Federal Tax - Major Tax Acts and Reports (1986-2015), Conference Committee Report Concerning the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508), Congress (United States)

2. SMALL BUSINESS INCENTIVES

a. Revision of estate freeze rules

Present Law

Estate tax inclusion relating to estate freezes

If a person, in effect, transfers property having a disproportionately large share of the potential appreciation in such person's interest in an enterprise while retaining an interest, or right in, the enterprise, then the transferred property is includible in his gross estate (Code sec. 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 in the gross estate had the transferor died at the time of the transfer.

Preferred interests in corporations and partnerships

The transfer of a residual interest in a corporation or partnership for less than full and adequate consideration is a gift.

The value of a residual interest in a corporation or partnership often is determined by subtracting the value of the preferred interest from the value of all interests in the corporation or partnership.

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 sell and both having reasonable knowledge of relevant facts. Under the “willing buyer, willing seller” valuation standard, it is assumed that rights will be exercised so as to maximize the value of the owner's interests. The failure to exercise rights in an arm's-length manner may give rise to a taxable gift.

Gift tax statute of limitations

Generally, no proceeding in a court for the collection of gift tax can begin without an assessment within 3 years after the filing of the return. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time.

Trusts and term interests property

The transfer of a remainder interest in property results in a taxable gift if the value of the remainder interest exceeds the value of any consideration received for such interest. The value of the remainder interest is the value of the entire property less the value of rights in the property retained by the transferor. Income interests retained by the transferor generally 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 interest rate.

Options and buy-sell agreements

Some courts have held that the price contained in a buy-sell agreement limits 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.

Lapsing rights

Some courts have held that the fair market value of property is determined the moment after death. Under this theory, the value attributable to a right that lapses upon death is not subject to estate tax.

House Bill

No provision.

Senate Amendment

Estate tax inclusion relating to estate freezes

The Senate amendment repeals section 2036(c) retroactively.

Preferred interests in corporations and partnerships

The Senate amendment provides rules for valuing certain rights held by the transferor or certain family members immediately after the transfer of a residual interest in a corporation or partnership. The rules rely on present law principles that value residual interests by subtracting the value of preferred interests from the value of the entire corporation or partnership, with an adjustment to reflect the actual fragmented ownership. The rules apply in determining the value of a residual interest that is transferred to, or for the benefit of, a family member.

The Senate amendment establishes specific valuation rules for three types of retained rights. First, a retained liquidation, put, call, conversion or similar right is valued at zero, unless such right must be exercised at a specific time and amount. Second, a retained distribution right that is noncumulative or lacks a preference upon liquidation is valued at zero if the transferor and applicable family members control the corporation or partnership. Third, a cumulative distribution right having a preference upon liquidation in a corporation or partnership in which the transferor and applicable family members retain control is valued under a special standard: the determination of whether a dividend can reasonably be expected to be timely paid is made without regard to the transferor's control. The amendment exempts from these rules a retained interest that is publicly traded, that is of the same class as the transferred interest, that is of the same class but for nonlapsing differences in voting power, or that possesses proportionally the same rights as the transferred interest.

The Senate amendment values a redemption or liquidation right without a fixed date at zero even if such right is held in conjunction with a cumulative distribution right. The Senate amendment does not specify the treatment of a distribution right with no fixed termination date.

The Senate amendment increases the amount of estate or gift tax on a subsequent transfer of the retained preferred interest by the time value of accumulated distributions. The amount of accumulated distributions and interest thereon that is subject to gift or estate tax is capped at an amount equal to (1) the excess of the fair market value of the residual interests in the corporation or partnership at the date of the subsequent transfer over the fair market value of such interests at the date of the initial transfer multiplied by (2) a fraction the numerator of which is the value of the preferred interests in the corporation or partnership held by the transferor and the denominator of which is the value of all such interests.

The Senate amendment also provides that the aggregate value of the junior equity interests in a corporation or partnership can be no less than 10 percent of the sum of the total equity in the corporation or partnership plus any debt which the corporation or partnership owes to the transferor or members of his family.

Except as provided in Treasury regulations, any redemption, recapitalization, contribution to capital, or other change in the capital structure of a corporation or partnership is treated as a transfer of an interest in such entity if an individual or applicable family member thereby receives a retained right affected by the bill. Regulations also may provide that such an event results in a transfer if the individual or applicable family member thereafter holds such an interest.

Statute of limitations

The Senate amendment provides that the gift tax statute of limitations runs for transfers subject to the rules governing preferred interests in corporations and partnerships and to increases in taxable gifts with respect to cumulative preferred stock only if the transfer is disclosed on a gift tax return with sufficient detail to apprise the Secretary of the Treasury of the nature of the transferred and retained interests.

Trusts and term interests in property

Under the Senate amendment, retained interests in trusts or term interests in property generally are valued at zero for gift tax purposes unless they take the form of an annuity or unitrust interest.

Buy-sell agreements

The Senate amendment provides that the value of property is determined without regard to any option, agreement, right or restriction, unless (1) the option, agreement, right or restriction is a bona fide business arrangement, (2) the option, agreement, right or restriction is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration, and (3) the terms of the option, agreement, right or restriction are comparable to those obtained in similar arrangements entered into by persons in an arm's length transaction.

Lapsing rights

Under the Senate amendment, the value of property is determined without regard to any restriction other than a restriction which by its terms will never lapse.

In addition, any right held by the decedent with respect to property includible in the gross estate which effectively lapses on the death of the decedent would, in valuing such property in the estate, be deemed exercisable by the estate.

Treasury study

The Senate amendment requires that the Secretary of the Treasury study buy-sell agreements and discretionary rights that have the potential for distorting transfer tax value and report the results of the study no later than December 31, 1992.

Effective date

The Senate amendment generally applies to transfers made and agreements entered into (or substantially modified) after October 8, 1990.

Conference Agreement

The conference agreement follows the Senate amendment, with the following modifications.

Preferred interests in corporations and partnerships

Valuation of distribution rights

The conferees are concerned that by ignoring liquidation, put, call and conversion rights held in conjunction with a distribution right, the Senate amendment undervalues certain applicable retained rights. By valuing at zero a liquidation right associated with a distribution right, the Senate amendment permits the possibility that the distribution right also would receive little value, particularly when such liquidation right is likely to be exercised at the earliest possible date.

Accordingly, the conference agreement modifies the rules applicable to the valuation of distribution rights. Under the conference agreement, a retained interest that confers (1) a liquidation, put, call or conversion right and (2) a distribution right that consists of the right to receive a qualified payment (as defined below) is valued on the assumption that each right is exercised in a manner resulting in the lowest value for all such rights. Each right receives a value consistent with that assumption.

Example 1.—Father retains cumulative preferred stock in a transaction to which the provision applies. The cumulative dividend is $100 per year and the stock may be redeemed at any time after two years or $1,000. Under the conference agreement, the value of the cumulative preferred stock is the lesser of (1) the present value of two years of $100 dividends plus the present value of the redemption for $1,000 in year two, or (2) the present value of $100 paid every year in perpetuity. If the present values are substantially identical, the stock receives such value.

A qualified payment is a dividend payable on a periodic basis and at a fixed rate[14] under cumulative preferred stock (or a comparable payment under a partnership agreement).[15] A transferor or applicable family member may elect to treat any other distribution right as a qualified payment to be paid in the amounts and at the times specified in the election.

The election to treat distribution rights as qualified payments cannot be inconsistent with the legal instrument underlying the right. Accordingly, the transferor cannot elect to treat a distribution right as a right to receive a qualified payment in excess of amounts that could actually be received under the instrument. For example, a transferor cannot elect to value a noncumulative right to $100 per year on the assumption that it would pay $110 per year.

Example 2.—Father and Daughter are partners in a partnership to which Father contributes an existing business. Father is entitled to 80 percent of the net cash receipts of the partnership until he receives $1 million, after which time he and Daughter both receive 50 percent of the partnership's cash flow. Father's liquidation preference equals $1 million. Under the conference agreement, the retained right to $1 million is valued at zero, unless Father elects to treat it as a right to receive qualified payments in the amounts, and at the times, specified in the election. If Father elects such treatment, amounts not paid at the times specified in the election become subject to the compounding rules.

Regulatory authority

The conference agreement also grants the Secretary of the Treasury regulatory authority to treat a retained interest as two or more separate interests under the provision. Such treatment would allow value to be accorded to the participating feature of a participating preferred interest pursuant to the exception for retained interests that are of the same class as the transferred interest.

Example 3.—Mother owns all the stock in a corporation. One class is entitled to the first $100 in dividends each year plus half the dividends paid in excess of $100 that year; the second class is entitled to one half of the dividends paid above $100. The preferred right under the first class is cumulative. Mother retains the first class and gives the second class to Child. Under the conference agreement, Treasury regulations may treat an instrument of the first class as two instruments under the provision: one, an instrument bearing a preferred right to dividends of $100; the other, an instrument bearing the right to half the annual dividends in excess of $100, which would fall within the exception for retained interests of the same class as the transferred interest.

Example 4.—Father and Daughter enter into a partnership agreement under which Father is to receive the first $1 million in net cash receipts and is thereafter to share equally in distributions with Daughter. Under the conference agreement, Treasury regulations may treat Father's retained interests as consisting of two interests: (1) a distribution right to $1 million and (2) a 50 percent partnership interest. Father could elect to treat the first interest as a right to receive qualified payments at specified amounts and times; the second interest would fall within the exception for retained interests of the same class as the transferred interest.

Limitation on transfer tax inclusion

Under the conference agreement, the limitation on the amount of unpaid dividends and interest subject to subsequent transfer tax equals (1) the excess of the fair market values of equity interests that are junior to any retained preferred interests at the date of the later transfer over such values as of the date of the prior transfer of the junior interest, multiplied by (2) a fraction (determined immediately before the later transfer), the numerator of which is the number of shares of preferred interests held by the transferor and the denominator of which is the number of all shares of the same class of preferred interest. This limitation applies with respect to each class of preferred held by the transferor or applicable family member.

Example 5.—A corporation has four classes of stock. Class A is entitled to the first $10 of dividends each year; Class B is entitled to the second $10 of dividends each year; Class C is entitled to the third $10 of dividends each year; and Class D is entitled to all dividends in excess of those paid to classes A, B and C. Classes A, B and C all have cumulative rights to dividends. In a transaction to which the provision applies, Father gives Daughter stock in classes A and C while retaining stock in class B. Class D is owned by an unrelated party. Dividends are not paid on the class C stock and several years later Father dies holding the class B stock. The cap on future amounts subject to transfer tax equals the excess of the fair market value of stock in classes C and D at the date of Father's death over such value at the date of the gift multiplied by a fraction equal to the percentage of class B stock held by Father.

Exceptions

Under the conference agreement, a retained interest is valued under present law if it is of a class which is proportionally the same as the transferred interest but for nonlapsing differences in voting power (or, in the case of a partnership, nonlapsing differences with respect to management and limitations on liability). This exception would apply, for instance, if the retained and transferred interests consisted of two classes of common stock, which shared in all distributions, liquidation and other rights in a two-to-one ratio. It would not apply to a partnership with both a general and limited partner if one partner had a preference with respect to distributions.

Except as provided in Treasury regulations, a right that lapses by reason of Federal or State law generally would be treated as nonlapsing under this exception. The conferees intend, however, that Treasury regulations may give zero value to rights which lapse by reason of Federal or State law that effectively transfer wealth that would not pass in the absence of a specific agreement. Such regulations could, for example, give zero value to a management right that lapses by reason of the death of a partner under the Uniform Partnership Act as adopted in a State if the decedent had waived in the partnership agreement the right to be redeemed at fair market value under that Act.

Definitions

The conference agreement modifies two definitions in the Senate amendment.

Junior equity interest.—In the case of a partnership, a junior equity interest is any partnership interest under which the rights to income and capital are junior to the rights of all other classes of equity interests in the partnership.

Transfer.—Except as provided in Treasury regulations, a contribution to capital, or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership is treated as a transfer of an interest in such entity if an individual or applicable family member thereby receives a retained right whose value would be affected by the provision. Regulations also may provide that such an event results in a transfer if the individual or applicable family member thereafter holds such an interest.

The conferees understand that such regulations would apply the provision to a contribution to capital, or a redemption, recapitalization, or other change in capital structure of a corporation or partnership that effects a transfer (determined under the above valuation rules). Thus, for example, the regulations might provide that a contribution to capital, or a redemption, recapitalization or other change in capital structure is subject to these rules if such event would result in a gift if all applicable retained interests were valued at zero.

The conference agreement provides, however, that the provision would not apply to a change in capital structure other than a contribution to capital if the interests held by the transferor, applicable family members, and family members are substantially identical before and after the change. The provision would not apply, for example, to a recapitalization not involving a contribution to capital if all shareholders held substantially identical interests both before and after the recapitalization. Nor would it apply to a change in corporate name. In addition, the conferees intend that the addition of capital to an existing partnership or corporation would result in the application of these rules only to the extent of such contribution.

Buy-sell agreements and options

The conferees do not intend the provision governing buy-sell agreements to disregard such an agreement merely because its terms differ from those used by another similarly situated company. The conferees recognize that general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several generally accepted methodologies may satisfy the standard contained in the conference agreement.

Treatment of certain restrictions and lapsing rights

In general

The conference agreement modifies the provision in the Senate amendment regarding the effect of certain restrictions and lapsing rights upon the value of an interest in a partnership or corporation. These rules are intended to prevent results similar to that of *Estate of Harrison* v. *Commissioner,* 52 T.C.M. (CCH) 1306 (1987). These rules do not affect minority discounts or other discounts available under present law. The conferees intend that no inference be drawn regarding the transfer tax effect of restrictions and lapsing rights under present law.

Lapsing rights

The conference agreement provides that the lapse of a voting or liquidation right in a family-controlled corporation or partnership results in a transfer by gift or an inclusion in the gross estate. The amount of the transfer is the value of all interests in the entity held by the transferor immediately before the lapse (assuming the right was nonlapsing) over the value of the interests immediately after the lapse. The conference agreement grants the Secretary of the Treasury regulatory authority to apply these rules to rights similar to voting and liquidation rights.

Example 6.—Parent and Child control a corporation. Parent's stock has a voting right that lapses on Parent's death. Under the conference agreement, Parent's stock is valued for Federal estate tax purposes as if the voting right of the parent's stock were non-lapsing.

Example 7.—Father and Child each own general and limited interests in a partnership. The general partnership interest carries with it the right to liquidate the partnership; the limited partnership interest has no such right. The liquidation right associated with the general partnership interest lapses after ten years. Under the conference agreement, there is a gift at the time of the lapse equal to the excess of (1) the value of Father's partnership interests determined as if he held the right to liquidate over (2) the value of such interests determined as if he did not hold such right.

Restrictions

Under the conference agreement, any restriction that effectively limits the ability of a corporation or partnership to liquidate is ignored in valuing a transfer among family members if (1) the transferor and family members control the corporation or partnership, and (2) the restriction either lapses after the transfer or can be removed by the transferor or members of his family, either alone or collectively.

Example 8.—Mother and Son are partners in a two-person partnership. The partnership agreement provides that the partnership cannot be terminated. Mother dies and leaves her partnership interest to Daughter. As the sole partners, Daughter and Son acting together could remove the restriction on partnership termination. Under the conference agreement, the value of Mother's partnership interest in her estate is determined without regard to the restriction. Such value would be adjusted to reflect any appropriate fragmentation discount.

This rule does not apply to a commercially reasonable restriction which arises as part of a financing with an unrelated party or a restriction required under State or Federal law. The provision also grants to the Treasury Secretary regulatory authority to disregard other restrictions which reduce the value of the transferred interest for transfer tax purposes but which do not ultimately reduce the value of the interest to the transferee.