Estate Tax 'Freezing' Put on Ice

A new tax law is cool toward widely used asset 'freezing' techniques for limiting estate taxes

You sell your construction company to your son, and then ten years later you die. Now the value of the company has become five times what it was when sold.

But because the value of the company at the date of your death is included in your estate, (even though you owned no stock in the company), your son is liable for the portion of estate taxes the company represents. With a top effective estate tax rate of 55 percent, your son cannot raise the needed cash for taxes, so he must sell the company to pay the estate taxes.

Does this sound unlikely or unfair? It will happen to some people, and it can happen to you. On December 18, 1987 President Reagan signed into law the Revenue Act of 1987, and in so doing dramatically changed traditional estate planning. In the Act was a new Section 2036(c), which will create situations like the examples above.

To understand 2036(c), basic estate taxation must also be understood. If a married person dies and transfers their property to their spouse, there is no estate tax. This exemption is called the "unlimited marital deduction."

However, when the surviving spouse dies, estate tax rates could severely diminish the value of the estate. Estate taxes start at 37 percent and increase to a top effective rate of 55 percent.

Each person has a one time personal exemption of $600,000 called a "unified credit." Hence, if an estate is valued under $600,000 there will be no estate taxes, but any value over $600,000 will be taxed at a minimum rate of 37 percent.

Before 2036(c) there were effective means to limit the estate tax burden by using "freezing" techniques. These techniques allowed parents to freeze the value of the property (at today's value) and retain that portion while transferring the potential future growth in the value to their children. Only the portion retained was included in the parent's estate, thus limiting estate taxes.

After amending Section 2036(c), 'freezing' techniques no longer work.

A commonly used technique was a "preferred recapitalization." Two classes of stock, preferred and common, are exchanged for the existing common stock: parents retain the preferred stock which pays an annual cash dividend, but doesn't have the potential to grow in value. Children then buy or are given the common stock, and any increase in the value of the company would go to the common stock shareholders.

With the huge federal budget deficit and a presidential promise not to raise taxes, Congress tried to raise taxes anyway without the average person knowing it. One of the ways to do this was through amending section 2036(c) such that "freezing" techniques no longer work. Now if a person violates 2036(c), assets believed transferred to children will be brought back into the estate of the parents for tax purposes.

Section 2036(c) applies if all three of the following tests are met:

- A parent owns 10 percent or more of the voting power or income rights of an enterprise.
- The parent transfers to his or her children a disproportionately large share of the future appreciation.
- The parent maintains some ownership or other rights and privileges in the transferred enterprise.

These criteria apply only to transfers taking place after December 17, 1987, and only to direct lineal relations (children, parents, grandparents).

The two most difficult items here to understand are the "disproportionate appreciation test" and the "retained interest test." Potential appreciation is determined by examining how the value of the retained interest will grow if the value of the company grows.

Here is an example: The parents own a company worth $1 million. They sell 600,000 of stock to their children and retain the other $400,000 in some form of stock, preferred or common. To avoid the disproportionality test, the parents must receive at least $.40 of every dollar made after the stock transfer.

The retained interest test is also confusing, since a person can retain an interest even if they don't own any of the enterprise. Parents are considered to retain an interest if they hold any rights of value. (Rights of value include, but are not limited to, consulting agreements longer than three years, employment agreements, deferred com-

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pensation agreements, or a company purchase or lease of property and/or equipment from the parents above fair market value.)

These tests would apply to many of the commonly used transfer techniques between parents and children, even plans that are used without the express purpose of freezing the value. Since the legislation is still fairly new, no one can be sure of exactly what will and will not fall under 2036(c).

However, there are still means that can be used that are clearly outside of the scope of 2036(c). For example, a parent owns stock in a company with only one type of stock. If the parent sells or gifts part or all of their stock to their children at fair market value, 2036(c) would not apply in most situations.

Section 2036(c) was enacted to eliminate abuses of the estate tax system, but results are so broad it severely punishes the uninformed. Legislation has been introduced in Congress to repeal Section 2036(c), but it does not have widespread support and prospects for repeal are slim. The better possibility is that 2036(c) will be altered to limit its broad scope.

Section 2036(c) is extremely complex, and there are many traps for the unwary. Reducing your estate taxes by transferring your business to your children is much more difficult as a result of 2036(c). With estate taxes starting at 37 percent and progressing to 55 percent, estate planning is a wise investment.

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