax future appreciation on assets not currently owned. We believe the tax system should encourage gifts and the transfer of equity in family owned businesses and farms to younger generations. While we oppose the development of tax policy based solely on revenue considerations, we note that promotion of gifts will generate tax revenues currently. Any legislation should not be effective before the date of introduction.

We commend you for focusing the discussion on American economic and social policy considerations of which tax issues are only a small ingredient. One of the most distinguishing features of our economy is the significant role played by the entrepreneurial class. More new jobs are created by small business than any other segment of the economy.

Small business is the most fertile environment for the types of innovations and creative ventures that have kept our technology in competition with others abroad. These businesses tend to be short on working capital and they often cannot go to the capital markets efficiently. Thus, self generated funds are the only means available for maintenance and growth of these businesses. Self generated funds should not be consumed by transfer taxes.

Thank you for the opportunity to express our comments to you. Mr. Diss and I will be glad to answer any questions you have.

Prepared Statement of Thomas K. Zaucha

Mr. Chairman, my name is Thomas K. Zaucha and I presently serve as the 1990 Chairman of the Small Business Legislative Council and as President and CEO of the National Grocers Association. I very much appreciate this opportunity to testify on behalf of both organizations concerning a subject of major importance to all of us: the legislative future of Internal Revenue Code Section 2036(c).

As you know, the Small Business Legislative Council (SBLC) is a permanent, independent coalition of over one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

The National Grocers Association has always been an active, vital member of the SBLC. We include over 2500 retail and wholesale grocery companies operating throughout the United States. N.G.A.'s retail members are predominately independent operators that are family owned and closely held businesses. N.G.A.'s wholesale members serve as the food distributors to these retail grocers.

To business members of both of these organizations the words "small," "independently operated" and "family owned" frequently describe a way of life. This is because thousands and thousands of N.G.A.-SBLC corporate members have always been and hope to remain small, independently operated, family owned business citi-

zens in their community and their country. I say that they "hope" to remain such contributing economic entities. For many of them the enactment and administration of IRS Code Section 2036(c) represents a daily threat to their very existence.

Within that context, it is of very special significance to us that the Senate Finance Subcommittee on Energy and Agricultural Taxation under the Chairmanship of Senator David L. Boren and the Senate Finance Subcommittee on Taxation and Debt Management under the Chairmanship of Senator Thomas A. Daschle have announced this joint hearing on proposals to prevent abuses in determining estate and gift tax values. Both Senators have continued to provide distinguished leadership in the ongoing legislative struggle to remove and rectify the disastrous threats to America's family owned businesses which Section 2036(c) continues to inflict. Today's hearing is a most important part of their efforts. We salute them, and extend our sincere appreciation for the invitation to appear here today.

Today I should like to examine the issues which surround Section 2036(c) from three important perspectives. While traditional, I feel they offer the most reasonable basis by which we can focus today's discussion. More specifically, permit me to examine the question of Federal legislative control over Estate Freezes from the perspectives of (1) the Past, (2) the Present, and (3) the Future.

Mr. Chairman, any meaningful discussion of the *past* must begin with a clear understanding of the prior legislative *history* which governed enactment of Section 2036(c). It might best be expressed in a simple formula:

Bad legislative *process* frequently produced bad *legislation* which in its own turn causes bad *results*. If you seek verification of this concept you need only examine the all too sad history surrounding Section 2036(c).

First, it is important to recollect the *process* which characterized the enactment of 2036(c) as a provision in the Internal Revenue Code through the Omnibus Budget Reconciliation Act of 1987 and amended by the Technical and Miscellaneous Revenue Act of 1988. No Congressional hearings were ever held on any of the major public policy issues involved or to consider other possible, less intrusive positions. Similarly, no substantive floor debate was conducted in either the House or Senate. Congress chose not to "look before it leaped" and in the confusion which followed it produced a promise from the Internal Revenue Service that "clarifying" regulations would very shortly be issued by the Service removing much of the doubt and disturbance which had been caused. And yet again the process failed us. For months and months we waited while the IRS labored in secret to produce clarification and correction.

Finally, it just seemed to give up. On August 31, 1989, the IRS published its document. Unfortunately, in virtually every area, Section 2036(c) remains as vague, confusing and damaging to family owned business as before. In no way was the wait worth it. Mr. Chairman, to us, this entire *process* can only be characterized as a bad one.

Now there can be no doubt that such a *process* subsequently produced inferior and dangerous *legislation*. While I do not have the time here to spell out all of the technical difficulties with Section 2036(c). Suffice it to say that they are indeed numerous in nature. However, among the most important I would include:

> First, Section 2036(c) is unworkable among other reasons because it relies on the notion of "disproportionate appreciation." All business assets appreciate at different rates so the concept is meaningless. This concept is particularly harsh on unincorporated family businesses because of the possibility that any gift of business assets might be caught by Section 2036(c) because the gift was not a fractional share of every asset used in the family business. Nearly any gift in the family business context had potential unexpected adverse tax consequences.
>
> Second, Section 2036(c) is not limited to gifts, but it impacts legitimate business transactions without an estate planning motive, for example, buy-sell agreements, debt, leases, and employment agreements. The same transactions which would be permitted General Motors would not be permitted a General Motors dealer. Legitimate business transactions could result in the inclusion of a portion of the common stock owned by a child in the estate of a parent. Efforts in 1988 to narrow the scope of Section 2036(c) through "cookie cutter" rules failed to take account of the diversity of family businesses.
>
> Moreover, the estate tax penalty from that inclusion is unrelated to the transaction. The appreciation in value could have been due entirely to the child's efforts in the business. Section 2036(c) is faulty because it was "an estate tax solution to a gift tax problem." It also unfairly imposed both a gift and an estate tax on the same transaction.
>
> Finally, Section 2036(c) attacked family cooperation in the guise of preventing "hidden giving." Section 2036(c) ascribed adverse estate tax consequences to a

> parent who helped a child start his own business. Section 2036(c) favors parents who completely separate from the family business prior to death. It discriminates against family businesses in favor of wealth in public or foreign corporations.

At this point, it is probably wise to note that 2036(c), as finally drafted, bears little meaningful relationship to the narrow, restricted "abuse" it was brought forth to correct.

As Senator Daschle so aptly put it in announcing these hearings, "Section 2036(c) is a trap for unsuspecting owners of small family businesses. Its provisions are capable of ensnaring a host of transactions that were not intended to fall within the scope of the original legislation,"

Remember, the prototypical "freeze" involved the recapitalization of a wholly owned corporation into two classes of stock: a preferred class, which had a preference for dividend or income payments on liquidation, and a common class which was junior, but had a right to appreciation over the stated value ("frozen value") of the preferred. The dividends on the preferred were artificially supported by a redemption right, a conversion right or a power to liquidate the company. These rights were never actually exercised so that over time the value of the preferred was frozen at its initial stated value. Moreover, the unpaid dividends accumulated in the company to the benefit of the common shareholders. Using time value of money concepts, the dividend payments if deferred into perpetuity approached a present value of zero. The actual present value was never that low as the life expectancy of the parent was often short and the frozen value of the preferred would be taxed in the parent's estate.

We have seen an inferior legislative *process* did indeed produce a flawed *statutory* document, so our final question in terms of the past must be, what have been its actual *results?*

First, it is important to understand that a vital component of the American economic system and our national prosperity has always been the family business. From this nation's farms and ranches to the corner family grocery store to a wide variety of enterprises which have proudly borne their family names for generations, independent family business has been at the very foundation of our country. This is powerfully attested to by the fact that heretofore Congress has consistently encouraged and sought to strengthen such family involvement.

Having said this, we must understand next that Section 2036(c) dangerously reverses the proven historical record and presumption in favor of the family business and its role in our economy.

Under its current provisions, parents may work long and hard years, motivated in great measure by the opportunity to build and pass on a true family business, only to see all such efforts defeated by the need to sell much or all of the enterprise to pay the tax collector's bill. Of course, it is important to combat any and all abuses of our tax code. But these must be narrowly defined and targeted. The current law, however admirable its purpose, paints with far too broad a legal brush.

In so doing, it is counterproductive to vital national economic goals which have long been promoted by prosperous family enterprises. Certainly, to the extent that these two goals or purposes seem in conflict, there can be no question that the promotion of the family economic contribution deserves clear precedence.

But, secondly, please think of this on an individual basis. *Family* owned businesses are not short-term concerns. A real family sees itself as a closely bound, dynamic entity yesterday, today, and *tomorrow*. The realistic potential of meaningful passage of a business from one generation to another is often the principal motivation for the ongoing prosperity. We say that family business is both "owned and operated" advisedly. For the *present* generation, the prospect of *future* appreciation represents a great legacy to his or her children. It also frequently represents a personal guarantee of retirement security. In both instances, again and again we must acknowledge that it often partially or totally sustains the actual day to day business operation. Operations, which when multiplied by the millions of family owners, are a central facet of our entire national economic life. But now, because of the confusion and risks which these tax code provisions have created, we find that everywhere legitimate intrafamily transactions and estate plans have ground to a halt. Lawyers, accountants and financial planners may well be kept busy dispensing costly advice, but the thousands of family owned and operated businesses which so profit this country cannot long exist in such an economic limbo. A prompt and clear restoration is a necessity.

Perhaps I can best "bring home" to you these consequences by sharing some "real life" examples drawn from my own members. I can assure you that such "test cases" are being repeated over and over and over again every single day.

To illustrate the onerous and substantial impact of Section 2036(c) on family owned businesses, N.G.A. has received reactions from grocers throughout the country. Some representative examples follow:

Last fall, Tom Goodner, owner and operator of Goodner's Supermarkets in Duncan, Oklahoma vividly told the Senate Small Business Committee the effect of Section 2036(c) on the four store operation that was started by his father 52 years ago. He had planned to pass the business on to his son and had initiated estate planning in December 1989. Mr. Goodner said, "I felt it necessary to initiate my estate planning process with our own counsel. But we were stopped dead in our tracks by the hazards of Section 2036(c)."

In Woodsville, New Hampshire, Chuck and Don Butson are the owners of Butson's Supermarkets. Their parents started the business almost 40 years ago and had begun the process of transferring the business to the second generation in the 1980s. Under the law prior to Section 2036(c), the family had taken substantial steps to obtain a business appraisal and undertake legitimate estate planning, including a partnership freeze. However, unfortunately in 1987 Section 2036(c) required a substantial reevaluation of the family's estate plan. As a result, the Butsons' had to go beyond the company to finance its purchase from their parents, thus terminating any debt or compensation that was accruing to them. The Butsons told us that after 40 years of active involvement by their parents in the business the hardest step was to inform their 71 year old father that he must sever his relationship with the company if the company was going to survive. Advice of counsel had made clear that the outside financing was necessary to replace the loan held by their parents. Indeed, they emphasized, the only thing making this transfer even possible was the parents' commitment to transferring the business to the next generation, and their willingness to step aside for their sons. Equally detrimental was the fact that this whole process had to be undertaken with substantial income tax consequences to the parents. Worse still was the adverse estate tax planning to his mother. Upon Mr. Butson senior's death last December, the mother had to forego any stepped up basis in stock to which she had previously been entitled. In the words of Chuck Butson, "Section 2036(c) created substantial and unnecessary legal and tax expenses. The passage of Section 2036(c) without any legislative hearings or fair notice to those affected gave no consideration for the planning we had already undertaken for an orderly transition within our family owned business. Congress should be pro-family, not anti- family."

Likewise, in New Philadelphia, Ohio, James A. Stoll, the owner of a single store, is a second generation grocer. He began in the business as a teenager with his father and took over the business as a young man when his father died. With five daughters who each own 2% of the stock in the company, Mr. Stoll and his wife, the majority owners, had begun to plan for the transfer of the business to the third generation. In 1987 Section 2036(c) drastically forestalled all of the estate planning which they had in mind. Assurance of an orderly transition of the business to the third generation was put "on hold." Mr. Stoll's overall assessment: "We don't know at all to what we are entitled under Section 2036(c). Our biggest fear is that we may ultimately be forced to sell. We can no longer count on passing the business on to the next generation. I cannot understand what the government could have been thinking of in passing this ill conceived law."

In Cynthiana, Kentucky, the fear of Section 2036(c) is equally chilling. Ken Techau, owner of Ken's New Market, has six children, four of whom are actively involved in the business, and to whom he wants to pass it on. The excessive reach and uncertainty of Section 2036(c) has caused Mr. Techau great concern because part of his business succession plan involves a buy-sell agreement. In his words, "We don't know what steps we can properly take. Section 2036(c) goes too far. My children have worked hard and long for the growth of our business and are entitled to own it. My biggest fear is that if Congress doesn't fix it right, we will be forced to sell the business."

In the face of countless such examples I was not surprised to read the headline in one recent *Wall Street Journal* article; which graphically proclaimed: "Inheritance Tax is Choking Successors to Family Firms/Removal of Estate-Tax Freeze Puts Big Burden on Small Business"

We know that in some 20 million cases current law make it difficult to pass on small family business without enormous, even devastating taxes. In fact for many, we here today are too late. The *Journal* reports that "Accountants say that thousands of businesses already have been sold after being hit with the tax burden."

Throughout 1988 and 1989, the SBLC, N.G.A. and numerous other concerned citizens and groups turned to our government for help. Too little was forthcoming. What message did we receive? "The best advice I can give small businessmen this

year is not to die," was what we heard from a legislative aide to Senator John Heinz (R-PA) Consolation for the medical practice but not the accountant.

But, as I emphasized at the outset of my testimony, I am happy to recognize what I see here today presents an opportunity for constructive resolution to a serious problem for family owned businesses.

This review now brings us to the *Present.* Here, my message as of today is far more constructive and encouraging. To date, we are most pleased to announce that 230 members of the House and 35 Senators have signed up as cosponsors of repeal legislation. Moreover, the past six months have witnessed a number of candid and productive discussions between members of this committee, the House Ways and Means Committee, the Department of the Treasury and the small business community. In particular, to date Assistant Treasury Secretary Kenneth Gideon, has been open, forthright and responsive in his approach to this area of genuine tax reform. A discussion draft proposal offered for public comment by Congressman Dan Rostenkowski, Chairman of the House Ways and Means Committee and other proposals developed by an American Bar Association task force, the District of Columbia Bar, the U.S. Chamber of Commerce and others have all served as constructive contributions to the ongoing progress of reform. Today's hearings are a vital additional part of that process.

Within that ongoing process it is important to provide reasonable evaluation of suggestions thus far made. In that context, the Ways and Means "Discussion Draft" can most certainly be said to be "on the table," in front of all of us. I have attached as a formal addendum our organizations' specific reaction to the Draft. As it makes clear, both the SBLC and N.G.A. must express many reservations with the committee draft, a number of them quite serious in nature. As it exists, it cannot be said to succeed. However, we are pleased to offer our specific comments and suggestions as a vital part of the cooperative, constructive process which we now see as emerging.

In concluding this area, let me deal with one assumption which too often underlies much of the discussion surrounding potential repeal or reduction of 2036(c). That is the assumption that legislative provision which somehow operates to reduce maximum revenue production of a section of the tax code is a "loophole." Thus, legal permission of "estate freezes" is seen as a "giant loophole" simply because it permits the transmission of a family owned business from one generation to another without the imposition of confiscatory tax rates. The facts are that our entire tax code is designed to raise revenue *and* to fairly promote economic activity. There obviously is one certain remedy for a headache . . . . decapitation; but except for 2036(c) our legislators have generally chosen to promote not discourage the growth and prosperity of some 20 million small, family-owned businesses in this nation. No wonder that the entire small business community, as represented by the Small Business Legislative Council and many other organizations, has fought this provision so fiercely. It is quite literally a battle for its life. Repeal of 2036(c) is not a loophole, rather it is a lifeline, to a vital sector of the American business community.

An obvious critical evaluation of the *Past,* clearly a more encouraging assessment of the *Present;* finally, what might I say of the *Future*? I think my message is simple: thousands of members of our country's family owned business community absolutely require timely relief. That action may take the form of reform. That action may take the form of repeal. But that action must be taken very soon!

One of today's distinguished Co-chairmen, Senator Boren of Oklahoma, made absolutely clear the *mandate for change* by which we believe the Congress and the Administration must be guided. In announcing today's Hearings he forcefully stated:

"I understand the concerns about the potential for estate tax avoidance. However, the current estate freeze rules—in Section 2036(c) of the Internal Revenue Code—go too far. These rules are too complex, broad and vague. As a result, they pose an unreasonable impediment to the transfer of family-owned businesses. These rules must be changed."

In closing, I would wish to return to my opening theme. In terms of the fundamental tax policy expressed in Section 2036(c) the small business community is really confronted with two roads. The "old" road, the one we have been compelled to travel for more than two long years, can only be characterized as a critical progression. Poor process begat poor legislation, which in its own turn has produced disastrous real world consequences. The hearings here today can mark a significant step down another road. It is a road which thus far has seen sound process, in which all of the travellers have appeared constructive, open-minded and cooperative. Members of the Committee, I urge you to continue this journey with us. But in closing, may I offer one last caution. DO NOT DELAY! This is a trip which none of us, ranging from individual businessman to the entire national economy, can afford to post-

pone. Detours, stop signs, delays should not, cannot be tolerated. Millions of family owned businesses throughout this nation demand *constructive action,* and they demand it NOW.

ADDENDUM

The following provides general reactions of the Small Business Legislative Council and the National Grocers Association to the direction of the House Ways and Means Committee Discussion Draft and a number of specific comments upon its content.

Drafting a replacement to current Section 2036(c) means identifying and guarding against the potential abuses without discrimination against family businesses. That is a delicate balance, but one which it should be possible to achieve. The Discussion Draft (the "Proposal") is based on a framework which could serve as a basis for such a replacement. First, it provides that preferred equity interests should be valued solely by reference to real economic rights, rather than meretricious, artificial rights. Second, the failure to exercise rights in an arms-length manner should result in a gift.

While the Proposal is an acceptable starting point for replacing current Section 2036(c), in its details it contains many of the same faults as the existing statute. These problems make the current Proposal unacceptable. Treasury and staff appear receptive to the concerns which have been raised and appear committed to developing an acceptable statutory scheme to eliminate the abuses which spawned Section 2036(c) without unfairly imposing on family businesses. Such an alternative would have wide support.

MARKET TESTING RATE

It is clear that the Proposal or any variation of it will end "freezes." The parent who retains the preferred while the child has the common will annually (1) be paid a dividend, (2) be treated as making a gift equal to the unpaid dividend or (3) have increased value in his or her estate through compounding. This thaw will be determined by the "market testing rate."

The replacement contains no mechanism for determining the market testing rate. However, the rate should not be higher than the applicable Federal rate ("AFR") which is the required rate on intrafamily loans. First, the proposal assumes that the stated dividends will be paid. This eliminates any need for a higher rate to account for risk, dividend coverage, or lack of marketability. The AFR represents a safe taxable rate of return.

Second, a higher rate would discriminate against family businesses in favor of investors. A wealthy individual can loan cash to a child to buy a business (or growth stock) and need only receive interest at the AFR.

Third, a higher rate suggests an attempt to go after the presumed greater return from families which work and invest together. This attempt is frequently phrased as an "attack on hidden giving."

Finally, the current non-deductibility of dividend payments should indicate a lower rate. "Blue Chip" corporate preferred stock often carries a rate lower than AFR.

Moreover, a lower testing rate than the AFR encourages the use of preferred stock as a means of business succession. It further allows the conservation of capital by family businesses so that these businesses are more productive, more competitive and ultimately pay more taxes.

The ideal market testing rate would account for these factors and would be less than 66% of AFR, reflecting reduction for the Federal corporate tax rate.

SPECIFIC COMMENTS ON THE PROPOSAL

In addition to our concern about the market testing rate, we also have specific comments on the technical problems with the Proposal. These problems can be divided into three categories: (1) problems related to overly broad application of the replacement, (2) fairness or (3) complexity and efficiency. The following listing of technical problems is in no specific order nor is the list intended to be all-inclusive.

PROBLEMS RELATED TO AN OVERLY-BROAD APPLICATION

Buy-Sell Agreements. Section 2702 of the draft statute is a separate part of the Proposal dealing specifically with buy-sell agreements and bears no relationship to the abuse which prompted Section 2036(c). The Treasury Regulations 20.2031-2(h) set forth a rule which appropriately balances the legitimate business objectives of family business owners against the Federal fisc:

> the option or contract price . . . . will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

The Regulation permits Treasury to ignore options in buy-sells which have an estate planning motive rather than a business motive. For example, the courts have backed Treasury when it ignored an option formula which produced a $0 value. A common situation is a parent selling the business to an active child at a fixed formula price derived in arms-length negotiations. If that agreement is not honored by the estate tax rules, unexpected and adverse tax consequences will result either to the purchasing child or the inactive children according to where the tax burden falls. Moreover, that tax burden being unknown will be impossible to plan for

In addition, according to Gary Crawford, an estate and tax adviser for Super Valu, a food wholesaler in Minneapolis, Minnesota, who counsels their retail customers:

> "Numerous plans in progress were halted when 2036(c) was adopted. None of these plans involved the use of preferred stock or other "freeze" techniques. For example, in six of these plans each of the retailers wanted to engage in a program to give voting and non-voting common stock to his children while he continued to be actively employed in the business. Each plan included a buy-sell agreement designed to transfer a controlling interest in the business to the children who were active in the management of the business. We could not proceed with any of these plans because of the large degree of uncertainty created by 2036(c) with respect to the tax consequences of the gifting program and the buy-sell agreements. After IRS published Notice 88-99, we were able to proceed with these plans cautiously, but with a large degree of uncertainty remaining with respect to the tax consequences of the provisions of Section 2036(c) relating to buy-sell agreements.
>
> "The proposed Chapter 14, continues to create uncertainty and impose special rules on family business transfers under buy-sell agreements or pursuant to redemptions. Virtually every ownership succession plan for a retailer involved the use of a buy-sell agreement to transfer shares to the children that are active in the business upon the retailer's death. The transfer under the buy-sell agreement is likely to take place through a redemption of the retailer's shares by the corporation. Hundreds of our retailers (mostly one to two store moderate sized businesses) have such plans in effect. These are common ordinary ownership succession planning arrangements, and to be effective, a high degree of certainty as to the tax consequences of such arrangements is essential. If Chapter 14 becomes law, most of our plans with buy-sell agreements will have to be revised substantially to attempt to avoid unexpected gift or death taxes, and many plans may be abandoned due to the uncertainty of the tax consequences."

If there is a legitimate concern about abuse of fixed price buy- sells which is not reflected in the reported cases, Section 2702 goes too far when it ignores rights of first refusal and leases in determining value for transfer tax purposes. Rights of first refusal and other transfer restrictions are always present in privately-held businesses. These rights do not fix value for estate tax purposes so that there is no "freeze" potential. However, like other aspects of ownership of stock in a private business, such as SEC restrictions, minority voting and lack of marketability, these restrictions depress value. It is discriminatory to ignore the value depressant effect of these rights when held by close family members, but to recognize that effect when held by others. This deviates too far from the concept of "fair market value."

SECTION 2702 SHOULD BE OMITTED ENTIRELY FROM THE PROPOSAL

Debt Leases and Employment Agreements. One of the principal criticisms of current Section 2036(c) is its application to legitimate business transactions without an estate planning motive. The 1988 tax act attempted to mitigate the effect of the statute by allowing certain types of leases, employment agreements and debt which followed "cookie cutter" rules. Really the 1988 act pointed out the conceptual flaws in Section 2036(c) by allowing certain "freezes," such as a 15 year note, and disallowing certain other "freezes," such as a 16 year note, although the economics of both transactions were the same. This approach also intruded on every business transac-

tion of a family owned business—"freezing" business transactions. Although the notice accompanying the Proposal states that the replacement does not apply to employment agreements, any provision to include debt in the value of an entity also catches employment agreements indirectly as a liability of the entity. The Proposal also contains an attack on these legitimate business transactions which must be cleared away.

Application to Third Parties. In 1988 the deemed gift rules under current Section 2036(c) were changed so that the section would no longer apply if the donee of the gifted interest disposed of the stock to a non-family member. The Proposal changed so that the deemed gift rule would not apply in a similar situation.

In addition, Section 2703(a)(2) applies these special valuation rules in non-family situations if a gift would have occurred under ordinary valuation principles. This seems to require the use of artificial meretricious devices in non-family member situations to avoid the application of Chapter 14. Rather, Chapter 14 should not apply to unrelated parties, except that employees and other such unrelated parties ought to be able to avoid a gift by structuring their preferred stock freezes at the market testing rate.

Miscellaneous Issues. The Proposal is over broad in a number of other respects:

(1) It requires the valuation of the *entity* rather than just the valuation of the preferred stock. Under the current literal language of the Proposal, unlike Section 2036(c), it could apply to the gift of non-voting common and retention of voting common. It could jeopardize minority discounts by valuing the entity and determining the value of the common by a subtractive method despite the accompanying notice language.

(2) It applies to stock which is not "frozen" in value. The Proposal should apply only to stock which has no appreciation potential. In other words, stock which has a fixed or stated value on liquidation, conversion or redemption. In such a case the appreciation rights with respect to the frozen capital reside in someone else. That someone else also benefits from any failure to pay the dividends on the preferred. The proportionality rule under current Section 2036(c) precludes estate taxation where there is no mismatch of capital and appreciation rights. A similar concept must be developed under the replacement.

(3) It applies to publicly-traded securities where there is no valuation issue.

(4) It assigns a zero value to a wide variety of rights which are not discretionary. It also requires the assignment of value to retained voting rights—a difficult valuation prospect.

(5) It applies to too many entities. The Proposal's 10% rule came from current Section 2036(c) where there is no sibling attribution. The threshold should be raised to 50% if sibling attribution continues to apply. In the way the Proposal will not apply where the entity is not subject to the family's control.

PROBLEMS RELATED TO FAIRNESS

80/20 Rule. The stated purpose of the Proposal is to ensure that 100% of the value of the business is taxed in the owner's estate. The 80/20 rule seems designed to ensure that 120% of the business is taxed in the owner's estate. Consider the case of two parents who want to help a child buy a grocery store:

> Investor Parent can loan the entire $1,000,000 child needs at the current AFR. The Investor Parent's estate includes the $1,000,000 note and the annual interest payments. However, Grocer Owner Parent cannot take back $1,000,000 of preferred in the grocery store at the AFR. If he does, he has made a gift of $200,000, and his preferred is still worth $1,000,000 at his death. (A total of $1,200,000, plus annual dividends) His alternatives (assuming he is properly advised) are to continue to share in 20% of the appreciation which is due to his child's efforts as to reduce his dividend payments.

In no case is Grocery Owner Parent able to bring his children in to the business on the same terms as Investor Parent. An unacceptable discrimination.

Inconsistent Application of the Valuation Rule. The Proposal is overly broad because the Treasury benefits from the adverse presumptions, but is not bound when taxpayers would benefit. For example, if a right is valued at zero, a gift results equal to the value of the right. If the right later appreciates in value, that appreciation is also taxed. Thus, the replacement, like current Section 2036(c), taxes the same property both for gift and estate tax purposes. It would be preferable to settle on a fair valuation rule which could apply in all circumstances, including a gift of specially valued preferred. The Proposal also should exempt the exercise or non-exercise of discretionary rights from the transfer tax system. It is possible that mere-

tricious rights which are valued at zero for Chapter 14 could still result in gift tax annually under Chapter 12.

Application to Stock Not Held by Transferor or Spouse. The Proposal unfairly applies to preferred stock held by family members of the transferor. Current Section 2036(c) does not go so far as to apply to frozen interests held by someone other than the transferor or his or her spouse. One of the common uses of preferred stock in a family business is to give inactive children preferred stock and active children common stock. This provision gives inactive children a veto over the gifts of common by the parents.

Liquidation Valuation. In family business with low cash flow such a as farm or real estate business, the IRS argues that the business should be valued at its liquidation value rather than its going concern value. Of course, this results in a higher value for the business. The Proposal mandates a cash flow or going concern approach for valuing the preferred stock. The IRS should not be permitted to value the business using a liquidation approach and then mandate the valuation of the preferred at cash flow value with its liquidation value is much higher. The method for valuing the business and the method for valuing the preferred must agree.

Hardship Exception. Although the Proposal goes a long way towards permitting flexibility by allowing a three year grace period for dividend payments and an insolvency exception, further relief is desirable. One improvement would be to allow relief when the earnings and profits or book income (adding back payments to family members) drops significantly from the adjusted earnings and profits on the date of the recapitalization. One concern has been that the business owner would set the dividend rate so high to avoid an initial gift that the rate itself would create hardship in paying future dividends. This objective computation would prevent this abuse as the drop in earnings would be separate from the dividend payments.

Prospective Application. The Proposal should apply prospectively only and generous transition period should be allowed for business owners and their advisers to adjust to these new rules.

Gift Tax Changes. The gift tax changes which target business transactions and allow unlimited gift tax exposure for business transactions were alternatives suggested in lieu of fixed valuation rules. As the Proposal contains fixed valuation rules, the proposed gift tax changes are unneeded. Moreover, further gift tax reporting requirements are unlikely to be productive. What is needed is a way to alert businessmen through the income tax return of the possible need to report transactions on a gift tax return. A further important change would be permitting business owners to waive the use of the unified credit (and to clarify existing law) so that gift tax returns can be audited and values finally determined. The present situation encourages game-playing by taxpayers and over-reaction by the IRS.

PROBLEMS RELATED TO COMPLEXITY AND EFFICIENCY

In Effect Transfers. One of the discredited aspects of current Section 2036(c) is its notion of "in effect" transfers. The concept is mathematically impossible to apply. Section 2703(c)(2) proposes to extend this unworkable concept to all of the transfer tax. This section should be removed and Section 2701 of the Proposal rewritten so that a gift will result to the common shareholders if the value of property exchanged exceeds the special value of the preferred stock received.

Tax Elections. The Proposal generally requires timely elections. Many businessmen will assume that no gift is being made by applying ordinary valuation principles and will not make the required elections in a timely manner. The Federal fisc will not be harmed by late elections as long as those elections are consistent with the taxpayer's prior actions.

Failure to Adopt Existing Tax Concepts. The Proposal would be simpler and easier to understand if it adopted other tax concepts, e.g. entities taxed under subchapters C or K (in lieu of partnership and corporation) and attribution rules from Section 318(a)(2).

36-968 0 - 91 - 8

Members of the Small Business Legislative Council

Air Conditioning Contractors of America
Alliance of Independent Store Owners and Professionals
American Animal Hospital Association
American Association of Nurserymen
American Collectors Association, Inc.
American Consulting Engineers Council
American Council of Independent Laboratories
American Dental Trade Association
American Floorcovering Association
American Institute of Architects
American Machine Tool Distributors Association
American Meat Institute
American Road & Transportation Builders Association
American Society of Travel Agents, Inc.
American Sod Producers Association
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehousemen's Association
Architectural Precast Association
Associated Builders & Contractors
Associated Equipment Distributors
Associated Landscape Contractors of America
Association of Physical Fitness Centers
Association of Small Business Development Centers
Association of the Wall and Ceiling Industries-International
Automotive Service Association
Bowling Proprietors Association of America
Building Service Contractors Association International
Business Advertising Council
Christian Booksellers Association
Council of Fleet Specialists
Electronics Representatives Association
Florists' Transworld Delivery Association
Helicopter Association International
Independent Bakers Association
Independent Bankers Association of America
Independent Medical Distributors Association
International Association of Refrigerated Warehouses
International Bottled Water Association
International Communications Industries Association
International Formalwear Association
International Franchise Association
Latin American Management Association
Machinery Dealers National Association
Manufacturers Agents National Association
Manufacturers Representatives of America, Inc.
Marketing Agents for Food Service Industry
Mechanical Contractors Association of America, Inc.
Menswear Retailers of America
NMTBA-The Association for Manufacturing Technology
National Association for the Self-Employed
National Association of Brick Distributors
National Association of Catalog Showroom Merchandisers
National Association of Chemical Distributors
National Association of Development Companies
National Association of Home Builders
National Association of Investment Companies
National Association of Passenger Vessel Owners
National Association of Personnel Consultants
National Association of Plumbing-Heating-Cooling Contractors
National Association of Realtors®
National Association of Retail Druggists
National Association of Small Business Investment Companies
National Association of Surety Bond Producers
National Association of the Remodeling Industry
National Association of Truck Stop Operators
National Association of Women Business Owners
National Campground Owners Association
National Candy Wholesalers Association
National Chimney Sweep Guild
National Coffee Service Association
National Council for Industrial Innovation
National Electrical Contractors Association
National Electrical Manufacturers Representatives Association
National Fastener Distributors Association
National Grocers Association
National Independent Dairy-Foods Association
National Knitwear & Sportswear Association
National Limousine Association
National Lumber & Building Material Dealers Association
National Moving and Storage Association
National Office Products Association
National Paperbox & Packaging Association
National Parking Association
National Precast Concrete Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Venture Capital Association
Opticians Association of America
Organization for the Protection and Advancement of Small Telephone Companies
Petroleum Marketers Association of America
Printing Industries of America, Inc.
Professional Plant Growers Association
Retail Bakers of America
SMC/Pennsylvania Small Business
Small Business Council of America, Inc.
Society of American Florists
Specialty Advertising Association International
United Bus Owners of America

1025 Vermont Avenue, N.W., Suite 1201, Washington, DC 20005
PHONE NO (202) 639-8500 / FAX NO (202) 347-4777

BEST AVAILABLE COPY

SMALL BUSINESS LEGISLATIVE COUNCIL,
October 1, 1990.

Hon. LLOYD BENTSEN, *Chairman,*
Committee on Finance,
U.S. Senate,
Washington, DC

Dears. Chairman: On behalf of the Small Business Legislative Council (SBLC), I wish to commend you for your efforts to repeal and replace the infamous Section 2036(c). We are greatly heartened by your participation in this on-going process. It is our fervent hope resolution of this problem will be included in the budget reconciliation legislation. It will be a tremendous boost to the small business community.

If there is one thing Section 2036(c) and Section 89 have taught us, it is to look before you leap. With that lesson in mind, we would like to offer some constructive comments that might help avoid problems down the road. We believe these changes can be accommodated without holding up the process.

Inclusion of language regarding buy-sell agreements is the single most serious obstacle before us. while your proposal attempts to merely codify existing IRS rules, it does mean countless small business owners will continue to be advised of the existence of the estate freeze rules. It will generate strong feelings the slate was not wiped clean. We believe it is too much goodwill to put at risk. Buy-sell agreements should be addressed at another time.

Clarification of subsection (b)(1) to establish that rights, not interests, are to be valued at zero would be helpful. We hope you would eliminate the ancestor rule, it produces unfair results.

We would recommend that you provide the taxpayer a way to secure a determination of the value of the gift. An open-ended statute of limitation is an invitation to problems down the road.

In addition to these matters, clarification on several items would be helpful. Among them are: the treatment of public entities; scope of the limited partners exception; application to discretionary rights; clarification of inapplicability to debt; special conversion rights; definition of distribution rights; use of attribution rules; consistent valuation of specially valued rights; and, the definition of term interest.

Again, we believe a fair and mutually satisfactory result can be achieved. We offer these cats in the belief we all want a result that will stand the test of time.

Small Business Legislative Council (SBLC) is a permanent, independent coalition of over one hundred trade and professional associations that share a can commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. while our policies are developed through consensus among our membership, we respect the right of individual associations to express their own views.

Sincerely,

THOMAS K. ZAUCHA, *Chairman of the Board.*

COMMUNICATIONS

STATEMENT OF THE AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION

The American International Automobile Dealers Association (AIADA) represents the 9,700 franchised new car and truck dealers who market imported vehicles in the United States. Our members and their 240,000 employees sell and service imported automobiles and trucks in the United States, as well as the domestically produced vehicles by these importers. AIADA appreciates the opportunity to provide the Energy and Agricultural Taxation and the Taxation and Debt Management Subcommittees of the Senate Finance Committee with our comments on the estate valuation freeze.

AIADA favors repeal or modification of Section 2036(c) of the Internal Revenue Code. Since the institution of Section 2036(c) a family-owned automobile dealership cannot be transferred from one generation to the next without excessive and confiscatory estate taxes. The estate tax burden resulting from a transfer of an automobile dealership could force two-, three-, even four-generation dealerships to dissolve or be sold rather than continue as family-owned enterprises.

Prior to the 1987 law instituting Section 2036(c), a typical means of transferring ownership and control of a dealership to a younger generation was the estate freeze. Under the estate freeze, the automobile dealer would recapitalize the dealership franchise, retaining a steady income from the business for retirement and partial control of the company. All of the potential future appreciation would be transferred to the next generation. Upon the death of the parent, the younger generation would inherit the remaining value of the company, and that major portion of the company that has been held by the parent would be subject to an estate tax. Future appreciation of the company that occurs while the company is under the direction of the younger generation would not be subject to the estate tax. Section 2036(c) ended this practice in 1987.

Section 2036(c) effectively bans the use of the estate freeze by bringing back into the estate (for purposes of calculating the value of the estate subject to tax) the appreciation that has occurred while the company is under the direction of the younger generation.

Imported automobiles are sold at more than 23,000 dealer outlets throughout the United States, with combined assets of more than $23 billion. Virtually every one of these dealerships is well above the $600,000 unified credit for estate taxes. The total value of today's automobile dealership can range from $1 million to well over $5 million. The average value of a dealer's franchise, exclusive of real estate, is approximately $1.1 million.[1] The average value of a dealer's real estate holdings is approximately $1.8 million.[2] As these numbers indicate, estate tax burdens are a very real concern for dealers.

In many cases, the property of three- and four-generation dealerships has appreciated dramatically and disproportionately compared to the business itself. This presents a tremendous estate tax burden for the heir charged with profitably operating a local, community-based retail business. In assessing the value of the dealership, the situation is very similar to that of a family farm in that most of the assets are non-liquid. Dealers typically have around 88 percent [3] of their dealership tied up in non-liquid assets such as inventory and dealership property, and some have total assets that are as high as 90 percent non-liquid. For those who inherit a dealership (which in all likelihood would be taxed at the maximum 55 percent rate), there are

[1] Dealer Management Association (DMA Group, Inc.) statistics for calendar year 1989.
[2] DMA Group, Inc. statistics for calendar year 1988.
[3] DMA Group, Inc. statistics for calendar year 1989.

few assets of significant value that can be sold without adversely impacting the basic business.

Furthermore, paying the estate tax by selling off assets of the dealership is no guarantee that the business can continue to operate. In a dealership, the owner has contractual arrangements with manufacturers and an obligation to the customer that require the owner to provide services, equipment, parts, new automobiles, etc. In almost all cases, the heir cannot simply sell off a portion of the business and maintain it as a whole. And all manufacturer franchise agreements require dealers to maintain a minimum amount of working capital in order to continue operating the franchise. Therefore, the heir could be forced out of business altogether.

Because the value of many dealerships is often tied up in dealership property that has greatly increased in value over time, we would suggest expanding the special use valuation (Section 2032A) available for family farmers to include family-owned businesses, such as dealerships, that have assets highly concentrated in property related to the business. Additionally, due to the estate tax problems resulting from the high value of dealership property, we would suggest expanding the deferred estate tax payment option (Section 6166) available for family farms and businesses to include the value of real estate property related to the business. Both of these changes would relieve excessive tax burdens that occur as a family-owned dealership is transferred to the next generation.

AIADA believes that passing a family automobile business from one generation to the next is not abusive tax planning. Family-owned dealerships have been a way of life in the United States. When Congress added Section 2036(c) to the Internal Revenue Code in 1987, it cast the net too broadly and has left owners of family-owned dealerships in a situation where they now have little or no way in which to pass on the business to the next generation—or if they do attempt to pass the business on it is an expensive and complex financial operation. Abuses that do occur as a result of estate freezes should be remedied in a way that does not endanger the basic American values inherent in community ties and continuity of ownership. Nor should the tax laws be so complex that individuals must spend large sums on estate planning.

Automobile dealers have been an important contributor to new job growth in the U.S. economy. In 1988, there were more than 336,000 individuals employed in the international automobile industry, with overall employment in the industry having grown by 11.6 percent since 1986. This ranks the international automobile industry as the sixth largest employer in the United States. This important source of economic growth should not be hampered with excessive taxes. Furthermore, automobile dealers have been the entrepreneurial leaders of small business, often having invested their life savings to start a business that holds considerable risk. We believe that the spirit shown by these dealers and other small business entrepreneurs should be encouraged, not penalized.

AIADA recommends that Section 2036(c) be repealed or modified to address tax abuses while allowing for the transfer of family-owned businesses from one generation to the next without excessive and confiscatory estate taxes.

AMERICAN NATIONAL BANK,
Saint Paul, MN, July 13, 1990.

Messrs. Chairman and Members of the Sub-Committee,
c/o Ms. Laura Wilcox,
Hearing Administrator,
U.S. Senate,
Committee on Finance,
Dirksen Senate Office Building,
Washington, DC.

I am writing you to address an issue that I, and obviously many other independent businessmen, see as the undoing of family businesses in this country. It is the so-called "Estate Tax Freeze" legislation.

The government says family businesses are the backbone of our economy. As I stated in my testimony before the House Ways and Means Committee, a copy of which is attached hereto, central to our free enterprise system is the opportunity for individuals to build and create wealth for themselves and their families, and in so doing to provide job opportunities for many others. This incentive, however, has been impeded and frustrated by an estate tax system which requires family businesses that have been built over several generations to be effectively taken apart to pay transfer taxes. This would no doubt be a national catastrophe. I find it hard to believe Congress really intended this to happen. Section 2036(C) of the Internal Rev-

enue Code effectively works as a disincentive to build and establish a successful, closely-held family business.

I strongly urge the Senate and the House to repeal Section 2036(C) retroactive to the date of enactment, December 17, 1987.

Very truly yours,

GEORGE B. BENZ, *Vice President.*

Attachment.

STATEMENT OF GEORGE B. BENZ ON A "DISCUSSION DRAFT" RELATING TO ESTATE VALUATION FREEZES

[Before the Committee on Ways and Means, U.S. House of Representatives]

Good afternoon, Mr. Chairman and members of the Committee. My name is George Benz, I am Vice President of American Bancorporation, a small bank holding company in Minnesota, and a Trustee of a Trust created by my grandparents more than fifty (50) years ago. This Trust owns a controlling interest in American Bancorporation. Either through direct ownership of American Bancorporation or indirectly through the Trust, the descendants of my grandparents control approximately eighty percent (80%) of the outstanding stock of American Bancorporation.

I would like to give you my comments regarding (1) the current estate tax freeze rules contained in Section 2036(C) of the Internal Revenue Code and (2) the discussion draft of the bill to modify Section 2036(C) which was issued by Chairman Rostenkowski on March 22, 1990.

With respect to the current estate freeze rules, it is my opinion these rules should be repealed in their entirety, retroactive to the date of enactment (December 17, 1987). I understand that the intent of Section 2036(C) was to prevent avoidance of transfer taxes. I heartily agree with this; however, I believe better enforcement of existing rules should be sufficient to prevent avoidance of these taxes.

I would suggest that the Internal Revenue Service's burden of enforcing the transfer tax rules would be lessened through extensive reporting requirements. For this reason, I suggest that legislation which repeals IRC Section 2036(C) should impose reporting requirements irrespective of whether or not the taxpayer believes that transfer taxes are due or that a gift has occurred.

I believe the concerns that have been raised by so many since the enactment of Section 2036(C) can be resolved by repealing Section 2036(C) retroactively—and by enacting an expansive reporting requirement, replete with severe penalties for noncompliance. I strongly believe the abuses Congress is attempting to curb can be stopped most cost effectively through better enforcement. This can occur if these transactions are required to be reported, irrespective of whether or not transfer taxes are currently due.

Our tax laws do not need to be further burdened with complicated valuation and disproportionate transfer rules. Rather, existing rules, adequately enforced, are sufficient to protect the integrity of the transfer tax system. These types of issues are most efficiently resolved in a voluntary compliance system through adequate enforcement.

Assuming Congress wants to enact additional rules specifically relating to transfers with retained interests, the method by which Congress implemented the new rules in 1987 is far too broad and unduly complex. I agree that a better approach is the one outlined in the Chairman's discussion draft, and I believe the discussion draft takes the right approach by addressing the allocation of value between family members, rather than taxing future appreciation to an individual no longer owning the property.

I am pleased to see that the approach in the new valuation rules is to tax the true value of transfers today and not to tax future appreciation in value by including the transferred property in the transferor's gross estate. The provision is intended to prevent undervaluation of the property transferred for gift tax purposes at the time of the transfer. As I previously indicated, it is important to prevent abusive transfers. However, the approach should not prevent intrafamily transfers at fair market value. To do so will inhibit growth and expansion of American business.

I am concerned that, as drafted, many existing arrangements will be unduly burdened by being required to become qualified fixed payments. In some cases, specifically my family, the interests owned by some individuals would not, and could not, be modified to become qualified fixed payments. Thus, the discussion draft effectively precludes transfers of any interests, other than a complete termination of the individual's interest.

Let me expand upon this point. I am sure you do not intend to limit transfers between family members which are not designed to avoid transfer or income taxes. I am most concerned with the rules when property is held in an irrevocable Trust whose investments are controlled by an Independent Trustee.

My concerns center around the restrictive definition of a qualified fixed payment and its affect on gift values. In our family situation, existing Trust arrangements will not result in qualified fixed payments and thus would be valued at zero when determining the amount of gift made to a family member. Even with a sale for fair market value, the retained interest would be valued at zero forcing our family members to dispose of all interests or pay significant gift taxes on assets not transferred.

For example, our family members have a life interest in a Trust which holds stock in American Bancorporation. These family members also own stock directly in American Bancorporation which may be periodically gifted or sold to other family members. Because the life interest is not a qualified fixed payment and because it cannot be modified to become a qualified fixed payment, that interest will be valued at zero. To determine any taxable gift in the event of either a gift or a sale the family member will, under the proposal, value all common stock held directly and the life interest in the irrevocable Trust which holds the common stock, and then determine an allocation of total value to the portion of such asset sold or gifted.

If we assume that a family member gives away all their American Bancorporation common stock which is held outright and maintains only their life interest in the irrevocable trust which owns stock in American Bancorporation, the value of the taxable gift will be the value of the stock gifted and the value of their life interest. A taxable gift has been created with respect to their life interest which was not given away. Because the life interest is valued at zero, nothing is owned now and the taxable gift is the total value of the common stock plus the life interest.

How could the committee correct this inequity in the proposed rules? A number of different approaches could be taken. The easiest would be an effective date which provided that, for purposes of these rules, an arrangement existing on a specified date would be deemed to be an interest or arrangement which made qualified fixed payments. A means of making the law more flexible would be to provide that a person's "interest" in property is very narrowly defined and does not include interests which own the identical property.

I believe that any legislation using the discussion draft approach will effectively preclude or inappropriately tax some valid business transfers. If this is true, at least existing arrangements should be unaffected.

The current taxation of future appreciation on the proposed taxation of a non-qualified fixed payment with high estate tax rates (almost double the highest income tax rate), and the generation-skipping transfer tax effectively prevent the transfer of family-owned businesses from one generation to the next. The marital deduction and the unification of gift and estate taxes discourages transfers until the last survivor of a marriage has died. To pay taxes in an inflationary society will require the sale or liquidation of family businesses. This is clearly counter-productive from a business standpoint and will cause inefficiencies in the national economy.

Central to the free-enterprise system is the opportunity for individuals to build and create wealth for themselves and their families. This incentive is impeded and frustrated by an estate tax system which requires a family business that has been built over several generations to be taken apart to pay transfer taxes. This system effectively works as a disincentive to build and establish a successful closely held family business.

In conclusion, I am extremely pleased to see that Chairman Rostenkowski and the Ways and Means Committee has taken significant steps toward protecting a sacred American tradition, the closely held family business. I encourage the committee to continue its efforts to repeal Section 2036(C) and replace it will rules that focus more closely on abusive situations and do not encompass valid transfers of the family business from one generation to the next. Rules regarding additional reporting should be sufficient. If not, rules as outlined in the discussion draft will be acceptable assuming existing arrangements which do not result in qualified fixed payments are not valued at zero.

Finally, with estate tax rates at twice the individual income tax rates, I encourage you to direct Treasury to study the entire transfer tax system and its effect on this country's competitive advantage within the global economy. Assuming the committee determines additional rules are needed beyond the repeal of Section 2036(C) and beyond additional reporting requirements with severe penalties, I encourage you to consider postponing adoption of any such rules until after Treasury has completed a

study of the entire transfer tax system and the affect upon family business in this country.

Mr. Chairman—thank you for the opportunity to express my comments to you.

BERGMAN, HOROWITZ & REYNOLDS, P.C.,
New Haven, CT, October 2, 1990.

Senator LLOYD BENTSEN,
Senate Office Building,
Washington, DC.

Re: S. 3113

Dear Senator Bentsen: This letter responds to your solicitation of public comment on the above-referenced legislation. We are a firm of 25 lawyers with offices in New Haven, Connecticut and New York, New York. Our practice is principally tax-oriented and, accordingly, most of our attorneys are actively engaged in United States estate planning for both domestic and foreign clients. We therefore welcome the opportunity to share with you our concerns as practitioners, as well as our clients' concerns, regarding the reform legislation proposed as an alternative to Section 2036(c).

We are troubled by the effective dates of the various reform proposals. When undertaking planning for our clients, it is now impossible to determine whether the rules of present Section 2036(c), the rules of your bill (which provides for a September 25 effective date), or the provisions of Congressman Rostenkowski's bill, H.R. 5425 (which includes yet another effective date), should be complied with. In order for the estate planning community effectively to address the needs of clients while Congress evaluates alternatives to Section 2036(c), it is of the utmost importance that the effective dates of the major bills be modified to include transitional relief for planning that complies with current Section 2036(c), when the transactions close after the nominal effective dates of the various reform bills, but prior to their actual enactment. In our office alone, millions of dollars worth of important family transactions are in limbo, pending Congress' final decision as to the form that revisions to Section 2036(c) will take.

We are also troubled by Section 3(d) of your bill, which would modify the valuation tables used for so-called "split interest" arrangements, whereby an elder generation retains an interest in property for life or a term of years, with the remainder given over to younger generation family members. By substituting 80% of the Federal mid-term rate for 120% of this rate (as normally required by Section 7520(a)(2)) for computing these tables, the values of remainder interests (and, consequently, the gift tax costs of transfers) are sharply increased. Effectively, the bill assumes that the older generation interest-holder will always arrange for the management of the split-interest property so as to achieve submarket rates of return.

While it is undeniable that this sort of abuse occurs, it is an overreaction irrebuttably to presume such behavior. For example, a client may be inclined to make a gift to his children at a time in his life when he is moving toward retirement but still has a few financial "loose ends" to tie down, such as the last few payments on a mortgage. There is nothing abusive in such a client's desire to create a grantor retained income trust, retaining an interest for a term of years corresponding to the remaining term of his mortgage note. Such a client can be relied upon to do much more than "anticipate" a fair return on the trust property during the period of his retained interest, if divergence from such a return would prove devastating to his finances. It is unfair to lump such an individual's circumstances together with the sort of abuse that first fueled Congress' perception that a statute like Section 2036(c) was a practical necessity. We believe that the bill casts too wide a net.

Moreover, any potential abuse addressed by these revised valuation tables can be dealt with by existing law, without recourse to Section 2036(c) or the language of the bill. Various Private Letter Rulings articulate the IRS position that a grantor who fails to require a fair rate of return from his trustees during the period of his retained interest will be deemed to have made additional gifts by acquiescing in his sub-standard return. PLR 8801008 (10/7/87); PLR 8806082 (11/18/87). Application of such a results-oriented test permits the punishment of abusive planning without penalizing taxpayers who enter into split interest arrangements for *bona fide* reasons.

Indeed, since repeal of Section 2036(c) would not remove this arrow from the IRS' quiver, the bill threatens inappropriate "double dipping." If initial gifts to split-interest arrangements are uniformly valued at rates that imply abusiveness, the IRS should not rely on these Private Letter Rulings to collect another round of gift taxes, if and when the anticipated submarket returns actually manifest.

Accordingly, if the new valuation rules are enacted in spite of the concerns voiced above, it is important that the legislative history specifically indicate that the theory of the cited rulings is no longer pertinent, since the potential for abuse has already been accounted for in valuing the initial gift.

We again thank you for the opportunity to offer these comments. We would be pleased to discuss them with your staff, if you so desire.

Very truly yours,

BERGMAN, HOROWITZ & REYNOLDS, P.C.

STATEMENT OF JONATHAN G. BLATTMACHR

INTRODUCTION

I am submitting this statement on behalf of the public interest. Although I am not authorized to speak on behalf of any organized group, I believe the vast majority of my fellow lawyers who practice in the field of estate planning would agree with the substance of my comments.

SECTION 2036(C) SHOULD BE REPEALED RETROACTIVELY

The legislative history to Section 2036(c) of the Internal Revenue Code, as enacted as part of Revenue Act of 1987, indicated that it was intended to address only certain corporate and partnership recapitalizations. However, it has evolved into a provision which attempts to eliminate the benefits of all estate planning, even planning which the Treasury Department itself had approved. For example, in Revenue Ruling 69-74, 1969-1 C.B. 43 the Internal Revenue Service described the tax consequences of the transfer of an arrangement known as a "private annuity." However, under the Treasury Department's interpretation of Section 2036(c), private annuities would effectively be "outlawed." *See* I.R.S. Advance Notice 89-99, 1989-2 C.B. 422.

Section 2036(c) is so flawed that, apparently, its creators and sponsors within the government acknowledge that it cannot be enforced and must be repealed. The only question is whether it should be followed by a substitute. I believe that although the original focus of Section 2036(c) which relates to certain limited corporate and partnership recapitalizations may have to continue to a limited degree, proposed Chapter 14 (made public on March 22, 1990) is not an appropriate alternative.

PROPOSED CHAPTER 14

Although it may seem to many that proposed Chapter 14 is preferable to Section 2036(c), I believe that is only because the proposal appears to have a less encompassing scope than Section 2036(c) does. In fact, the basic approach of Chapter 14 is in some ways less rational and fair than Section 2036(c) is.

Under the United States' system of taxation, taxes have been and should be directly related to the taxpayers ability to pay. Certainly, no one would propose an income tax on more than the taxpayer's income. But that is exactly what Chapter 14 can do.

Under our current estate, gift and generation-skipping transfer tax system, taxes are imposed on an asset's fair market value. Fair market value represents the market or "cash" value of an asset and, accordingly, is directly related to the taxpayer's ability to bear the burden of taxation. Chapter 14 would use artificial rules of valuation specifically designed to overvalue an asset. Therefore, our transfer tax system would no longer be related to the taxpayer's ability to pay and would unfairly burden the taxpayer.

It may be true that some assets have more value to some people than others. Family heirlooms are a classic example. However, no one seriously proposes that an estate or gift tax should be imposed based upon an heirloom's unique value to surviving family members. Rather, like other assets, it is valued and taxed at its fair market value.

Nonetheless, the rules of Chapter 14 will artificially overvalue assets. Indeed, it will prescribe a zero value to assets in a donor's hands in order to overvalue assets transferred or deemed to be transferred by the donor, even where the donor has no control over the value or the transaction.

For example, under proposed Chapter 14, a daughter buys shares of stock, on a recognized exchange, at their fair market value. If her mother, together with members of the mother's family and the mother's siblings, owns 10 or more of the interest in the corporation whose stock the daughter has purchased and if her mother owns preferred stock as well, the mother will be deemed to have made a gift basical-

ly equal to the value of the preferred stock she retains, merely because her daughter buys assets on the market. Certainly, the marketplace did not cause the shares of stock to be sold to the daughter for anything other than their fair market value. Indeed, under these circumstances, her mother could have no control over the market and might be guilty of a violation of the securities laws or other criminal statutes if she attempted to manipulate artificially the market value of the stock.

Proposed Chapter 14 causes the same effect in the closely-held family situation. Indeed, in many ways, proposed Chapter 14 would be more onerous in the closely-held context. Under proposed Chapter 14, family members would be deemed to have made gifts to each other if a corporation fails to make a payment on the preferred stock or debt, for example, even where the family members do not control the business and the business has compelling economic reasons not to make those payments.

Moreover, by directing that common stock must always be worth 20 of the whole of the business, proposed Chapter 14 would again artificially overvalue assets in many circumstances.

Indeed, it seems possible that proposed Chapter 14 would be an unconstitutional tax.

Trusts—Proposed Chapter 14 also would revise rules relating to gifts made through trusts. Again, rather than using real fair market value, proposed Chapter 14 would specifically and intentionally overvalue these gifts and, therefore, not be related to the taxpayer's ability to pay.

One of the trust transfer rules to which proposed Chapter 14 is specifically addressed is the so-called "grantor retained income trust" or "GRIT." Barely a year ago, Congress specifically approved the use of GRITs in a form prescribed under Section 2036(c). In that legislation, the Congress prohibited the use of grantor retained *annuity* trusts. Yet, under proposed Chapter 14 taxpayers would be permitted to use grantor retained annuity trusts but prohibited from using the GRITs which the Congress recently approved. In fact, neither grantor retained annuity trusts nor GRITs is "abusive." In fact, in my judgment, these trusts will enhance revenues to the Treasury over the next five years. The way the estate and gift tax system is structured, these transactions result in a prepayment of transfer tax. In fact, using the Treasury's own valuation tables, there is no reduction in the amount of tax paid from a "time use of money" perspective.

Options to Acquire Property—Although the legislative history to the Revenue Act of 1987 strongly suggests that Section 2036(c) was not intended to have any effect for estate and gift tax purposes on options to acquire property, IRS Notice 89-99 takes the position that such options are proscribed by the section unless they are in a limited form. Basically, proposed Chapter 14 would legislatively confirm the Treasury's position with respect to the prohibition of almost all options to acquire property unless in a certain form which form is even more restrictive than the form provided for in IRS Advance Notice 89-99. The estate and gift tax rules relating to options to acquire property was, in large measure, developed by the Treasury Department itself. See, for example, Treasury Regulation Section 20.2031-2(h); Rev. Rul. 59-60, 1959-1 C.B. 237. The Treasury's position was based upon concepts of *real* fair market value, and, accordingly, has been endorsed by the courts. Perhaps, more important, the position set forth in the Treasury Regulation and Revenue Ruling reflect the reality that a business needs to control ownership of interests in it.

Propose Chapter 14 would artificially value properties subject to such options, and, therefore, impose a tax not related to the taxpayers' ability to bear the burden of taxation. A detailed study by the Treasury of the use of such options in businesses certainly should be undertaken before Congress should adopt a rule which would proscribe basic business planning which began long before the Federal estate tax was first enacted.

RECOMMENDATIONS

I recommend the immediate repeal of Section 2036(c) retroactive to its original effective date. I recommend that Congress enact legislation which would require taxpayers to disclose certain transaction which the Treasury believes may result in property being taxed at less than its fair market value for wealth transfer tax purposes. Taxpayers who fail to comply with such disclosure requirements should be subject to penalties. The Congress enacted such a provision relating to so-called "Haffner" bonds as part of the Tax Reform Act of 1984. I understand that those provisions worked extremely well. I see no reason why it could not be used for other transactions which the Treasury regards as abusive of the wealth transfer tax system.

Furthermore, I recommend a moratorium on any change in the rules relating to transfers through trusts. Perhaps, it would be appropriate for the Treasury to study

the actuarial tables which it uses to determine interests in trusts. However, it seems appropriate only if consistent actuarial factors are used regardless of the kind of trust transfer involved.

Finally, no new rules should be promulgated relating to options to acquire property. Indeed, it is understood that members of the Treasury have represented that no changes would be made in this area. Proposed Chapter 14 , however, would greatly change the rules and adversely affect legitimate business planning by many closely-held companies.

Thank you for the opportunity to submit this statement.

COOPERS & LYBRAND,
Washington, DC. October 5, 1990.

Hon. LLOYD BENTSEN,
703 Senate Hart Office Building,
U.S. Senate,
Washington, DC.

Dear Mr. Chairman: We are pleased to submit our comments regarding S. 3113, introduced on September 26, 1990, to repeal and replace §2036(c). The comments are based on our firm's extensive practice in estate and financial planning for businesses and individuals.

We commend you Chairman Bentsen and Senators Boren and Daschle for introducing S.3113. We wholeheartedly endorse the repeal of §2036(c) and its replacement with gift tax valuation rules aimed at determining a more accurate value at the time of the initial transfer. Mr. David E. Lajoie, a partner in our Dallas office, has testified and submitted comments on replacement legislation for §2036(c) in connection with the prior release of the House "Discussion Draft" (later H.R. 5425) and other proposals. Mr. Lajoie testified on June 27, 1990 at the hearing before the Senate Finance Subcommittees on Energy and Agricultural Taxation and Taxation and Debt Management on estate valuation freezes.

We note with approval that most of our concerns have been addressed in S. 3113:

- The bill defines control for purposes of identifying retained rights affected by the valuation rules as 50% or more of the stock of a corporation (by vote or value) or 50% or more of the capital or profits interest in a partnership or any interest as a general partner. This provision will focus only on potentially abusive situations.
- The bill alleviates serious cash flow concerns produced by the minimum transfer rules and market rate qualified payments proposed in the House bill. The approach of amending §2031 to provide that unpaid cumulative distribution rights will be included in the valuation of the retained interest for purposes of future transfers (at death or during life) appears to solve the dilemma of trying to balance taxpayer cash flow concerns against the government's concern that valuation assumptions would not be reflected in future events.

We note that new §2031(c) will result in a gift tax provision being included in an estate tax code section. We suggest that a provision similar to new §2031(c) be added either to current §2512 of Chapter 12 or to new §2512A. This same suggestion should be considered in connection with proposed §2031(d), dealing with buy/sell agreements, which also applies for gift tax purposes.

- The bill revises the valuation tables for purposes of transfers or acquisitions of split interests (including GRIT transactions) within more than one family generation. As we previously testified, "[t]he solution is not to eliminate this type of planning since there is nothing inherently abusive in giving away interests in property. The solution is to arrive at a proper valuation that is fair to the taxpayer and fair to the government."

We think that substituting 80% of the mid-term AFR for the current 120% provided in current §7520 is a fair solution if applied consistently. Therefore, we propose that you consider a recapitalization safe harbor utilizing the same 80% mid-term AFR to establish dividend payments for cumulative referred stock. This will provide more valuation certainty for those taxpayers willing to use the safe harbor rate.

- The effective date of S. 3113 is for transfers, acquisitions, or deaths after September 25, 1990. Any date prior to this date would have unfairly deprived taxpayers of the ability to plan major transactions without full knowledge of the rules to be applied. It is suggested that the enactment date—or at least the date of committee or conference action—of any legislation would be more appropriate. Taxpayers have been plagued with confusion over whether they are subject to existing law, the

House bill or the Senate bill and, in any event, all but the most aggressive taxpayers have halted estate freeze type planning because of this uncertainty.

We urge you to find some way to enact this legislation as soon as possible. Section 2036(c) places many of our family business clients in jeopardy of having ordinary business transactions and transfers of property produce disastrous consequences at the death of the business owner. Consequently, repeal of this provision should remain a legislative priority.

We commend you on S. 3113 and offer our assistance in connection with these comments and any other aspects of the proposal. Mr. Lajoie can be contacted at (214) 754-5253 or you can call Pam Pecarich at 822-4239 or Sam Starr at 822-4279 in our Washington, D.C. office.

Sincerely,

COOPERS & LYBRAND.

213 East 110th Street
Kansas City, Missouri 64114
Phones: (816) 942-2547 Home
(816) 966-2880 Workday
October 12, 1990

Ms. Laura Wilcox, Hearing Administrator
Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20510

Re: 2036(c) Revisions

Dear Ms. Wilcox:

I would like to offer comment on the proposed revisions of the Internal Revenue Code relating to the currently unwieldy Section 2036(c). I offer two suggestions which would raise revenue, restore fairness, and be comprehensible.

1. In the case of "retained life estate" and closely held stock situations, the code by statute should **disallow any discount for marketability** or minority interest where a family (by some definition) owns more than 50% of the stock in aggregate. A body of law (e.g., Bright) has grown up on the fiction that valuation discounts should be awarded because there is no good market for a decedent's ownership interest. In reality a family will have little disunity of purpose so as to really merit diminished valuation. This solution would be relatively easy to implement. It would allow a straightforward valuation of whatever interest is transferred without all the current gamesmanship.

2. In a related area, **disallow the deduction of interest** on tax deficiencies and deferred payment of estate tax where it is currently a deductible administrative expense under IRC 2053. Income tax law now generally forbids deduction of interest expenses; thus, this change would be consistent, and it would raise revenue. Additionally, it would address the inherent inequality of allowing some estates additional deductions for paying taxes later in time. The current deduction of interest reduces actual tax in estates which pay tax later in time while at the same time creating needless algebraic complexity of "interrelated computations." Overrule Bahr and save IRS a lot of time in processing refunds.

I write this as an individual interested in effectively closing two prominent estate tax loopholes in a generally simple manner. If you have any questions, please feel free to call me at the above phone numbers. With best regard to you in your difficult task.

Sincerely,

Jim Dingwerth

Jim Dingwerth

BEST AVAILABLE COPY

FAMILY HOLDING COMPANY GROUP,
Washington, DC, October, 5, 1990.

Ms. LAURA WILCOX, *Hearing Administrator,*
U.S. Senate,
Committee on Finance,
205 Dirksen Senate Office Building,
Washington, DC

Re: S. 3113 (Repeal of section 2036(c) and Proposed Alternatives) Family Holding Company Group

Dear Ms. Wilcox: As counsel for the Family Holding Company Group, I am writing to express the basic support of our group for S. 3113 as introduced by Senators Bentsen, Boren and Daschle. The Family Holding Company Group is an organization of 24 family companies which is concerned with the impact of Federal tax policy on family companies in general and family holding companies in particular. The members of our group are companies that either have a portfolio of invested assets such as publicly traded securities or which control or are associated with family owned operating businesses. The stock of these member holding companies is owned by family groups and is not actively traded. By way of additional background regarding our group and its concerns with this subject, I am enclosing a copy of the statement which we filed with the Senate Finance Subcommittee on Taxation and Debt Management in connection with hearings by that subcommittee on July 13, 1990 concerning the repeal of section 2036(c).

Our group strongly believes that it is important to repeal section 2036(c) in this Congress. To the extent that there is a perceived need to provide alternative legislation to prevent abusive estate tax freeze devices, we believe that such legislation should be clearly limited to any such abuse situations and should be straightforward and understandable. Under these standards we commend Senators Bentsen, Boren and Daschle for the development and introduction of S. 3113, which we believe to be the best alternative to section 2036(c) that has been introduced to date. Therefore, we wish to express our basic support for this legislation proposal.

We are concerned, however, with the scope and meaning of section 3(e) of S. 3113, which would amend section 2031 of the Internal Revenue Code by adding a new subsection (d). Our concern relates to proposed section 2031(d)(3) which would require that any buy-sell agreement have terms which "are comparable to similar arrangements entered into by persons in an arm's-length transaction" in order to be considered in valuing of family companies. This is in addition to the requirements that such buy-sell agreement be a bona fide business arrangement and not be a device to transfer property to members of the decedent's family for less than adequate and full consideration. In view of these two requirements, it is not at all clear to us what additional standard is introduced by proposed section 2031(d)(3). If the agreement satisfies the bona fide business arrangement, what more must it do to satisfy proposed section 2031(d)(3). Literally read, this provision would seem to require a family company to model its agreement on some similar arrangement between persons in an arm's-length transaction and that a failure to do so would leave a buy-sell agreement ineffective in determining estate tax values even though the agreement is a bona fide business arrangement and is not a device to reduce taxes. Where would a company find "similar arrangements" which would satisfy the Internal Revenue Service and how closely would the buy-sell agreement in a family company have to parallel such "similar arrangements?" We believe the proposed section 2031 (d)(3) is unnecessary and, if enacted, will unnecessarily cause confusion, uncertainty and discord. We, therefore, recommend that it be deleted.

We appreciate your consideration of our comments. If you or any other member of the Senate Finance Committee staff or the Joint Committee staff would like to discuss these matters with me, please call me.

Sincerely yours,

H. STEWART DUNN, JR.

Attachment.

STATEMENT OF THE FAMILY HOLDING COMPANY GROUP

The Family Holding Company Group is an organization of twenty-four family companies which is concerned with the impact of Federal tax policy on family companies in general and family holding companies in particular. Family holding companies are companies that either have a portfolio of investment assets, such as publicly traded securities, or which control or are associated with actual family-owned

operating businesses. The stock of these member holding companies is owned by family groups and is not actively traded.

Family investments held through holding companies are subject to an unfavorable tax regime under present Federal tax law:

(1) While families which hold investments or operate active businesses directly, or through partnerships and S corporations, are taxed at a maximum income rate of 28 percent, corporations (including family corporations) are taxed at a maximum rate of 34 percent.

(2) Unlike publicly held companies, mutual funds, real estate investment trusts and most other corporations, a family holding company is either subject to the personal holding company tax of section 541 or the accumulated earnings tax of section 531, so that family holding companies must either distribute all or most of their earnings or be subject to these penalty taxes.

(3) Due to the erosion of the dividend received deduction (now only 70 percent), dividend earnings received by these companies are subject to triple tax (i.e., at the level of the payor corporation, the family holding corporation and the individual shareholder).

(4) At the death of a family holding company shareholder, large amounts of estate taxes must generally be paid even though the decedent's shares are unmarketable.

Because of this punitive taxation regime, almost every member of our Group would liquidate if it could do so without being subject to another prohibitive tax—this one on the appreciation in the assets held by the company. Congress has imposed an unfairly discriminatory level of taxation on investments held through family companies at the same time making it prohibitively costly to change the structure of such investments.

In light of the highly unfavorable income taxation of family holding companies, the enactment of section 2036(c) in 1987 and its troublesome amendment in 1988 were severe blows to our membership. Shareholders of family holding companies suffer to the same degree as any other shareholders of family companies under section 2036(c), but they may not qualify for extended estate tax payments under section 6166. Consequently, in light of the existing duplicative and unfair taxes on family holding companies, we urge the immediate repeal of section 2036(c) with retroactive effect to December 17, 1987.

We wish to thank and commend Senator Daschle, Senator Boren and the other senators in attendance at the joint hearing on June 27 for their strong statements in support of the repeal of section 2036(c). Failure to repeal this overbroad and inequitable legislation would expose many shareholders in members of our Group to inestimable and potentially disastrous estate taxes.

We wish again to commend Chairman Rostenkowski for introducing the discussion draft. We also commend the Treasury Department for its extensive list of modifications to this draft which are set forth and supported in Deputy Assistant Secretary Michael J. Graetz's testimony of June 27, 1990 before your subcommittees. These modifications are generally supported by our Group. We note, however, that at page 12 of Mr. Graetz's testimony he recognizes the serious objections to restrictions on buy-sell agreements in the discussion draft but states that Treasury is studying this subject and has not yet developed a satisfactory alternative. For the reasons set forth below, we submit that present law fully protects the Treasury against any misuse of buy-sell agreements in estate, gift and other transfer tax matters and that with the repeal of section 2036(c) no further legislation is either necessary or appropriate regarding such agreements.

We strongly object to proposed section 2702 of the discussion draft which would require that certain options (or agreements) be disregarded in determining the value of an interest in any family business. There is no dispute that family businesses frequently use and genuinely need such options (or agreements) for *bona fide* non-tax business reasons (*e.g.*, to prevent sales to hostile outside interest, to protect the family business in cases of divorce, bankruptcy, *etc.*). Present law simply evaluates whether any such options (or agreements) have any real impact on the fair market value of such interest in the family business. If it does not actually reduce the price a willing buyer would pay a willing seller, then it does not reduce the value for transfer tax (estate, gift and generation-skipping) purpose. If it does actually reduce such price, then this is recognized also for transfer tax purposes. Thus, present law gives options (or agreements) no more or no less significance than any other fact or factor that is considered in determining fair market value. Long-standing Treasury regulations expressly address and prevent any abuse in this area. Reg. §20.2031-2(h).

Section 2702 would create an exception to the general fair market value standard; such an exception is unnecessary, unfair and very bad tax policy. Congress should certainly not be adopting exceptions to long-established and well accepted tax policy for the purpose of increasing gift and estate taxes on interests in family business.

Neither section 2702 of the discussion draft nor any comparable exception to the fair market value standard which denies equal treatment to family business should be adopted. Congress should be encouraging family business by the repeal of section 2036(c) and not penalizing family business by adopting provisions such as section 2702 of the discussion draft.

HARTER, SECRETS & EMERY,
Rochester, NY, October 4, 1990.

Senate Finance Committee,
U.S. Senate,
Dirksen Senate Office Building,
Washington, DC.

Gentlemen: I want to first thank you for giving me the opportunity to make a statement before the Committee on this important legislative matter. I have been engaged in the practice of law for over 30 years and view myself as a business lawyer in the broadest sense. My practice clients are primarily closely held small business corporations and their owners. I am an advisor to my clients not only on their business and legal matters, but also on matters relating to estate and tax planning.

In the course of advising my clients, it has been necessary for me to become familiar with Internal Revenue Code Section 2036(c) Due to the nature of my practice, I have had extensive experience in advising clients on transactional legal issues that are impacted by the statute. It is from this vantage point that I offer the following statement on Senator Bentsen's proposal to replace Section 2036(c) (the "Bentsen Proposal"). The opinions expressed in this statement are solely those of the author. I represent no one other than myself as a practicing lawyer. While the opinions and commentary are my own, my experience tells me that they are shared by a multitude of closely held business owners and farmers throughout our nation, and by their professional advisors as well.

I. POLICY CONSIDERATIONS

A. The Repeal of §2036(c)

The case for the repeal of §2036(c) is overwhelming and does not have to be reargued in this statement. The fact that Representative Archer's bill, H.R. 60, has over 200 co-sponsors demonstrates that Congress is well aware of the need for repeal. The fact that the Bentsen Proposal includes such a repeal is clearly a positive factor.

B. The Case for No Replacement

There no longer is a need for statutory curtailment of asset freezes. While freezes were popular in the 70's and early 80's, even then the tax and business structure of "freezing" transactions was so complex that only a small group of professional advisors could effectively deal with them, and few clients could afford the very substantial legal, accounting and valuation costs of structuring them. The mid-80's brought on a stream of cases, rulings and regulations which, in combination, made it not only risky, but doubtfully practical to continue to implement "freezes." Any "freeze" that has legal substance and would pass audit scrutiny ends up having no economic substance as a "freeze." Further, the great preponderance of family businesses today are "S" corporations due to significant income tax advantages. Since "S" corporations can only have one class of stock, this eliminates all freeze possibilities for all "S" corporations. In short, there is no practical need for legislation and the revenue impact of eliminating future asset "freezes" is grossly overstated. What is really needed to protect the integrity of the transfer tax system is the establishment of a reporting requirement for freeze transactions and increased audit surveillance of abusive transactions. Since the Bentsen Proposal does provide for an unlimited extension of the assessment period for undisclosed asset freezes, it does address this last issue in an effective way.

C. The Burden of Tax Legislation on Closely Held Businesses

Closely held businesses and their owners have been repeatedly battered by the deluge of tax legislation and regulation that has been placed on their shoulders. Since 1976, fifteen major tax legislative proposals have been enacted by Congress

dealing with income or estate taxation, and all of them have significantly impacted small businesses and their owners. The small business owner is over his head in terms of statutory and regulatory compliance. To layer a complex and convoluted statutory scheme like §2036(c) or the Rostenkowski proposal on top of everything else is just too much. It is now time for common sense and reason to prevail—it is time to end this nightmare for the closely held business owner. I believe that the simplicity and clarity of the Bentsen Proposal addresses this issue in a very effective way and will bring some reason to this legislative quagmire.

D. The Burden of Tax Legislation on the System

Think of all of the money, time and priceless energy that has been wasted on the enactment of §2036(c) and its aftermath. Not only by Congressmen and their staff, but by Treasury, the IRS, the Joint Committee on Taxation, OMB and countless lawyers, accountants, bankers, insurance persons, financial planners, taxpayers and others. If all of the money, time and energy spent on §2036(c) and its amendments and the Rostenkowski proposal were positively directed into requiring compliance with the current estate and gift tax system, or, for that matter, the Bentsen Proposal, it certainly would have a revenue positive impact. I believe that the Bentsen Proposal is something we can all live with and will put an end to all of this needless expenditure of time and money.

E. The Need to Simplify Tax Legislation.

Laws, particularly tax laws, should be susceptible to understanding, not only by a handful of elitist tax lawyers, but by clients who are expected to evaluate the advice they are given and follow the laws. Few professionals understand §2036(c) or the Rostenkowski proposal, and if the professionals do not understand, what chance do clients have? Clients engage in normal business transactions (like entering into leases or employment contracts) only to find that a technical application of a broad and complex statute puts their transaction in potential violation of a statute with significant adverse tax consequences. What is worse yet is that even if the issue is one that is identified, there are often no reliable answers and no reliable process for obtaining those answers. The simplicity of the Bentsen Proposal has great appeal to both taxpayers and their professional advisors.

II. A QUALITATIVE ANALYSIS OF THE BENTSEN PROPOSAL

A. For one who has struggled through the complexities of §2036(c) and the Rostenkowski proposal, the immediate reaction is "Why has it taken so long to bring some reason and sanity to this issue?" I am sure the apparent simplicity of the Bentsen Proposal obscures the difficulty and complexity of putting such a proposal together. At this point one should probably say "Thank God" and not be critical of the process, but I cannot resist pointing out that the best legal minds in the country have been telling Treasury, the IRS and the committee staffs to narrow the scope of the statute and focus solely on valuation methodology. The Bentsen Proposal is to be greatly commended for adhering to this advice.

Notwithstanding all the smoke and mirrors utilized by Treasury and the Joint Committee Staff to create the basis for a broad congressional mandate to enact a statute that will forever foreclose any future valuation abuse, such a mandate did not form the underpinnings for §2036(c). From the beginning, the legislative history clearly indicates the intention of Congress to curtail the "estate capital freeze" and no more. As time went on, the committee staffs were able to shape the legislative commentary to suit their more expanded purpose, but that is pure and simple boot strapping. If we accept that the original intent of Congress in authorizing §2036(c) was to curtail corporate and partnership capital freezes, it is then impossible to say that the Bentsen Proposal does not fully fulfill this need. In order to create effective capital freeze, *all* of the following must be in place:

1. The senior generation must have a non-participating equity interest.
2. The junior generation must have a participating equity interest.
3. The frozen equity interest held by the senior generation must not produce an income stream (a "thaw").
4. The non-frozen equity interest must be valued by the subtraction method.
5. The frozen equity interest must sustain its value through rights other than guaranteed distribution rights (so-called "bells and whistles")
6. The transferor, the transferee and/or other family members must control the entity so that they can control the exercise or non-exercise of the bells and whistles.

It is clear that the point that I just made is well understood by the drafters of the Bentsen Proposal, since each of the criteria which I have listed are effectively treat-

ed under the new proposed §2512A. At the same time, there are no provisions in that section that would interfere with normal business transactions conducted at arms' length, even when the participants in those transactions are family members. If the Bentsen Proposal stopped at this point, it would have more than adequately fulfilled the original congressional purpose.

B. It is questionable whether it is necessary to impose a statutory structure on split interests in property acquired by different family members. Trying to create a rationale for a safe harbor for a 10 year income interest, as was the approach in §2036(c)(6) is very difficult. Why is a 10 year GRIT any better or worse than a 11 year GRIT? Likewise, trying to create distinctions between personal use property and other types of property, or creating legal fictions that the purchase of a split interest in property by two people is really the purchase of the entire interest by one and a subsequent transfer of a partial interest by that person to another, simply creates artificiality, a distinction with no legal significance other than a contrived result. For these reasons, I believe the approach of §2036(c) and the Rostenkowski proposal both fall short of the mark. On the other hand, it has long been a part of our tax policy to either encourage or discourage certain transactions by modifying the interest rate tables on which the economic assumptions for these transactions rest. Thus, in this case, if it is the belief of Congress that the economic results and rewards of split interest transfers are too generous under the present application of the interest rate tables, or, that as a matter of tax policy, such transactions should be rebalanced in terms of their rewards, then the appropriate way to accomplish this is to change the interest rate assumptions. If measured from no other vantage point other than "simplification," this approach has much to offer since it replaces a lot of complex and artificial rules with a simple arithmetic adjustment. The Bentsen Proposal is far superior to other proposals and solutions which have been offered in this area.

C. The option rule is not necessary to protect the integrity of the transfer tax system. In effect, the best evidence of this is that the proposal for new §2031(d) so closely follows the current Treasury Regulations §20.2031-2(h) Proposed sections 2031(d) (1) and (2) are taken directly from the regulation. While proposed Section 2031(d)(3) appears to be new, it is hard to see that it adds anything of legal substance to the first two requirements. If this is the case, why confuse the legal profession and the courts by codifying a legal area that is already adequately covered by regulations. It will only bring the Service, or possibly the courts, to the conclusion that Congress intended to impose some new standard in this area, since otherwise the statute would have been unnecessary. This will simply be the prelude to confusion and perhaps an aberrant legal result.

As the proposal currently reads, the burden of proof is on the taxpayer to show that the criteria of §2031(d) are met. This means that the Service will put taxpayers through the hoops every time they run across a shareholders agreement among family members. Since the essential ingredient in the three criteria of proposed Section 2031(d) is fair market value, the presumption of the inapplicability of the option or agreement in determining estate tax value will only foment more valuation controversy, the need for valuation experts and ultimately more valuation litigation. It is not in the interest of our tax policy to promote increased levels of valuation controversy which will further clog the dockets of an already overburdened tax court. For this reason, it would be much preferred for the proposed new section to presume that the three requirements of Section 2031(d) are met unless the Service demonstrates to the contrary.

There is no need for the option rule in any case where unrelated parties are also parties to the agreement. At worst, this should create a rebuttable presumption that the three requirements of proposed Section 2031(d) are met under those circumstances.

Having made the foregoing commentary, I would be remiss if I did not say that the proposal for new Section 2031(d) is far superior to any solution provided by §2031(c) or the Rostenkowski proposal. It relieves businessmen of the burden and expense of constantly obtaining business appraisals. It also recognizes that trying to judge whether parties "reasonably believed" that one pricing mechanism or another would be calculated to produce fair market value at some point in time in the distant future is an exercise in futility that will provoke constant controversy between the Service and taxpayers. Finally, the proposed section gets Congress out of the business of telling businessmen how they should value their business, or that one method is better than another, or that a formula approach is required, when conventional industry standards long developed may have rejected the application of any formula. New Section 2031(d) is such a significant improvement over prior attempts in this area, that by comparison, it deserves support even if no changes are

made. Owners of family businesses, and farmers as well, need some simple rules that they can understand and rationally apply in this area. I believe new proposal Section 2031(d) meets this important test.

D. The proposal for the extension of the statute of limitations is reasonable under the circumstances. The administration of our tax system is dependent on voluntary reporting and audit. Many of the transactions which might involve the special valuation rules of proposed Section 2512A would not, but for the valuation rules, require reporting. If not reported, they may not be picked up until a subsequent gift tax or estate tax audit. Such an audit might take place at a time after which the 6 year statute of limitations has run on the original gift. In order to promote disclosure, prompt reporting, and timely audit, it is appropriate to place non-complying taxpayers indefinitely at risk.

E. The American Institute of Certified Public Accountants in testimony before the Senate Committee on Small Business on September 13, 1989, took the position that Section 2036(c) should be repealed and any replacement legislation for §2036(c) should be placed on hold until such time as Congress has an opportunity to examine the transfer tax system and its current impact on small businesses. For Congress to undertake such a study would, indeed, be a very positive step and would send a signal to small business owners as well as farmers that Congress is still concerned about them. As a practical matter, small businesses and their owners cannot afford to have 60% of the value of the enterprise extracted from the enterprise at the time of each generational transfer. It was recently calculated that only 5 of family businesses last for three generations and that our transfer tax system is the major contributor to this statistic. The small enterprise system, as we have known it in America, is in jeopardy. Foreign financial interests are the principal beneficiaries of the current system, and they are eagerly taking up America's small business enterprises.

While the Bentsen proposal does authorize a study, it directs the focus of the study only to abuses. This will simply produce a litany of items from Treasury's "wish list," most of which are generated from their relative lack of success in important litigation matters. The study should be much broader than that. It should, as has been suggested, direct itself to a review of the transfer tax system as it applies to family enterprises, farmers and closely held business interests. The taxpayers only turn to abusive tactics when the system is not working for them, and their is plenty of evidence that this important constituency is struggling with the manner in which the transfer tax system impacts them. Such a study might develop some long term answers to the problem rather than producing more controversy and patchwork legislation.

III. SUMMARY

While any legislative bill can be picked to death by the experts who have the advantage of technical review, it is necessary to judge legislation on whether, in balance, it fairly deals with the subject matter and whether it leaves an improved state of affairs. I believe that the Bentsen Proposal passes this test. The proposed statutory change has a narrow focus and is conceptually quite simple, and as a result raises a minimum of technical and interpretive questions. It is clearly directed to dealing with valuation abuse in key areas, but it is fair and reasonable in its approach to the problem. More importantly, it will bring some certainty to family planning issues in several key areas and will permit professionals to advise their clients with some assurance of result. Finally, the approach is simple and susceptible to understanding, not only to an elite cadre of tax professionals, but to a large host of professional advisors and clients who have been left in the dust by the complexity of existing Section 2036(c) and the Rostenkowski proposal.

Very truly yours,

THOMAS A. SOLBERG.

HARWELL MARTIN & STEGALL, P.C.,
Nashville, TN, October 4, 1990.

Senator LLOYD BENTSEN, *Chairman,*
Senate Finance Committee,
205 Dirksen Senate Office Building,
Washington, DC.

Re: Comments on S. 3113

Dear Senator: The following is submitted in connection with your introduction of S. 3113.

PROPOSED NEW INTERNAL REVENUE CODE SECTION 2512A

Proposed Code subsection 2512A(b)(1) would generally treat any rights under "applicable retained interests" as having a value of zero. Subsection 2512A(b)(2) would except from such treatment rights under interests which are of the same class as the transferred interest. However, neither this nor the other exceptions found in the bill recognizes that the transferor may retain an interest, though not of the same class as the transferred interest, which is not preferred over the transferred interest. This is particularly true in today's complex corporate structures involving several classes of preferred stock. Such an exception is found in H.R. 5425 in proposed Code section 2701(a)(3)(C)(ii) though the language of that exception is flawed in that a single right, regardless of its magnitude, that is preferred over the transferred interest would appear to preclude the retained interest from being within the exception even though all other rights under the retained interest are subordinate to those of the transferred interest. A clearly written exception should be included in S. 3113.

Proposed Code subsection 2512A(c)(2)(B)(ii) defines "control," in the case of limited partnerships, as "the holding of any interest as a general partner." The definition is unnecessarily and unfairly broad in that an individual may hold a small interest as a general partner in a limited partnership in which voting control is held by some or all of the other general partners. Accordingly, this definition of "control" should be eliminated or made more specific.

S. 3113, in proposed new subsection 2512A(c)(3)(A)(i), refers to "stock described in subsection (a)(1)." However, proposed subsection 2512A(a)(1) does not describe stock. Instead, it refers to transfers described in subsection (a)(2) Accordingly, proposed subsection (c)(3)(A)(i) should be clarified.

PROPOSED NEW INTERNAL REVENUE CODE SUBSECTION 2031(C)

Proposed subsection 2031(c) states that, with respect to corporate or partnership interests which confer distribution rights, the value of such interests for estate and gift tax purposes shall generally "include" the lesser of the value of the unpaid but accumulated distributions or the liquidation value. It is unclear under this proposed subsection whether the lesser of the two values is a minimum valuation for estate and gift tax purposes, is in addition to the value of such interest without regard to such distribution or liquidation rights, or is intended to be the value of such rights. The proposed additional subsection should be clarified.

PROPOSED NEW INTERNAL REVENUE CODE SUBSECTION 2031(d)

Proposed Internal Revenue Code subsection 2031(d) provides that any option, agreement, or other right to acquire or use property at a price "less than its fair market value would not be taken into account for valuing such property for estate or gift tax purposes unless the option, agreement or other right: (i) is a bona fide business arrangement, (ii) is not a device to transfer such property to family members for less than adequate and full consideration, and (iii) contains terms comparable to similar arrangements entered into by persons in an arms-length transactions. The inclusion of the second of the three requirements (that the option or other right not be a device to transfer property to family members at less than its full and adequate consideration) is unnecessary in light of the other two requirements. Requiring that options or other such agreements among family members be bona fide business arrangements with terms comparable to similar arrangements entered into by persons in arms-length transactions assures that such options or other agreements are not the proscribed devices. The additional requirement that such option or other agreement not be a device is therefore unnecessary. Furthermore, the use of the broad and elusive term "device" would create considerable uncertainty with regard to the tax consequences of legitimate transactions which meet the other two requirements.

TREASURY STUDY

Subsection 3(g) of S. 3113 directs the Secretary of the Treasury to conduct a study of the prevalence and type of options, agreements and other methods used to distort property valuations for estate, gift and generation-skipping transfer tax purposes. The result of the study, with legislative recommendations, is to be reported by the Secretary no later than December 1, 1992. As recognized by the Senate Finance Committee in its news release upon the introduction of S. 3113, current Code Sec-

tion 2036(c) includes "unreasonable impediments that have hampered legitimate transfers of family businesses, particularly small businesses." Furthermore, the "complexity breadth and vagueness" of Section 2036(c) has caused many taxpayers, uncertain about the scope of current law, to refrain from making legitimate transactions. For these reasons, S. 3113 would repeal section 2036(c). However, the study mandated by subsection 3(g) of S. 3113 should then be used to design appropriate legislation to prevent the use of valuation distortion methods, instead of enacting proposed Code section 2512A and its companion subsections 2031(c) and (d) prior to the identification of the valuation distortion methods to be regulated and the recommendation of an appropriate legislative response.

CONCLUSION

I appreciate the opportunity to make comments on S. 3113. However, it is unfortunate that our legislative process precludes the thoughtful study of complex legislation and its impact upon taxpayers. Nevertheless, even an analysis made under the present time constraints reveals the need for substantial clarification.

Sincerely,

L. GLENN WORLEY.

HOPKINS & SUTTER,
Washington, DC, July 6, 1990.

Hon. DAVID L. BOREN, *Chairman,*
Senate Finance Subcommittee on Energy and Agricultural Taxation, and
Hon. THOMAS A. DASCHLE, *Chairman,*
Senate Finance Subcommittee on Taxation and Debt Management,
U.S. Senate,
Washington, DC.

Dear Chairman Boren and Chairman Daschle: This statement is submitted for inclusion in the printed record of the public hearing held on June 27, 1990 on the proposals relating to estate valuation freezes. Our comments are presented on behalf of this firm and not with respect to any particular client. We recommend that any legislation being considered as a replacement for Section 2036(c) of the Internal Revenue Code retain the so-called II statutory GRIT provision of Section 2036(c)(6). Alternatively, if the statutory GRIT is not going to be retained, we recommend that any legislation which adversely affects statutory GRITs be enacted on a prospective basis.

The Discussion Draft of March 22, 1990 effectively precludes the utilization of Grantor Retained Income Trusts (GRITs) as a viable estate planning technique. In 1988, after careful deliberation and extensive study, the Congress added a safe harbor for so-called "statutory GRITs in new Section 2036(c)(6) of the Internal Revenue Code. This provision was enacted in the Technical and Miscellaneous Revenue Act of 1988. The safe harbor applies for transfers to a trust in which the transferor/grantor retains a right to receive amounts determined solely by reference to income from trust property if the term of the right does not exceed ten years and the grantor is not a trustee of the trust. The Discussion Draft effectively eliminates those GRITs currently permitted under Section 2036(c)(6) by valuing the retained interest at zero and taxing the entire value of the property involved in the transaction as a transfer from the holder of the retained interest to the holder of the remainder interest.

The Discussion Draft treatment of GRITs represents a complete reversal of the tax policy adopted by Congress barely two years ago in their enactment of the statutory GRIT provision. As a matter of sound tax policy, the statutory GRIT has had the salutary effect of encouraging lifetime transfers of wealth. As a matter of fairness and equity, and to ensure stability in estate planning, the statutory GRIT provision of Section 2036(c)(6) should be retained.

If the Subcommittees feel it is necessary to address this area again after only two years, any changes should be made on a prospective basis only, to become effective after the date of their enactment, and grandfathering any GRITs existing on that date. Additionally, transitional relief should be made available to those taxpayers who acted in reliance on the statutory GRIT provision, permitting them to unwind without adverse tax consequences any GRITs that are not grandfathered by the new legislation.

We appreciate this opportunity to present our comments on this important issue.

Respectfully submitted,

WILLIAM C. WEINSHEIMER.

NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PARKS,
Arlington, VA, July 6, 1990.

Hon. DAVID L. BOREN,
U.S. Senate,
Committee on Finance,
Room SD-205, Dirksen Senate Office Building,
Washington, DC.

Attn: Ms. Laura Wilcox, Hearing Administrator

Dear Mr. Chairman: The National Association of Industrial and Office Parks respectfully offers the following comment regarding the Discussion Draft on Section 2036(c)—Estate Freezes—as it relates to transfers with retained life estates.

NAIOP supports the repeal of Section 2036(c) without qualification.

Although said Section, together with many others of the Internal Revenue Code, seeks to protect against tax abuse, the ripple effect of this section is the systemic destruction of small businesses (and in this instance, family-owned businesses) and entrepreneurial activity, forcing the businesses to either be ceded to larger companies or simply go out of business, to pay death taxes.

We believe that the effect of this Section is far more inimical to the societal and economic fabric of this country than any revenue that can possibly be generated by its existence.

The National Association of Industrial and Office Parks (NAIOP) represents over 7,000 professionals involved in developing, master planning, designing, constructing, financing and managing industrial and office properties. The Association's national headquarters are in Arlington, Virginia, (703) 979-3400.

Thank you for your consideration.

Sincerely,

FRANK D. VISCEGLIA, *President.*

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS,
Washington, DC, October 5, 1990.

Hon. LLOYD BENTSEN, *Chamman,*
Committee on Finance,
205 Dirksen Senate Office Building,
Washington, DC.

Dear Mr. Chairman: On behalf of the National Association of Wholesaler-Distributors (NAW), I am hereby submitting the following comments on your legislation, S. 3113, which would repeal and replace current rules on estate freeze transactions under Internal Revenue Code Section 2036(c).

NAW is a federation of 114 national wholesale distribution trade associations (a list is attached as Appendix A), 57 state and regional associations and 2,000 individual wholesale distribution firms. All told, NAW represents approximately 40,000 companies with 150,000 places of business. These firms range in size from those with less than $1 million in annual sales to those with over $13 billion.

The wholesale-distribution industry is typified by small, closely-held companies. NAW's Distribution Research and Education Foundation estimates that well over ninety percent of wholesale-distribution firms are privately held, most of which are managed by the principal owner. The average size firm represented by NAW has approximately $5 million in sales and employs 30 individuals.

The distribution industry experienced a rapid growth in business starts just after World War II. The entrepreneurs who started these new companies or took over the reins of family-run businesses are now at retirement age. They are now in the process of developing plans to turn their companies over to their sons and daughters. For most of them, passing on the family businesses to future generations has been a lifelong goal. Unfortunately, however, Section 2036(c) is a profoundly significant barrier to keeping a business in the family.

Repeal of this section of the Code is one of NAW's highest priorities and we have actively participated in the process of arriving at a viable solution to this critical problem. NAW's chairman testified before the House Ways and Means Committee

last April on draft legislation which would replace the current statute with new rules and submitted testimony to the Finance Committee in conjunction with its hearing on this issue last summer. We have also been working with your committee, the Ways and Means Committee and other affected business organizations to affect positive changes in the law.

NAW commends your introduction of S. 3113, which is designed to retroactively repeal Section 2036(c) and replace prospectively the current law on estate freezes. The clearest benefit of S. 3113 is that its approach to resolving the debate over estate freezes is straightforward, relatively simple, but most importantly designed to focus on the question of abusive valuation freezes without the added baggage of the current law.

In analyzing your proposal we have the following specific comments:

DISCRETIONARY RIGHTS

S. 3113's treatment of discretionary rights is a positive step in the right direction. The bill's specification of those rights having no value coupled with its widely accepted rules applying to the valuation of other rights will provide much-needed latitude in objectively determining whether a gift has occurred during recapitalization.

80-20 RULE

NAW has had concerns with 2036(c) replacement proposals which seek to set forth a specific formula that would determine the value of preferred stock by requiring that a minimum of 20 percent of the value of the stock is taxable as a gift. Debts and leases to shareholders would be added to this 20 percent, serving only to increase potential gift tax liability. The so-called 82-20 rule would tend to favor companies with large cash reserves as well as potentially impose an inappropriate tax assessment.

We are pleased to note that not only does S. 3113 abandon the 80-20 rule, but seeks to establish an objective rule for the determination of a gift during a recapitalization.

DEEMED DIVIDEND RULE

Critics of estate freeze transactions argue that dividends promised under the recapitalizations are rarely paid. Some reform proposals have sought to set up specific mechanisms whereby failure to pay a dividend automatically results in gift or ultimately estate taxes.

However, many factors must be taken into account in determining a business' ability to pay dividends, not the least of which is the business' profits and its ability to pay. While we agree that a mechanism to prevent abuses by those who never intend to pay dividends needs to be in place, it should not be done at the risk of a business' financial viability.

S. 3113 attempts to address both issues by adding the value of the cumulative unpaid dividends to the estate upon the owner's death, limited to the value of the business at that time.

By not mandating a specific time period by which dividends must be paid without forcing a gift tax while maintaining an incentive to make dividend payments is a realistic and practical approach.

CUMULATIVE PREFERRED STOCK VS. NONCUMULATIVE PREFERRED STOCK

NAW does have concerns with the bill's neglect to allow non-cumulative preferred stock to have value. The proposal's insistence that only cumulative preferred stock can have value in a recapitalization may conflict with a firm's banking agreements.

By promising to pay a dividend to a stockholder before a creditor, a company can inadvertently violate current lines of credit or inhibit future lenders from making loan agreements.

This is an issue which we hope can be resolved and we would like to work with you to that end.

SPECIFIED DISCOUNT RATE

Of greater concern to NAW is the bill's absence of a specific dividend rate on preferred stock issued in an estate freeze transaction.

Guidance to the Internal Revenue Service on this issue is absolutely necessary if it is to fairly enforce a new estate freeze statute. Absent such guidance, it is our fear that well-meaning IRS agents will erroneously apply the market dividend rate of a Fortune 100 corporation to a small, closely-held company.

BUY-SELL AGREEMENTS

In NAW's view, S. 3113 defuses an issue of great concern to business in the treatment of buy-sell agreements. The bill will codify current IRS regulations, which in the past have been accepted as fair by both the IRS and taxpayers.

CONCLUSION

Mr. Chairman, NAW applauds Senator Boren's, Senator Daschle's and your efforts to repeal and replace Section 2036(c) of the Internal Revenue Code. NAW stands ready to work with you to expeditiously deal with this issue during the current Congress.

Sincerely,

DIRK VAN DONGEN, *President.*

Attachment.

STATEMENT OF THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

I. THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS AND THE WHOLESALE DISTRIBUTION INDUSTRY

NAW is a federation of 116 national wholesale distribution trade associations (a list is attached as Appendix A), 57 state and regional trade associations and 2,000 individual wholesale distribution firms. All told, NAW represents approximately 40,000 companies with 150,000 places of business. These firms range in size from those with less than $1 million in annual sales to those with over $13 billion.

The wholesale-distribution industry is typified by small, closely-held companies. NAW'S Distribution Research and Education Foundation estimates that well over ninety percent of wholesale-distribution firms are privately held, most of which are managed by the principal owner. The average size firm represented by NAW has approximately $5 million in sales and employs 30 individuals.

The distribution industry experienced a rapid growth in business starts just after World War II. The entrepreneurs who started these new companies or took over the reins of family-run businesses are now at retirement age. They are now in the process of developing plans to turn their companies over to their sons and daughters. For most of them, passing on the family businesses to future generations has been a lifelong goal. Unfortunately, however, Section 2036(c) is a profoundly significant barrier to keeping a business in the family.

Studies of our industry point to a steady trend away from closely-held private corporations to more publicly and foreign-owned entities due to changing market forces and economies of scale. In fact, section 2036(c) encourages a business owner to sell his or her company to an outside buyer rather than to pass it on to a family member. Additionally, Section 2036(c) causes discrimination between business owners who can simply lend cash to their children to finance the purchase of a business over a business owner whose cash is tied up in the business. As one wholesaler-distributor succinctly stated in a letter to her Congressman:

> "Successful businesses such as ours are regularly solicited for purchase by Fortune 500 companies. It seems inevitable to me with the lucrative offers being made and the estate taxes that will have to be paid under the current laws, that the small family-held businesses will eventually be eliminated. I am sure that this is not the intent of Congress, but [estate] tax laws combined with aggressive larger corporations will surely lead to this end."

II. PROBLEMS WITH SECTION 2036(C)

The Revenue Act of 1987, P.L. 100-203, signed into law on December 22, 1987, added, virtually unnoticed and without public comment, Section 2036(c) to the Internal Revenue Code.

The term "valuation freeze" or "estate freeze" refers to a technique commonly used by owners of closely-held business to, for instance, give non-voting stock to children who are active in the business or to minor grandchildren who have not yet demonstrated the maturity to be involved in business decisions. Through this technique, the entire family benefits from the success of the business, but control of the business rests in the hands of those active in it.

Congress took the view in the Revenue Act of 1987 that "estate freezes" were being abused. The only official description of the "abuse" that Congress was seeking to curb with Section 2036(c) was contained in the House Ways and Means Committee report accompanying the House version of the 1987 Act. The description focuses

almost exclusively on recapitalizations or restructurings of business entities into "preferred" and "common" interests followed by gifts of the common interest. According to the House report, this technique:

> "permits appreciation in the value of the corporate asset to pass between generations without being subject to gift or estate taxes, even though the voting and dividend rights of the preferred stock . . . give the owners beneficial enjoyment of the entire corporation . . . "

It was therefore concluded that a change in the law was necessary because "keeping a preferred stock interest in any enterprise while giving away the common stock resembles a retained life estate, and should be treated as such."

Despite the apparent clarity of the legislative purpose, the imprecision of the language in Section 2036(c) makes it susceptible to an extremely broad interpretation under which few family transactions or transactions involving family business entities are clearly outside its reach.

The most onerous result of 2036(c) is that any increase in value attributable to the assets transferred to the heirs through the typical estate freeze will revert to the parent's estate upon death, resulting in punitive taxation, even if it was through the efforts of the heirs that the value increased.

While the Technical Corrections Act of 1988 made certain clarifications to Section 2036(c) and the IRS has issued regulations, they are as ambiguous and imprecise as the original provision itself and, in fact, may have expanded both the reach of the provision and the severity of its penalties.

III. THE CONTROVERSY OVER DEFINING ABUSIVE VALUATIONS IN A CLOSELY-HELD BUSINESS

At the heart of the controversy over estate freezes are the rules by which individual assets of a business, individual rights of a stockholder to receive future income from the business, and the rights to future appreciation of the business are valued.

Valuation lies at the heart of the estate and gift tax system since taxes are calculated based on these valuations. These questions of valuation are rendered even more complex when posed in the context of a closely-held business, for although IRS regulations specify factors to be used in determining value, can seldom be ascertained on a mechanical basis.

Valuations for publicly-held companies are relatively easy to calculate, because the future income of a publicly-held company is generally not dependent on any one business, fashion, trend, geographic area, or person. And the value of their stock is set in a public market and can be easily found in the newspaper.

For closely-held businesses, however, valuations cannot be ascertained on a purely mechanical basis. Questions of value and the variety of rights which might be associated with a closely-held business caused the IRS to assert that there was a need to prohibit estate freezes. This view did not prevail in the courts. So, the IRS proposed Section 2036(c) to prohibit passing between generations any asset which might appreciate over time, no matter which other attributes of ownership might have passed between family members. As a result, wholesaler-distributors and other business owners are now blocked from attempting to fashion a plan for ensuring the orderly perpetuation of their businesses. The obstacles presented by current law are prohibitive whether the need is to plan for an orderly transfer of the business between generations or for a plan which provides for continuity of the business in the face of an untimely or accidental death.

IV. WAYS AND MEANS DISCUSSION DRAFT

On March 22, the House Ways and Means Committee issued a discussion draft which would repeal Section 2036(c) and replace it with new statutory language. We commend the Committee for the spirit in which this draft was introduced and are committed to a cooperative effort to produce an acceptable replacement statute for Section 2036(c).

A statutory replacement for Section 2036(c) is realistic and desirable provided that it is carefully targeted to the primary abuses which 2036(c) initially sought to address. Any proposal to replace 2036(c) should, however, be limited in scope. It should focus only on preventing abusive valuations and preventing the owner of a closely-held business from passing on substantially appreciated assets without taxation.

It should also permit a business owner to craft a plan which is fair and representative of the facts in each individual situation. Such an approach must recognize the unique nature of a closely-held business which can be subject to variations in profits

and income over a number of years. It must also provide for certainty in the process.

While NAW believes the proposed draft is an extremely positive first step in the process of reforming current law, we would like to state our concerns with the draft proposal and offer our suggestions for improvements.

V. DISCRETIONARY RIGHTS

First of all, the proposed limitations on various discretionary rights are far too severe. There are circumstances in which a discretionary right is critical, even if it is never exercised. Rights to purchase common stock or to share in the future appreciation of the company with a conversion right has a determinable value which should be recognized.

We suggest that the Committee more broadly review those rights and specifically list those which are considered abusive. Clearly abusive rights should be distinguished from those rights which have a value which can be independently verified.

The rules should also be internally consistent and if a value of zero is ascribed for gift tax purposes, it should also follow that the same value should result for estate tax purposes at death. The rule should not place the IRS in such a position that it can arbitrarily disregard or include those rights when it is in their interest to do so. This potential inconsistency creates vast future uncertainties, making perpetuation planning impossible.

We are pleased that the Treasury Department, in its June 27 testimony before the Finance Committee, stated it believes that regulatory authority be given to expand those non-income rights which are given value under the discussion draft.

VI. INDEBTEDNESS CONSIDERATION

Secondly, we suggest that consideration of indebtedness be eliminated from the 80-20 calculation. Including indebtedness in this equation can cause problems because debt to deferred compensation plans, retirement plans or other qualified debt—all of which may have a perfectly valid business purpose—would have to be factored into this equation. This particular rule opens the door for the IRS to consider issues of compensation and control, which are very complex issues.

The 20% rule itself is curious for it seems to allow for the combination of preferred and common stock to have a value below that of the original equity. In our view, it places too great a reliance on increasing the value of the common stock while reducing the value of the preferred stock. If the other valuation principles are sound, we question the appropriateness of this safe harbor approach.

VII. DETERMINATION OF RATE

Thirdly, the value of the preferred stock is also impacted by the dividend rate which the parents will receive. The chosen rate must be compared to the market rate at the time of the recapitalization, and if it is below market, the value of the preferred stock must be reduced by a percentage based upon a relationship of the actual rate to market rates. This can have the effect of increasing the value of the common stock and increasing the gift tax due at the time of the recapitalization. The definition of market rate for a security of a closely-held business should not result in a rate so high that the gift tax liability from a recapitalization would exceed the actual income tax liability from an outright sale.

Clearly, dividend rates far below market are a transparent attempt to shift value. However, requiring a rate far above market rates is equally unfair.

The fact is that requiring a rate which is to high discriminates between the business owner whose assets are tied up in his business over the business owner who is wealthier and can simply transfer cash to his children. The uncertainty is compounded by the potential zealousness of the IRS agent who may review the whole transaction ten or fifteen years alter the fact. It is critical that there be some clear guidelines in the proposal on defining market rate, or, in the absence of such guidance, a consideration that the market rate be limited in some manner, similar to what has been done in the imputed interest rules.

VII. OTHER ISSUES

Additionally, the dividend payment rule requires that upon failure to pay the dividend by the third year, such debt be considered a gift and that a gift tax be due. There is no exception for hardships except for bankruptcy or liquidation. A closely-held business can find that due to changing markets or simply increased interest rates on debt that payment of a dividend is not simply a hardship, but could place the entire business at risk. Violations of loan agreements could occur and the good

will of suppliers could potentially be put in danger under these circumstances. A hardship rule is necessary and important to allow a deferral of time for the dividend to be paid without triggering the gift tax and to allow the business to work out its difficulties. The Tax Code already makes such provisions available under the Earnings and Profits Test which a company must make prior to paying a regular dividend.

Of equal concern to the wholesale-distribution industry are: the additional complexities and compliance costs relating to the proposed rules on Buy-Sell Agreements outside of a recapitalization; complex elections which might be missed and need to be simplified; the requirement for mutual consent of all family members to the deemed gift rule; extension of the statute of limitations from three to six years; and, the absence of a specific list of requirements for which the statute of limitations is lifted.

IX. CONCLUSION

In conclusion, NAW hopes that its concerns, which reflect those of an industry deeply affected by 2036(c), will be given serious consideration by this Committee. NAW is committed to equitable treatment to all businesses under the Tax Code and its members will be best served by a speedy resolution of the problems imposed by current law.

APPENDIX A

National Wholesaler-Distributor Organizations Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers Association
American Machine Tool Distributors Association
American Supply Association
American Traffic Safety Services Association, Inc
American Veterinary Distributors Association
Appliance Parts Distributors Association, Inc
Associated Equipment Distributors
Association of Steel Distributors
Association of the Wall and Ceiling Industries International
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc
Bicycle Wholesale Distributors Association, Inc
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesale-Distributors
National Kitchen & Bath Association

Electrical-Electronics Material Distributors Association

Farm Equipment Wholesalers Association
Fire Suppression Systems Association
Fluid Power Distributors Association, Inc
Food Industries Suppliers Association
Food Marketing Institute
Foodservice Equipment Distributors Association

General Merchandise Distributors Council
Graphic Arts Suppliers Association

Health Industry Distributors Association
Hobby Industry Association of America

Independent Laboratory Distributors Association
Independent Medical Distributors Association
Independent X-Ray Dealers Association
Industrial Distribution Association
Institutional & Service Textile Distributors Association, Inc.
International Sanitary Supply Association
International Truck Parts Association
Irrigation Association

Machinery Dealers National Association
Material Handling Equipment Distributors Association
Motorcycle Industry Council
Music Distributors Association

National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association Flour Distributors, Inc.
National Association of Hose and Accessories Distributors
National Association of Manufacturing Opticians
National Association of Marine Services, Inc.
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers
National Association of Tobacco Distributors
National Association of Writing Instrument Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Grocers Association
National Independent Poultry and Food Distributors Association
National Industrial Glove Distributors Association
National Insulation and Abatement Contractors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc
National Printing Equipment and Supply Association, Inc
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Wastes Management Association
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
Northamerican Heating & Airconditioning Wholesalers Association
North American Horticultural Supply Association
North American Wholesale Lumber Association, Inc

Optical Laboratories Association
Outdoor Power Equipment Distributors Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Petroleum Marketers Association of America
Post Card Distributors Association of North America
Power Transmission Distributors Association, Inc

Safety Equipment Distributors Association, Inc
Security Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Steel Service Center Institute
Suspension Specialists Association

Textile Care Allied Trades Association

United Products Formulators & Distributors Association

Video Software Dealers Association

Wallcovering Distributors Association
Warehouse Distributors Association for
Leisure and Mobile Products, Inc.
Water and Sewer Distributors of America
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association, Inc.
Wine & Spirits Wholesalers of America, Inc.
Woodworking Machinery Distributors Association
Woodworking Machinery Importers Association

National Association of Wholesaler-Distributors
1725 K Street, NW, Washington, D.C. 20006 • 202/872-0885

7/5/90
116 Member National Associations

BEST AVAILABLE COPY

National Automobile Dealers Association,
Washington, DC, July 2, 1990.

Van McMurtry,
Staff Director Senate Finance Committee,
U.S. Senate,
205 Dirksen Senate Office Building,
Washington, DC.

Dear Mr. McMurtry: The National Automobile Dealers Association, a trade association representing more than 22,000 franchised auto dealers, appreciates the opportunity to comment on proposals to amend section 2036(c) of the Code.

Prior to 1987, owners of small businesses frequently employed estate freeze transactions to facilitate the transfer of their businesses to their children. As one example of an estate freeze transaction, an owner of a small business would recapitalize the business by first dividing his equity into a preferred stock interest with limited rights and a fixed rate of return, and a common stock interest to which future appreciation would inure. The owner would then transfer the common stock interest to his or her children by way of a gift, subject to the gift tax. This transaction enabled the transferor to receive income and continue to have a hand in the business. At the same time, the transaction facilitated the ultimate transfer of that business to the next generation.

Legislation enacted several years ago has in effect eliminated this valuable estate planning tool. Since 1987 section 2036(c) has required that if a small business is recapitalized and the common stock interest is phased by way of a gift to the prior owner's sons, the transferred common stock interest is brought back into the transferor's gross estate. NADA believes that this is bad policy. It is bad for small family owned businesses. It is bad for the economy as a whole.

NADA believes that it is critically important that the Internal Revenue Code contain gift and estate tax provisions that allow independent small business enterprises to be transferred from generation to generation. Without such provisions, the burden of the estate tax itself will in many cases be so great that these businesses must be sold to raise money to pay estate taxes. More often than not the purchasers will be larger enterprises that will operate without the benefit of family leadership and strong community ties.

As you are well aware, independent small businesses have contribute greatly to this nation's economy. The facts are clear: from 1976-1986, 12.8 million of the 22.3 million new jobs created in this country were created by small businesses. In other words, more than 57 percent of the new jobs created across the country were in the small business sector. Moreover, in 1982 small businesses contributed 30 percent to the nation's GNP. These statistics make clear just how important a role small businesses—most of which are family owned—played in our economy prior to the enactment of section 2036(c). While executives running the multinationals focus on short-term returns, owners of family businesses focus on long-term investment; that is, on ensuring that the family business will be productive in the future and provide a source of employment and income for their children and grandchildren.

By making the transfer of a family business so very expensive, the enactment of section 2036(c) may well change all of this. If the burden of estate taxes is so great that a family will have to sell the business to pay the taxes, the incentives to risk capital and expend tremendous energy to build a business for family and future generations are dramatically reduced. Simply put, section 2036(c) turns on its head the incentives that fueled small business growth for so many years.

NADA recognizes, however, that the estate freeze transaction prior to 1987 was sometimes subject to abuse. In this regard NADA understands that on occasion parties would overstate or understate the value of the retained or gifted interest to suit their tax planning needs. Section 2036(c), however, is excessive in scope; it is so broad that it eliminates this very important business and estate planning tool.

There are many other situations in which the scope of section 2036(c) is excessive. For example, if an owner were to cause his business to recapitalize, and were to transfer the common stock interest to his son or daughter in exchange for a long-term note, the sale generally would not be respected for Federal estate tax purposes. Not only has Congress made it more difficult to pass an interest in family business to the next generation by inter vivos gift, but it has now said certain sales on arms length terms will not be respected. In our view, this is unwise and excessive.

It is important to recognize in this regard that the division of a corporation's equity into preferred and common stock interests and the gift of either class of interest from on generation to another is not in and of itself abusive. The tax laws have long recognized the importance of allowing businesses great flexibility in de-

signing their capital structure. More importantly the tax law has always sanctioned the inter vivos transfer of property from one generation to the next so long as an adequate gift tax is paid. With proper valuation rules in place, adequate gift tax will be paid.

The repeal of section 2036(c) is an especially important issue for NADA. Traditionally, auto dealers have been family owned enterprises with close ties to the community. In fact, the overwhelming majority of auto dealerships today are locally owned, with more than 60 percent of them now being run by the children of their founders. It would be unfortunate if Federal tax policy were to force the sale of these family businesses and sever the ties that bind them to their communities.

NADA urges the Committee to repeal section 2036(c) expeditiously, and to replace it with narrow rules that address prior valuation abuses.

Respectfully,

H. THOMAS GREENE.

STATEMENT OF THE NATIONAL RETAIL HARDWARE ASSOCIATION

Mr. Chairman and Members of the Committee on Finance: My name is Frank Greenhaw, and I am the president of the National Retail Hardware Association (NRHA), a national association of 18,000 hardware store owners. I am pleased to submit this testimony to discuss the proposal to replace Section 2036(c) of the Internal Revenue Code—a provision that has become a household term in the hardware business.

I compliment the committee for holding these hearings. The hardware industry has been deeply affected by Section 2036(c) and stands to be equally affected by the replacement proposal perhaps more than most small businesses.

Before I get into the details of the issue, I would like to state for the record NRHA's policy regarding the transfer of family businesses. We believe that closely-held family owned businesses play a very important role in our communities, and that all impediments to the successful transfer of such businesses should be repealed.

Our problems with Internal Revenue Code Section 2036(c) can be summarized as follows:

First—Section 2036(c) focuses, unfairly, on family owned small businesses.

Second—Current law requires that retailers pay transfer taxes on the entirety of a businesses' assessed value. Because most of this assessed value is tied up in real estate and inventory, we are forced to sell all or part of the business to pay the taxes!

Third—Hardware stores are valued by their market value, rather than earning capabilities. This method creates disproportionately burdensome transfer tax assessments, often encouraging the sale of the business.

The discussion proposal before you is very important to NRHA members because it signifies to our members that the Congress and the U.S. Treasury have chosen to move away from the "policeman" mentality of 2036(c). However, as written it fails to help NRHA members transfer hardware stores intact to their children.

The system described in the discussion draft would prevent legitimate transfer of hardware stores to family members for the following reasons:

—The proposal attempts to value our businesses during recapitalization using the cash flow method. This system will not help hardware stores. Curiously, the cash flow method is most injurious to those stores that generate the least earnings.

—The proposal continues the trend initiated by Section 2036(c) of placing enforcement concerns over concerns for the continuing survival of family businesses. According to this proposal, family business owners are still forced to operate at a competitive disadvantage to those individuals with wealth represented by other business investments.

More specifically, the income stream approach compares the store's earnings with some yet-to-be-determined market rate. Businesses that can pay Qualified Fixed Payments at or above the applicable Federal rate escape large transfer taxes. However, the National Retail Hardware Association estimates that hardware stores provide an average rate of return before taxes of 3.[illegible]. If the market rate chosen to implement the plan is the applicable Federal rate of 10%, hardware store owners in particular would be in trouble. According to our figures, this would mean that 64%

of the average hardware store's fair market value could be deemed to be a gift at the time of recapitalization, and thus subject to the transfer tax.

This approach, therefore, wrongfully assumes that the firm can pay out at a constant rate applicable to yields of other investments or businesses. When you sit down and do the math, you realize that most retailers are faced with two alternatives:

(1) Sell the business to satisfy the estate tax obligations; or

(2) Cannibalize the business to meet the presumptive and artificially high rate of return.

Neither of these two options encourage the survival of a business that pays Federal, state, and local taxes, and the salaries of many employees. The main problem with section 2036(c) remains the main problem with this replacement proposal—it targets family owned businesses, placing them at a disadvantage compared to families who have liquid assets represented by marketable securities, cash or collectibles.

To sum up, Mr. Chairman, small businessmen spend their lives working fifty and sixty hours a week to nurse businesses that sometimes generate a 3% rate of return. Without Federal funding, they have generated tax revenues and jobs for their communities. What they want is to be able to transfer these businesses intact to the next generation. Neither Section 2036(c) nor the new discussion draft allows this transfer to occur. Therefore we must respectfully continue to ask for complete repeal of section 2036(c).

Attachment.

NATIONAL RETAIL HARDWARE ASSOCIATION,
Indianapolis, IN, October 3, 1990.

Hon. LLOYD BENTSEN,
U.S. Senate,
703 Hart Senate Office Building,
Washington, DC.

Dear Mr. Chairman: I am writing this letter on behalf of the members of the National Retail Hardware Association, in response to your request for comments on estate freeze legislation contained in S. 3113. As you know, many hardware stores are closely-held, family-owned businesses, the very type of enterprises that are most impacted by the anti-state freeze provisions of Internal Revenue Code Section 2036(c).

NRHA continues to support as its basic position the need for complete repeal of Section 2036(c). We believe that the continued operation of family-owned small businesses is very important, and that all impediments to the successful transfer of such businesses should be repealed. In previous testimony, NRHA Past President Frank Greenhaw outlined our problems with Section 2036(c) as the following:

1. Section 2036(c) focuses, unfairly, on family-owned small businesses.
2. Current law requires that retailers generally pay transfer (i.e., estate and gift) taxes on the entirety of a business' value at the time of transfer. Because most of this value is tied up in real estate and inventory, and because there is very little cash on hand, retailers are forced to sell all or part of the business to pay the taxes.
3. When hardware retailers are forced to sell off essential assets to pay Federal taxes, their stores are left at a severe disadvantage compared to their larger competitors. Given the retailers' inability to earn sufficient cash from operations in the future to replace these essential assets, many do not survive the crippling impact of the current estate tax rules.

This issue has been explored in some detail by both the Senate Finance Committee and the House Ways and Means Committee. As you have previously pointed out in a letter to Mr. Greenhaw, it seems to be a consensus that "this provision is confusing, extremely difficult to administer, and needs to be repealed." We are in complete agreement with these sentiments, and greeted with enthusiasm your recommendation during last year's budget reconciliation bill that Section 2036(c) be repealed.

We were, however, extremely disappointed when the provision was subsequently stripped from the tax bill. At that time, it was understood that the removal of the provision was unrelated to the obvious merit of our issue. Furthermore, we were made to believe that we would not be forgotten, and that this important topic would be taken up again in the near future.

I was pleased to learn of your continued efforts on behalf of our members and the small business community in general. Treading the razor's edge between the Treasury's concerns regarding abusive transactions and small business' inability to sur-

vive complex and ever-changing taxing schemes and regulations, you have introduced a thoughtful, balanced document that goes further than any competing "modification" proposal to rectify current problems.

In summary, NRHA's reaction may be described as follows:

1. Section 2036(c) must be repealed immediately, perhaps accompanied by a mandate to have Treasury study abusive transactions. This would allow our members to transfer their stores to their children under a survivable tax burden. With an unimpeded transfer of ownership, the businesses would continue to prosper and generate increasing tax revenues for the government.

2. If circumstances preclude complete repeal of Section 2036(c), we must then wholeheartedly support S. 3113 as the best alternative proposal. This bill does repeal Section 2036(c) and it does respond to past NRHA suggestions regarding the need for better rules to determine the value of ownership rights and to permit reasonable "buy-sell" agreements without subjecting the entire value of the business to transfer tax.

Again, Mr. Chairman, thank you for your continued leadership and responsiveness on the repeal of Section 2036(c). Your perseverance and willingness to pursue dialogue with us on this issue is greatly appreciated. We would very much like to have this issue settled during consideration of this year's budget reconciliation bill, if possible, and stand ready to help in any way that we can.

Sincerely,

HAL MARSOLAIS, *Managing Director.*

NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

Chairman Boren and Chairman Daschle, distinguished members of the subcommittee, my name is Robert J. Tutty and I am President and Manager of Chouteau Telephone Company in Chouteau, Oklahoma. My company serves 2700 rural subscribers and has a density of only 10 subscribers per mile of telephone line. In addition to Chouteau, I am also submitting testimony on behalf of the National Telephone Cooperative Association.

The National Telephone Cooperative Association (NTCA) is a national trade association representing almost 500 small, independent cooperatives and commercial telephone systems serving rural customers in more than 42 states. Half of our members are commercial companies and half are cooperatives.

I commend Chairman David Boren and Chairman Thomas Daschle for having a joint hearing on the current estate freeze rules—Section 2036(c).

Section 2036(c) enacted by Congress in 1987, abolished "estate freezes," a common method for many small family-owned telephone companies and family farms to be passed from one generation to the next. The elimination of the estate freeze provision has increased the tax liability of the inheritors to a rate as high as 55 percent. The children may be forced to sell the family-owned company to pay these high estate taxes.

This provision was initially aimed at halting a business owners perceived ability to transfer a disproportionate right to future appreciation in the value of a business, without being subject to transfer fees.

Under prior law, some business owners could make a gift of the companies' common stock, retain the preferred stock and claim that the preferred stock represented substantially all of the value of the business. In this manner, the owner would attempt to "freeze" the transfer tax value of the retained business interest at its value on the date of the disproportionate transfer. The principal concern that led to the proposal of Section 2036(c) was a concern that the business interests transferred within a family were being undervalued for transfer tax purposes.

However, these concerns could have been met by improved enforcement of existing rules. Instead, Section 2036(c) was enacted. The statute was dangerously overbroad, ambiguous and aimed almost exclusively at family-owned businesses. It provides the incentive for parents to sell a family business to non-family members rather than attempt to pass it on to future generations.

NTCA members who have family-owned telephone companies, farms or small businesses are adversely affected by Section 2036(c).

All NTCA members live in rural areas and rural America is especially negatively impacted by this provision. More and more, young people from rural areas are leaving and moving to urban areas. To revitalize rural communities we need to encourage people to move to rural areas, but we also need to provide incentives to keep young people in their communities. Often, the only reason an individual remains in

a community is because they have inherited, or will inherit, a small family-owned business, such as a telephone company or a family farm. Passing on a business to the next generation is a common occurrence in a small town or rural community. The same kind of job opportunities that are available in an urban area don't exist in rural areas.

Our tax policy should encourage, not discourage, the transfer of a family business from one generation to the next. A majority of small businesses fail, so we should be working to keep alive the ones that have been successful. Congress has held hearings and been concerned with the rise in leveraged buyouts. Supporting family-owned businesses is one way we can attempt to cut down on the increase of mergers and conglomerates.

I would assume that representatives from all states would like to see that capital created in their home state has an opportunity to be put to creative uses at home rather than be taxed away, maybe requiring the sale of hard earned assets. Failing to protect these businesses from unusual twists of the tax code only insures that local ownership will be forfeited through forced sale to large New East and West coast corporations.

Selling the business at the time ownership goes to the next generation is a demoralizing prospect, as well as a loss to the state and locality. Obviously businesses sold to entities in the financial centers of the country also deliver their liquid assets to banks and financial institutions of those regions, rather than to the institutions and the economy where they are earned. Suddenly one more corporation is created which is guided by absentee owners.

All small or rural states will lose the positive results of their own growth when they lose the local placement of profit generated from the success of home based companies.

I believe that the most efficient way to solve the problems of this law is to begin with repeal. Some type of legislation may be necessary to prevent valuation abuses in family transfer of control transaction. However, beginning with a clean slate appears to be the best method. Section 2036(c) is overly broad and unworkable and causes confusion among everyone including legislators, lawyers and business owners. New legislation needs to be narrower in scope, more equitable and simpler. I believe the first step in helping family business owners is to repeal Section 2036(c) and then move on to a workable alternative.

Chairmen and members of the subcommittee, thank you for taking my comments into consideration and understanding the devastating impact this law will have on rural America.

NEW YORK STATE BAR ASSOCIATION, TAX SECTION,
New York, NY, October 10, 1990.

Hon. LLOYD BENTSEN, *Chairman,*
Senate Committee on Finance,
205 Dirksen Senate Office Building,
Washington, DC.

Dear Senator Bentsen: We are writing to express our enthusiastic support for the estate freeze legislation which you introduced on September 26, 1990. However, we believe we should point out that as presently drafted the "control" definition of Section 2512A(c)(2) read together with the attribution rules of Section 2512A(e), leaves certain loopholes which should be corrected.

As indicated in its statement to the House Committee on Ways and Means, the Tax Section of the New York State Bar Association fully endorses the repeal of Section 2036(c) of the Internal Revenue Code. The Section also supports replacing Section 2036(c) with legislation designed to correct the valuation abuses which led to its enactment, provided such legislation does not interfere with legitimate business transactions among family members. In this regard, the Section favors a "closed transaction" approach to the taxation of transfers of closely-held business interests which, by addressing the valuation issues at the time of the initial transfer, would provide certainty to the taxpayer and would eliminate or reduce the enormous administrative burdens created by Section 2036(c) and the replacements proposed thus far.

The Section applauds the approach taken in the concise legislation sponsored by you as achieving these goals in an uncomplicated, focused manner. The proposed legislation is evidence that the Senate Finance Committee has listened and responded to the concerns of both taxpayers and the government in arriving at a constructive and balanced solution to the problems that motivated Section 2036(c).

36-968 0 - 91 - 9

In particular, the Section supports the following features, which have the effect of focusing the legislation on those transactions with the greatest potential for abuse under the transfer tax system:

(1) Limiting the application of the legislation to transfers of interests in entities in which the transferor and his family members (including siblings) hold at least 50 percent of the equity and removing from the scope of the legislation those interests for which market quotations are readily available.

(2) Limiting the application of the special valuation rules to transfers to family members where the transferor, his or her spouse, their ancestors and ancestors' spouses retain interests in the entity.

(3) Removing transfers of interests in trust from the scope of the special valuation rules and, instead, modifying the valuation tables under Section 7520 where a term or life interest is held by an individual in a generation higher than that of a remainderman.

We believe, however, that by ignoring the combined interests of the transferor and certain family members and providing a very limited set of attribution rules, the bill as introduced creates loopholes that would enable many transfers to escape the scope of the special valuation rules in those very situations where the incentive and opportunity for valuation manipulation is most significant

To eliminate such loopholes, the Section believes that the proposed control test under Section 2512A(c)(2) used to determine whether an applicable retained interest exists, should be applied immediately before, rather than after, the transfer and the rules governing the attribution of interests to the transferor should be expanded to include all interests held by lineal descendants of the transferor and transferor's spouse, regardless of whether they have reached majority.

It would also be advisable to clarify that the entity attribution rules under proposed Section 2512A(e)(3)(A) will apply not only to the transferor, but also to any relevant individual, preferably by amending Section 2512A(e).

We would also point out that under the proposed control test, even if so modified, transfers of interests in a closely-held business which is owned by a small group of unrelated families, none of which "controls" the entity, will not be subject to the proposed legislation, even though the owners of the business may have common estate planning goals.

The Section also believes that certain points may require clarification. In particular, the Section assumes that the concepts contained in proposed Sections 2031(c) and (d) are intended to apply not only to deathtime transfers but also lifetime gifts. This point should be clarified in the final legislation by corresponding amendments to Chapter 12.

Once again, subject to these comments, we enthusiastically endorse the proposed legislation.

Very truly yours,

ARTHUR A. FEDER, *Chair*

OVERBEY LAW FIRM,
Little Rock, AR, October 4, 1990.

Senator LLOYD BENTSEN, *Chairman,*
Senate Finance Committee,
205 Dirksen Senate Office Building,
Washington, DC.

Re: Comments on S. 3113

Dear Senator: We understand that you have requested comments on your proposed legislation which would repeal the harsh effects of Internal Revenue Code Section 2036(c) Our comments with respect to S. 3113 are as follows:

I. PROPOSED INTERNAL REVENUE CODE SECTION 2512A

A. An additional exception should be included at proposed IRC Section 2512A(b)(2) to include retained interests which contain no rights having any preference over any rights of the transferred interest. This would allow the transfer of a more "senior" preferred stock when two or more classes of preferred stock are held by the transferor, and the transferor retains the "junior" class(es) of preferred stock. An exception similar to this is contained in H.R. 5425 at proposed IRC Section 2701(a)(3)(C)(ii).

B. Proposed IRC Section 2512A(b)(3) provides an exception for cumulative distribution rights, and provides "the determination as to whether the cumulative distributions can reasonably be expected to be paid shall be made without regard to whether the person retaining the interest possesses control over the entity." Additional statutory guidance needs to be provided with respect to the kinds of factors which will be considered in determining whether a cumulative distribution can "reasonably be expected to be paid" (i.e., the overall profitability of, and cash flow of the business; other debt obligations of the business; etc. Is a sinking fund required?)

C. Proposed IRC Section 2512A(c)(3)(A)(i) refers to an interest which "is a right to convert into a fixed number (or fixed percentage) of the shares of the same class of stock as the stock described in subsection (a)(1) . . . The problem here is that no stock is described in subsection (a)(1) Rather, subsection (a)(1) provides as follows:

> "IN GENERAL—Solely for purposes of determining whether a transfer described in paragraph (2) is a gift (and a value of such transfer), the valuation rules provided in subsection (b) shall apply."

Presumably, the stock referred in proposed IRC Section 2512A(c)(3)(A)(i) is the transferred stock. However, this is not clear from the statutory language.

II. NEW PROPOSED IRC SECTION 2031 (c)

New proposed IRC Section 2031(c) contains rules which include the value of any accumulated but unpaid dividends in the estate of a decedent holding cumulative preferred stock at death. What is the effective date of this provision? Subsection (h) of S. 3113 states that it applies to estates of decedents dying after September 25, 1990. Does this mean that if a decedent acquired a cumulative preferred stock interest prior to September 25, 1990, and held such interest on the date of his death occurring after September 25, 1990, that such stock would be subject to the provisions of new proposed IRC Section 2031(c)? It seems very unfair to apply new rules to preferred stocks issued many years before.

III. NEW PROPOSED IRC SECTION 2031 (d)

New proposed IRC Section 2031(d) contains rules regarding the effect, for estate valuation purposes, of agreements, etc. governing rights to acquire property for less than fair market value. New proposed IRC Section 2031(d)(3) provides that such an agreement shall be disregarded unless "Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction." Additional guidance is needed with respect to the factors to be considered in determining whether a particular agreement meets this standard.

We certainly support your concept of repealing IRC Section 2036(c). However, several of the provisions of S. 3113 need additional clarification and refinement. Even then, there may still remain some difficulties in implementing the concepts behind S. 3113.

Cordially yours,

THOMAS L. OVERBEY.

LLOYD LEVA PLAINE, ET AL.
Washington, DC, October 5, 1990.

Hon. LLOYD BENTSEN,
U.S. Senate,
703 Hart Building,
Washington, DC.

Dear Senator Bentsen: The enclosed comments on S. 3113 are those of the undersigned in their individual capacities The undersigned are all members of the Joint Task Force of the Section of Taxation and the Section of Real Property, Probate and Trust Law of the American Bar Association and the American College of Trust and Estate Counsel. The comments are those of the individuals only and are not the comments of any of the entities.

We very much appreciate your efforts and the efforts of Senators Boren and Daschle and your staffs in drafting S. 3113.

Sincerely,

Lloyd Leva Plaine, Dave L. Cornfeld, Frederick R. Keydel, John J. Lombard, Jr., Jere D. McGaffey, Mal-

colm A. Moore, Pam H. Schneider,
Thomas P. Sweeney.

Attachment.

The bill S. 3113 is a vast improvement over section 2036(c) and H.R. 5425. We appreciate the efforts of Senators Bentsen, Boren and Daschle and their staff in drafting S. 3113. The following addresses a few substantive changes and some technical changes which we believe should be made to the bill before it is enacted.

SUBSTANTIVE SUGGESTIONS

1. The Joint Task Force of the Section of Taxation and the Section of Real Property, Probate and Trust Law of the American Bar Association and the American College of Trust and Estate Counsel submitted a statutory proposal for an alternative to section 2036(c) on August 22. Both the Joint Task Force Proposal and S. 3113 use an upfront gift valuation approach and do not have the complex deemed gift and adjustment rules of H.R. 5425. The Joint Task Force consciously decided the simpler approach was more administrable and preferable even though it could subject a portion of the transfer to double taxation in some cases. The Joint Task Force preferred simplicity and administrability and assumed any net cost to taxpayers or to the government would be small. However, to be comfortable with that approach, instead of valuing noncumulative discretionary distribution rights at zero, the Joint Task Force proposal stated in its proposed section 2512A(a)(2) that

> (2) Noncumulative distribution rights.—If the retained discretionary right is a right to distributions other than distributions which are cumulative, such right shall be presumed not to exist unless the taxpayer establishes, by evidence other than the possession of control over the corporation (or partnership) the extent to which such distributions can reasonably be expected to be paid.

S. 3113, however, does not create a rebuttable presumption. Rather, it treats such a retained right as having a value of zero. This difference between the two approaches increases the chances that nonabusive transfers will be caught within the scope of section 2512A of S. 3113 and once caught, the interest will be exposed to double or triple taxation. The Joint Task Force had viewed the "presumption" approach as a way to attempt to confine the risk of double taxation to abusive situations by limiting the statute's applicability to cases where the taxpayer could not show that distributions could reasonably be expected to be paid.

We believe S. 3113 should be changed to either (i) use the presumption approach described above, or (ii) add a provision stating that a right valued under section 2512A(b)(1) shall be treated as not existing rather than being treated as valued at zero and further, upon the later transfer of a right that had been valued under section 2512A(b)(1), the value of the right shall be its value determined under section 2512A(b)(1) for purposes of determining the extent to which the transfer of the right is subject to transfer tax.

2. The Joint Task Force proposal excluded nondiscretionary distribution rights from the scope of the statute, because such rights are not capable of post-transfer manipulation. We are concerned that the approach taken in S. 3113 will pull within the scope of section 2512A retained distribution rights that are not discretionary. The effect of this could be, for example, to include within the scope of the statute (and value at zero) many distribution rights under garden variety partnerships that, although non-cumulative, are fixed and therefore not capable of post-transfer manipulation or abuse. We believe such rights should not be valued at zero.

3. The reference to interests being of the same class in section 2512A(b)(2)(C) is not helpful in the context of partnership interests, which are not commonly denominated in terms of classes. A more helpful approach would be to exclude from the statute any interest that has no preference over any other interest (other than preferences as to voting, management or liability for partnership debts).

4. The 50 percent control provision in section 2512A(c)(2) should apply to liquidation, put, call and conversion rights—not just to distribution rights. Where nonfamily interests possess more than 50 percent, it is extremely unlikely that such rights would be exercised or not exercised in a manner that benefits such nonfamily owners. The 50 percent control should be made a threshold—not just an exception.

5. a. Subparagraphs (1) and (2) of proposed section 2031(d) are similar to the existing regulations. The addition of subparagraph (3) is unnecessary and may be confusing. Subparagraph (3) could be read to suggest that agreements which meet (1) may not be arms' length. The terms of subparagraph (3) should be met if the terms of subparagraphs (1) are satisfied. We believe it would be better to delete subpara-

graph (3) and state in the legislative history that a showing similar to what is now subparagraph (3) is evidence of the requirement that the arrangement be a bona fide business arrangement.

b. The word, "unless" in the first sentence of proposed section 2031(d) should be changed to, "except to the extent that" to make it clear that arms' length bona fide restrictions in an agreement that also sets an invalid price may be taken into account in determining the value of the underlying property.

c. The effective date in (h) of S. 3113 should be changed to provide as follows:

> The amendments made by subsection (e) shall not apply to transfers made after September 25, 1990 insofar as the transferred property is affected by any option, agreement, right, or restriction entered into, granted, imposed or most recently substantially modified prior to September 25, 1990.

TECHNICAL COMMENTS

1. Section 2512A should be changed to clarify that only the discretionary rights described in section 2512A(c)(1)(A) or (B) are valued at zero rather than the entire interest. The phrase "described in subsection (c)(1)(A) or (B)" should be added after the word "right" in section 2512A(b)(1).

2. It would be preferable to retitle section 2512A(b)(2) as "Exceptions" and delete the phrase "right conferred by an."

3. The exception in section 2512A(b)(2)(A) where market quotations are readily available for the applicable retained interest "on the date of the transfer" should be "as of the date of the transfer" in case the transfer is on a weekend or a holiday. Further, the exception should also apply if market quotations are readily available for the transferred interest.

4. The reference to "non-lapsing" in section 2512A(b)(2) should be deleted. It would subject garden variety partnerships to section 2512A because, for example, when a general partner dies, his estate does not have the same management rights as he did.

5. The flush language to section 2512A(b)(2) needs to be clarified. Does the fact that partners are free to amend a partnership agreement mean the exception is not applicable? Further, most agreements provide that when a general partner withdraws, the limited partners can change the general partners interest into a limited partner interest.

6. Although we do not believe the bill intends to treat debt, a lease or compensation agreement as an interest in a corporation or a partnership, that should be made clear in the statute by defining "interest" or in the legislative history.

7. The Joint Task Force purposefully did not use the subtraction method. If the subtraction method is retained in the statute either (i) the legislative history should make it clear that minority discounts are not affected by the provision or (ii) language similar to that in section 2701(a)(1)(A) of H.R. 5425 should be added:

> ". . . Appropriate adjustments . . . shall be made for the relative sizes of the interests transferred or retained. . . ."

8. a. Section 2512A(b)(3) should be written as a separate rule not as an exception to the exemption for cumulative preferred. This could be done by changing ", except that" on line 22 of page 4 to "; however,"

b. It would be preferable to insert the word "timely" before the word "paid" in section 2512A(b)(3) on line 1 of page 5 since this refers to a cumulative distribution right.

9. Section 2512A(c)(3) should be changed so that it is "For purposes of paragraph (1)(B)" and the phrase "if an interest —" in (A) is changed to "If a right—" and the flush language on line 22 is changed to "then such right shall not be treated as a conversion right." Further, the reference in section 2512A(c)(3)(B) to "clause (i)" should be changed to "subparagraph (A)."

10. Section 2512A(e)(3)(B) [page 9] attributes a sibling's interest for purposes of the 50% test but not the interest of an emancipated child. The sibling's interest should not be imputed (that is very often the adverse party), especially if the parents are dead. An individual's child probably should have his or her interest attributed to such individual even after the child has attained the age of majority.

11. Proposed section 2031(c) should be changed to read as follows:

> (c) VALUATION OF CERTAIN CUMULATIVE BUT UNPAID DISTRIBUTIONS.—In the case of any interest in a corporation or a partnership which is an interest that (i) was treated as an applicable retained interest for purposes of applying section 2512A to any prior transfer by an individual and (ii) that confers a distribution right (as defined in section 2512A(d)(1)) with respect to which

the distributions are cumulative, the value of the cumulative but unpaid distribution rights with respect to such interest for purposes of applying this chapter and chapter 12 as of the individual's death or transfer of such interest shall be the lesser of—

(1) the value of such distributions which have accumulated but remain unpaid (determined without regard to any discount relating to time of payment other than the discount, if any, applied in determining the value of such right under section 2512A(b)(3) in connection with such prior application of section 2512A), or

(2) the portion of the liquidation value of the entity to which the decedent or transferor, as the case may be, at that time was entitled by reason of holding the cumulative but unpaid distribution rights with respect to such interest.

12. The flush language of proposed section 7520(f) should be changed to read as follows:

then, in determining the value of any such interest, subsection (a)(2) shall be applied by substituting '80 percent' for '120 percent'. For purposes of this subsection, (i) generation assignment and (ii) the extent of an individual's interest acquired through an entity shall be determined under section 2651 (to the extent subsection (d) thereof would apply, this subsection shall not apply).

13. It should be made clear that the right to receive an amount (par value or par value plus premium) in the event of the liquidation of the corporation, should be considered a "distribution right" and not a "liquidation right." The latter term should only refer to the value of a right to cause a corporation to be liquidated at the discretion of the holder of the preferred stock.

If an appraiser finds that a corporation is likely to be liquidated at the death of the preferred stockholder or within a finite number of years for economic considerations and without regard to any discretionary powers, should the preferred stock be valued (a) on the basis of a finite stream of dividends; (b) a finite stream of dividends plus the value of the right to receive the liquidation proceeds at the end of that period; or (c) on the basis of the value of a stream of annual dividends for an infinite number of years? Perhaps, theoretically, the last two methods would result in the same value, but somewhere there should be an explanation. The definition of distribution right in section 2512A(d)(1) and of liquidation rights in section 2512A(d)(2) does not help.

14. Section 2512A(e)(3) should be clarified to establish a proportionality rule such as set forth in the attribution rules of section 318(a)(2) Also, in the case of an interest held by a corporation, there should be no attribution to an individual who is not in control. (See section 318(a)(2)(C)).

15. Conforming changes should be made in section 1015, in the inter vivos direct skip valuation rules, and in section 2512(c) [to provide cross references to sections 2031(e) and (d)].

Statement of the Regional and Distribution Carriers Conference

The Regional and Distribution Carriers Conference, Inc. is pleased to have the opportunity to comment on the issue of estate valuation freezes at this joint hearing before the Subcommittee on Energy and Agricultural Taxation and the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance.

The Conference is the national trade association representing motor carriers that specialize primarily in local and regional freight distribution. The Conference's more than 300 members are principally family-owned businesses or closely-held corporations who operate in one or more states, delivering and picking-up general freight. They provide the essential link that gets goods delivered to stores and factories in thousands of communities across the nation. It is affiliated with the American Trucking Associations.

Conference members operate in a very competitive market that rewards innovative, responsive, efficient and economical service. Typically, their businesses are the result of the enterprise of a founding family member who had the fortitude, perseverance and "get-up and go" to carve out a successful niche in what is easily the most competitive transportation business.

My own experience is not unusual. My brother and I took over our parent's regional truck line in 1980. In the last 10 years, L. Neill Cartage Company has more than doubled its revenues serving Chicago, Illinois, and surrounding states. I employ 60 people as drivers, dock workers and office staff.

We are the second generation of ownership of L. Neill Cartage, and hope to bring our children into the business as our father brought us in. But, Section 2036(c), my lawyers and accountants tell me, may make it very costly for our children to inherit and grow the business, as long as they are exposed to an estate tax that can reach sixty cents on the dollar. It is a real concern for me.

I expect it is an equally important concern for many members of our Conference who, like me, run family-owned trucking firms. Their firms, and thousands like them throughout America, are the sinew and fiber of the trucking industry. They represent over 90 percent of the fleets in the business and provide the bulk of the jobs in the industry. Section 2036(c) and the so-called "discussion draft" proposed by the House Ways and Means Committee would drain capital resources from firms such as mine and our members, that are living, functioning businesses.

A family business is not an inanimate collection of physical possessions and investments to be passed on to heirs. A family business is a living, growing enterprise that gains its strength from the generations who commit their lives and futures to its nurture and increase. When public policy destroys the prospect of future growth and success for family enterprises, there really isn't much sense in starting or continuing such ventures. With Section 2036(c), we have reached this point in the evolution of our estate tax laws.

Section 2036(c) is a veritable tax minefield for unsuspecting owners of family businesses. It is so complex and broad that totally innocent and straightforward estate transfers can be ensnared by its provisions. These legal labyrinths don't help our members serve their customers better. Nor do they make them more competitive. In fact, they do the opposite: they increase costs and the expenditure of unproductive time without producing one additional dollar of revenue.

Isn't the time long overdue to begin really simplifying our tax laws? I recently read an article in the *Wall Street Journal* that pointed out that even the ranking Republican on the House Ways and Means Committee found that he couldn't figure his own income tax last year, even though he has had a hand in drafting much of our tax law. Even big business is reeling from the complexity of our tax laws, according to the article. So you can imagine how bad it is for a company of our size.

In the 10 years since I assumed control of L. Neill Cartage Company, the burden of rules and regulations with which we have to comply—that have nothing to do with soliciting and transporting freight—has expanded enormously. Government seems to be reaching into every corner of our business without any let up.

Today I have to meet an ever-growing number of rules about how I hire, fire, compensate my employees and otherwise run my firm that have little or no bearing on the essential purpose of our business, which is to deliver personal, efficient and economical service to our customers.

The subject before you—estate valuation freezes—is yet another example of Congress destroying any incentive for individuals to start up, build and pass on a business, which I was raised to believe is a big part of the American Dream. The Conference asks that you repeal Section 2036(c). If there are flagrant violations of tax law in estate planning practice, then single them out and make them illegal. Then small trucking firms such as ours can concentrate more of their time and energy on building more efficient and prosperous businesses to serve America and provide jobs and security for our employees.

The Regional and Distribution Carriers Conference is prepared to work with the Senate Committee on Finance on this issue. Thank you for the opportunity to present our views on this vital matter.

SEELIGSON & STEINBERG,
Dallas, TX, October 16, 1990.

MS. LAURA WILCOX,
Hearing Administrator,
Committee on Finance,
205 Dirksen Senate Office Building,
Washington, DC.

Re: Pending Repeal and Replacement of IRC Section 2036(c)—H.R. 5425 and S. 3113

Dear Ms. Wilcox: This letter addresses the proposed effective date of the pending legislation changes. We respectfully submit that any effective date earlier than the date of actual enactment into law of the replacement provisions would be invalid on constitutional grounds with respect to transfers preceding the date of enactment. The Federal estate tax and the Federal gift tax are excise taxes, that is to say, taxes

upon a specific event. There is an undeniable element of unfairness in a retroactive excise tax. The unfairness arises should Congress attempt to tax a transfer which was tax-free when it was made. Taxpayers are entitled to know, for example, the precise gift tax consequences of a transfer on the date that the transfer is made. As of this writing, Section 2036(c) is the existing tax law applicable to certain transfers and taxpayers should be able to rely upon this law until it has actually been repealed by the President signing into law legislation presented to him. Suffice to say, it is quite possible that the President may veto any such legislation.

You realize, however, that H.R. 5425 bears a proposed effective date of August 1, 1990, and S. 3113 bears a proposed effective date of September 26, 1990, and that these separate proposals are quite different one from another, leaving taxpayers and their advisers in complete confusion with regard to a transfer which the taxpayer wishes to make and to which present Section 2036(c) would clearly apply. For example, it is patently unfair for a taxpayer to establish today a statutory grantor retained income trust (Section 2036(c)(6)) and not be able to know with precision the Federal gift tax consequences of his act.

Without providing you an extensive legal brief on this issue, we would point out that the U.S. Supreme Court has under analogous circumstances held that a retroactive feature of the Federal estate tax is unconstitutional. In *Nicholas* v. *Coolidge*, 47 S. Ct. 710 (1927), the court in striking the retroactive feature, stated:

> . . . And we must conclude that Section 402(c) of the statute here under consideration, in so far as it requires that there shall be included in the gross estate the value of property transferred by a decedent prior to its passage merely because the conveyance was intended to take effect in possession or enjoyment at or after his death, is arbitrary, capricious and amounts to confiscation. . . . 47 S. Ct. at 714

Our research indicates that this decision has not been overruled by the U.S. Supreme Court.

Consequently, we respectfully submit that constitutional concepts and basic fairness require that the President be presented with replacement legislation which has as its effective date the date of enactment. We request that you and others holding important positions in the legislative process make every effort to change the proposed effective dates so that there shall be no retroactive features whatsoever regarding the replacement legislation. As a minimum, the members of Congress should be made to understand that serious constitutional questions do exist with respect to any retroactive effective date regarding replacement legislation. If they are warned of such fact, then they simply may not wish to impose an unfair and perhaps unconstitutional retroactive effective date upon taxpayers.

We also wish to point out that IRS Commissioner Goldberg has recently requested of House Ways and Means Committee Chairman Dan Rostenkowski that tax legislation not bear retroactive effective dates or dates in the later part of the tax year, and instead that new tax legislation bear prospective dates (see enclosure).

No one can predict at this time what the form of proposed legislation shall be in light of the significant differences in the House version and the Senate version. Should the replacement legislation be enacted with either of the proposed effective dates or a date prior to the actual date of enactment, then much confusion could arise as to the constitutional validity of the application of the new law to transfers made after the retroactive effective date and prior to the date of enactment. Such circumstances would only give rise to wasteful expense, consternation and litigation with respect to taxpayers caught in such circumstances. All such problems could be easily avoided if the date of enactment is made the effective date. Such an effective date or a prospective effective date is required by basic concepts of fairness.

Please feel free to contact me if you have any questions regarding the matters mentioned in this letter. Your cooperation regarding this important point shall be appreciated.

Yours very truly,

CHARLES R. JOHNSON.

ROUTE TO: (1)________ (2)________ (3)________

Standard Federal Tax Reports

Taxes on Parade®

Vol. 77 — NUMBER 37 AUGUST 29, 1990

Goldberg Targets Problems Caused by Late Enactment of Laws

Congress should enact tax proposals early in the calendar year or "use prospective effective dates," IRS Commissioner Fred T. Goldberg, Jr., told House Ways and Means Committee Chairman Dan Rostenkowski in a recent letter. "Our greatest single concern is the potential effect of late-enacted legislation with current year effective dates on the next filing season," he explained. Goldberg expressed concern regarding the "adverse impact on taxpayers, return preparers, state and local governments, and the IRS resulting from late enactment of tax law changes that affect the upcoming filing season."

The Commissioner emphasized that the IRS begins planning for the annual filing season many months in advance. "Each January, as we

COMMERCE, CLEARING, HOUSE, INC.
Setting the standard since 1913
4025 West Peterson Avenue Chicago, Illinois 60646

begin processing more than 100 million individual income tax returns for one filing season, we also begin planning for the next filing season," he told Rostenkowski. Part of this planning includes: (1) the revision and testing of more than 4,000 computer software programs involving more than 10 million lines of code; (2) the training of 29,000 service center employees to process returns and compute bills and refunds; (3) the training of 7,000 taxpayer service employees who answer 41.5 million taxpayer inquiries; (4) the design and revision of 250 forms and 110 publications; and (5) the printing and distribution of over 1.3 billion copies of forms and instructions at a cost of $65 million. The competitive bidding process begins in early spring in order to reserve two months of printing time in late fall by the largest commercial printing firms.

With respect to the effect of late tax law changes on parties outside the IRS, Goldberg noted that computer software companies that develop tax computation programs used by accountants and taxpayers require time in which to revise and test their programs. "State and local governments that key their tax systems to the federal system need time to revise their forms and computer systems. Most importantly, taxpayers and tax professionals need time to learn new rules," Goldberg pointed out.

While errors by individual taxpayers, preparers and the IRS are "costly," he warned that mistakes in forms or computer programs could be "disastrous." Acknowledging that many factors influence the legislative process and that tax law changes may well occur late in the year, Goldberg called on Rostenkowski to "keep in mind the need for adequate lead time to implement those changes."

SIMPSON INVESTMENT COMPANY,
Seattle, WA, October 5, 1990.

Hon. LLOYD BENTSEN, *Chairman,*
U.S. Senate,
Committee on Finance,
205 Dirksen Senate Office Building,
Washington, DC.

Dear Senator Bentsen: We appreciate the efforts of you and Senators Daschle and Boren to resolve the problems of IRC Section 2036(c), and the opportunity to comment on S. 3113.

As discussed in prior letters to you and the Committee, we strongly believe that the present 2036(c) must be repealed in order to end rampant confusion and unfairness that severely threatens the ability of family-owned businesses to survive as family-owned for more than a single generation.

If it is the judgment of Congress that a replacement section should be enacted along with repeal of the present 2036(c), then it appears to us that S. 3113 is the best effort yet to draft a replacement. Given a choice between S. 3113 and no change in present law, we would strongly favor S. 3113.

In the event that any further opportunities at revision remain, we wish to state two concerns with S. 3113:

- Subsection (e)(5), beginning at page 9, line 9, states that except as provided in regulation, a redemption (and certain other changes) shall be treated as a transfer of interest under certain conditions. We ask that after the word "redemption" on line 17, you insert "(other than a redemption under Section 303)." This change would exempt from the statute the present IRC provision that allows an estate to redeem closely held stock to pay estate taxes. Without this exception, an executor will not know how to proceed with a redemption until regulations are issued.
- A new subsection 2031(d), beginning at page 12, line 7, provides that restrictive buy-sell agreements are to be disregarded for valuation purposes except in certain circumstances. While the circumstances are generally those where the transaction was comparable to an arms' length transaction, this will cause factual problems that will leave families with buy-sell agreements at a loss as to how to proceed.

In summary, we strongly urge that this issue be resolved prior to adjournment of this Congress. Although we did not see 2036(c) specifically listed in the budget summit agreement, we hope that you can include this needed reform.

Sincerely yours,

WM. G. REED, JR., *Chairman*

SIMPSON TIMBER COMPANY,
Seattle, WA, July 2, 1990.

Hon. DAVID L. BOREN, *Chairman,*
United States Senate,
Committee on Finance,
Subcommittee on Energy and Agricultural Taxation,
Room SD 205, Dirksen Senate Office Building
Washington, DC.

Dear Senator Boren: I ask that you enter this as my statement for the record of the Joint Hearing on Estate Freezes, held last Wednesday, June 27, 1990.

I am chairman of Simpson Timber Company, a family-held company engaged in growing and harvesting trees and manufacturing and selling building products.

I wish to commend you and Senator Daschle, chairman of the Subcommittee on Taxation and Debt Management, for recognizing that some serious problems exist with Section 2036(c) of the Internal Revenue Code, and for your willingness to hold the Joint Hearing and consider repeal or change of this section of current law.

Simpson Timber Company is a medium-sized company in our industry. We own about 765,000 acres of timberlands in Washington, Oregon and California. Our 2,400 employees produce lumber, plywood and doors in 12 manufacturing plants in 7 West Coast communities. The company is an important part of the economy in most of those cities. Our products are marketed nationally and internationally.

Trees are the heart of Simpson's business. We are harvesting our second forest and planting our third, assuring a perpetual supply of wood products. Simpson plants seedlings immediately after an area is harvested, and our records show that 85 million seedlings have been planted in California and Washington since 1943.

Simpson tree farms benefit the environment. They produce oxygen, absorb carbon dioxide, are home for wildlife, and are mostly open for public recreation. Fish habitat is a very special interest and avocation of mine, and I'm pleased to report that fish and timber harvesting can and do coexist on Simpson lands and in much of the forest products industry.

This year, 1990, is the Simpson Centennial and we're celebrating throughout our operations the stewardship of the owners and employees who have brought the company through the first 100 years.

My great-grandfather, Sol Simpson, founded the company in southwest Washington State in 1890, as we say with "50 men and 12 horses." I represent the fourth generation of ownership and some of the children of my generation—those being the fifth generation—have completed their education and are starting with the company. They are preparing to continue the business.

Before addressing Section 2036(c), it might be useful to address the merits of family-owned businesses, because this section of law has made it difficult to plan lifetime transfers of interest in family enterprises.

Family businesses have advantages and disadvantages, and Simpson has experienced both over the last century. However, they seem to offer some very real benefits to society and to the environment. Let me see if I can explain:

Growing trees for timber as a crop is a long-term business. It takes 50-60 years to grow a crop of Douglas fir, western hemlock or coastal redwood to maturity.

In general, I believe family businesses can be more interested in long-term goals rather than short-term profits. Unlike widely owned corporations, we don't have uninvolved stockholders primarily seeking immediate return on investment.

Since we plan to continue Simpson as a family business, the concept of sustained yield has special meaning to us. We operate on the basis that trees are a renewable resource, and that we will manage our lands for continuous production of timber, now and in the future. It is not by accident that there are more trees growing today on the original Simpson lands than there were when the company first became a landowner in 1895.

Today, in the era of LBOs, there have been many takeovers of what had been well-managed timberlands, with the result in some instances of an increase in harvest rate to service the debt. This situation isn't likely to occur with family businesses, and public policy, it seems to me, should encourage the continuity of family ownership over generations.

Section 2036(c), in its effort to correct the estate tax "freeze," is so far-reaching that many legitimate and nonabusive business transactions particularly ones between family members—are caught in the net. The result is added taxes that inhibit the ability to, or increase the costs of, continuing to maintain the family business. Family businesses are then forced to sell out or go public. The result is that local control and focus is lost, and some of the social and environmental benefits in the forest management sense are placed at risk.

Under present law, it is unlikely Simpson will be able to remain family-owned over the long term.

While our family favors repeal of 2036(c), I believe family businesses are willing to consider alternatives, but we hope these can be as narrow, as simple, and as clear as possible. In addition to its economic problems, 2036(c) is so complicated and overly broad that not even our attorneys or accountants can clearly explain when and how it applies to our business transactions.

The draft of a possible replacement for Section 2036(c) prepared by the House Ways and Means Committee may well create the same kinds of problems we have seen with Section 2036(c). There are numerous unanswered questions setting the stage for a renewed atmosphere of uncertainty and confusion as these experts try to advise their clients how to proceed.

One specific concern with the proposal has been brought to my attention in a very personal sense. My father died last October after a long illness. At the present time, we are planning for a redemption of stock to pay his death taxes. Should the proposed replacement to Section 2036(c) become law, the language makes it unclear as to the consequence of a redemption to provide funds to pay death taxes and is dependent upon regulations for clarification. This makes an uncertain situation for us.

I appreciate the opportunity to have this statement in the record of the Joint Hearing.

Sincerely yours,

WM. G. REED, JR., *Chairman.*

Statement on the Discussion Draft Proposal to Replace Internal Revenue Code Section 2036(c)

to

Senate Finance Committee
United States Senate

Thomas A. Solberg
Harter, Secrest & Emery
700 Midtown Tower
Rochester, New York 14604
(716) 232-6500

Topical Index

I. Policy Considerations

A. The Repeal of IRC §2036(c)
B. The Case for No Replacement
C. The Burden of Tax Legislation on Closely Held Businesses
D. The Burden of Tax Legislation on the System
E. The Need to Simplify Tax Legislation
F. The Need to Evaluate the Transfer Tax System

II. The Discussion Draft Proposal and its QFP Solution

A. The Proposal Effectively Eliminates the Use of Preferred Stock
B. Preferred Stock Should be Valued in the Context of its Issuance
C. There is No Need for a Statutory Methodology to Value Preferred Stock
D. QFP's Should be Limited to Equity Interests
E. The Minimum Junior Equity Rule
F. Dealing with Hybrid Securities
G. Debt Subject to Contractual Restrictions
H. Leases as QFP's - The Fixed Payment Requirement
I. The Need for a Better Solution for Noncumulative Preferred Stock
J. The Compounding Rule for Unpaid Cumulative Dividends
K. The Deemed Gift Rule Applied to Transfer of QFP's
L. Expanding and Redefining the Insolvency Exception
M. Indirect Holding and Entity Attribution
N. Post Death Recapitalizations
O. Grandfathering of Prior Transactions
P. Limiting Regulatory Authority

III. The Option Rule

A. The Option Rule Inhibits Intergenerational Transfers
B. The Purchase Option and its Role as an Employment Incentive
C. There is No Need for the Option Rule
D. The Option Rule Should Not Apply When Unrelated Parties Hold Similar Options
E. The "Fair Market Value" Requirement
F. The Periodic Review of the Formula
G. The Need to Utilize a Formula for Option Pricing
H. Disregarding Leases and Rights of First Refusal in Valuing Property
I. Other Technical Suggestions

IV. A New Proposal to Create a Safe Harbor for Small Business Preferred Stock

2301018JWG-1

Senate Finance Committee
United States Senate
Room SD-
Dirksen Senate Office Building
Washington, D.C. 20510

Gentlemen:

I want to first thank you for giving me the opportunity to make a statement before the Committee on this important legislative matter. Making discussion drafts of complex tax legislation available to practicing professionals is a very positive approach for Congress and taxpayers alike. I have been in engaged the practice of law for over 30 years and view myself as a business lawyer in the broadest sense. My practice clients are primarily closely held small business corporations and their owners. I am an advisor to clients not only on their business legal matters, but also on matters relating to estate and tax planning.

In the course of advising my clients, it has been necessary for me to become familiar with Internal Revenue Code Section 2036(c). Due to the nature of my practice I have had extensive experience in advising clients on transactional legal issues that are impacted by the statute. It is from this vantage point that I offer the following statement on the discussion draft proposal to replace Section 2036(c) (the "Proposal"). The opinions expressed in this statement are solely those of the author. I represent no one other than myself as a practicing lawyer. While the opinions and commentary are my own, my experience tells me that they are shared by a multitude of closely held business owners and farmers throughout our nation, and by their professional advisors as well.

Policy Considerations

A. The Repeal of §2036(c)

The case for the repeal of §2036(c) is overwhelming and does not have to be reargued in this statement. The fact that Representative Archer's bill, H.R. 60, has over 200 cosponsors demonstrates that Congress is well aware of the need for repeal. The fact that the Proposal includes such a repeal is clearly a positive factor.

B. The Case for No Replacement

There no longer is a need for statutory curtailment of asset freezes. While freezes were popular in the 70's and early 80's, even then the tax and business structure of "freezing" transactions was so complex that only a small group of professional advisors could effectively deal with them, and few clients could afford the very substantial legal, accounting and valuation costs of structuring them. The mid-80's brought on a stream of cases, rulings and regulations which, in combination, made it not only risky, but doubtfully practical to continue to implement "freezes". Any "freeze" that has legal substance and would pass audit scrutiny ends up having no economic substance as a "freeze". Further, the great preponderance of family businesses today are "S" corporations due to significant income tax advantages. Since "S" corporations can only have one class of stock, this eliminates all freeze possibilities for all "S" corporations. In short, there is no practical need for legislation and the revenue impact of eliminating future asset "freezes" is grossly overstated. What is really needed to protect the integrity of the transfer tax system is the establishment of a reporting requirement for freeze transactions and increased audit surveillance of abusive transactions.

C. The Burden of Tax Legislation on Closely Held Businesses

Closely held businesses and their owners have been repeatedly battered by the deluge of tax legislation and regulation that has been placed on their shoulders. Since 1976, fifteen major tax legislative proposals have been enacted by Congress dealing with income or estate taxation, and all of them have significantly impacted small businesses and their owners. The small business owner is over his head in terms of statutory and regulatory compliance. To layer a complex and convoluted statutory scheme like §2036(c) or the current Proposal on top of everything else is just too much. It is now time for common sense and reason to prevail - it is time to end this nightmare for the closely held business owner. Repeal of §2036(c) with no replacement is the only sensible answer.

BEST AVAILABLE COPY

D. The Burden of Tax Legislation on the System

Think of all of the money, time and priceless energy that has been wasted on the enactment of §2036(c) and its aftermath. Not only by Congressmen and their staff, but by Treasury, the IRS, the Joint Committee on Taxation, OMB and countless lawyers, accountants, bankers, insurance persons, financial planners, taxpayers and others. If all of the money, time and energy spent on legislative proposals like §2036(c) and the current proposal were positively directed into requiring compliance with the current estate and gift tax system, it certainly would have a revenue positive impact.

E. The Need to Simplify Tax Legislation.

Laws, particularly tax laws, should be susceptible to understanding, not only by a handful of elitist tax lawyers, but by clients who are expected to evaluate the advice they are given and follow the laws. Few professionals understand §2036(c), and if the professionals do not understand, what chance do clients have? Clients engage in normal business transactions (like entering into leases or employment contracts) only to find that a technical application of a broad and complex statute puts their transaction in potential violation of a statute with significant adverse tax consequences. What is worse yet is that even if the issue is one that is identified, there are often no reliable answers and no reliable process for obtaining those answers.

F. The Need to Evaluate the Transfer Tax System as it Applies to Closely Held Businesses and their Owners

The American Institute of Certified Public Accountants in testimony before the Senate Committee on Small Business on September 13, 1989 took the position that Section 2036(c) should be repealed and any replacement legislation for §2036(c) should be placed on hold until such time as Congress has an opportunity to examine the transfer tax system and its current impact on small businesses. For Congress to undertake such a study would, indeed, be a very positive step and would send a signal to small business owners as well as farmers that Congress is still concerned about them. As a practical matter, small businesses and their owners cannot afford to have 60% of the value of the enterprise extracted from the enterprise at the time of each generational transfer. It was recently calculated that only 5% of the family businesses last for 3 generations and that our transfer tax system is the major contributor to this statistic. While sanctioning asset freezes may not be the most effective way for dealing with this problem, some mechanisms need to be explored to provide relief. The small enterprise system, as we have known it in America, is in jeopardy. Foreign financial interests are the principal beneficiaries of the current system, and they are eagerly taking up America's small business enterprises.

II. The Discussion Draft Proposal and its Qualified Fixed Payment Solution.

A. The Proposal Effectively Eliminates the Use of Preferred Stock in Closely Held Business Planning.

The Proposal assumes that preferred stock issued by closely held corporations will be valued based upon the application of market interest rates to produce an effective yield, and thus value, for the preferred stock. While the Proposal does not state how these test rates will be developed, the accompanying explanation states that the income stream will be valued "using appropriate market discount rates". What is the appropriate discount rate to be applied to a small fish wholesaler, a mom and pop grocery store or a small tool and die shop? Some have suggested that risks of this nature will require returns in excess of 20%. Under those circumstances, if the actual dividend rate on the preferred stock is 6% (the equivalent of 9 1/4% in after tax earnings), the stock will be valued at only a small fraction of its liquidating value and a significant gift will occur on its issuance. The only way to shore up the value of the preferred stock is to make the dividend rate 20%, but no small closely held business can afford that kind of payment on preferred stock. Worse yet, such a rate, or even half of that, would create a reverse freeze since the cumulative growth of the preferred stock income stream would undoubtedly exceed any growth, or rate of return, that might conceivably be anticipated with respect to the common stock. Unless special low test market rates are established by statute for preferred stock issued by closely held corporations (see proposal set forth in IV herein), the valuation methodology will act as a complete prohibition on the issuance of preferred stock. If this is the intended result, there is a simpler way to get there.

B. Closely Held Preferred Stock Should be Valued in the Context of its Issuance.

Preferred stock issued by closely held corporations is generally issued under circumstances that involve factors that are not reflected in normal securities markets. To create a fiction that the party receiving the preferred stock has alternative investment opportunities available in the market lacks reality. Generally the issuance of such stock coincides with the intergenerational transfer of control of the business to younger family members. The senior generation wants to assume a passive role, and is willing to leave the decision-making to younger generation shareholders, but does not want to continue to expose their equity investment to the significant risks of the business, particularly under new and unproven management. A sale to family members is always a possibility, but frequently the size of the after-tax investment is so large that even an installment sale is not an economic reality. Unlike a sale occasioned by death, no insurance proceeds are available to fund the sale, so a compromise solution is necessary. Out of this crisis comes the preferred stock solution. The principal advantage of the preferred stock is the liquidating preference which it enjoys over the common stock owned by the younger generation. This equity cushion provides the element of security which the senior generation shareholder is looking for. The dividend yield on this type of preferred stock is typically very low and non-cumulative in recognition of the fact that there are severe limitations on the ability of most small businesses to service preferred stock dividend requirements, particularly when the dividend payment, unlike interest on debt, is not tax deductible to the corporation. This does not usually trouble the senior generation owner since he has the prospect of receiving some return on his preferred stock investment and he probably was receiving no return on his common stock that he formerly owned, given that most small businesses do not pay dividends. The preferred stock owner gives up the prospect for growth, but he receives in return the security of his investment which he bargained for and so he is satisfied that the exchange is fair.

Is there a loss to the transfer tax system in such an arrangement? That depends on many factors, including whether the common stock goes up or down and the income received on the preferred stock, if any. If a sale alternative had been pursued, a comparative analysis of revenue, gain or loss would depend on whether the after-tax proceeds of sale would have been invested over the remaining lifetime of the seller to restore the asset base to a value that exceeds the alternative value of the preferred stock and the income received on it. It is by no means a certainty that the transfer tax system suffered any loss or that it was compromised. Contrary to the view apparently held by certain staff personnel, closely held business values go both up and down. A review of the high small business casualty rate in our Bankruptcy Courts will confirm that.

C. There is No Need to Invent a Statutory Methodology to Value Preferred Stock.

Investment bankers and other security valuation experts have been valuing preferred stock for years. There is no need to adopt a complex statutory scheme to value preferred stock. The valuation confusion arises out of specially designed "bells and whistles" that are put on closely held preferred stock issues to support a value artificially. These "bells and whistles" are rights which the preferred shareholder can exercise on a discretionary basis (such as conversion rights, puts, liquidating rights and voting rights) and which, in the family context, may never be exercised. These artificial rights, which inflate preferred stock valuations, can be best dealt with by a simple statute that says for valuation purposes they are to be disregarded or, alternatively, that they are to be valued under the assumption that they will not be exercised to add value to the preferred stock. With such a rule, qualified appraisers and valuators will not have any trouble valuing the preferred stock with traditional valuation methodology. A proposal similar to this was recommended by the American Bar Association ad hoc task force in July, 1989, but was rejected by Treasury as not being sufficiently comprehensive since it gave up too much of the ground that Treasury gained through the enactment of §2036(c).

D. The Definition of Qualified Fixed Payments ("QFP") Should be Limited to Equity Interests.

Most of the inequity and uncertainty that developed from §2036(c) resulted from the concept that debt, leases, contracts, options and other intangible property rights served to create disproportionality. The Proposal uses the term "interest in the entity" in defining the requirements of a QFP, but does not define that term except to later say that any indebtedness or lease shall be treated as an interest in the entity. Presumably this

leaves the door wide open for regulations to establish the boundaries of the term "interest in the entity". We have been down the "safe harbor" road once before in §2036(c) and that simply turned into a vehicle for the regulators to expand the statute and create uncertainty for its "chilling effect". The intent of the Proposal was to eliminate valuation abuse in the issuance and transfer of equity interests. This can be effectively accomplished by limiting the term "interest in the entity" to equity interests and not having it comprehend a concept that any stream of payments from an entity (irrespective of the value received) is potentially such an interest. If valuation or other tax problems arise with respect to promissory notes, leases or other instruments which do not reflect value received, there are many sections of the Internal Revenue Code, as well as case law developed doctrines, that adequately deal with these problems.

E. The Minimum "Junior Equity" Rule.

The rule which requires a minimum junior equity equal to 20% of total equity is not required. Existing valuation principles applicable to preferred stock already consider the asset coverage ratio and the dividend coverage ratio of the preferred stock. If an effort is made to "sop up" the entire shareholders' equity in preferred stock (to place a nominal value on the common stock) the effect of this will be to reduce the asset coverage ratio and dividend coverage ratio of the preferred stock down to a point where the preferred stock will only be valued at a fraction of its liquidation preference. This will, in turn, increase the value of the common stock. No statutory provision is required to produce this result, since the valuation concept is well established and was, in fact, memorialized in the Service's own ruling on valuing preferred stock, Rev. Rul. 83-120.

The other problem with the minimum equity rule is the inclusion of shareholder debt as equity. The rule was obviously put in place to deal with abusive debt-equity ratios, but catches within its net all shareholder debt irrespective of the debt-equity ratio. The rule would penalize any corporation which could qualify for bank debt, but where shareholders (for whatever reason) prefer to lend the corporation its financial requirements. The statute also fails to take into consideration bank debt supported by shareholder guaranties, entity debt from related entities, entity debt supported by guaranties of related entities and entity debt supported by collateral from shareholders or from related entities. Since existing preferred stock valuation principles already deal with the minimum junior equity problem, it seems unnecessary to recreate those same principles by statutory mandate and at the same time introduce arbitrariness, inequity and uncertainty.

F. The Statute Does Not Effectively Deal With Hybrid Securities.

Since the Proposal conceived the term "equity interest" in the context of the classic preferred stock recapitalization, it also conceived that the equity interests would fit the classic definition of either common stock or preferred stock. In doing so, the Proposal does not effectively deal with the myriad of hybrid equity interests that are frequently encountered today. For example, the statute applies to the retention of any equity interest if the interest has any preferential rights. It is not uncommon for corporations to have two classes of common stock, each having a limited liquidating preference, with equal participation after the preference amounts are paid out to each class of common. If there is good asset coverage on the preferences, each class of common will have equal value as a practical matter, and yet, under the Proposal, the security with the first preference would be valued at zero. Problems of this nature are even more frequently encountered in partnerships since it is common in real estate development partnerships and oil and gas partnerships to have limited preferences permitting a return of capital followed by income sharing. Another security that does not fit well into the proposal is a preferred stock or partnership equity interest with a dividend or income payment that is part cumulative and part non-cumulative, or that is non-cumulative and has a "make-up" right on liquidation. These same problems with hybrid securities were encountered under §2036(c) and never successfully resolved in any fair or equitable manner.

G. Debt Subject to Contractual Restrictions.

Debt falls within the definition of a QFP if the payment is fixed as to both amount and time. This would include shareholder debt. Payment of shareholder debt is frequently subject to restrictions imposed by third party contracts such as subordination agreements and bank term loan agreements. While the statute contemplates the inability of the

ne 25,
ge 5

...ower ... pay the debt due to insolvency or bankruptcy and provides relief from the ...emed gift rule, it does not effectively deal with non-payment due to contractual ...strictions which ripen due to defaults in loan agreements and similar documents. In ... of the frequency and business significance of these types of restrictions, the ...finition of QFP should be clarified to provide that such restrictions do not make the ...yment provisions conditional. Further, nonpayment by reason of defaults which trigger ...payment restrictions should not result in "deemed gifts".

H. Leases as QFP's and the Fixed Payment Requirement.

The Proposal would include leases as QFP's. Many commercial leases would not meet the definition of a QFP since they do not meet the final payment requirement. One example ...uld be retail store leases which almost all have percentage rent clauses. This ...inforces the argument that "entity interests" should be limited to equity interests.

I. The Proposal Needs a Better Solution For Noncumulative Preferred Stock.

For reasons discussed earlier, it is not uncommon for closely held corporations, ...ere income and cash flow are uncertain, to issue noncumulative preferred stock. Under the Proposal the holder can elect to have noncumulative preferred stock treated as a QFP. ... the election is not made, the noncumulative preferred stock will be assigned no value ...d an overvaluation of the common stock will result. If the election is made, and if the noncumulative dividend is not paid for a period exceeding three years, the lapsed payments ...nstitute deemed gifts, even though there may be significant business reasons justifying, ...deed necessitating, non-payment. Under current law a court would look at the facts and ...rcumstances to determine whether a constructive gift had occurred. If the Proposal is ...acted, a case law doctrine producing a reasoned result will be replaced with an ...bitrary statutory result that is unfair to the preferred stockholder. The same problem ...ists with respect to partnership payments when the right to payment is contingent on or ...mited by income or cash flow of the partnership.

J. The Compounding Rule for Unpaid Cumulative Dividends Creates a Reverse Freeze.

In order to have unpaid cumulative dividends not be regarded as deemed gifts, they must provide for compound interest on arrearages, presumably at market interest rates. This will be undoubtedly result in a reverse freeze for the holder of the preferred stock ...nce the market rate accumulation will produce growth faster on the preferred stock than ... likely potential growth that might take place on the common stock.

K. The Application of the Deemed Gift Rule to Transfers of the QFP.

The holder of a QFP who transfers the QFP is to be treated as having made a deemed ...ft equal to the difference, if any, between the QFP valued under the Proposal provisions ...d the actual fair market value of the QFP. While there might be a rationale to support this rule in gift transfers, the rule should operate both ways to allow a tax refund or ...edit if the fair market value exceeds the special valuation computed value. The same ...le might be applied to sales to family members. However, I believe that the transfer ...tion should contain a complete exclusion for any arms-length sale negotiated with an ...related third party. There is no opportunity for valuation abuse under those ...rcumstances since the transferor's economic interests are served by maximizing the ...rchase price. The estate tax valuation adjustment in the related subsection should ...kewise exclude value increases if value is fixed by an actual sale to an unrelated third ...rty. It should also provide for a tax basis increase for the asset if a valuation ...fferential is included in the estate with respect to such asset.

L. The Insolvency Exception Needs to be Expanded by Redefining the Term "Insolvency".

With respect to QFP's, the Proposal provides relief from the deemed gift rules if the payor of the QFP is "Insolvent". The Proposal adopts the IRC §108(d)(3) definition of insolvency except it specifically excludes any debt due to the holder of the QFP from the insolvency computation. There is no reasonable basis, in this context, to exclude related party debt from the definition of insolvency. IRC §108(d)(3) states that insolvency exists if the liabilities exceed the fair market value of the assets. This definition is too narrow and needs to be expanded to cover any circumstance under which the holder of the QFP cannot obtain payment after pursuing all legal remedies available to such holder.

101039JWG

While most instances would seemingly meet the insolvency test under these circumstances, the subjective nature of the test, requiring a determination of fair market value of assets, is not certain enough. It is bad enough not to get paid, it is worse to simultaneously incur tax liability for a deemed gift.

The deemed gift rule should also be suspended where contract moratoriums are negotiated in good faith between the debtor and creditor. Frequently, a determination is made that the only way to get paid eventually is to grant some current debtor relief by way of forgiveness or extensions of time. While this is frequently worked out in a Chapter 11 proceeding, it is sometimes worked out in state court proceedings or by private agreement to minimize administrative expenses and delays.

M. <u>The Attribution Rules Need Redefinition.</u>

Section 2703(b), which is the only entity attribution rule, states that a right or interest will be treated as held by an individual if such right is held "indirectly" by such person through a corporation, partnership, trust or other entity. This begs the question, since it does not tell us when an entity right will be deemed to be held "indirectly" by a person. The family attribution rule should be limited to spouses and lineal descendents.

N. <u>Post Death Transfers Should be Excluded From the Proposal.</u>

Release 89-99 made it clear that Section 2036(c) did not apply to a post death recapitalization under a direction contained in a Will. Transfers involved in such a recapitalization should be likewise excluded from the Proposal.

O. <u>The Proposal Needs to Provide Broad Grandfathering of Prior Transactions.</u>

Section 2036(c) contained broad grandfathering provisions for transactions antedating the effective date. Not only were transactions grandfathered, but in the case of preferred stock, the failure to pay preferred stock dividends or the failure to convert the preferred stock to common following the adoption of the statute did not constitute disproportionate transfers. Similar provisions are required with respect to the Proposal.

P. <u>The Regulatory Authority of Treasury Should be Limited.</u>

The regulatory authority given to Treasury should be very limited so as to force the enactment of a statute from whose language taxpayers can determine their basic rights and obligations. When broad regulatory authority is granted, the regulators become legislators, as has been the case with §2036(c). Taxpayers are entitled to hold Congress responsible for tax legislation and this process can only be effective if regulatory authority is curtailed. Taxpayers and their professional advisors can no longer live with the concept that they must wait several years to find out how the regulatory authorities are going to interpret a broad or vague statute.

By way of example, Section 2703(c) should be changed so that changes in capital structure will be treated as transfers only "<u>to the extent</u>" provided in regulations" and not "except as provided in regulations". This properly places the burden on Treasury to establish transactional guidelines for "in effect" transfers.

III. <u>The Option Rule</u>

A. <u>The Option Rule Inhibits Intergenerational Transfers of Closely Held Business Interests</u>

The option rule eats at the heart of the shareholders buy-sell agreement. Almost every closely held small business with more than one owner has a shareholders agreement which restricts lifetime transfers of shares and provides for a mandatory option to purchase shares on the death of a shareholder. The lifetime restriction controls the transfer of shares while the owners are alive. The mandatory purchase option at death provides a guaranteed market for the shares of a deceased shareholder. This is very important since there otherwise may be no market for such shares. Such mandated sales provide needed liquidity to pay estate taxes and estate expenses. The option also lets the deceased shareholder arrange the price and terms of sale for his estate while he is still alive. For the surviving shareholder, the option enables him to agree on a price

[illegible] the [illegible] whether by formula or otherwise) and this, in turn, enables him to arrange [illegible] insurance funding which will make the purchase economically feasible. [illegible]damental [illegible] the arrangement is that the price for the shares is set (whether by formula [illegible]) at the time the option agreement is entered into so that each party can plan [illegible] estate (if he is the first to die) or the purchase and transition of the business (if [illegible] the survivor) with some degree of certainty.

The Proposal states that where options are held by family members (as is the case in [illegible]ry family corporation) the shares of the deceased shareholder are to be valued without [re]gard for the option price set forth in the shareholders agreement unless the option [pri]ce is determined by a formula, is subject to a review every three years and at the time [of] each review it is determined that the formula is reasonably expected to produce fair [mar]ket value at the time of sale. To require a periodic review and renegotiation of the [op]tion pricing formula every three years, in effect, takes away the prime benefit of the [op]tion which is price stability and the ability to plan the funding of the purchase price [in] advance with some certainty. Without the benefit of purchase options, the [in]tergenerational transfer of closely held business interests will be greatly inhibited.

It is true that the Proposal does not prohibit shareholder agreements that do not meet the criteria of the option exception, but in those cases the option price will be [di]sregarded for estate tax valuation purposes. This prospect offers the worst of two [wor]lds! The decedent's estate must sell the shares at the option price, but if fair market value, determined independent of the option agreement, is determined to be [sig]nificantly greater than the option price, the estate tax on the shares could be greater than the sale proceeds. Nevertheless, if all of the exception's criteria are not met (including the subjective "fair market value" test), that is the problem the decedent and his beneficiaries would end up with.

B. <u>The Purchase Option is the Principal Employment Incentive Available to Closely Held Family Businesses</u>.

Small closely held family businesses do not have the ability, from a financial [v]iewpoint, to compete with larger publicly held companies in terms of executive [co]mpensation. Neither do they have marketable stock to use in stock option plans or stock bonus plans. The principal inducement for family members to remain in the family business in the long term prospect of being able to acquire control of the business on terms and at a price that is both fair and one that they will be able to afford. The only way to guarantee this is through a shareholders option agreement. Such an arrangement will hold no benefit for them if they have to renegotiate the pricing terms every three years and surrender any leverage the option agreement may have obtained for them.

C. <u>There is No Need for the Option Rule</u>

The option rule is not necessary to protect the integrity of the transfer tax [sy]stem. Existing estate tax regulations currently do this very adequately. Treasury Regulation §20.2031-2(h) is very explicit on how shares subject to options are to be [va]lued. This regulation recognizes that the potential abuse by "low-ball" pricing in family options and clearly states that the option is to be disregarded unless it represents a bona fide business arrangement and not a device to pass the decedents shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth". This estate tax regulation serves the transfer tax system very well. It is well understood by taxpayers, it is well settled by case law and should not be replaced with a new rule which causes wide ranging substantive and procedural problems.

D. <u>The Option Rule Makes No Sense Where Both Family Members and Unrelated Parties Hold Similar Options</u>

Frequently family members and non-family members will have identical option rights under the same shareholders agreement. It does not seem fair or practical to continually renegotiate price with family members but let non-family members retain the benefit of their bargained for options. On the other hand, if the agreement does not meet the formula pricing review requirements of the Proposal, how does the estate value the shares? Is the stock optioned by non-family members valued based on the option price and the stock optioned by family members valued as if the option did not exist? This could result in two different values for the same security in a single estate. The answer is that the

posal option rule should never apply when there are non-family members holding identical options to those held by family members.

E The Proposal's "Fair Market Value" Requirement for Option Pricing is Not Practical or Workable.

In order for an option to control the estate tax value of shares, the proposal would, among other things, require the option price to be established by a formula reasonably expected to produce a price which would approximate fair market value of such property as of the time of such sale". (emphasis added) This subjective test introduces a significant element of uncertainty. There is no way for the parties to know whether they have met this test and the Service will not issue advance rulings on the question. Valuation issues on closely-held stock are already the central focus of all estate tax field audits and have turned the audit procedure into an estate tax negotiation due to the only aggressive valuation positions taken by field agents. This rule will only aggravate the audit problems and produce more appeals and valuation litigation. Failure to meet the test will mean that the stock, although sold under the option, will be valued as if the option did not exist. This presents the potentially disastrous result discussed in Section A, above.

The Tax Court has said that valuation of closely held stock is an art and not a science. The large number of valuation cases clogging the Tax Court docket demonstrates that value is in the eye of the beholder and is an issue over which acknowledged experts can have widely divergent views. Given this scenario, how are the parties to an option ever to know if the pricing mechanism is reasonably expected to produce fair market value at some point in the far distant future. Perhaps they could get a professional appraiser to express an opinion on this prior to entering into the option agreement, but there is nothing in the Proposal that would protect them if they got such an opinion. And is it fair to small businesses to impose on them a $10,000 - $20,000 cost for a valuation opinion every time a shareholders agreement is entered into?

Perhaps it is the shareholders' reasonable expectation that the statute is referring to and that if they form a good faith judgment about the formula and fair market value, then there is a conclusive presumption that the test is met. This would probably turn the requirement into a nullity, since shareholders frequently know a great deal about their businesses, but usually know nothing about its value or how value is determined.

F. The "Formula Review" Requirement of the Proposal is Not Practical or Workable.

The Proposal requires a review of the option pricing formula every 3 years in order for the option price to be a factor in the estate valuation of the property. The purpose of the review is to determine whether the formula option price originally selected continues to provide a reasonable expectation of a selling price which will approximate fair market value at the time of the sale. Aside from the process itself, the term "approximately" used in conjunction with the "fair market value" illustrates the impracticability of the rule itself and will surely spawn more litigation. The rule suggests that all shareholder option agreements to which family members are a party be drafted with price reopeners at the end of every three year period. This could obviously lead to subsequent impasse over price and no agreement at all. Any shareholder who made a bad bargain could bail out. What value would such an agreement provide to any party? It is doubtful whether such an option agreement would meet the current test under the §2031 regulations since the agreement would effectively provide all parties with an escape hatch. Finally, the same questions regarding the determination of fair market value (See Section E above) would occur all over again at 3 year intervals. The rule is well calculated not to please anyone other than professional appraisers.

G. The Proposal Requirement That Option Pricing be Established by a "Formula" is Too Restrictive.

The Proposal requires that the option pricing be established by a formula. This, in itself, implies the necessity to use a professional appraiser since shareholders know very little about option pricing formulas. This is also contrary to the current practice of most closely held corporation shareholder agreements which do not generally utilize formula pricing for options. While large publicly held corporations have the operational stability to create a predictable result with earnings or cash flow formulas, the uncertainty of the financial results in the small closely held business creates a high

l f [...] mfort among shareholders when formula pricing is suggested. Most [...]uent. Shareholders (whether or not related) would rather look to book values, asset [...]ues, liquidating values, appraisals or simply fix an option price at a monetized amount [...]mutual agreement. In the later case, the agreement may provide for periodic reviews [...]h some automatic price adjustment if agreement can not be reached after the review. It [...]ot clear that any of these pricing methods would constitute a "formula". In the [...]sely held corporation context, shareholders are looking for a pricing mechanism that [...]ll offer them stability and a dependable and foreseeable result, and will often [...]rifice the opportunity to maximize value to achieve those ends. The Proposal should be [...]tisfied if the "approximately fair market value" test is achieved by the parties, and [...] require them to achieve it by "formula".

H. Disregarding Rights of First Refusal and Leases Ignores Reality.

The Proposal would ignore rights of first refusal in valuing property if the right held by a family member. Rights of first refusal are very common in lease transactions and should be given their contractual effect in valuations of such property. Likewise, if [...] perty is subject to a legally binding lease, the economic impact of the lease should be [...]nsidered in valuing the lease. To do otherwise would preclude leases and rights of first refusal among related parties since the asset would be valued in the estate as if the contractual right did not exist, but the contractual right could, nevertheless, be [...]nforced.

I. Other Technical Suggestions

The three year review requirement would be better tied to the date of death rather than the date of sale. The six month prohibition on resales should not tie into the date of death, but rather to the date of transfer under the option. The option exceptions only apply if there is not a "readily ascertainable market value" for the property. This term needs a definition or a cross-referencing to other sections of the Code that provide a definition of the term.

[...] A Proposal to Create a Safe Harbor for Small Business Preferred Stock.

The current Proposal effectively creates a prohibition on preferred stock recapitalizations. Requiring the preferred stock to be valued based on a market rate index puts them out of reach as a practical matter. Many small closely held businesses continue to require the availability of some limited form of preferred stock recapitalization if intergenerational transfers of family businesses are to continue to be a reality. There is a Congressional policy which recognizes that small businesses need special considerations, particularly in dealing with the transfer tax system. My proposal would create a statutory safe harbor which would permit any closely held corporation to issue up to $2,000,000 in cumulative preferred stock and not have that preferred stock valued by the rules of §2701(a)(2). Such stock would be valued based on a statutory index dividend rate set at 4% per annum. The deemed gift rule would apply to any dividend not paid for three years, but the preferred stock shareholder would have the right to treat the deemed gift as a present interest gift so long as the holder of the common stock holds a current "put" against the corporation (or the preferred shareholder) equal to the accumulated and unpaid dividends on the preferred stock. Under such circumstances the preferred shareholder would be entitled to apply his annual gift tax exclusion to cover all or a part of any deemed gift created by any failure to pay the dividend. The minimum junior equity rule (without the shareholder debt included) would apply to such preferred stock and reporting requirements would be established to report the recapitalization and all deemed gifts, whether or not covered by the annual gift tax exclusion. Non-cumulative preferred stock would not qualify for the safe harbor. The amount of the preferred stock permitted to be issued under this proposal would be indexed for inflation or deflation. The deemed gift rule on transfer would apply as would the special valuation rule on the death of the transferor and the spousal exception.

This would permit some limited relief for owners of closely held family businesses. It is certainly in the furtherance of the Congressional policy to assist small business and, in principle, is not unlike statutory relief currently granted to closely held businesses and farmers under IRC §§303, 2032A and 6166. Having a 4% interest rate as an index valuation rate reflects a fair return for the exchanging shareholder considering all the circumstances, a dividend payment that the closely held corporation could generally afford to pay and otherwise protects the integrity of the transfer tax system. The dollar

...itation ... the preferred stock will ... make ... useful ... the small ... business and will ... Most importantly, this safe harbor proposal would answer the criticism of small business owners.

Summary

A. Section 2036(a) should be repealed.

B. It is doubtful whether a replacement is required. Existing tax statutes and doctrines if vigorously enforced can deal with the perceived problem. The system cannot accommodate another major tax proposal of this magnitude.

C. Before enacting any further legislation, Congress should undertake a study of the transfer tax system and its current impact on small business.

D. If the Proposal is adopted, it should have a much narrower focus and its structure and operation should be greatly simplified.

E. Under no circumstances should the "option" provision be included in the Proposal.

F. A "safe harbor" should be established for a limited issue of small business preferred stock.

BEST AVAILABLE COPY

STATEMENT OF H.A. TRUE, JR.

Thank you, Mr. Chairman and members of the Senate Finance Committee, for allowing me to submit this written statement. It is directed to Section 2036(c) of the Internal Revenue Code and S. 3113 which would repeal Code Section 2036(c) and replace that Code Section with provisions affecting the valuation of property transfers for gift tax purposes.

My name is H. A. True, Jr.; and I am a partner, director and shareholder in the various entities known as the True Companies of Casper, Wyoming.

My father was a landman for a major oil company, so I literally grew up in the oil business. My contacts with his many friends in the industry convinced me that I wanted to become an independent oil operator. My first job in the oil fields was in the summer of 1931, and subsequent summer jobs helped in working my way through engineering college.

Since graduation from college in 1937, I have been involved full-time in the oil and gas business. I first worked for a major oil company in the field for over 11 years. In 1948, I gambled on an opportunity to start on a road to becoming my own boss by accepting a position of manager of a small drilling company. If the company operations were successful, I was to earn an ownership interest. Fortunately, the company operations were successful; and by 1951, I held a 50-percent ownership. In 1954, my wife and I actually realized our dream of owning our own business when we acquired the outstanding partnership interests and corporate stock owned by a business associate with whom we had been operating since 1951.

My wife and I are blessed by having four children; one girl and three boys. As the children grew, they were encouraged, but not pressured, to join the family business. As they began to show an interest and work in the business, small shares were transferred to them as gifts or as sales of interest.

By 1971, it was apparent that all four children were planning on entering the business; and during the period 1971 through 1973, significant transfers were made to them. These transfers, covered by mandatory buy/sell agreements to assure that the interests would remain in family hands, were treated as taxable transactions. Any taxes due were timely paid.

Our values of these gifts and sales were challenged by the internal Revenue Service. The Federal District Court, in several actions, upheld our valuations. These lawsuits were long, time-consuming and expensive.

The children all became actively involved in the businesses and have devoted their time, talents and energies in maintaining and expanding the enterprises since the time they graduated from college. In 1984, our daughter made the decision to leave the businesses; her interests were sold to the remaining family members under the established buy/sell agreements.

During the entire period of time that our children have been involved in our business, we have been organized in a manner to assure that the businesses would continue as a viable family enterprise from one generation to the next. We have consistently advised our employees that this was to be a continuing business which would provide them with stable and enduring employment. The business has suffered the ups and downs of the energy industry. But even in today's depressed economic conditions in the industry, we still employ in excess of 700 people. Unfortunately, under Section 2036(c), we can no longer give our employees such assurances.

If, as in our case, a large portion of the value of a business is the result of the industrious efforts of the children involved, it seems completely inequitable for the appreciation to be taxed in the parents' estate as is required under Section 2036(c). Many businesses will have to be liquidated, and the employees will lose their jobs. Some businesses will end up in the hands of larger corporations which normally move at least the headquarters of a business and reduce the number of employees because of efficiency requirements. Instead of paying income taxes, these employees will be collecting unemployment funds.

Even without the prohibitive estate taxation mandated in Section 2036(c), the *Wall Street Journal,* in its issue of August 9, 1989, points out that only 30 percent of the family businesses—which make up 98 percent of all United States businesses—survive to the second generation, and only 13 percent survive to the third generation.

An article in the September 6, 1990, issue of *USA Today* points out the gross inequities of Section 2036(c) and gives examples of long-time family businesses which obviously cannot survive to another generation under its terms.

If Section 2036(c) had been in existence since 1971, there would be no way our sons could pay the estate tax and continue the businesses they have contributed to so greatly. While we feel, at least for the present, that our existing buy/sell agree-

ments are grandfathered under Section 2036(c), we already have grandchildren in college and grandsons and granddaughters close to college who express considerable interest in joining our businesses. Assuming the continuation of Section 2036(c), the only advice I can give to these young people is, "Forget it. No matter how hard you work, or how much you contribute, you will never be able to own even a part of the business which your grandparents and your fathers have built."

Most small, family-owned enterprises are comprised of a single asset which constitutes the major value of the business. This is especially true in the real estate, ranch and farm industries. It does not take a very large enterprise to have a fair market value of $3 million. At today's estate tax rates, a $3 million estate is assessed in excess of $1 million in estate taxes. Additionally, fifty-five cents of each one dollar of estate value over $3 million is paid as tax. In many instances, this forces a business into a distressed sale, total or partial liquidation, or a substantial contraction of the business enterprise in order to provide funds to pay the estate taxes.

Section 2036(c) was enacted into law without any public input, hearings or debate; and the reason given for submitting Section 2036(c) was to close a perceived loophole utilized to freeze the estate value of corporate stock. Unfortunately, Section 2036(c) as written and as interpreted by the rules issued by the Internal Revenue Service throws the baby out with the bathwater and forces the discontinuance of a family business upon the death of the parent who at one time had a substantial interest in the business. It includes not only family corporations but every other form of family business of which I am aware.

For years I have resisted the choices of selling or going public as most similar businesses have done in order to keep the business in my family and assure our employees' future employment.

If Section 2036(c) remains in the law, I would tell my sons not to make the same mistake I made by not selling the business for cash or equities which can be precisely measured in an estate.

It has been my experience with the Internal Revenue Service that the only ways to establish fair market value of a business in an estate would be:

1. Sell to an outsider at a distressed price;
2. Accept an unrealistically high market value established by the Internal Revenue Service; or
3. Establish through a long, unpleasant and expensive lawsuit a value determined by the court.

I urge this Committee to support the bills to repeal Section 2036(c) outright and thereby restore the ability of families to pass their businesses to family heirs. Such action will enable family businesses to continue creating jobs and improve the economy of the country.

S. 3113 repeals Section 2036(c), and we enthusiastically support this part of the bill. Unfortunately, the replacement provisions of S. 3113 also cause many problems for the transfer of interests in family-owned enterprises from one generation to the next. This proposed legislation, like Section 2036(c), is overly broad and restrictive and will be impossible for the Internal Revenue Service to administer; it encourages unfair application and litigation; it encourages noncompliance and fraud; and it undermines our self-assessment tax system. These provisions are not needed since the present laws, excluding Code Section 2036(c), are adequate to cover the transfer of family enterprises in most cases. While I am sure there have been abuses in this area of valuation, it should not be immoral for parents to transfer the family business from one generation to the next at the least possible tax liability.

The valuation of a taxable transfer is contingent upon many factors and must be made in light of the facts and circumstances surrounding each interest transfer. The provisions in the proposed legislation do not solve these valuation problems. The legislation merely makes it more complicated and much more of a burden for taxpayers to arrive at a proper valuation and does not significantly improve the valuation process or assure the proper self-assessment of taxes.

Unfortunately, the proposed legislation does not accomplish an alternative to these three choices listed above nor does it simplify the valuation procedures or stop the perceived abuses which the Internal Revenue Service and Treasury Department are trying to accomplish.

I urge this Committee to support a bill to repeal Section 2036(c) and to discourage any legislation changing the present rules regarding the transfer of interests to family members. Such action by the Congress will enable family businesses to continue creating jobs and improve the economy of the country. I will then be able to inform my employees and my grandchildren that my business will continue for

many years into the future and that they will have a place in the future of the business.

Thank you.

U.S. CHAMBER OF COMMERCE,
Washington, DC, October 5, 1990.

Hon. LLOYD BENTSEN, *Chairman,*
Senate Committee on Finance,
703 Hart Senate Office Building,
Washington, DC.

Dear Senator Bentsen: The U.S. Chamber of Commerce is pleased to submit the following comments on S. 3113, which retroactively repeals section 2036(c) and replaces it with special valuation rules.

The Chamber supports the repeal of section 2036(c) and has stated that any replacement must be a narrow gift tax provision targeted at curbing potential estate freeze valuation abuses. S. 3113 largely meets this test. Your legislation would largely remove the cloud of complicity and hardship brought on family businesses by section 2036(c). The Chamber believes that there are changes that should be made to the legislation and we urge that these changes be made before the legislation is approved. However, the legislation is clearly preferable to H.R. 5425.

The Chamber recommends the following changes to S. 3113:

VALUATION OF DISCRETIONARY RIGHTS

The legislation is intended to value certain potentially abusive discretionary rights at zero, while permitting other rights to hold their fair market value. Subsection (b)(1) of the bill states ". . . the value of any right with respect to which an interest is being treated as an applicable retained interest under subsection (c) shall be treated as being zero." Subsection (c) defines "applicable retained interest" as "any interest in an entity which confers" certain enumerated rights. In order to clarify that only the enumerated discretionary rights are valued at zero rather than the entire interest, we suggest that subsection (b)(1) be written to state ". . . . the value of any right which results in an interest being treated as an applicable retained interest under subsection (c) shall be treated as being zero."

APPLICATION TO PUBLIC ENTITIES

Subsection (b)(2)(A) of the legislation excludes retained interests for which market quotations are available. The exception should also apply in situations where market quotations are available for the transferred interest. In such cases, the special valuation rules should obviously not apply to those transferred interests.

CONSISTENT VALUATION OF SPECIALLY VALUED RIGHTS

It is important to make clear in the legislation that any special valuation rules that apply at the time of the initial gift valuation will also apply for later gift and estate tax valuation purposes. An example of the danger of the legislation's present omission is as follows: Parent transfers common stock and retains noncumulative preferred stock with a put right. Both discretionary rights are valued at zero under the legislation. The special valuation of the preferred stock obviously results in a higher gift tax on the common than would otherwise be the case. This is acceptable; however, the legislation fails to protect against the later potential for the IRS to turn the tables on the taxpayer. For example, even if the dividends are not later paid (as it was assumed they would not be), the IRS could take the position under the *Dickman* [1] case that the failure to pay the dividend is a gift. A third transfer tax can result upon a subsequent transfer (whether by gift, sale, or bequest) of the preferred stock, because the special valuation rules no longer apply.[2] This would occur, for example, if the IRS were allowed to revalue rights at death that were valued at zero at the outset.

Valuation of the same preferred stock under different methods depending on the nature of the transaction is fundamentally unfair. Enactment of this statutory valuation scheme without amendment would serve as a substantial impediment to legitimate estate freeze transactions.

---

[1] *Dickman* v. *Commissioner* 75 U.S., 330 (1984).
[2] *Estate of Snyder* v. *Commissioner,* 93 T.C., 43 (1989).

BUY-SELL AGREEMENTS

The business community is united in its opposition to any legislation that would adversely affect buy-sell agreements. Paragraph (1) and (2) of proposed subsection 2031(d) codify existing Treasury regulations governing buy-sell agreements. They require that an agreement be a bona fide business arrangement and not a device to transfer property to members of a decedent's family for less than adequate and full consideration. However paragraph (3) adds a new test stating that the terms of an agreement must be comparable to similar arrangements entered into by persons in an arms' length transaction." This redundant and confusing requirement should be removed from the legislation. It implies there are certain buy-sell agreements, which though clearly not estate tax planning devices, are still unacceptable to the Treasury. It could allow the IRS unwarranted authority to force the taxpayer to find similar agreements to justify their buy-sell agreement.

STATUTE OF LIMITATIONS

If any gift required to be reported on a return is not reported or disclosed on a return, the legislation would extend the statute of limitations indefinitely. This is an unfair provision that will dramatically increase taxpayer uncertainty. Taxpayers have a right to know that gift valuations will not be challenged by the IRS years after they occur. The legislation should not alter current law with regard to the statute of limitations.

MINORITY DISCOUNT

As currently drafted the legislation is likely to eliminate minority discounts. The value of the transferred interest is determined through the "subtraction method." Under the legislative framework the appraiser first determines the value of the retained preferred interest, which is then subtracted from the value of the whole. The remainder is the value of the transferred or gifted interest. The subtraction method allows no adjustment for minority discount in the transferred interest. For example, if it is determined through the subtraction method that a 40 percent interest in the business has been transferred to the younger generation with 60 percent returned by the parent, the 40 percent interest would typically be entitled to a discount due to the lack of control. Yet the legislation does not appear to allow for this adjustment. H.R. 5425 on the other hand allows for a minority discount. Section 2701(a)(1)(A) of that bill provides that in determining the proper value of the transferred and retained interests ". . . Appropriate adjustments shall be made for the relative sizes of the interests transferred or retained." Similar language should be included in S. 3113.

APPLICATION TO CONTROLLING INTERESTS

The Chamber continues to believe that special valuation rules should apply only to entities in which the family has a controlling interest. The legislation provides this for the valuation of distribution rights but not for liquidation, put, call, or conversion rights.

PARTNERSHIP PROVISION

Subsection (b)(2)(C) of the legislation excludes from the special valuation rules those partnership transfers where the retained partnership interest differs from the transferred interest in that it has only "nonlapsing differences with respect to management and limitations on liability." The transfer of a limited partnership interest and retention of a general interest would therefore not be covered as long as other rights in the interests were the same. We suggest a slight change in the wording above to: "nonlapsing differences with respect to management or limitations on liability." This language will also exclude from coverage of the legislation the transfer of a general partnership interest and retention of a "managing" general partnership interest—a common and nonabusive transaction for family businesses.

APPLICATION TO ANCESTORS

The legislation includes ancestors as "applicable family member[s]." This means parents can be treated as retaining property held by a grandparent and creates a situation where parents may pay gift tax on property the parent neither owns or transfers. If the grandparent's interest is an applicable retained interest under subsection (b)(1), such as non-cumulative preferred stock, it could be valued at zero. Since the transferred interest is the value of the whole minus the retained interest, the transferred interest will obviously be inflated by valuing grandparent's interest

at zero. Grandparents interest is in effect treated as transferred by parent to children and taxed accordingly. For example, grandparent owns non-cumulative preferred stock, while parent owns common stock. The parent transfers the common stock to children. In such a case, the parent will be considered to have retained the preferred stock held by the "applicable family member" (grandparent), but this preferred stock will be valued at zero under subsection (b)(1). Since the parent's retained interest is zero, the transferred interest will be valued far higher than it should. This is clearly an unfair result. The legislation should not apply to ancestors in this manner.

Again, the Chamber thanks you for introducing this important legislation and we look forward to working with you and your staff. Please feel free to contact David Burton or John Carson of our staff for additional information.

Sincerely,

DONALD J. KROES.