Proposed Regulations Issued for Estate "Freezes"

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controlled entity. Certain rights, such as a right to receive a conversion right, or (2) a distribution right in a family that confers (1) a discretionary liquidation, put, call or extraordinary payment right (such as the right to compel liquidation), the rights are valued on the assumption that each right will be exercised in a manner that results in the lowest total value for all of the rights.

The proposed regulations generally follow the statute, see 1 Ag. Law Digest 232 (1990), in providing for the valuation of reacquired property through foreclosure).

FOOTNOTES

3 See notes 6-18 infra.
4 See I.R.C. § 166.
7 Treas. Reg. § 1.166-1(c).
8 See Cole v. Comm'r, T.C. Memo. 1987-228 (bad debt deduction not allowed where creditor failed to demonstrate that debtor had insufficient equity in assets to pay debt); Hill v. Comm'r, T.C. Memo. 1987-424 (bad debt deduction not allowed where general partner failed to prove worthlessness of advances made to partnership or that partnership insolvent and made no demand for payment).
9 Treas. Reg. § 1.166-2(c).
10 Treas. Reg. § 1.166-2(b).
11 I.R.C. § 166(a)(1).
12 Treas. Reg. § 1.166-3.
13 Treas. Reg. § 1.166-3(b).
14 See I.R.C. § 166(a).
15 See In re Farrington, 90-1 U.S.T.C. § 50,125 (N.D. Okla. 1990) (debtor in bankruptcy entitled to business bad debt reduction for advances to corporation of which taxpayer was 49 percent shareholder; debtor's activities more extensive than those of most shareholders).
16 I.R.C. § 166(d)(1).
17 I.R.C. § 166(d)(2).
18 Treas. Reg. § 1.166-5(a).
19 I.R.C. § 166(d)(1)(B). Losses are reported on Schedule D, Form 1040.
20 See I.R.C. § 166(d)(2).
21 I.R.C. § 166(f), before amendment by Tax Reform Act of 1976, Sec. 605(c), Pub. L. 94-455.
22 Id.
23 I.R.C. § 166(d)(2).
25 I.R.C. § 166(d)(2).
26 See Barnes v. Comm'r, 801 F.2d 984 (9th Cir. 1987), aff'g, T.C. Memo. 1985-456 (payment of guaranteed debt on behalf of taxpayer's corporation qualified only as nonbusiness bad debt where tax-payer incurred obligation in capacity as shareholder).
27 Ltr. Rul. 7953004, Sept. 7, 1979;
28 Ltr. Rul. 7953004, Sept. 7, 1979;
30 Id.

PROPOSED REGULATIONS ISSUED FOR ESTATE "FREEZES"

by Neil E. Harl

The repeal of I.R.C. § 2036(c) in 1990 as part of the Revenue Reconciliation Act of 1990 was accompanied by enactment of rules shifting estate freezes away from federal estate tax and toward the federal gift tax arena. Proposed regulations have now been issued for the statute, I.R.C. § 2701-2704. 56 Fed. Reg. 14322 (April 9, 1991).

The proposed regulations generally follow the statute, see 1 Ag. Law Digest 232 (1990), in providing for the valuation of retained or residual interests which are obtained by first establishing the value of preferred interests and subtracting that value from the overall value of the partnership, corporation or other business enterprise. However, in several notable instances, the proposed regulations provide important additional guidance for planners:

• Generally, an applicable retained interest is any interest that confers (1) a discretionary liquidation, put, call or conversion right, or (2) a distribution right in a family controlled entity. Certain rights, such as a right to receive a mandatory payment that is fixed as to time and amount are treated as neither an extraordinary payment nor a distribution right. Prop. Treas. Reg. § 25.2701-2(b)(4). If a qualified payment right (generally a right to a fixed-rate cumulative dividend payable on a periodic basis or the partnership equivalent) is held in conjunction with an extraordinary payment right (such as the right to compel liquidation), the rights are valued on the assumption that each right will be exercised in a manner that results in the lowest total value for all of the rights. Prop. Treas. Reg. § 25.2701-2(a)(3).

• The amount of an individual's gift is determined using the subtraction method of valuation. Prop. Treas. Reg. § 25.2701-3(a). The value of senior interests (including applicable retained interests) is subtracted from the value of the entire entity to determine the value of junior interests such as common stock. Id. Proposed regulations prescribe a three step method for applying the subtraction method--

The valuation of the various classes of equity interests must be made using a consistent set of assumptions.

(2) Reduce the value of the entity determined in the first step by the sum of the fair market value of all senior equity interests held by non-family members and by the sum of the values of the family-held senior equity interests. Prop. Treas. Reg. § 25.2701-3(b)(2). A special adjustment is provided in this step to avoid attributing value to a transferred interest that will not inure to equity interests held by family members.

(3) Reduce the amount determined in step 2 by the sum of the fair market values of the family held junior equity interests. Prop. Treas. Reg. § 25.2701-3(b)(3). The balance is then allocated among the transferred interests and other interests of the same class or subordinate classes held by the family.

A minimum value rule provides a floor on the value of junior equity. I.R.C. § 2701(a)(4). Prop. Treas. Reg. § 25.2701-3(c). The value of the junior equity must be not less than 10 percent of the sum of total equity in the entity, plus debt owing to the transferor and applicable family members. Prop. Treas. Reg. § 25.2701-3(c)(1). Indebtedness incurred for current operating expenses is not indebtedness for this purpose. Prop. Treas. Reg. § 25.2701-3(c)(2). A lease of property is not indebtedness without regard to the length of the lease term, if the lease payments are made on a current basis and represent full and adequate consideration for use of the property. Id. A lease is considered for full and adequate consideration if a good faith effort is made to determine the fair rental value under the lease and the terms of the lease conform to the value so determined. Proposed regulations adopt the statutory definition of a junior equity interest in a partnership (junior as to income and capital). Prop. Treas. Reg. § 25.2701-3(c)(1).

• An individual may elect to treat a payment that is not a qualified payment as a qualified payment. Prop. Treas. Reg. § 25.2701-2(c)(1). If such an election is made, the value of the right under the election cannot exceed the fair market value of the right determined without regard to the election. Taxpayers are allowed to make "partial" elections with respect to otherwise non-qualifying distribution rights. Id. The portion of the qualified payment that is valued under a partial election must meet all of the requirements of a qualified payment (amounts must be payable periodically and no less frequently than annually).

An individual is permitted to elect out of qualified payment treatment. A partial election out may be made but a partial election out must be made as to a consistent portion of every qualified payment. Prop. Treas. Reg. § 25.2701-2(c)(1).

Without an election out, applicable family members who hold qualified payment rights are subject to the valuation rules even though they have made no transfer and may not be aware that a transfer has been made. The individuals are then subject to the compounding rule for missed payments, thus potentially increasing their future gift and estate tax liability.

To avoid this result, the proposed regulations consider an applicable family member as having elected not to treat payments as qualified payments unless a statement signed by the individual is attached to the transferor's gift tax return affirmatively electing to treat the payments as qualified payments. Prop. Treas. Reg. § 25.2701-2(c)(4).

For purposes of determining whether an entity is a controlled entity, the proposed regulations attribute to an individual only those interests held by lineal descendants of the parents of the individual and spouse. Prop. Treas. Reg. § 25.2701-2(b)(5).

A contribution to capital or a recapitalization, redemption or other change in capital structure is treated as a transfer if the transferor or an applicable family member receives an applicable retained interest as a result of the transaction. Prop. Treas. Reg. § 25.2701-2(b)(2).

The proposed regulations treat similar transactions as transfers if the transferor or an applicable family member otherwise holds an applicable retained interest after the transaction and, as a result of the transaction, either the individual receives additional property or the value of the applicable retained interest already held by that individual increases. A contribution to a start-up entity is treated as a transfer because creation of a new entity presents the same opportunities for transferring wealth as a contribution to an existing entity.

• The freeze valuation rules do not apply—
  (1) if there are readily available market quotations on an established securities market for the value of the transferred interest;
  (2) to retained interests if there are readily available market quotations on an established market for the value of the applicable retained interest;
  (3) if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportionally the same as the class of the transferred interest; or
  (4) if the transfer results in a proportionate reduction of each class of equity interest held by the transferor and all applicable family members in the aggregate immediately before the transfer. Prop. Treas. Reg. § 25.2701-1(c).

• Retained interests in trust or term interests in property generally are valued at zero for federal gift tax purposes unless in the form of an annuity or unitrust interest. I.R.C. § 2702(a). An exception is provided in the proposed regulations for transfers of an interest in trust to a family member if the remainder interest in the trust qualifies for the federal gift tax charitable deduction. Prop. Treas. Reg. § 25.2702-1(c)(3). A transfer in trust is not subject to the valuation rules if the only property held in the trust is a personal residence of the term holder. A "qualified personal residence trust" provides additional flexibility. Prop. Treas. Reg. § 25.2702-5(e). The term personal residence is defined to mean the principal residence and one other residence of the term holder consistent with the principles of I.R.C. § 163(h). Prop. Treas. Reg. § 25.2702-5(c).

• Relative to buy-sell agreements, 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 the property to members of the decedent's family for less than full and adequate consideration; or
(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. I.R.C. § 2703(b). Prop. Treas. Reg. § 25.2703-1(b)(1).

The Conference report indicates that it is not the intent that a buy-sell agreement be ignored merely because its terms differ from those used by another, similarly situated firm. General business practice may recognize more than one valuation approach even within the same industry. A binding agreement exclusively among persons who are not natural objects of each other's bounty meets the above three requirements. Prop. Treas. Reg. § 25.2703-1(b)(3). A right or restriction is comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business. Prop. Treas. Reg. § 25.2703-1((b)(4).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

AGRICULTURAL LABOR
EMPLOYER LIABILITY. The plaintiff was the grandson of the defendant and worked on the defendant's dairy farm as a laborer. The plaintiff was injured while chasing a stray calf and sued the defendant for failure to warn of a dangerous condition. The court reversed the trial court's directed verdict for the defendant and held that a directed verdict was improper because there was evidence that the defendant knew about the dangerous condition, a fallen fence rail, and did not fix the condition. Evidence of the plaintiff's contributory negligence presented a jury question and could not be used to support a directed verdict. McCord v. McCord, 575 So.2d 1056 (Ala. 1991).

BANKRUPTCY
GENERAL
AVOIDABLE LIENS. The debtors sought to avoid a judicial lien against their homestead except to the extent of any equity remaining after the mortgage and the claimed exemption. The lienor argued that the lien was avoided only to the extent the lien impaired the exemption. The court held that the lien was avoided only to the extent the claimed exemption was impaired. In re Sanglier, 124 B.R. 511 (Bankr. E.D. Mich. 1991).

The debtor sought to avoid a judicial lien which was senior to a federal tax lien as impairing the homestead exemption. The debtor argued that under Section 724(b)(1), the judicial lien was junior to the tax lien because the judicial lien was avoidable. The court held that the seniority status of the judicial lien over the tax lien was not affected by the avoidability of the judicial lien unless the lien was actually avoided. Because the judicial lien did not impair the homestead exemption when considered in its priority status, the judicial lien remained senior to the tax lien. In re Spearman, 124 B.R. 620 (E.D. N.Y. 1991).

AVOIDABLE TRANSFERS. The pre-petition foreclosure sale of the debtor's homestead was held to be avoidable where the sale was not recorded until after the debtor filed Chapter 7 bankruptcy. In re Williams, 124 B.R. 311 (Bankr. C.D. Cal. 1991).

After being granted relief from the automatic stay, a secured creditor obtained foreclosure and sale of the debtors' farm. The creditor sought further relief from the stay when the debtors refused to relinquish possession of the farm. The court held that the Bankruptcy Court could not relitigate the reasonableness of the sale price and granted relief from the stay. Farm Credit Bank of Omaha v. Franzen, 926 F.2d 762 (8th Cir. 1991).

Within three months prior to filing bankruptcy, the debtor transferred the debtor's one-half interest in the homestead to the debtor's nondebtor spouse. The court held that the transfer was avoidable where the debtor was insolvent at the time of the transfer and the transfer was made without consideration. In re Osbourne, 124 B.R. 726 (Bankr. W.D. Ky. 1989).

DISCHARGE. The debtor's debt to the seller of a combine was held nondischargeable where the debtor listed a positive net worth of $1 million on the financial statement but nine days later listed a negative net worth of $-1.4 million on the bankruptcy schedules. The creditor was held to have reasonably relied on the financial statement in making the purchase loan. In re Myers, 124 B.R. 735 (Bankr. S.D. Ohio 1991).

ESTATE PROPERTY. The court held that the debtor's property subject to the PACA trust was not included in the bankruptcy estate. Asinelli, Inc. v. Dole Fresh Fruit Co., 47 Agric. Dec. 1720 (Bankr. M.D. N.C. 1988).

EXCEPTIONS. The debtors claimed as exempt the proceeds of milk sales still held by a third party. The trustee failed to object to the exemption within the time allotted by Rule 4003(b) but brought a late objection. The court held that where an objection is filed late, the exemption would be allowed if the debtor had a good faith statutory basis for the exemption. The court held that the debtors' exemption was not allowable under any statutory exemption and disallowed the exemption of the milk proceeds. In re Kingsbury, 124 B.R. 146 (Bankr. D. Me. 1991).

The debtors were allowed an exemption, under Tex. Ins. Code art. 21.22, § 1, for an uninsured/underinsured motorist's claim against their insurance company. In re Hosek, 124 B.R. 239 (Bankr. W.D. Tex. 1991).

In pre-bankruptcy planning, the debtor purchased a life insurance policy, a baby grand piano and a harpsichord, although the debtor did not play the instruments. The trustee objected to the debtor's claimed exemptions in the

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