

**SECTION 2701
AND
ESTATE TAX FREEZES
REVISITED**

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CASE STUDY

Fact Pattern for Estate Freeze Prior to 1987

Meg A. Byte [Meg] owned all of the common stock in Macro Software Design, Inc. [hereinafter MSD]. MSD was extremely successful and the value of the corporation was rapidly increasing each year.

As a result of the continuing growth in the value of the corporation, Meg was worried about the constantly increasing value of her MSD stock in her estate. Meg's goal was to limit or freeze the value of her MSD stock for federal estate tax purposes.

CASE STUDY

The following steps were taken to freeze the value of the MSD stock in Meg's estate:

- 1. MCD was recapitalized tax-free under section 368 of the Code.**
- 2. Under the recapitalization, in exchange for all of her voting common stock of MSD, Meg received new voting preferred stock and new non-voting common stock. [MSD could not be a Subchapter S corporation].**

The preferred stock had a dividend preference but the dividend right was non-cumulative. On liquidation of MSD, the value of the preferred stock was limited to its fair market value as of the date it was created.

CASE STUDY

In order to minimize the value of the common stock for gift tax purposes, the preferred stock was given additional rights. For example, Meg, as owner of the preferred stock, had the right to “put” the preferred stock to MSD at any time. Since the preferred stock was the only voting stock, the preferred stock was also given the sole right to vote the liquidation of MSD.

3. The plan was for Meg to retain the preferred stock and to give the non-voting common stock either to her children or to an irrevocable trust.

CASE STUDY

At the time of the gift of the common stock, the value of the common stock was extremely low because of all of the rights of the preferred stock. However, Meg's estate was "frozen" because the value of the preferred stock retained by Meg increased only very little or not at all. The value did not increase because of the preferred stock's limited liquidation rights and because MSD never paid any dividends. The preferred stock's preference for dividends was non-cumulative.

Changes in the Internal Revenue Code to Combat “Freezes”

Section 2036(c)

To curtail estate tax valuation freezes of corporate stock and partnership interests, Congress enacted the former §2036(c) as part of the Omnibus Budget Reconciliation Act of 1987.

BNA Tax Management Portfolio 835 states: “Former §2036(c) applied when a person owning (directly or indirectly) 10% or more of the voting power or income stream (or both) in an enterprise transferred property having a disproportionately large share of the potential appreciation of that interest while retaining an interest therein. The transferred interest, valued at the time of death, would be included in that person's gross estate. The original version of former §2036(c) contained a loophole that permitted a transferor to avoid the impact of former §2036(c) by transferring the retained interest more than three years before the transferor's death.”

Section 2036(c)

In other words, if Meg did the estate tax freeze after the enactment of 2036(c) in 1987, Meg would be required to include in her estate the value of all of the common stock which she gave away during her life. The common stock would be valued at the date of her death. However, Meg could avoid section 2036(c) and 2035 by transferring her retained preferred stock more than 3 years before her death. In 1988, Congress amended section 2036(c) to close this loophole.

Notwithstanding this 1988 amendment, Congress ultimately determined that section 2036(c) was too difficult to administer and placed too great a responsibility on the IRS to monitor it. Therefore, in 1990, Congress enacted the Revenue Reconciliation Act of 1990 which repealed former §2036(c) retroactive to the date of its enactment, December 17, 1987 and which substituted Chapter 14, including section 2701 in its place. Section 2701 became effective on October 9, 1990.

Section 2701

Section 2701 was designed to create an immediate deterrent to the use of the estate tax freeze through the use of special valuation rules for gift tax purposes. Additionally, section 2701 places the burden on the taxpayer by making the freeze transaction subject to immediate gift tax consequences. Unless certain restrictive limitations are met, for gift tax purposes, the interest retained by the transferring person (the preferred stock in the case of Meg) is valued at zero for gift tax purposes. Consequently, the value of the gift (the non-voting common stock in Meg's situation) would be value of the entire interest owned by the transferring person. In Meg's situation, the gift would be the entire value of MSD at the date of the transfer of the common stock.

Section 2701

Section 2701 applies in the following circumstances:

- 1. An equity interest in a corporation, partnership or limited liability company is transferred downstream to or for the benefit of certain members of the transferor's family. Such family members include a spouse, a lineal descendant of the transferor and spouse, and a spouse of such lineal descendants. All of these persons are in the same generation as the transferor or "downstream." Gifts to siblings, for example, are not included. §2701(e)(1);**
- 2. An equity interest that is senior (e.g. preferred stock) to the transferred interest is retained by the transferor or by "applicable family members." An "applicable family member" includes the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor. §2701(e)(2). All of these persons are in the transferor's generation or higher.**

Section 2701

Impact of section 2701:

After the transfer of the interest by gift, if the transferor or “applicable family members” have certain rights, identified as a right to receive a “qualified payment,” then section 2701 will not apply. If the transferor or “applicable family members” do not have a right to receive a “qualified payment,” then section 2701 will apply.

If section 2701 applies to a transfer, the value of the gifted property will not be reduced by the value of interests retained by the transferor/donor and applicable family members. Therefore, in effect, for gift tax purposes, the retained interest is valued at zero.

Section 2701

The right to a "qualified payment" is a right to receive a dividend payable on a periodic basis on cumulative preferred stock (or a comparable payment under any partnership interest) to the extent the dividend (or comparable payment) is determined at a fixed rate or bears a fixed relationship to a specified market rate. See §2701(a)(3); §2701(c)(1) and (3). Most commentators conclude that to find a specified market rate, one should use the rates paid on publicly traded preferred stocks.

Therefore, the practical effect of section 2701 is that the corporation or partnership must pay a market-rate dividend or a fixed dividend on the preferred stock (or its equivalent in partnership terms) in order for that stock (or partnership interest) to have any value for gift tax purposes.

Section 2701

For most closely-held businesses, a mandated required payment of a dividend (or partnership equivalent) places too great a burden on the enterprise.

Consequently, the utility of the traditional recapitalization freeze is severely limited. Due to the qualified payment requirements and the complicated rules of 2701, attorneys abandoned the recapitalization freezes.

Revisiting Estate Tax Freezes

1. Horizontal Slice Approach

The classic estate tax freeze was never available to owners of Subchapter S corporations. Subchapter S corporations cannot create preferred stock. S corporations are limited solely to common stock. However, an S corporation can have voting and non-voting common stock as long as the only difference is the voting rights among the shares of common stock (section 1361(c)(4)).

Section 2701(a)(2)(C) specifically provides that section 2701 does not apply to situations where the only difference between the retained interest and the transfer interest is voting rights.

Horizontal Slice Approach

Thus, if an S corporation has voting and nonvoting common stock and the only difference between the two classes of stock is the voting rights, any transfer of the nonvoting stock is not covered by section 2701.

Similarly, if a limited liability company has voting and nonvoting membership interests and the only difference between the two membership interests is the voting rights, any transfer of the nonvoting membership interest is not covered by section 2701.

Horizontal Slice Approach

Example:

In 2012, Meg A. Byte [Meg] owned all of the common stock in Macro Software Design, Inc. [hereinafter MSD]. MSD was extremely successful and the value of the corporation was rapidly increasing each year. MSD is a Subchapter S corporation.

Meg could take the following steps to limit the value of the MSD stock in Meg's estate:

- 1. MSD can be recapitalized tax-free under section 368 of the Code.**
- 2. Under the recapitalization, in exchange for all of her voting common stock of MSD, Meg receives new voting common stock and new non-voting common stock.**

Horizontal Slice Approach

Example (continued):

3. Meg retains the voting common stock and gives the non-voting common stock either to her children or to an irrevocable trust.

4. For gift tax purposes, Meg will no longer be able to discount the value of the gift due to lack of control and lack of marketability.

Meg can employ this same technique for a limited liability company.

Revisiting Estate Tax Freezes

2. Ignore section 2701 and Utilize Maximum Gift Tax Exclusion

Section 2701 has long served as a deterrent to estate tax freezes because it was designed to create a significant gift tax.

The gift tax exclusion was only \$600,000 in 1990. It gradually increased to \$675,000 by 2001. The gift tax exclusion became \$1,000,000 in 2002 and remained at that amount until 2011 when it became \$5,000,000. [Note: a husband and wife have a combined gift tax exclusion of \$10,000,000]. [Presently \$11,180,000 per person].

For planning purposes, a transferor could ignore section 2701 and treat the retained interest as having a zero value for gift tax purposes.

Ignore section 2701 and Utilize Maximum Gift Tax Exclusion

Example 1:

In 2018, Meg A. Byte [Meg] owned all of the common stock in Marco Software Design, Inc. [hereinafter MSD]. MSD is extremely successful and the value of the corporation was rapidly increasing each year. The present value of MSD is \$11,000,000.

As a result of the continuing growth in the value of the corporation, Meg is worried about the constantly increasing value of her MSD stock in her estate. Meg's goal is to limit or freeze the value of her MSD stock for federal estate tax purposes.

Ignore section 2701 and Utilize Maximum Gift Tax Exclusion

The following steps are taken to freeze the value of the MSD stock in Meg's estate:

- 1. MSD is recapitalized tax-free under section 368 of the Code.**
- 2. Under the recapitalization, in exchange for all of her voting common stock of MSD, Meg receives new voting preferred stock and new non-voting common stock. [MSD is not a Subchapter S corporation].**

The preferred stock has a dividend preference but the dividend right is non-cumulative. On liquidation of MSD, the value of the preferred stock is limited to its fair market value as of the date it was created.

Ignore section 2701 and Utilize Maximum Gift Tax Exclusion

In order to minimize the value of the common stock for gift tax purposes, the preferred stock is given additional rights. For example, Meg, as owner of the preferred stock, has the right to “put” the preferred stock to MSD at any time. Since the preferred stock is the only voting stock, the preferred stock is also given the sole right to vote the liquidation of MSD.

3. The plan is for Meg to retain the preferred stock and to give the non-voting common stock either to her children or to an irrevocable trust.

Ignore section 2701 and Utilize Maximum Gift Tax Exclusion

At the time of the gift of the common stock, the value of the common stock is extremely low because of all of the rights of the preferred stock. However, the retained preferred stock violates the requirements of section 2701. Consequently, for gift tax purposes, it has a value of zero.

The gift value of the non-voting common stock that Meg transferred will be \$11,000,000. Since this is the amount of the gift tax exclusion, no gift taxes will be paid. Meg has achieved her goal of freezing the value of the preferred stock in her estate. When Meg dies, the adjusted taxable gift that will be added back to her estate for federal estate tax purposes will be \$11,000,000. Under section 2701(e)(6), the value of the preferred stock in her estate will be reduced by this \$11,000,000.

If Meg dies after 2026 (assuming the sunset provision remains in effect), the estate tax calculation will be as follows:

- 1. Assume at her death the Corporation has increased in value to \$20,000,000. Of this amount, the value of the preferred stock has increased from \$11,000,000 to \$13,000,000. Consequently, the non-voting common is now worth \$7,000,000.**
- 2. The gift tax exclusion at the date of the gift was \$11,000,000. The gift tax exclusion at death was \$5,500,000.**
- 3. Section 2001(b) calculation:**

Taxable estate [preferred stock \$13,000,000 - \$11,000,000 adjustment under section 2701(e)(6) = \$2,000,000] plus adjusted taxable gifts (\$11,000,000) = \$13,000,000; Tentative tax on \$13 million = \$345,800 + (40% x \$12,000,000 = \$4,800,000) = \$5,145,800. [Tentative Tax]

Calculate and subtract the “aggregate amount” under section 2001(b)(2) using the gift tax exclusion at death (\$5,500,000). The adjusted taxable gift (\$11,000,000) at the tax rate at death = [\$345,800 + 40% x \$10,000,000 = 4,345,800] - (credit [exclusion amount \$5,500,000] at date of death = 345,800 + 40% of \$4,500,000= 2,145,800) = 2,200,000. Therefore under section 2001(b)(2) the “aggregate amount” would be \$2,200,000.

Estate Tax = \$5,145,800. (tentative tax) - \$2,200,000 (section 2001(b)(2) gift tax adjustment) - \$2,145,800 (unified credit amount on \$5,500,000) = \$800,000.

VARIATION 1

Meg does not make any gift during life. The value of the stock at death is \$20,000,000.

Taxable estate [only common stock \$20,000,000 plus adjusted taxable gifts (\$0) = \$20,000,000; Tentative tax on \$20 million = \$345,800 + (40% x \$19,000,000 = \$7,600,000) = \$7,945,800.

[Tentative Tax]

Under section 2001(b)(2) the “aggregate amount” would be \$0.

Estate Tax = \$7,945,800. (tentative tax) - \$2,145,800 (unified credit amount on \$5,500,000) = \$5,800,000.

VARIATION 2

The facts are the same as Example 1 except the estate and gift tax exclusion always remains at \$11,000,000.

Taxable estate [preferred stock \$13,000,000 - \$11,000,000 adjustment under section 2701(e)(6) = \$2,000,000] plus adjusted taxable gifts (\$11,000,000) = \$13,000,000; Tentative tax on \$13 million = \$345,800 + (40% x \$12,000,000 = \$4,800,000) = \$5,145,800. [Tentative Tax]

Calculate and subtract the “aggregate amount” under section 2001(b)(2) using the gift tax exclusion at death (\$11,000,000). The adjusted taxable gift (\$11,000,000) at the tax rate at death = [\$345,800 + 40% x \$10,000,000 = 4,345,800] - (credit [exclusion amount \$11,000,000] at date of death = 345,800 + 40% of \$10,000,000 = 4,000,000) = 4,345,800. Therefore under section 2001(b)(2) the “aggregate amount” would be \$0.

Estate Tax = \$5,145,800. (tentative tax) - \$0 (section 2001(b)(2) gift tax adjustment) - \$4,345,800 (unified credit amount on \$11,000,000) = \$800,000.

VARIATION 3

The facts are the same as Example 1 except the gift tax exclusion is \$11,000,000 at the date of gift must be used. The gift tax exclusion is \$5,500,000 at death. The IRS rules under section 2001(g)(2) that to compute the aggregate amount under section 2001(b)(2), the gift tax exclusion at the date of the gift must be used.

Taxable estate [preferred stock \$13,000,000 - \$11,000,000 adjustment under section 2701(e)(6) = \$2,000,000] plus adjusted taxable gifts (\$11,000,000) = \$13,000,000; Tentative tax on \$13 million = \$345,800 + (40% x \$12,000,000 = \$4,800,000) = \$5,145,800. [Tentative Tax]

Calculate and subtract the “aggregate amount” under section 2001(b)(2) using the gift tax exclusion at death (\$11,000,000). The adjusted taxable gift (\$11,000,000) at the tax rate at death = $[\$345,800 + 40\% \times \$10,000,000 = 4,345,800]$ - (credit [exclusion amount \$11,000,000] at date of death = $345,800 + 40\%$ of $\$10,000,000 = 4,000,000$) = 4,345,800. Therefore under section 2001(b)(2) the “aggregate amount” would be \$0.

Estate Tax = \$5,145,800. (tentative tax) - \$0 (section 2001(b)(2) gift tax adjustment) - \$2,145,800 (unified credit amount on \$5,500,000) = \$3,000,000.

In this case, the 2,000,000 of appreciation in the preferred stock plus \$5,500,000 of the lifetime gift is being taxed

Ignore section 2701 and Utilize Maximum Gift Tax Exclusion

Meg can employ this same technique for a limited liability company. She can create 2 classes of membership interest. One class will be similar to the preferred stock and the second will be similar to the non-voting common stock.