

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 2036.08-03
CASE MIS No.: TAM-102866-99
Date: June 7, 1999
Number: **199938005**
Release Date: 9/24/1999

LEGEND:

Corporation =
Partnership =
Decedent =
Child 1 =
Child 2 =
Child 3 =
Child 4 =
Date 1 =
Date 2 =
Trust =
Year 1 =
Bank =
W =
X =
Y =
Z =

ISSUE:

Is the value of the closely held stock transferred by Decedent to Partnership includible in Decedent's gross estate under § 2036(b), because, in his capacity as general partner, Decedent retained the right to vote the stock?

CONCLUSION:

The value of the closely held stock transferred by Decedent to Partnership is includible in Decedent's gross estate under § 2036(b), because, in his capacity as general partner, Decedent retained the right to vote the stock.

FACTS:

Decedent and his brother each owned a 50 percent interest in Corporation represented by W voting and X nonvoting shares of common stock. In Year 1, in conjunction with the renegotiation of Corporation's revolving credit agreement with Bank, Bank required the shareholders to devise a plan of management and ownership succession.

On Date 1 in Year 1, Decedent and his brother carried out the following transaction. Each transferred 55 percent of his stock to a family limited partnership (Partnership) (Y shares of voting and Z shares of nonvoting common) in exchange for 10 general partnership units, 1,000 Class A limited partnership units, 100 Class B limited partnership units, and 100 Class C limited partnership units.¹ Also on Date 1, Decedent transferred 50 Class B units to Child 1, 50 Class B units to Child 2, 50 Class C units to Child 3, 50 Class C units to Child 4, and his remaining partnership units and stock to a revocable trust of which he was trustee (Trust). Under the terms of Trust, at his death, Trust assets passed to his four children.

In a letter dated one month before Date 1, the estate planning attorney for

¹Class A units share profits after preference payments to Class C and Class B, units. Class C unit holders first receive 100% of profits up to 5% of their capital account; then Class B unit holders receive the same percentage; remaining profits are distributed 32% to Class A, 32% to Class B, 32% to Class C, and 4% to general partnership unit holders. However, the stock held by the partnership paid no dividends. In a sale, exchange, disposition, or deemed disposition, first, built in gains are to be distributed to the Class A unit holders according to their capital accounts, but do not increase those accounts. Then, remaining gains are allocated 48% to Class C and 48% to Class B unit holders, 4% to general partnership unit holders. Any liquidation is treated as a sale, exchange, or deemed disposition, triggering capital gains.

Decedent and his brother states that he has enclosed a draft of a new first Article to the partnership agreement of Partnership and a "draft of a gift trust that could be used to receive the B and C units that are intended to be given to the children at this time." The letter suggests that Decedent and his brother could create identical separate trusts or joint trusts with the end result being a single trust for each child to hold the child's B or C units.

Article 8.3 of the partnership agreement authorized the general partners to vote the shares of Corporation as follows:

Prior to the death of the survivor of [Decedent] and [his brother], the General Partners will have complete discretion regarding the voting of any Controlled Corporation's shares; provided, however, that if the General Partners cannot agree about how the shares of [Corporation] should be voted on any issue, then each General Partner shall vote a number of the Partnership's shares bearing the same proportion to the total shares owned by the Partnership that the number of General Partnership Units held by that Partner bears to the total number of General Partnership Units outstanding.

At his death on Date 2, Trust held Decedent's 10 general partnership units, his 1,000 Class A limited partnership units, and 22.5 percent of the outstanding stock in Corporation. On the federal estate tax return, the estate included in Decedent's gross estate, the date of death value of the 22.5 percent stock interest in Corporation and of the 10 general partnership units and 1,000 Class A limited partnership units.

LAW AND ANALYSIS:

Section 2036(a) provides that the gross estate includes the value of property to the extent of any interest in the property of which the decedent has at any time made a transfer (except in case of a bona fide sale for 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 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.

Section 2036(b)(1) provides that , for purposes of § 2036(a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a "controlled corporation" is considered to be retention of the enjoyment of transferred property. Under § 2036(b)(2), a corporation is 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 § 318), or had 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.

The provision now contained in § 2036(b) was incorporated initially into § 2036(a) by the Tax Reform Act of 1976. Subsequently, the Technical Corrections Act of 1978 added § 2036(b).

The underlying legislative history states that in enacting the provision, Congress intended to overrule United States v. Byrum, 408 U.S. 125 (1972). In Byrum, the Supreme Court held that the decedent's retention of the right to vote transferred stock did not constitute the retention of the enjoyment, right to income, or the right to designate who shall possess or enjoy the transferred stock, for purposes of § 2036(a). In reaching this conclusion, the Court noted that the decedent, as controlling shareholder, had a fiduciary duty to the corporation and its shareholders and, thus, could not act solely to promote his own interests at the expense of the corporation or its other shareholders. Congress believed that 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. H.R. Rep. No. 1380, 94th Cong., 2d Sess. 65 (1976), 1976-3 C.B. (Vol. 3) 735, 799; See also, S. Rept. No. 745, 95th Cong., 2d Sess. 89-90 (1978).

The legislative history also states that the provision applies even if the transfer of stock is indirect, such as where the decedent transfers cash or other property to a trust of which he is trustee and the trust uses the cash or property to purchase stock in a "controlled" close corporation from the decedent. The decedent would be viewed as transferring stock to the trust for § 2036(b) purposes. Further, the capacity in which the decedent exercises the voting rights is immaterial. H.R. Rep. No. 1380, supra, at page 65, 1976-3 C.B. (Vol.3) at page 799. Finally, the retention of voting rights may be indirect, such as where the decedent transfers voting stock to a trust of which he is not trustee, but has an arrangement or agreement with the trustee to vote the stock as the decedent directs. The decedent would be viewed as indirectly retaining the right to vote the stock for § 2036(b) purposes. S. Rept. No. 745, supra, pages 90-91 (1978).

In this case, in view of the ownership of the Corporation stock by Partnership and Trust, and the decedent's right to vote the stock, Corporation was a controlled corporation for purposes of § 2036(b)(2) with respect to Decedent, between the date of transfer to Partnership and Decedent's date of death.

Further, the transfer of Decedent's Y shares of voting stock to Partnership is properly viewed as a transfer of the stock, for purposes of § 2036(b), for less than adequate consideration. That is, Decedent, in substance, transferred the stock to Partnership in exchange for 10 general partnership units and 1000 Class A limited partnership units. The 100 Class B and 100 Class C units passed to Decedent's

children, pursuant to an integrated plan, at the moment Partnership was formed.² Thus, these units cannot properly be viewed as received by Decedent in exchange for the transfer of his stock to Partnership. Because Decedent did not receive all of the consideration for his transfer of stock to Partnership, Decedent transferred the stock for less than adequate consideration for purposes of § 2036(b). In addition, it is doubtful that the transfer to the family owned partnership designed to produce an estate freeze could be characterized as a "bona fide" sale.

As a general partner, Decedent retained the right to vote the Y shares. In this regard, the statutory language expressly states that the statute applies where the decedent retains "either directly, or indirectly" the right to vote the stock. The legislative history indicates that the statute applies regardless of the capacity in which the decedent exercises the voting rights. The statute applies where the stock is voted by the decedent indirectly through a fiduciary, and accordingly, would necessarily apply where the decedent holds the voting rights directly, as a fiduciary. Accordingly, Decedent's retention of the right to vote Corporation stock in his capacity as a general partner constitutes the retention of the right to vote the transferred stock for purposes of § 2036(b).

The estate argues that Decedent could only vote Corporation stock in conjunction with the other general partner, and therefore, § 2036(b) does not apply. We disagree. First, we note that under Article 8.3 of the partnership agreement, if the general partners cannot agree on how the shares in Corporation are to be voted, then each general partner is to vote that number of shares proportionate to his general partnership units. Thus, the partnership agreement authorized Decedent, at a minimum, unilaterally to vote the shares he transferred to Partnership. Further, under § 2036(b), the retained right to vote transferred stock constitutes the retained enjoyment of the stock, and the legislative history indicates that the statute applies regardless of the capacity in which a decedent exercises the voting rights. Thus, we believe the statute applies even if the voting power is only exercisable by a decedent in conjunction with another.

We believe that § 2036(b) would also apply if the steps of the transaction in this case had occurred several years apart. That is, if Decedent had transferred his Y shares of Corporation voting stock and Z shares of nonvoting stock in exchange for 10 general partnership units, 1,000 Class A limited partnership units, 100 Class B limited partnership units, and 100 Class C limited partnership units and two years later,

² Under the "end result" test for applying the "step transaction" doctrine, if it appears that formally separate steps are actually parts of a single transaction intended from the beginning to reach the end result, the tax consequences are based on the substance of the transaction not on the formalities structured by the parties. See, Penrod v. Commissioner, 88 T.C. 1415 (1987).

transferred the Class B and C units to his four children, then under § 2036(b), the date of death value of the Y shares held in the partnership would be includible in Decedent's gross estate.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.