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THE APPLICABILITY OF SECTION 2036(a) TO RETAINED VOTING RIGHTS DEVICES AFTER THE TAX REFORM ACT OF 1976

Section 2036 of the Internal Revenue Code of 1954 provides that in certain situations the gross estate of a decedent shall include the value of property which the decedent transferred prior to his death. Thus, if the decedent has retained interest in the transferred property for his lifetime, or for a period not ascertainable without reference to his death, or for a period of time which does not in fact end before his death, the property is included in his gross estate under section 2036. Additionally, if the decedent retains the right to possess or enjoy the property or its income, or to designate possession or enjoyment of the property or its income, the property will become part of the decedent's gross estate.[1]

One controversy surrounding section 2036 has been the question of its applicability to the retention of voting control of transferred stock. The position of the Internal Revenue Service has been that the retained voting control of stock constitutes enjoyment of the property for purposes of section 2036 and that the value of the transferred shares therefore should be included in the decedent's gross estate.[2] However, taxpayers have taken the position that the retention of the voting rights in transferred stock is not a situation within the purview of section 2036.

In 1972, the Supreme Court considered this issue in *United States v. Byrum*.[3] There, the grantor had transferred to trusts the shares of three closely held corporations, but had retained the voting rights to the shares. The Court sustained the taxpayer's position that he no longer "enjoyed" the shares for estate tax purposes, and held that the value of the transferred shares was not includible in the taxpayer's estate under section 2036.[4] In response to this decision, Congress amended section 2036. The amendment, part of the Tax Reform Act of 1976, simply reads:

> [T]he retention of voting rights in [transferred][5] stock shall be considered to be a retention of the enjoyment of such stock.

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[1] Section 2036(a) provides in full:

> (a) GENERAL RULE—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.
>
> For purposes of paragraph (1), the retention of voting rights in retained stock shall be considered to be a retention of the enjoyment of such stock.

The last sentence was added as part of the Tax Reform Act of 1976.

[2] Rev. Rul. 67-54, 1967-1 C.B. 269.

[3] 408 U.S. 125 (1972).

[4] *Id.* at 143-44, 150.

[5] The amendment actually speaks of the retention of voting rights in "retained stock." However, "retained" is a clerical error and probably should read as "transferred." *See* Gaubatz, *The Non-Taxation of Nontestamentary Acts: Will* Byrum *Survive the Tax Reform Act of 1976?*, 27 CASE W. RES. L. REV. 623, 624 n.4 (1977); H.R. REP. NO. 1380, 94th Cong., 2d Sess. 65, [1976] U.S. CODE CONG. & AD. NEWS 3418.

However, the effectiveness of the amendment as a prohibition against tax avoidance devices similar to the one used by the settlor in *Byrum* is unclear.

This article will begin by tracing the development of various devices used prior to 1976 by controlling shareholders in closely held corporations to avoid the usual negative estate tax consequences occurring after the transfer of their corporate equity and the retention of their corporate control. The Supreme Court case of *U.S. v. Byrum,* which authorized the use of one of these avoidance devices, will be analyzed, and the express congressional response to the *Byrum* holding—the 1976 amendment to section 2036—will be examined. Several of the avoidance devices used successfully by taxpayers before the 1976 amendment to section 2036 will then be reexamined in light of that amendment. Finally, the article will present some judicially untested devices which may be successful in avoiding section 2036 tax consequences, notwithstanding the 1976 addition to that section.

I. RETENTION OF VOTING RIGHTS CASES PRIOR TO THE TAX REFORM ACT OF 1976

In *United States v. Byrum,* the Supreme Court dealt with the issue of whether transferred stock, in which the grantor had retained voting rights, was includible in his gross estate under section 2036.[6] In that case the decedent, Byrum, transferred shares in three closely held corporations to an irrevocable trust for the benefit of his children, or if they died before the termination of the trust, for the benefit of their surviving children. The trust agreement named a bank as the sole trustee and vested it with broad and detailed powers to control and manage the trust property.[7] However, the trustee only could exercise these powers subject to certain rights which Byrum had reserved. Byrum reserved the right to vote the shares of the transferred stock; to disapprove the sale or transfer of any trust assets, including the shares transferred to the trust; to approve investments and reinvestments; and to remove the trustee and designate another corporate trustee to serve as successor.[8]

At the time of his death, Byrum had the right to vote at least 71% of the common stock of each corporation. Byrum's voting rights stemmed from voting stock which he had not transferred to the trust and from the voting rights which he had retained in the stock which he had transferred. The government argued that the transferred stock should be included in Byrum's gross estate, basing its position on two separate subsections of section 2036(a). The government's primary contention was that under section 2036(a)(2) Byrum had retained the right to designate enjoyment of the income from the transferred stock.[9] In summarizing the government's 2036(a)(2) argument, the Court stated:

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[6] 408 U.S. 125, 131 (1972).

[7] *Id.* at 126-27.

[8] *Id.* at 127.

[9] *Id.* The Government cited United States v. O'Malley, 383 U.S. 627 (1966), as authority for including the shares in Byrum's gross estate under § 2036(a)(2). In *O'Malley,* the settlor of five inter vivos trusts named himself as one of three trustees. Under the trust agreement, the trustees were given the sole discretion either to pay income to the life beneficiary or to accumulate it as part of the principal. The trust instrument provided that undistributed net income in any calendar year became part of trust principal. The Supreme Court held that under § 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939, the predecessor of section

> The argument is a complicated one. By retaining voting control of the corporation whose stock was transferred, Byrum was in a position to select the corporate directors. He could retain this position by not selling the shares owned and by vetoing any sale by the trustee of the transferred shares. These rights, it is said gave him control over corporate dividend policy. By increasing, decreasing, or stopping dividends completely, it is argued that Byrum could "regulate the flow of income to the trust" and thereby shift or defer the beneficial enjoyment of the trust income between the present beneficiaries and the remaindermen. The sum of this retained power is said to be, tantamount to a grantor-trustee's power to accumulate income in the trust, which this Court has recognized constitutes the power to designate the persons who shall enjoy the income from the transferred property.[10]

Alternatively, the government argued that under section 2036(a)(1) Byrum had retained "enjoyment" of the transferred stock because his retained control resulted in his being guaranteed continued employment and remuneration, and in his having the right to determine when, if at all, the corporation would be liquidated or merged.[11]

The Supreme Court rejected both of the government's contentions. As to the section 2036(a)(2) claim, the right to designate enjoyment claim, the Supreme Court concluded that Byrum did not retain such a right and that, therefore, the transferred shares were not includible in his gross estate.[12] A significant portion of the Court's opinion discussed the difference between a "power" to designate enjoyment and the "right" to do so. The Court defined "right" as something legally enforceable and concluded that there was no such "right" to designate enjoyment retained in the trust instrument.[13] The Court reasoned that Byrum's power to select corporate directors, and thus to control dividend policy did not confer any legal right to command the directors to pay or not to pay the dividends.[14] Hence, the Court concluded that Byrum retained only a "power" and not a legally enforceable "right" within the meaning of section 2036(a)(2).

The Court was influenced in its "right to designate" decision by Byrum's fiduciary duty as the majority shareholder not to misuse his power to promote his own interests at the expense of the corporate welfare.[15] The Court pointed out that the directors of the corporations also had a fiduciary duty to all the shareholders which was unrelated to the needs of the trust or to the desires of Byrum.[16] The Court noted that there was a

2036(a)(2), the accumulated income from the transferred property was includible in the grantor's gross estate. *Id.* at 634. The Court reached its conclusion by reasoning that because he had retained a power, as one of 3 trustees, to accumulate or distribute income, the grantor had retained the right to designate enjoyment of the property within the meaning of the statute. *Id.*

[10] *Id.* at 132.

[11] *Id.* at 145.

[12] *Id.* at 143-44.

[13] *Id.* at 136-37.

[14] *Id.* at 137.

[15] *Id.*

[16] *Id.* at 138.

substantial number of minority shareholders who would have a cause of action under state law had Byrum or the directors violated their fiduciary duty.[17] Hence, based on the fact that Byrum had a fiduciary duty not to put his own interest above those of the corporation, and also that the directors had a similar duty, the Supreme Court concluded that Byrum's power to control the board of directors did not result in a legally enforceable right to designate enjoyment.[18]

Based on these considerations the Court arrived at its holding: "We conclude that Byrum did not have an unconstrained defacto power to regulate the flow of dividends to the trust, much less the 'right' to designate who was to enjoy the income from trust property."[19]

Having concluded that Byrum had not retained a section 2036(a)(2) right to designate enjoyment, the Court next rejected the government's contention that Byrum had retained a section 2036(a)(1) "enjoyment" of the property. The Court determined that "enjoyment" as a term in a tax statute connotes "substantial present economic benefit."[20] Applying this standard to Byrum, the Court found that the taxpayer had retained no "substantial present economic benefit." The Court viewed the power to liquidate or merge as contingent and speculative and, therefore, not a present benefit.[21] The Court spoke of Byrum's continued employment and compensation as inevitable for the controlling shareholder in a closely held corporation[22] and hence not a result of his retention of voting rights in transferred stock. In the Court's view, therefore, neither of these factors constituted section 2036(a)(1) "enjoyment" of the transferred property.[23]

As a final point on the issue of enjoyment the Court noted that Byrum had never transferred control of the corporations since the trust to which he had given the stock did not own 50% of the stock of any of the corporations.[24] The Court stated that at his death Byrum owned a majority of the shares in one corporation, and probably could have exercised control

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[17] *Id.* at 142.

[18] *Id.* at 136-37. In further support of its decision, the Court observed that practical difficulties prevented Byrum's power over dividend policy from being considered a right to designate enjoyment. The Court reasoned that the three companies Byrum controlled were subject to the usual economic and business fluctuation experienced by small businesses. The Court enumerated the customary fluctuations as bad years, product obsolescence, new competition, damaging litigation, new inhibiting government regulations and bankruptcy. *Id.* at 139. Hence, there was no certainty of a flow of earnings available for dividends. *Id.* Moreover, the Court noted that even if the earnings were available for dividends and Byrum could flood the trust with income, he had no way to force the trustees to pay it out rather than to accumulate it. *Id.* at 143. In light of these practical difficulties, the Court refused to conclude that Byrum's power constituted a section 2036(a)(2) right to designate enjoyment. *Id.* at 143-44.

[19] *Id.*

[20] *Id.* at 145. The *Byrum* Court cited Commissioner v. Estate of Holmes, 326 U.S. 480 (1946), in which the Supreme Court stated that "enjoy" and "enjoyment" as used in tax statutes are not terms of art but connote "substantial present economic benefit rather than technical vesting of title or estates." 408 U.S. at 486. The *Byrum* Court also interpreted section 2036 as contemplating a "retention of an attribute of the property transferred." *Id.* at 149. The Court listed as "attributes" the right to income, the use of the property, or a power of appointment with respect to either income or principal. *Id.* The Court apparently did not consider voting rights as an attribute of the property.

[21] *Id.* at 149-50.

[22] *Id.* at 150.

[23] *Id.*

[24] *Id.* at 148.

of the other two corporations because of his large stockholdings.[25] Accordingly, since Byrum did not transfer corporate control, the Court concluded that his retention of voting power did not amount to section 2036(a)(1) enjoyment.[26] As a result of the *Byrum* Court's analysis of section 2036, the retention of voting rights by the grantor in his individual capacity resulted neither in a section 2036(a)(1) retention of enjoyment nor a section 2036(a)(2) right to designate enjoyment.[27]

The Supreme Court's decision in *Byrum* was important because it authorized a taxpayer to retain control over a closely held corporation while simultaneously transferring estate tax liability for the value of the controlled shares. The significance of *Byrum* was heightened when the Tax Court, relying heavily on that case, approved another device designed to separate the control of a closely held corporation from the estate tax liability usually accompanying that control.

Estate of Gilman v. Commissioner[28] was decided in 1975, three years after *Byrum*. In *Gilman* the decedent transferred six of ten shares of corporate voting stock to a trust for the benefit of his sons[29] but continued to be employed by the corporation after he transferred the stock. The trust indenture provided that there be three trustees, and that their acts and decisions be by majority vote.[30] The trustees were given broad managerial and investment powers, including the right to vote the stock held in trust.[31] The decedent-settlor was one of the three trustees and in this position could exercise a degree of control over the transferred stock. The Tax Court held that the value of the stock was not includible in the decedent's gross estate under either subsection (a)(1) or subsection (a)(2) of section 2036.[32]

The court gave two reasons for its section 2036(a)(1) "retention of enjoyment" holding. First, the court concluded that the decedent Gilman had not retained "enjoyment" under the transfer.[33] The court noted that a retention of enjoyment "under" the transfer is required by section 2036(a)(1).[34] Gilman's continued employment as chief executive, the court

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[25] *Id.* at 149.

[26] *Id.* at 150.

[27] Justice White wrote a dissenting opinion in *Byrum*, in which Justices Brennan and Blackmun joined. *Id.* at 151. The dissent stated that Byrum did retain section 2036 enjoyment because he had majority control of two corporations whose stock he had transferred to the trust, and used this control to remain in salaried positions in both corporations. *Id.* at 151-52. The dissent also reasoned that section 2036 was applicable because Byrum had control over which trust beneficiaries, life tenants or remaindermen, would receive the benefit of trust income. *Id.* at 152.

[28] 65 T.C. 296 (1975), *aff'd per curiam*, 547 F.2d 32 (2d Cir. 1976).

[29] The remaining four shares of corporate voting stock were owned by the decedent's sisters.

[30] 65 T.C. at 300. The decedent retained the right during his lifetime to appoint successor trustees, but he never exercised this power. *Id.*

[31] *Id.* "The trustees were given broad management and investment powers, including full 'power and authority to grant, bargain, sell, assign, transfer and convey all or any part of the trust estate.' Included among these management powers was the right to vote the stock held in trust." *Id.* quoting the trust indenture.

[32] *Id.* at 306.

[33] *Id.*

[34] Treas. Reg. § 20.2036-1(a)(ii). "An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred."

reasoned, was not a right retained "under" the transfer since he did not reserve a right in the trust instrument to continue to serve; there was just a mere probability of his doing so. This "mere probability," in the court's view, did not constitute substantial enjoyment within the meaning of section 2036(a)(1).[35]

As a second ground for its section 2036(a)(1) holding, the court relied on *Byrum* in concluding that Gilman's retention of voting rights as one of three trustees did not constitute section 2036 enjoyment of the transfered property. The court reasoned that Byrum's retention of voting rights in his individual capacity certainly gave him more control over the transferred shares than did Gilman's retention of voting rights as only one of three trustees. Since the Supreme Court had held that Byrum's retained powers did not constitute section 2036 enjoyment, the court reasoned that neither was Gilman's retention of a lesser power such an enjoyment.[36]

The *Gilman* court also relied on *Byrum* in concluding that Gilman had not retained a section 2036(a)(2) right to designate enjoyment. The court noted that the *Byrum* Court had viewed the ability to control corporate dividend policy as a "power" and not as a section 2036(a)(2) "right."[37] On that basis the *Gilman* court held that the decedent's power to control corporate dividend policy did not constitute a section 2036(a)(2) right to designate enjoyment.[38]

Gilman was a significant case in that the Tax Court rejected the government's position that a retention as minority trustee of voting rights in transferred stock constituted section 2036 enjoyment. In so doing, the Tax Court demonstrated that it intended to follow strictly the Supreme Court's decision in *Byrum*.[39]

McNichol's Estate v. Commissioner, 265 F.2d 667 (3d Cir.), *cert. denied*, 361 U.S. 829 (1959), states that for section 2036(a)(1) to apply the enjoyment of the transferred property must be reserved "in connection with or as an incident to the transfer." 265 F.2d at 670.

[35] 65 T.C. at 312. The court also rejected the government's contention that Gilman retained enjoyment because the Tax Court had determined that his salary was excessive in one year. The amount of the salary that was later determined to be excessive approximated a dividend that Gilman had waived that year. The court noted that this would have been advantageous to the corporation since salary payments are deductible and dividends are not. Therefore, the payment of this excess salary did not show that Gilman could exploit the company at will. *Id.* at 314. The court said this was so even though the attempt to benefit the corporation was unsuccessful. *Id.* This appears to be dubious reasoning since the corporation was not, in fact, benefitted. Significantly, the corporation did not recover the excess salary from Gilman. The court also pointed out that the excessive salary in only one year was aberrational, and did not support the government's argument. *Id.* at 313-14.

In one year the IRS assessed the corporation an accumulated earnings tax, that is, a tax on retained earnings considered excessive for corporate purposes. The court also held that the failure of the corporation to recoup this accumulated earnings tax liability from the decedent's estate did not show that Gilman retained enjoyment of the transferred stock since such a recoupment claim is highly unusual. *Id.* at 315.

[36] *Id.* at 310.

[37] See text at note 11 *supra*.

[38] *Id.* at 316-17. Following the rationale in *Byrum*, the *Gilman* court also mentioned Gilman's fiduciary duty to the other shareholders as a further reason for holding that Gilman did not retain a section 2036 "right." *Id.* at 317. Similarly, the court was influenced by the fact that Gilman was outvoted on dividend policy in three years. *Id.*

[39] *See generally* Pressment, *Effect of Tax Court's* Gilman *Decision on Estate Planning for the Close Corporation*, 44 J. TAX 160 (1976).

Although *Byrum* and *Gilman* dealt with the formal retention of voting rights, taxpayers also used the device of informal retention of voting rights to avoid the application of section 2036. The Tax Court treated this issue in *Estate of Beckwith v. Commissioner.*[40]

In *Beckwith*, the decedent owned no stock at his death, but proxies received from a trust he settled allowed him to control a corporation.[41] The government argued that the decedent had informally retained enjoyment under section 2036 since he annually received proxies from the transferred stock. The Tax Court held that the value of the trust was not includible in Beckwith's gross estate because he did not retain a right to designate enjoyment within the meaning of section 2036(a)(2).[42] The court noted that in order for section 2036 to apply, the grantor must retain a right "under the transfer."[43] While the court determined that the grantor need not expressly retain a legally enforceable right at the time of the transfer, it concluded that the statute suggests the need for a pre-arrangement, or at least an informal understanding at the time of the transfer under which the right is retained.[44] The court did not find such an agreement in *Beckwith*, but rather found that the proxies were given voluntarily to Beckwith each year by the trustees.[45] Therefore, since there was no retention of a right at the time of the transfer, the court held that section 2036 did not operate to include the stock in Beckwith's estate.

The *Byrum, Gilman* and *Beckwith* decisions all allowed controlling shareholders in closely held corporations to enjoy corporate control and estate tax advantages. Retention of voting rights in the transferred stock resulted in both the grantor's continued control of the corporation and the removal of the transferred stock from his gross estate. The *Byrum* decision was especially controversial and prompted a number of criticisms of the Court's rationale and holding.[46] The decision in *Byrum* allowed controlling stockholders in closely held corporations to continue to vote shares that were transferred to a trust, and to avoid federal estate taxes on these shares. This result prompted the 1976 Amendment to section 2036.[47]

[40] 55 T.C. 242 (1970).

[41] *Id.* at 245. Beckwith had the legal right to vote 15% of the stock under a trust created by his wife, and 22% of the stock under a revocable trust which he created. He was able to vote another 39% of the stock, the stock in controversy here, by proxies received annually from the trustees of a trust Beckwith had settled.

[42] *Id.* at 248.

[43] See note 32 *supra.*

[44] *Id.* at 247-48.

[45] *Id.* at 250-51.

[46] The Court was criticized for its reliance on the fact that Byrum was restrained by a fiduciary duty. This restraint was said to be not as limiting as the Court had suggested because derivative suits by minority shareholders to compel dividend distribution have little chance of success and are not a realistic threat. Note, 14 B.C. IND. & COM. L. REV. 1091, 1100 (1973). The *Byrum* Court was also criticized for not finding that the retention of voting rights was a retention of enjoyment. It was asserted that this retention allowed Byrum to retain economic benefits and enjoyment of the trust assets. Note, 46 TUL. L. REV. 1038, 1040 (1972). One commentator noted that closely held corporations do not ordinarily pay significant dividends, but that voting rights are very important because they allow corporate control. Therefore, the retention of voting rights by Byrum permitted him to maintain the most significant asset of such stock ownership—corporate control. Comment, *Judicial Limitation of Section 2036: The* Byrum *Doctrine*, 61 GEO. L.J. 1087, 1096-97 (1973).

[47] *See* H.R. REP. NO. 1380, 94th Cong., 2d Sess. 65, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3418.

II. THE 1976 AMENDMENT TO SECTION 2036 AND ITS IMPLICATIONS FOR RETAINED VOTING DEVICES

A. *The 1976 Amendment*

Fearing estate tax avoidance, Congress responded to the *Byrum* decision in the Tax Reform Act of 1976 with an amendment to section 2036(a)(1). The amendment states:

> [T]he retention of voting rights in [transferred][48] stock shall be considered to be a retention of the enjoyment of such stock.

The purpose behind the passage of this amendment may be discerned from the House Ways and Means Committee Report:

> Your committee believes that the voting rights are so significant with respect to corporate stock that the retention of voting rights by a donor should be treated as the retention of the enjoyment of the stock for estate tax purposes. Your committee believes that this treatment is necessary to prevent the avoidance of the estate and gift taxes.[49]

The most obvious result of this amendment is that a grantor who retains voting rights in transferred stock will have this stock included in his gross estate at its fair market value on the date of his death. Retention of voting rights as an individual is thus no longer an advantageous estate planning device.

Yet, there are unresolved questions concerning the application of amended section 2036 to the various retained voting rights situations previously described. The situation is also unclear in regard to additional estate planning devices which may be used in attempts to circumvent the Tax Reform Act of 1976. The probable impact of the 1976 amendment to section 2036 on the retained voting rights devices will now be discussed.

B. *The Effect Of The Amended Section 2036 On Retained Voting Rights Devices*

1. Tax Advantages of Lifetime Transfers of Property After the Tax Reform Act of 1976

An analysis of retained voting rights situations in light of the Tax Reform Act of 1976 first requires an understanding of the advantages of inter vivos transfers after 1976. Only by such an understanding of the advantages of inter vivos transfers can one grasp the significant effect that section 2036 may have on a grantor's estate tax liability.

Prior to the Tax Reform Act of 1976, property subject to a completed lifetime gift was not includible in the grantor's gross estate. Gift tax rates were approximately 75% of estate tax rates. Thus, property transferred during the grantor's lifetime, and subject to gift taxes, was usually taxed at

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[48] See note 3 *supra*.

[49] H.R. REP. NO. 1380, 94th Cong., 2d Sess. 65, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3418.

a lower rate than property includible in the grantor's gross estate, and subject to estate taxes.[50] Lifetime gifts of property therefore were made to avoid the higher estate tax liability.

The Tax Reform Act of 1976 imposed a unified structure of gift and estate tax rates.[51] With this unified gift and estate tax structure it now appears to be less important whether property is transferred during the lifetime of the grantor or at his death. However, there are still significant tax incentives present, making lifetime transfers of property advantageous.

One such incentive relates to post gift appreciation. Such appreciation may escape inclusion in the grantor's gross estate because only the value of the property at the time of the gift giving is included in the computation of the grantor's tentative estate tax.[52] Moreover, there is a credit allowed for the amount of tax paid on gifts made after December 31, 1976.[53] In this manner the grantor generally avoids gift and estate tax liability on the appreciation in value of the property from the date of the gifts until his death.[54] This appreciation does not escape taxation entirely since the donees pay an estate tax on the property when it is included in their estate, or pay a gift or income tax when they transfer the property. Therefore, the advantage of removing the appreciation from the grantor's estate is the tax deferral gained.[55] This may be of particular significance if the estate tax is deferred for an entire generation.[56]

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[50] There is also an annual exclusion from tax of $3,000 of gifts per donee. I.R.C. § 2503(b). There is no comparable estate tax exclusion.

[51] I.R.C. § 2001.

[52] *Id.*

[53] I.R.C. § 2001(b)(2).

[54] "The importance of this appreciation element cannot be easily exaggerated in an inflationary economy such as America has experienced in the past and can reasonably be expected to experience in the future." Johnson, *Lifetime Giving under the Tax Reform Act of 1976,* WILLS, EST., TR. ¶ 3546 (P-H). The manner in which one avoids estate and gift taxes occurring after the date of the gift can be illustrated as follows: Grantor makes a taxable gift of property valued at $250,000 on January 1, 1977, and pays a gift tax on that amount. If the grantor dies more than three years later, thus avoiding section 2035 problems, only the $250,000 will be included in the grantor's estate even if the property subject to the gift has increased in value. The grantor's estate will also be allowed a credit for gift tax previously paid on the gift. Therefore, assuming that the property has a fair market value of $300,000 on the date of the grantor's death, only $250,000 will be includible in his gross estate. Hence, $50,000 ($300,000-250,000) will avoid inclusion in the grantor's gross estate. The tax on that amount will be effectively deferred.

[55] An exception to the general rule that post gift appreciation avoids inclusion in the grantor's gross estate may be found in I.R.C. § 2035(a). Under that section, property which the grantor transferred within three years of his death will be includible in his gross estate. This property must be included in the grantor's gross estate at its fair market value on the date of his death. Hence, appreciation in the property after the date of the gift will be included in the grantor's gross estate. In effect, section 2035(a) prevents a grantor from utilizing the advantages of deferral for gifts made within three years of his death. Additionally, section 2035(c) requires that the grantor's gross estate be increased by the amount of gift taxes paid on a transfer within three years of his death. Therefore, the advantages of lifetime giving are diminished when the transfer is made within three years of the grantor's death. For further discussion of section 2035, see in this issue Note, *Section 2035: Taxing of Gifts Made Within Three Years of Death, supra at* p. 577.

[56] The deferral of tax can be very significant, particularly if it is for a number of years. Thus, if the tax may be deferred for 20 years, the effect is that of an interest free loan from the government to the donees for that period of time. The donees may use the money for investment, deriving interest, dividends, and profits from it. It is possible, of course, that the deferral will be of little or no value. For example, if the donee dies before the grantor, or if the donee transfers the property before the death of the grantor, there will be no deferral. In

In addition to favorable estate tax consequences, there are also income tax advantages which may result from inter vivos transfers of property. When a donor in a high income bracket transfers income producing property, he also transfers the income tax burden to the donee. Therefore, when a parent in a high income tax bracket makes a gift of income producing property to a child in a lower income tax bracket, the overall tax burden on the family may be substantially reduced.[57] The value of this income tax advantage will, of course, depend on the tax bracket differential between the parent and the child. However, in many cases, the tax saving will be sufficient incentive for a lifetime gift.

Therefore, estate tax deferral and lower income tax rates can make lifetime giving advantageous even after the imposition of uniform gift and estate tax rates in the Tax Reform Act of 1976. Taxpayers might wish to use these income and estate tax advantages by transferring stock in closely held corporations during their lifetimes. However, taxpayers who wish also to retain voting control of the corporation are faced with a problem. Amended section 2036 seems to deny to controlling shareholders the ability both to minimize estate and income taxes and to maintain corporate control. Yet the effect of this one sentence amendment is far from clear since it does not explicitly deal with some of the variations of retained voting control which taxpayers had attempted before the 1976 amendment. Predicting the future viability[58] of these retained voting control devices requires that they be analyzed in light of the Tax Reform Act of 1976.

2. Status of Retained Voting Rights Devices After 1976

(i) *Retention of voting rights in grantor's individual capacity—the* Byrum *case*

As previously discussed, *Byrum* was a significant decision for controlling shareholders of closely held corporations, authorizing what one commentator called "the ultimate in estate planning."[59] After the Tax Reform

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fact, a tax will be paid on the post gift appreciation before the grantor would have paid the tax if he had not made the gift. Also, if the donee dies soon after the grantor, there will be a deferral, but probably of little value. For a discussion of deferral, see 1 S. SURREY, W. WARREN, P. McDANIEL, H. AULT, FEDERAL INCOME TAXATION 413-19 (1972).

[57] Johnson, *supra* note 54, at ¶ 3546. An illustration of income tax advantages is as follows: A person who has a very high income may be liable for federal income taxes as high as 50% for earned income and 70% for unearned income. A parent in the 70% bracket for unearned income receiving dividends of $100,000 would be liable for income taxes of $70,000 on these dividends. If the parent gives 20% of this stock to each of his five children and assuming his children have no other income, the effective income tax rates on these dividends for each child would be computed at the children's lower tax bracket. Each child would probably be in approximately the 34% tax bracket and the dividends would be taxed at an effective rate of approximately 20%. Therefore, the dividends would result in a tax liability of only $20,000. This represents an income tax savings of $50,000.

[58] "Viability" used in this context refers to the ability of the device to achieve retention of corporate control while minimizing estate and income taxes.

[59] "The ultimate in estate planning for most controlling stockholders of closely held corporations is the avoidance of a federal estate tax on corporate voting shares that they have transferred to a trust in which they have reserved the uninterrupted right to continue voting the shares." Pressment, *supra* note 39, at 160. The author also notes that prior to ***Byrum***, most estate planners warned their clients against structuring an estate plan on the basis of such an arrangement because of the IRS position concerning section 2036(a). *Id.*

Act of 1976, it is almost certain that when a controlling shareholder in his individual capacity retains voting rights in transferred stock, the value of the stock on the date of his death will be includible in his gross estate. This *Byrum*-type situation is clearly prohibited by the amendment. Therefore, the grantor's gross estate will not avoid estate tax liability on the appreciation of the transferred property after the date of the gift. There is thus no deferral of estate taxes. Retention of voting rights as an individual would no longer seem to be an advantageous estate planning device.

(ii) *Retention of voting rights by grantor as a minority trustee—the* Gilman *case*

Another estate planning device used prior to the 1976 Act was illustrated in the *Gilman* case where the grantor retained voting rights as one of three trustees of a trust to which the stock was transferred. The *Gilman* court held that the transferred stock was not includible in the grantor's gross estate.[60] However, in light of the 1976 amendment to section 2036, the viability of this device is in doubt. A reading of the House Ways and Means Committee Report, explaining the 1976 Amendment to section 2036, supports this conclusion. The report states that "[f]or purposes of the provision, the capacity in which the decedent exercised the voting rights is immaterial."[61] This statement would appear to indicate that a grantor's retention of voting rights in a capacity as trustee, rather than in an individual capacity, is sufficient for the application of section 2036(a).

Further support for the conclusion that retention of voting rights as a minority trustee is now within section 2036 can be gathered from an analysis of the factors behind the *Gilman* device. Applying section 2036 to such situations would reflect corporate reality. A minority trustee may exert great influence over corporate policy. Moreover, it is probable that a grantor will appoint co-trustees who are amenable to his wishes. Therefore, based on the legislative history and a consideration of corporate reality, retention of voting rights as a minority trustee should be held a retention of enjoyment within the meaning of section 2036(a).

(iii) *Informal retention of voting rights—the* Beckwith *case*

In *Beckwith*[62] the decedent did not formally retain voting rights in transferred stock, but rather annually received proxies to vote this stock. The court there held that since the proxies were voluntarily transferred in a later separate transaction, the stock was not includible in the transferor's gross estate under section 2036(a).[63] Thus the court refused to hold that the grantor had retained section 2036 "enjoyment" through this informal arrangement. This precise result probably has survived the Tax Reform Act of 1976 since section 2036 still requires that the voting rights be retained at the time of the transfer.[64] But it is quite certain that section 2036 will apply if the court finds that a grantor is given proxies pursuant to a

[60] 65 T.C. 296, 306 (1975), *aff'd per curiam*, 547 F.2d 32 (2d Cir. 1976).

[61] H.R. REP. NO. 1380, 94th Cong., 2d Sess. 65, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3418.

[62] 55 T.C. 242 (1970).

[63] *Id.* at 250.

[64] See text and note 34 *supra*.

formal or informal prearrangement, because in that instance the required retention "under" the transfer is present.[65] Informal retention of voting rights thus appears to be a poor estate planning device since its success in avoiding the effect of section 2036 will depend upon whether the court finds that there was an arrangement at the time of the transfer. Certainty is of great value in estate planning, and such certainty is not present in the *Beckwith* situation since a court after the grantor's death could determine that an informal retention of rights actually occurred "under" the transfer thereby bringing the transfer within the purview of section 2036.

In any case, the Technical Corrections Bill of 1977,[66] if enacted, may clarify the applicability of section 2036 to informal voting rights situations. The bill makes it clear that the 1976 Amendment to section 2036 applies to direct or indirect retention of voting rights, and applies only in the case of controlled corporations.[67] The Joint Committee on Taxation's explanation to the 1977 bill states that an indirect retention is present where the grantor subsequently acquires voting rights in the transferred stock.[68] Thus, in the Joint Committee's view, where a grantor transfers stock, and later acquires proxies annually, there would be an indirect retention of voting rights. In essence, assuming this provision of the Technical Corrections Bill of 1977 is enacted, situations may fall within section 2036 even if the grantor retains no rights under the transfer. Section 2036 may be brought into operation when the grantor later acquires the voting rights.[69] Therefore, the holding of *Beckwith* probably would not survive if the 1977 Technical Corrections Bill is enacted.

As has been demonstrated, it is doubtful that the devices employed in *Byrum*, *Gilman* and *Beckwith* will remain viable in light of the changes in section 2036 implemented by the Tax Reform Act of 1976 and contemplated by the Technical Corrections Bill of 1977. However, it is probable that

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[65] 55 T.C. at 247-48.

[66] H.R. 6715, 95th Cong., 1st Sess. (1977), as referred to the House Committee on Ways and Means on April 28, 1977.

[67] The relevant portion of the bill provides:

> (1) IN GENERAL—SECTION 2036 (relating to transfers with retained life estates) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:
>
> (b) Voting Rights
>
> (1) IN GENERAL—For purposes of subsection (a)(1), the direct or indirect retention of voting rights with respect to a controlled corporation shall be considered to be a retention of the enjoyment of the transferred property.
>
> (2) CONTROLLED CORPORATION—For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if at any time after the transfer of the property and during the 3 year period ending on the date of the decedent's death, the decedent owned (with the application of section 318) or has the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

H.R. 6715, 95th Cong., 1st Sess. (1977).

[68] JOINT COMMITTEE ON TAXATION, DESCRIPTION OF H.R. 6715; TECHNICAL, CLERICAL AND CONFORMING AMENDMENTS OF THE TAX REFORM ACT OF 1976, 95th Cong., 1st Sess. 27 (CCH ed. 1977).

[69] Section 2036(a) applies only where the grantor retains voting rights "for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death . . . ." Therefore, section 2036(a) would not seem to apply where the grantor occasionally received proxies after the transfer. The statute would apply if he exercises the proxies for his lifetime.

other devices will be utilized in attempting to make it possible for a grantor to retain control and enjoyment of the closely held corporation, to minimize estate taxes, and to avoid the effects of the 1976 amendment to section 2036.

III. PROPOSED AVOIDANCE DEVICES

There are two new devices which possibly may be utilized to avoid the amended section 2036. One possibility is the initial structuring or the recapitalization of the corporate stock so that the preferred stock is voting stock, and all common stock is nonvoting. A second possibility is capitalization,[70] or recapitalization,[71] with 2 classes of common stock, one voting and the other nonvoting. Both of these devices will be discussed in this section.

As to the first method, utilizing voting preferred stock and nonvoting common stock, the stockholder would retain the voting preferred and transfer the nonvoting common. Retaining the voting stock allows the grantor to continue to control the corporation.[72] Since the retained stock is preferred, it has a stated value and dividend rights. The stock may be struc-

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[70] In some instances the initial capitalization will be tax free. *See* I.R.C. § 351. However, in order for the incorporation to be tax free under § 351, the 80% control requirement of I.R.C. § 368(c) must be met "immediately after the transfer." In the type of incorporation contemplated in this article, the stockholder does meet the control requirement immediately after the transfer. However, if it is determined that the transfer of the nonvoting common after the recapitalization was part of a "series of steps" of a single transaction, the control requirement would not be met, and incorporation would not be tax free under section 351. *See generally* II S. SURREY, W. WARREN, P. MCDANIEL, H. AULT, FEDERAL INCOME TAXATION 181-85 (1973).

[71] Although the recapitalization is tax free under I.R.C. § 368(a)(1)(E), there still may be negative income tax consequences through the operation of I.R.C. § 306. When the shareholder retains preferred stock in a recapitalization, this stock is labelled section 306 stock, and any proceeds from its sale may be treated as ordinary income. However, ordinary income treatment is limited to the amount that would have been a dividend at the time the 306 stock was distributed had the corporation distributed money rather than the stock. I.R.C. § 306(a)(1)(A). Furthermore, when one receives a carryover basis from the stockholder, as does a donee or one who inherits the stock of a decedent dying after December 31, 1976, this stock remains § 306 stock, and any proceeds from its sale, as above, will be treated as ordinary income. I.R.C. § 306(c)(1)(C).

Section 306(b) provides exceptions to § 306(a) ordinary income treatment. However, these exceptions are not likely to apply in the situation contemplated in this article because of the attribution rules of § 318(a). Although it appears that § 306(a) will not apply if the parent-stockholder transfers all his preferred stock to one whose stock will not be attributable to him under § 318(a), and his children also dispose entirely of their stock interest in the company, this would be an unlikely occurence.

Hence, it must be concluded that the application of § 306(a) could be so severe that the stockholder may wish to avoid a preferred-common stock recapitalization. In each situation, the estate and income tax advantages of this type of recapitalization must be balanced against the adverse income tax effects brought on by the operation of § 306(a).

Additionally, § 306's ordinary income tax consequences may be avoided by redemption of the stock to pay the stockholder's death taxes. I.R.C. § 303. Moreover, the Technical Corrections Bill of 1977 contains a provision which dictates capital gain treatment in cases of a § 303 redemption of § 306 stock. H.R. 6715, 95th Cong., 1st Sess. § 3(a)(2).

[72] When the grantor retains the voting stock of the corporation, he can elect the board of directors, which controls corporate policy. H. HENN, LAW OF CORPORATIONS 410 (2d ed. 1970).

tured so that on liquidation of the corporation the preferred stockholders are only entitled to this stated value and dividend arrears.[73] The nonvoting common stock is then transferred by gift at a time when the stated value of the retained stock can absorb the value of the corporation. This is important because if at the time of the gift the value of the corporation is reflected in the retained preferred stock, there will be minimal gift tax consequences when the common stock—with little or no value—is transferred.[74]

By thus retaining voting preferred stock and making a gift of nonvoting common stock, the donor is in a position to take advantage of tax deferral. This results since the device permits the donor to exclude the value of post-gift appreciation from his estate. Under the unified gift and estate tax provisions, only the fair market value of the stock at the date of the gift will be includible in the grantor's gross estate. Therefore, the appreciation in value of the transferred stock after the date of the gift will not be included in the grantor's gross estate. Moreover, since the preferred stockholders are only entitled to the stated value of their stock, any appreciation in the value of the corporation will take place in the transferred nonvoting common stock. As noted earlier, it is the donees who will pay an estate, gift or income taxes on the post transfer appreciation.[75] Thus, this device provides the advantage of tax deferral.[76]

Another device which may be used to avoid the effect of the amended section 2036 is a variation of the just discussed scheme of retaining voting preferred stock and making a gift of nonvoting common stock. This variation involves a corporate structure with two classes of common stock. Only one of these classes would be voting, and this class should represent only a small percentage of the total common stock of the corporation. In this manner, the class of nonvoting common will represent a large percentage of the corporation's total value. The grantor then retains the small amount of stock representing the entire voting power of the corporation, and transfers all the nonvoting common. The result is much like that achieved when the grantor retains voting preferred and transfers nonvoting common since post gift appreciation will be reflected in the transferred nonvoting common. However, where the grantor retains common stock, a portion of the appreciation in value of the corporation after the gift will take place in this retained common stock. The amount of this appreciation of course should

[73] The stock is preferred because on liquidation of the corporation the claims of the preferred stockholders normally must be satisfied before the common stockholders receive anything. The dividends paid on the preferred shares are usually based on a percentage of the face value of the stock. The preferred stockholders would not share in high earnings of the corporation, and preferred stock dividends are usually limited to this stated percentage. If the stock is participating, however, it may share in corporate dividends in excess of the stated percentage. *See* H. HENN, *supra* note 68, at 208-12.

[74] I.R.C. § 2512(a). The transferred stock has little value at the time of the transfer because the value of the corporation is reflected in the retained voting stock.

[75] The device of retaining preferred voting stock and transferring nonvoting common stock has the greatest utility when most of the appreciation in value of the transferred stock occurs after the date of the gift since the post gift appreciation will not be included in the grantor's gross estate. Conversely, when the appreciation in value of the corporation has occurred prior to the gift, this device has little value because the pre-gift appreciation will be included in the grantor's gross estate.

[76] For an illustration of this principal, see note 54 *supra*.

be slight since the retained voting common should represent only a small percentage of the total corporate equity. Therefore, most of the appreciation in value of the corporation after the gift should be reflected in the nonvoting common[77] and the donees will be liable for the taxes on this appreciation. As noted, by using this device involving dual classes of common stock, the donor's estate will be liable for some post-gift appreciation in the value of the corporation. Consequently, the tax deferral will not be as significant as when the grantor retains preferred stock, since in that case there would be no post transfer appreciation includible in the grantor's gross estate.

These two capitalization devices appear to avoid the effect of the 1976 amendment to section 2036 since in the use of the devices the grantor is not retaining voting rights in transferred stock, but is retaining the voting stock itself. Thus, the grantor can use either scheme to transfer the value of the corporation while retaining voting control.

Nevertheless, the Technical Corrections Bill of 1977[78] may present an obstacle regarding the use of capitalizations and recapitalizations to avoid the effect of section 2036. That bill provides that an indirect retention of voting rights in a controlled corporation constitutes section 2036 enjoyment. Arguably, capitalizations and recapitalizations could be viewed as transfers in which the grantor has indirectly retained voting rights since in either situation the grantor is retaining the voting stock of the corporation and making a transfer of nonvoting common. Hence, it appears that the grantor has made a transfer of stock after which he has indirectly retained the voting stock of the corporation. There are, however, several answers to the argument that these capitalization and recapitalizations result in an "indirect retention" within the meaning of the 1977 Bill.

In the first place, the very words of the House Ways and Means Committee, in its report accompanying the 1977 Technical Corrections Bill, seem to rebut this "indirect retention" position. The text of the committee report commenting on the proposed amendment to section 2036 states:

> Where the decedent owned both voting and nonvoting stock and transferred the nonvoting stock to another person, the rule [requiring inclusion in the gross estate where a decedent indirectly retained voting rights in stock of a controlled corporation transferred by him] does not apply to the nonvoting stock simply because of the decedent's ownership of the voting stock.[79]

Thus, congressional intent would not call for the applicability of section 2036 to a capitalization or recapitalization scheme.

Another counter argument to the indirect retention position is based on the statutory language. Section 2036 requires retention of voting rights in transferred stock.[80] In a capitalization or recapitalization the voting

[77] As an illustration of this, assume that the retained voting common represents 5% of the total common stock, the other 95% representing the nonvoting common which was transferred. Of the post gift appreciation, 5% will be reflected in the retained common, but 95% of the appreciation will be represented in the transferred stock, and hence will not be includible in the grantor's gross estate.

[78] See note 66 *supra*.

[79] H.R. REP. NO. 700, 95th Cong., 1st Sess., *reprinted in* FED. TAXES EST. & GIFT ¶ 135, 311 (P-H October 12, 1977).

[80] See note 3 *supra*.

rights are retained in retained stock. Therefore, section 2036 should not apply since no voting rights are retained in transferred stock. Hence, the stockholder should succeed in maintaining corporate control and remove post gift appreciation from his estate. Moreover, it is possible that the "indirect retention" provision of the 1977 bill will not be enacted. Therefore, it is probable that these situations would succeed in avoiding the effect of the section.

Even if the indirect retention argument cannot be used to bring section 2036 into operation, these devices may yet be brought within section 2036 as a 2036(a)(2) "right" by the grantor to designate enjoyment. This type of § 2036(a)(2) argument was treated by the government in Revenue Ruling 67-54.[81] There, upon recapitalization, the grantor retained all ten voting shares of the corporation, and transferred 990 shares of nonvoting stock to a trust for the benefit of his children. The trustee was required to obtain the permission of the grantor before disposing of the stock. The value of the transferred stock was held to be includible in the grantor's gross estate:

> Where a decedent transfers nonvoting stock in trust and holds for the remainder of his life voting stock giving him control over the dividend policy of the corporations, he has retained, for a period which did not in fact end before his death, the right to determine the income from the nonvoting stock. If he also retains control over the disposition of the nonvoting stock, either as trustee, by restriction upon the trustee, or alone or in conjunction with another, he has in fact made a transfer whereby he has retained for his life the right to designate the persons who shall possess or enjoy the transferred property or the income therefrom.[82]

The ruling thus treated the grantor, who had transferred nonvoting stock in trust while retaining voting stock in the same corporation, as retaining for his life, or for a period which did not in fact end before his death, the right to designate who shall possess or enjoy the transferred property. Consequently under section 2036(a)(2), the value of the transferred stock was includible in the grantor's gross estate.[83]

Revenue Ruling 67-54 refers to the grantor's "right" to designate possession or enjoyment. It also quotes treasury regulation section 20-2036-1(b)(3) of the Estate Tax Regulations which states in part that such a right "includes a reserved power to designate the person or persons to receive the income from the transferred property, or to possess or enjoy non-income producing property, during the decedent's life or during any other period described in paragraph (a) of this section."[84] The interpretation of a section 2036(a) "right" in Revenue Ruling 67-54 appears to be consistent with the regulations. Both of these interpretations equate a "power to designate" with a 2036(a)(2) "right to designate." Hence, under this analysis recapitalization would not avoid the effect of section 2036, since the stock-

[81] Rev. Rul. 67-54, 1967-1 C.B. 269.
[82] *Id.* at 270.
[83] *Id.*
[84] *Id.* Treas. Reg. § 20.2036-1(b)(3) (1958) (amended 1960) also states that it is immaterial in what capacity the grantor exercised this power.

holder would retain the power to control corporate dividend policy which Revenue Ruling 67-54 and regulations have determined to be within section 2036. However, both of these interpretations appear to be at variance with the interpretation of section 2036(a)(2) which the Supreme Court rendered in *Byrum*.

Under the *Byrum* interpretation, when a grantor retained merely a "power" he did not retain a section 2036 "right."[85] Therefore, the authority of *Byrum* on this point would allow a recapitalization to avoid the effect of section 2036, since the grantor would be retaining only a "power" and not a "right" within the meaning of the statute. Since the precedential value of *Byrum* is important in determining the viability of recapitalizations, the *Byrum* Court's section 2036(a)(2) holding must be reconsidered in light of the 1976 amendment.

The 1972 *Byrum* decision apparently authorized what Revenue Ruling 67-54 had forbidden in 1967. Congress intended to overrule *Byrum* in 1976, but its success on this point is in doubt. The 1976 amendment does not address the section 2036(a)(2) designation of enjoyment. Even a situation such as that found in Revenue Ruling 67-54 does not clearly come within the language of the 1976 amendment since there is no retention of voting rights in transferred stock. Rather, in a situation such as that in Revenue Ruling 67-54, the voting stock itself is retained and nonvoting stock is transferred. Therefore, it is possible that the *Byrum* Court's position that the grantor has retained a power and not a 2036(a)(2) right may still have precedential value.

If the *Byrum* Court's reasoning on 2036(a)(2) is still valid, then recapitalization may avoid the effects of 2036. In the recapitalization the grantor retains "powers,"—i.e. voting control of the company, power to elect a board of directors and power to control dividend policy—similar to those which the *Byrum* Court refused to view as section 2036 rights. The grantor in a recapitalization is also restrained—as was the grantor in *Byrum*—from acting against the interests of the other shareholders or the corporation by a fiduciary duty owed to the owners of the nonvoting common. Therefore, despite Revenue Ruling 67-54 and the regulations, the recapitalizations may be successful in resisting a section 2036(a)(2) designation of enjoyment attack. If this is so, recapitalization would allow a grantor to continue corporate control and reduce his estate tax liability.

It is possible, however, that *Byrum's* section 2036(a)(2) position has been undermined by the 1976 amendment to section 2036, and that Revenue Ruling 67-54 is therefore controlling. By enacting the 1976 amendment to section 2036 it may be that Congress was rejecting not only the narrow holding of *Byrum*, but its entire section 2036 rationale as well.

Nevertheless, even if Revenue Ruling 67-54 is still effective, a recapitalization may be distinguishable from the situation outlined in the ruling. If such were the case, the ruling would not be dispositive. In Revenue Ruling 67-54, the nonvoting common stock was transferred to a trust with restrictions on the disposition of the stock. In contrast, in a recapitalization the grantor may transfer the stock to his children as individuals, or to a trust with no restrictions as to disposition of the stock. Hence Revenue Rul-

[85] 408 U.S. at 136-37.

ing 67-54 and section 2036(a)(2) may not be applicable[86] since the children or trustee could sell the stock and thereafter would not be dependent on the dividend policy of the grantor's corporation for their income. Therefore, the grantor would not be in a position to designate who should enjoy the income from the property within the meaning of section 2036(a)(2).

Although it is unclear whether the previously discussed recapitalizations will succeed in withstanding section 2036 attacks, it is probable that they will be attempted and will require judicial or legislative consideration. However, even if these recapitalizations do withstand section 2036 challenge, it must also be noted that the taxpayer may face the further problem of a "control premium" being assigned to his retained stock.

The Internal Revenue Service may take the position that the retained stock includible in the gross estate should include an additional value assigned as a "control premium." This "control premium" represents the additional value of the stock due to the voting control element inherent in the stock.[87] Assigning a voting control element reflects the corporate reality that a controlling shareholder's interest in the corporation is more valuable than his actual percentage of stock ownership because he can control corporate policy. For instance, in *Estate of Salisbury*,[88] the decedent owned 51.8% of the voting power of the outstanding shares at the time of his death. The Tax Court held that the fair market value of the stock on the date of his death should include a "control premium" of 38.1%[89] of the stated value of the shares.

The application of such a "control premium" defeats at least in part the purpose for which any one of the aforementioned estate tax avoidance devices are used. By valuing the voting shares at their stated value plus a "control premium," at least a portion of the appreciation in the transferred stock after the date of the transfer would, in effect, be included in the grantor's gross estate. How much of the appreciation would be included in the grantor's gross estate is unclear, since it depends on the court's determination of the value of the "control premium."

In summary, the previously discussed recapitalizations may succeed in avoiding the effect of the amended section 2036, although the government may attempt to increase the estate tax valuation of the retained stock through the imposition of a "control premium." However, in the event that these recapitalizations do achieve the dual objective of allowing corporate control and estate tax minimization, they will be a powerful estate planning tool.

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[86] If the trustee could dispose of the stock, the trust would consist of the proceeds from the sale, or new property purchased with the proceeds. Under these circumstances, the grantor would not have retained a "right to designate" within the meaning of section 2036(a)(2) since his control of the corporate dividend policy would not necessarily control the flow of income to the trust. It is important to note, though, that the grantor often wants the stock to remain in trust for the benefit of his children. The trustee's selling of the stock, which the grantor could not prevent, would be contrary to his wishes. Therefore, the grantor may well wish to put restrictions on the disposition of the stock, thus increasing the possibility of a section 2036 attack.

[87] As stated in Treas. Reg. § 20.2031-2(f), in valuing stock for estate tax purposes "the degree of control of the business represented by the block of stock to be valued" is a relevant factor.

[88] 1975 T.C.M. ¶ 333, at 1401 (P-H).

[89] 38.1% was the court's somewhat arbitrary estimate of the value of the voting control element. *Id.* at 1417.

CONCLUSION

The 1976 amendment to section 2036 states that the retention of voting rights in transferred stock is a retention of enjoyment of that stock. When such enjoyment is present, section 2036 mandates that the value of the transferred stock on the date of the grantor's death be included in his gross estate. Taxpayers wishing to avoid this result probably will utilize several devices to remove post gift appreciation from their gross estate. Taxpayers today probably will use capitalization or recapitalization devices as a means to avoid the 1976 amendment to section 2036. Although there are variations on these devices, they basically involve the retention of corporate control in the form of voting preferred stock or voting common stock, with the removal of post gift corporate appreciation by the transfer of nonvoting common stock in which the subsequent financial growth of the company will take place. These devices will certainly encounter section 2036 challenges by the government, and although the outcome of these clashes is not clear it is probable that they will be upheld.

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