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THE GIFT OF OPPORTUNITY

Randall J. Gingiss*

INTRODUCTION

This Article examines the federal transfer tax treatment of gifts of services as well as other opportunities in order to see how such activities fit, or at least ought to fit, within our transfer tax system. The Article will examine how gifts of opportunity and services compare to gifts of interests in closely held businesses and will suggest that, instead of trying to tax gifts of opportunity, the Internal Revenue Code ("Code") should be amended to exempt closely held businesses from the transfer tax system. The existence of closely held businesses is something to be encouraged. Transfer taxation hinders the passing of closely held businesses because it places a heavy burden on the next generation. Although closely held businesses can be taxed in an enforceable manner, they are inherently difficult to value. Gifts of services and opportunity accomplish the same result as gifts of interests in corporations and partnerships but, unlike the latter, are incapable of enforceable taxation. If closely held businesses must be taxed, there is an easier and more enforceable way to tax them that avoids the valuation problems inherent in the current system.

The starting point of the discussion is a classic 1977 article by Professor George Cooper. In his article, Professor Cooper discusses various methods by which careful planning could avoid the federal estate tax on the estates of wealthy individuals. Some of his concerns about widely used methods of transfer tax avoidance have been remedied by legislation such as the federal generation-skipping transfer tax. Others have been remedied by court decisions.3

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The author wishes to thank three of his colleagues and friends for their helpful comments on this Article: James Colliton, Professor of Law, DePaul University; David Sinow, Professor of Finance, University of Illinois at Urbana-Champaign; and Donald Zeigler, Professor of Law, New York Law School.

2. I.R.C. § 2601 (West Supp. 1991). Unless otherwise indicated, all citations to the Internal Revenue Code are to this version.
Some still remain. In particular, Professor Cooper looked at several tax avoidance techniques, such as the gift of services, as loopholes in the gift tax system. He concluded that changes must be made in the transfer tax system to close these loopholes. I am suggesting that some of those loopholes are incapable of being closed, and exempting closely held businesses not only will be fairer but also will accomplish desirable social goals.

Part I of this Article examines the case law and statutory authority on the issue of taxing gifts of services and opportunity. Although there is little statutory authority directly bearing on the issue, there has been a sporadic history of cases that test the outer limits of the gift tax statutes.

Part II deals with the problems of valuation. Valuation of closely held businesses is one of the most difficult issues in the current tax system. Any suggested alternatives to the current federal gift tax and federal estate tax should address the difficulty of placing a reasonable fair market value on interests in closely held businesses.

Part III discusses the alternatives that have been suggested to date as well as their impact on gifts of opportunity and gifts of interests in closely held businesses. There are a number of suggested alternatives to the current transfer tax scheme, including a wealth tax, an accessions tax, a consumption tax, a restructuring of the current system to make gifts difficult to complete, or simply a repeal of the transfer taxes accompanied by repeal of Code section 102, thereby subjecting gifts and inheritances to income tax. These alternatives will be reviewed here only in the context of gifts of opportunity or of services compared to inheritances of incorporated family businesses or family partnerships.

Part IV of this Article articulates new alternatives that exclude taxation of closely held businesses. If, however, some sort of tax on closely held businesses is inevitable, the tax should be based on modified income, which will render valuation at death or at the time of a gift unnecessary.

The threshold issue is what can or should be done about the inability to tax gifts of opportunity or services under the current gift tax. Professor Cooper’s suggestion is a wealth tax. His thesis is that an annual wealth tax would

4. See infra notes 47-60 and accompanying text (discussing family partnerships); infra notes 69-71 and accompanying text (business referrals, such as in Crowley v. Commissioner, 34 T.C. 333 (1960)); infra notes 72-83 and accompanying text (bringing one’s children into a partnership).
5. See infra notes 146-51 and accompanying text (discussing current wealth tax proposals).
6. See infra notes 152-55 and accompanying text (discussing the possibility of an accessions tax).
7. See infra notes 156-57 (examining a consumption tax proposal).
9. See id. at 245.
10. See infra notes 147-48 and accompanying text (discussing a proposal to create a comprehensive tax base).
11. See Cooper, supra note 1, at 231-35. The wealth tax concept has frequently raised constitu-
make it unimportant which family member has the wealth, so that a gift of opportunity would be no different than a gift of shares of, say, General Motors. Both a wealth tax and Professor Cooper's discussion of it have received considerable discussion. My suggestions and conclusion are far different than the alternatives suggested in the current literature.

The proposal that closely held businesses should not be the subject of transfer taxation, as with most proposals, has definitional problems and requires scrutiny to ensure that it will not encourage questionable behavior without social function other than tax avoidance. These problems are inherent in most taxing schemes, including the current federal estate and gift taxes. I make certain assumptions:

- The current gift tax cannot and should not attempt to tax most of the cases discussed above. There are simply too many practical problems that are too difficult to address.
- It is offensive to attempt to tax dining room discussions.
- The problems of valuing services and opportunity are insurmountable. The problems in valuing closely held businesses are not much easier and the Internal Revenue Service ("Service") has lost a great many valuation cases.
- It is impossible to trace the source of investment advice that results in a particular investment, except in some obvious cases involving investments on behalf of minor children.
- Closely held businesses generally do not run themselves, but require as much effort from the younger generation as from the older simply to hold their own.
- There is a greater bias against inherited wealth than against wealth built through one's own efforts. Closely held businesses require the continuing efforts of owners.
- There is pressure on closely held businesses with many collateral owners (cousins several generations down from the founder) to pay dividends, which is a doubly taxed form of distribution that in turn creates some

 שלנו: Based on Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 637 (1895), which held that taxes on real property, personal property, income from real property, and income from personal property were "direct taxes" that had to be apportioned among the states in accordance with population. Id. The 16th Amendment to the United States Constitution overruled Pollock insofar as an income tax was concerned, but left in place Pollock's holding that a tax on wealth was unconstitutional. The United States Supreme Court overruled Pollock on the issue of exemption of state bonds from federal registration requirements in South Carolina v. Baker, 485 U.S. 505, 526-27 (1988). Whether this case overruled Pollock for all purposes is not clear from the decision.

12. See, e.g., Gilbert P. Verbit, Taxing Wealth: Recent Proposals from the United States, France and the United Kingdom, 60 B.U. L. Rev. 1, 1-5 (1980) (discussing the renewed attention being focused on a periodic wealth tax).
pressure to buy out the collaterals or go public. There are adequate safeguards in the income tax system against massive payroll padding for relatives.

A common theme of alternative proposals is that all forms of inherited wealth must be taxed at the time of transfer. This may be understandable from the point of view of an inheritance of a residence or valuable jewelry, but I suggest taxation at time of transfer is an unnecessary requirement for taxing a closely held business.

What gives property value? In the case of jewelry or art, it is the combination of inherent beauty and scarcity. With regard to a residence, there is a nonmonetary benefit in the form of in-kind use. In the case of bank accounts and publicly listed securities, there is a storage of purchasing potential as well as the potential to earn income. With closely held businesses, it is income-earning potential. If one insists on taxing closely held businesses, and if one is willing to wait until that income becomes possessory, there is a very simple means to tax it. It is called an income tax. For the very wealthy, one need only make the income tax more progressive for income from a successful business. Perhaps a claim of an exemption from transfer taxation would be the point at which an income tax surcharge would be imposed. The disadvantage here, however, would still be a difference between the treatment of business transfers and transfers of services or other opportunities. The inability to make the distinction on a taxable basis argues in favor of a tax-free treatment for both transfers of services and opportunity on the one hand, and closely held businesses on the other.

I. Existing Cases and Statutes

There is currently no direct mention of the gift of opportunity in the trans-


16. It may be argued that there is a monetary equivalent in avoided rent. The United Kingdom attempted to tax such rental value in income without success. See Income Tax Act of 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, ch. 10, §§ 106-215, repealed by Finance Act of 1963, § 14 (Eng.).

17. I have not attempted to define "closely held business" for purposes of this Article. Section 6166 of the Internal Revenue Code, which allows a deferral of taxes for closely held businesses, has a definition that covers corporations and partnerships:

For purposes of this section, the term "interest in a closely held business" means—
(A) an interest as a proprietor in a trade or business carried on as a proprietorship;
(B) an interest as a partner in a partnership carrying on a trade or business, if—
(i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or
(ii) such partnership had 15 or fewer partners; or
(C) stock in a corporation carrying on a trade or business, if—
(i) 20 percent or more in value of the voting stock of such corporation is included in
determining the gross estate of the decedent, or
(ii) such corporation had 15 or fewer shareholders.

I.R.C. § 6166.
fer tax statutes. The Service has, from time to time and with varying success, attempted to bring such gifts within the orbit of the gift tax.

A. Dickman v. Commissioner—The Most Recent Landmark

In *Dickman v. Commissioner*, the United States Supreme Court established that the gratuitous giving of the use of property constitutes a taxable gift, thereby putting an end to the use of interest-free demand loans as a device to pass wealth to family members outside of the federal transfer tax system. Some of the language in the case is quite broad: “Congress intended the gift tax statute to reach all gratuitous transfers of any valuable interest in property . . . . [T]he gift tax was designed to encompass all transfers of property and property rights having significant value.” Such language indicates that there is confusion surrounding the term “property.” The question remains whether the Service can go beyond the term “property” and cover gifts of opportunity, such as education, business investments, business contacts, and services.

Any such examination is aided by a review of the goals that the federal transfer tax system was intended to accomplish. While the early versions of the federal estate tax were intended to raise revenue, it appears that the current purpose, to the degree that it has been enunciated at all, is to inhibit the passing of inherited wealth from generation to generation. The federal gift tax was enacted as a backup to the estate tax to prevent taxpayers from avoiding the estate tax by making lifetime gifts. Gifts of services, including spotting business opportunities and business contacts, cannot be passed by will. Using the federal gift tax to tax these items does not serve any backup purpose, yet independently taxes valuable transfers. Nevertheless, such gifts do accomplish an increase in the wealth of junior generations. It is well estab-

18. Id. For purposes of this Article, the “transfer tax statutes” are the federal estate tax (Chapter 11 of the Code, I.R.C. §§ 2001-2210), the federal gift tax (Chapter 12 of the Code, I.R.C. §§ 2501-2524), the federal generation-skipping transfer tax (Chapter 13 of the Code, I.R.C. §§ 2601-2663) and Special Valuation rules (Chapter 14 of the Code, I.R.C. §§ 2701-2704). The last is not a separate tax but a set of rules that apply to the others.


20. Id. at 343.

21. Id. at 334.


23. Rhodes, supra note 22, at 581-82.

24. Lowndes et al., supra note 13, at 664.
lished, for example, that the children of wealthy families who have not yet inherited any property are nevertheless wealthier than the children of less wealthy families. This has sometimes been explained as a transfer of human capital, as distinguished from property.

B. Limited Statutory Coverage

The concept of gifts of opportunity has had limited coverage in the transfer tax statutes. The gift tax statute expressly excludes gifts of educational expenses from its coverage. When one considers that less than 1% of all families have to worry about transfer taxes to begin with, the educational expense exemption is very curious from a policy perspective. If this exemption is to be justified at all, it must be justified on the basis that to tax these expenditures would be offensive to an overwhelming percentage of the population. Although only a small percentage will have to pay the taxes, a much larger percentage will have return filing requirements that will simply be ignored. This would not be the first time that massive noncompliance has justified a relaxation of the gift tax laws.

25. See Jatscher, supra note 22, at 52.
26. See Michael J. Boskin, An Economist’s Perspective on Estate Taxation, in DEATH, TAXES AND FAMILY PROPERTY: ESSAYS AND AMERICAN ASSEMBLY REPORT, supra note 22, at 56, 58. For an interesting, readable, and controversial book that discusses the role of human capital, see generally THOMAS SOWELL, THE ECONOMICS AND POLITICS OF RACE, AN INTERNATIONAL PERSPECTIVE (1983). Sowell argues that much of the transfer of human capital comes from certain cultural groups such as Jews, Chinese, Japanese, and West Indian blacks who, upon emigration, have risen out of poverty in a generation. Without passing judgment on the validity of his analysis, it raises some interesting gift-tax questions if the gift of opportunity is taxed. Many poverty-stricken, first-generation Jews, Chinese, Japanese, and West Indian blacks (and many other groups as well) would owe a gift tax they could not possibly afford to pay.
27. I.R.C. § 2503(e).
29. Even with today’s college expenses, it will take some time before cumulative costs for all children exceed the annual exclusion for each child ($10,000 for each donee from each donor, $20,000 per donee for each married couple) and the exemption equivalent from the gift tax ($600,000 for each individual, $1.2 million for a married couple). I.R.C. §§ 2503(b), 2513, 2505.
30. 1981 Estate and Gift Tax Hearings, supra note 22, at 176 (joint statement of Harvie Branscomb, Jr., Chairman, and John S. Nolan, Chairman-Elect, Section of Taxation, American Bar Association).
31. Section 2515 of the federal gift tax was enacted with the Internal Revenue Code of 1954. It provided that creation of tenancy by the entirety in real property between spouses was not a taxable gift unless spouses elected it to be so, thereby statutorily overruling cases such as Lilly v. Smith, 96 F.2d 341 (7th Cir.) (holding that the creation of a tenancy by the entirety between spouses constitutes a taxable gift), cert. denied, 305 U.S. 604 (1938). In explaining the enactment, the House Ways and Means Committee stated:

Under present law the creation of a tenancy by the entirety may result in a gift from one spouse to the other at the time the tenancy is created. Moreover, the termination of the tenancy may also constitute a gift unless the proceeds are divided between the husband and wife. Frequently, real property is held in a tenancy by the entirety to ensure the right of survivorship in the surviving spouse. Many couples who elect this method of buying a home have no intention of making a gift at the time of the crea-
The second area where the concept of opportunity appeared in the gift tax statute is more obscure (and no longer existent). It occurred in the context of the now-repealed Code section 2036(c). Section 2036(c) was designed to stop the use of preferred stock asset freezes. With a preferred stock asset freeze, a parent and majority shareholder recapitalizes a corporation into preferred and common shares with characteristics such that the preferred shares would be worth the current value of the corporation, but would be frozen in value. All appreciation in the value of company shares would belong to the common shares. The parent would then give the common shares to children, taking the position that the common had little, if any, value.

Section 2036(c) was enacted in Section 10402(a) of the Revenue Act of 1987. As enacted, the statute was both complex and ambiguous. It stated that if an individual held a substantial interest in an “enterprise,” and such individual transferred a disproportionate amount of appreciation while retaining rights to income or voting rights, the transferor would be deemed to have retained an interest in the transferred interest so that the transferred interest would be included in the transferor’s estate. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") attempted to correct some of the ambiguities.

A major ambiguity in section 2036(c) was what constituted a retained interest in income. Although the statute was aimed at a preferred share interest, it could, as worded, apply to a loan from, or employment contract retained by, the senior generation. It was also unclear whether a new enterprise, formed by investments made by the senior and junior generations at the same time, was covered by the statute. TAMRA defined two kinds of loans that were not retained interests in an enterprise and therefore were exempt from the reach of the new statute: qualified debt and qualified start-up debt. If the lender met the requirements of either of these categories, he would not be deemed to have retained an income interest in the enterprise. It is in the latter category, qualified start-up debt, that the concept of business opportunity gets its only explicit mention in the transfer tax statutes:

Qualified Start-up Debt is defined as any indebtedness if:
(I) such indebtedness unconditionally requires the payment of a sum certain in money,
(II) such indebtedness was received in exchange for cash to be used in any enterprise involving the active conduct of a trade or business,
(III) the person to whom such indebtedness is owed has not at any time of the tenancy by the entirety or any knowledge that they are considered as having done so.

transferred any property (including goodwill) which was not cash to the enter-
prise or transferred customers or other business opportunities to the enter-
prise,
(IV) the person to whom such indebtedness is owed has not at any time
(whether before, on, or after the exchange referred to in subclause (II))) held
any interest in the enterprise (including an interest as an officer, director, or
employee) which was not qualified startup debt,
(V) the person who (but for subparagraph (A)(i)) would have been an origi-
nal transferee (as defined in paragraph (4)(C)) participates in the active
management (as defined in section 2032A(e)(12)) of the enterprise, and
(VI) such indebtedness meets the requirements of clauses (v) and (vi) of
subparagraph (C). 36

The details of section 2036(c) are unimportant for purposes of this discussion.
Of importance, however, is that the Code attempted to attach transfer tax
significance to certain nonproperty items: transfer of goodwill; transfer of cus-
tomers; transfer of business opportunities; and holding an interest as officer,
director, or employee.

The Service in recent years has not attempted to pursue gifts of services. 37
The closest the Service came to taxing these gifts was under the 1939 Code in
the companion cases of Hogle v. Commissioner (Hogle I), 38 and Commiss-
tax case, arose out of the same transaction. The cases were not only decided
by the same court, but by the precisely same panel of judges.

The facts relevant to both Hogle I and Hogle II are simply stated. Mr.
Hogle established a trust for the benefit of his three children. The trust was
clearly irrevocable. Profits from trading on margin belonged to the trust, but
losses were to be made up by Mr. Hogle and his wife. Any losses, however,
were ultimately repaid by profits of the trust. Sales on margin were made by
the trust at Mr. Hogle's direction. In Hogle I, the Tenth Circuit described Mr.
Hogle's activity as follows:

The income thus created and the profits thus realized were not merely in-
come accruing from the corpus of the trust or from capital gains realized
from disposition of corpus, but were profits earned through trading on mar-
gins involving the exercise of personal skill and judgment of Hogle and were
in substance the personal earnings of Hogle. The amount of trading on mar-
gins which Hogle was to carry on for the trust was wholly in his discretion.
He could trade little or much or not at all for the benefit of the trust as he
saw fit. Thus, he exercised practical control over what portion of income

37. W. LESLIE PEAT & STEPHANIE J. WILLBANKS, FEDERAL ESTATE AND GIFT TAXATION: AN
ANALYSIS AND CRITIQUE 50-53 (1991); RICHARD B. STEVENS ET AL., FEDERAL ESTATE AND GIFT
38. 132 F.2d 66 (10th Cir. 1942) (Hogle I).
39. 165 F.2d 352 (10th Cir. 1947) (Hogle II).
from his personal efforts in trading on margins should accrue to the trust.40

The Hogle I opinion does not go so far as to say that Mr. Hogle allocated profit from trades after the fact. Therefore, one assumes that all trades for the trust were identified before the profit or loss was known. It is also clear that the trades did not initially require capital from the trust. In one instance, the Hogles put up the collateral necessary for a trust to trade on margin. It was clearly services that Hogle was giving that caused the court to conclude: “In substance, he gave to the trust in each of those years the profits derived from a designated portion of his individual efforts. It amounted in each of those years to a voluntary assignment of a portion of his personal earnings.”41

This quotation from Hogle I appears to support the conclusion that Hogle’s trading for the trust was a gift. In Hogle II, however, the court reached the conclusion that no gift was involved:

The purpose of the [gift tax] statute is to reach and lay a tax upon every type and kind of transfer of property by gift. With that legislative purpose in mind, the terms “property,” “transfer,” “gift,” and “indirectly,” as used in the statute, should be interpreted in their broadest and most comprehensive sense. But the tax cannot be sustained unless there was a transferor, a transferee, and an effective transfer of title or other economic interest or benefit in property having the quality of a gift.

The net income derived from trading carried on in behalf of the trusts accrued immediately and directly to the trusts, and did not consist of income accruing to Hogle which he transferred by anticipatory gift to the trusts. Hogle never owned an economic interest in such income.48

It is clear from the holding in Dickman that Hogle II’s conclusion that the gift tax only applies to effective transfers of title or interest in property is no longer valid.49 Furthermore, Hogle II was cited favorably in Crown v. Commissioner,44 a case holding that there is a distinction between gifts of services and interest-free loans.45 Crown, however, was explicitly overruled by the holding in Dickman.

Most of the cases that raise these issues are income tax cases. Hogle II appears to be the only attempt to treat the income tax and the gift tax in pari materia in the context of a gift of services.46

C. Family Partnerships

Professor Cooper suggested, however, that the use of a family partnership

40. Hogle I, 132 F.2d at 71.
41. Id.
42. Hogle II, 165 F.2d at 353 (footnotes omitted).
43. See Dickman v. Commissioner, 465 U.S. 330, 343 (1984); see also supra notes 19-21 (discussing the holding in Dickman).
44. 585 F.2d 234 (7th Cir. 1978).
45. Id. at 241.
46. Professor Cooper gave Hogle II only a passing mention. See Cooper, supra note 1, at 180.
could avoid the difficulties of both the income and gift tax systems. Code section 704(e) deals with family partnerships. It provides:

(1) RECOGNITION OF INTEREST CREATED BY PURCHASE OR GIFT.—A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

(2) DISTRIBUTIVE SHARE OF DONEE INCLUDIBLE IN GROSS INCOME.—In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be in- cludible in his gross income, except to the extent that such share is determined without allowance of reasonable services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor’s capital . . . .

(3) PURCHASE OF INTEREST BY MEMBER OF FAMILY.—For purposes of this section, an interest purchased by one family member from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered donated capital. The “family” of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts created for the primary benefit of such persons. 47

Professor Cooper saw an abuse for such family partnerships in real estate ventures:

Among the most impressive uses of family partnerships described to us were situations which made effective use of borrowed funds to leverage the potential for shifting value to children. Suppose that a partnership is created for a new business venture. The father, who is a real estate entrepreneur, becomes the general and managing partner and makes a modest contribution to capital. His children become limited partners, making a capital contribution equal to or even larger than their father’s. The substantial funds needed for the project are borrowed from banks or other independent lenders. To the extent that the transaction succeeds, the banks or other outside lenders are paid off and the overriding gains accrue to the children in proportion to their capital contributions. But if the transaction fails, the parent as general partner is left holding the major share of liability. Thus the child has been presented with a risk-free opportunity for substantial gain, free of transfer tax. New [Code sections] 465 [and] 704(e) would preclude use of this leveraging technique in many situations, but would have no effect on real estate transactions, where primary use seems to be made of it. 48

Professor Cooper was prophetic. Seven months after his article was published, the Tax Court decided Carriage Square, Inc. v. Commissioner. 49

47. I.R.C. § 704(e).
48. Cooper, supra note 1, at 181-82 n.59.
Carriage Square, the facts were substantially similar to the family partnership scheme described by Professor Cooper. The only significant difference was that in Carriage Square there was an intervening corporation as general partner, of which the father, Arthur Condiotti, was a 79.5% owner and his tax adviser, William Barlow, was owner of the balance of the shares. The corporation, Carriage Square, Inc., contributed $556 to the partnership for a 10% of profits interest. Five trusts each contributed $1000 and each received an 18% of profits interest. These trusts had been created by $1000 gifts from Mr. Condiotti’s mother who, coincidentally, received a $5000 gift from Mr. Condiotti immediately prior to making the gifts. The trusts immediately invested in the partnership, a limited partnership called Sonoma Development Company. The beneficiaries of the five trusts were Mr. Condiotti, his wife, and his three children.

Mr. Condiotti would purchase land, taking a loan from both Crocker Bank and the seller. He would then sell parcels of the land to the partnership, and the partnership would borrow from the same bank on a continuing guarantee from Mr. Condiotti and his wife. The partnership would then receive a construction loan from Crocker Bank with the same guarantee. As the real estate development became successful, the loan would be repaid and the substantial profits would belong to the trusts.

The attitude of the Tax Court can best be summed up in Judge Goffe’s concurrence:

All of the members of the Court recognize that the tax avoidance scheme of Arthur Condiotti and his accountant-tax adviser, William P. Barlow, cannot be allowed to stand. It is an obvious attempt, and a somewhat crude attempt, lacking legitimate business purposes, to spread large anticipated sums of ordinary income among several taxpayer trusts to achieve a low rate of tax on such income.

Notwithstanding a unanimity of attitude against these Condiotti family partnerships, there is anything but a unanimity of reasoning. The majority’s reasoning was so convoluted that it at least had the good sense to virtually limit its own holding to the facts of the case. Even more problematic is that if the transaction in Carriage Square is not characterized as a taxable gift under the gift tax rules, the result of the income tax holding exacerbates the gift tax problem. In an era of 31% maximum tax rates, spreading income among various taxpayers is of limited value. Making tax-free gifts to one’s child or the child’s income tax liability, however, is a significantly more dangerous abuse that Carriage Square appears to allow.

50. In an income-splitting context, this gift followed by a gift back casts some doubt on who is really the grantor of the trust for purposes of the grantor trust rules. See, e.g., Weigl v. Commissioner, 84 T.C. 1192, 1227 (1985) (holding that the individual controlling the assets in the trust, and not the person who nominally funded the trust, was the grantor).

51. In Private Letter Ruling 91-13-009, discussed infra notes 61-64 and accompanying text, the Service has taken the position that a guarantee of a loan by itself is sufficient to constitute a gift.

52. See Carriage Square, 69 T.C. at 130-31 (Goffe, J., concurring).
The majority's reasoning is that under the family partnership rules, the capital borrowed from the Condiottis was not capital at all. Therefore, the borrowed capital was not a "material income producing factor." In addition, the majority found that there was no bona fide partnership. With regard to borrowed capital, the court found:

Sonoma did employ large amounts of borrowed capital in constructing houses on the lots which it purchased from the Condiottis. While borrowed capital, under other circumstances, may be "capital" for section 704(e)(1) purposes, we hold that it is not in this instance. Petitioner, as Sonoma's only general partner, was the only partner in Sonoma whose liability for repayment of such borrowed capital was not substantially limited. Furthermore, Crocker would not have loaned such capital to Sonoma secured by partnership assets (or the general partner's assets) alone, but would loan such capital to Sonoma only after a continuing guarantee had been executed making the Condiottis liable for Sonoma's debts to Crocker in the event Sonoma did not pay them. Since Sonoma made a large profit with a very small total capital contribution from its partners and was able to borrow, and did borrow, substantially all of the capital which it employed in its business upon the condition that such loans were guaranteed by nonpartners, we think that section 1.704(e)(1)(i), Income Tax regs., prohibits the borrowed capital in the instant case from being considered as a "material income-producing factor." The regulation requires that such capital be "contributed by the partners."

With regard to the existence of a partnership, the court found the transaction essentially a sham:

We hold, therefore, that Sonoma was not a partnership in which capital was a material income producing factor and consequently section 704(e)(1) is inapplicable. However, the trusts must still be recognized as partners unless it appears that the parties did not in good faith and acting with a business purpose intend to join together as partners.

We are unable to find that the parties acted with a business purpose because the trusts received a 90-percent share of Sonoma's profits even though they made no material contribution to the business. Their capital contribution was not material since Sonoma could borrow substantially all the money necessary to conduct its business as long as the Condiottis guaranteed its debts (which they did). The trusts provided no services and their liability was limited to the amount of their contributed capital plus their share of retained earnings. Furthermore, we cannot find that the parties in good faith intended to join together as partners where petitioner provided all the services necessary for the conduct of a partnership business, assumed substantially all risk of loss, and utilized its business contacts in obtaining large loans required by the partnership business, but nevertheless was given

53. For a detailed discussion of capital as a material income-producing factor, see Sheldon I. Banoff et al., Family Partnerships: Capital as a Material Income-Producing Factor, 37 TAX LAW 275 (1984).
54. Carriage Square, 69 T.C. at 127.
only a share of the partnership profits which was exactly equal to its share of capital contributions. Accordingly, we hold that the trusts were not bona fide partners of Sonoma so that respondent correctly allocated the income earned by Sonoma to petitioner.55

There are some serious problems with the majority's opinion, most of which are ably identified in Judge Goffe's concurrence. First, the theory adopted by the court was not argued by either party. Second, the idea that borrowed capital may not be capital is antithetical to the way in which real estate purchases are typically financed. Third, distinguishing between general partners and limited partners is definitional to all limited partnerships and it is clear that a limited partnership is a recognized form of partnership under subchapter K of the Code.56

By ignoring the partnership entity existing among the Condiottis and not applying the family partnership rules, the court taxed the wrong entity. The one with the unlimited liability was Mr. Condiotti. He is the one who should have been taxed. The corporation, although having unlimited liability as a matter of law, did not have sufficient assets to cover possible losses. This point was argued by Mr. Condiotti but received only a footnote mention in Judge Tannenwald's dissent.57 Judge Tannenwald did not agree with the decision to ignore the partnership entity. He argued that Mr. Condiotti, having created the form of the transaction, ought not be free to ignore the form of the transaction and succeed in claiming that substance should prevail over form. Judge Tannenwald also provided a rationale that is more useful from the point of view of a gift tax analysis:

The share of partnership income attributable to each trust, while proportionate to the initial capital investments by each partner, was grossly disproportionate when the role of Condiotti, and particularly the use of his credit standing, is taken into account. Nor is there any indication that investments by the trusts were intended to promote the success of the partnership's business either through the participation of the trusts or the use of their credit. In short, I think it more appropriate to treat the trusts' partnership interests as having been acquired by gift within the meaning of section 704(e)(2).58

Once it is accepted that the interest from the trusts is acquired by gift, then it follows that the allocation is disproportionate. The issue is whether or not Judge Tannenwald's logic can be extended to the gift tax itself and not merely to the family partnership rules. Failure to make the transition will leave open the use of an S Corporation, which has no equivalent in the family partnership rules.59 The ability of a trust to hold S Corporation shares is more limited than

55. Id. at 128.
57. Carriage Square, 69 T.C. at 141 n.3 (Tannenwald, J., dissenting).
58. Id. at 140-41 (Tannenwald, J., dissenting).
59. See Cooper, supra note 1, at 185. The Internal Revenue Code allows readjustment of income in an S corporation where, if other family members are shareholders, an individual renders
the ability of a trust to own a limited partnership interest, but if income tax spreading is no longer a goal, this can be accomplished by making the trusts completed gifts for gift tax purposes but grantor trusts for income tax purposes.\(^\text{60}\)

**D. Loan Guarantees**

The failure to make such a transition will also leave open the naked guarantee of a child's business loan as a tax-free gift. The Service raised this issue in Private Letter Ruling 91-13-009.\(^\text{61}\) In that ruling, the father offered his guarantee to allow various of his five children to obtain business loans. The taxpayer asked for a ruling that such a guarantee did not constitute a gift or at least, if there was a gift, that it could not be ascertained until such a time in which payment was made pursuant to the guarantee by the father. Citing *Dickman* and *Commissioner v. Wemyss*,\(^\text{62}\) the Service stated:

> The agreements by T to guarantee payment of debts are valuable economic benefits conferred upon the shareholders of the acquiring companies and entities. You state that, without guarantees, those shareholders [T's children] may not have obtained the loans or, in the very least, would have had to pay a higher interest to obtain the loans. Consequently, when T guaranteed payment of the loans, T transferred a valuable property interest to the shareholders. The promisor of a legally enforceable promise for less than adequate and full consideration makes a completed gift on the date the promise is binding and determinable in value rather than when the promised payment is actually made.\(^\text{63}\)

The Service, however, did not discuss the issue of how the gift of a guaranteed loan is to be valued. The ruling makes clear that another gift occurs when the guarantee is actually called. If the loan is called at death, while it may be deductible, it is subject to a corresponding increase in the estate for the right of reimbursement against the children.

The worst aspect of Private Letter Ruling 91-13-009 relates to the marital deduction. The ruling holds that the face amount of the marital deduction is reduced by the face amount of the guarantee, and to the extent it can be satisfied out of a qualified terminable interest property ("QTIP") trust, it may cause the loss of the marital deduction for the entire QTIP.\(^\text{64}\)
It is understandable that the Service desires to tax this sort of help. The folly of attempting to do so, however, is seen by comparing the guarantee of a loan by a parent to the parent's borrowing the money himself and then lending it to the child. If the parent loans funds to the child on a demand basis, the gift taxation of that loan is covered by Code section 7872 on below-market loans. Section 7872 states that a below-market loan is treated as if the lender made the loan at market, the borrower paid the lender the market rate of interest, and the lender then made a gift to the borrower of the difference between the amount of market interest and the interest actually paid. As of the writing of this Article, that market rate of interest is set by the Code at 6.85%. If the parent borrowed the money from the bank, he would likely pay a point or two over the lender's prime lending rate. The parent then can make a tax-free gift of 3% or 4% per year, as section 7872 does not address the source of the parent's funds. This result is highly ironic: Making a 6.85% loan is not a taxable gift under the federal gift tax but guaranteeing a loan that has a lending rate of one or two points over the prime lending rate is subject to the gift tax.

E. Sending the Child Business

Assisting one's child in business is another potential gift tax abuse mentioned by Professor Cooper and addressed obliquely by TAMRA's amendments to section 2036(c). Professor Cooper discusses this topic with reference to Crowley v. Commissioner, a case involving a parent's use of his business to help the businesses of his children. In Crowley, Mr. Crowley controlled a savings and loan association. The business generated various collateral sources of income, such as appraisal fees, insurance fees, and abstract title policy commissions. He established a partnership that was owned equally by his four minor children. The partnership was established to handle this collateral work generated by the savings and loan. The oldest child, still in college, had received some training in appraisal work and handled such work with his father's assistance. The appraisal fees were divided between the savings and loan and the partnership. His son also acquired a license as an insurance agent so he could handle the insurance needs of the savings and loan. The Tax Court held that the income was all taxable to the partnership and not to Mr. Crowley. Once the Tax Court concluded that the income belonged to the partner-

65. I.R.C. § 7872.
66. Id.
67. As of the writing of this Article, the prime lending rate is 9% so that the parent could borrow at 10% or 11%.
68. This is the difference between 10% or 11% and the 6.85% rate under I.R.C. § 7872.
69. Cooper, supra note 1, at 184-87 (discussing Crowley v. Commissioner, 34 T.C. 333 (1960)).
70. Crowley v. Commissioner, 34 T.C. 333, 345-47 (1960). The Tax Court, however, held against Mr. Crowley on one issue. The court found that Mr. Crowley provided his children with a
ship of Mr. Crowley's children, the gift tax issue disappeared. This case illustrates some of the limits to which one might want to push the gift tax and the futility of doing so. There is nothing in the Crowley opinion to indicate that the prices paid for appraisals or for insurance were more than would have been paid to an independent third party. Nevertheless, a college student with no prior experience would have a difficult time, without such parental assistance, in obtaining such an appraisal business. The insurance is a somewhat easier case not to treat as a taxable gift since the son was licensed, and presumably it takes some ability to pass an insurance proficiency test. Even then, however, that only ameliorates the gift tax issue with respect to the son in the business, not to the other children in the partnership. The son, after all, could have gone to work as an employee of the father and received some of the same benefits. What was occurring was not exactly a transfer of goodwill from the father to the partnership, because the partnership presumably had none until the son could build some reputation on his own. Rather, it was simply a business opportunity that the son and his siblings had not earned on the basis of ability and experience. Trying to tax this as a gift, however, is next to impossible. The same could be said for hiring the son as an employee if he were not otherwise qualified. If a transfer tax is to be exacted at all on job or business opportunities, one hopes it will be imposed on the underlying corporation and not the parent.

F. Lifetime Gifts of Partnership Interests

A partnership between parents and children can produce additional difficulties. A situation with which I am personally familiar involves a father and two sons. For many years, the father was a successful lawyer with a unique niche, involving both contacts and considerable legal skill. For most of those years, he hired associates but never made them his partner. Finally, his sons graduated law school and joined their father at a wage scale identical to unrelated associates. For the next six or seven years, the sons were treated no differently from other associates with respect to compensation. The sons, however, were given special training and introduced to the father's very valuable contacts. After six or seven years, at about the same time that most 200-lawyer law firms were making associates partners, the father made the sons partners for gift when he loaned money to the partnership at 2 1/2% interest and the partnership reloaned the funds at a higher rate to a loan customer whom Mr. Crowley had already identified. Id. Section 7872 of the Code would now reach a similar result. See I.R.C. § 7872.

71. The Service actually attempted to place a gift tax on these situations after losing a related income tax case in Fischer v. Commissioner, 5 T.C. 507 (1945) and 8 T.C. 732 (1947), acq., Rev. Rul. 8-732, 1947-1 C.B. 2. In the former case, the Tax Court held that a bona fide partnership existed between a father and his two sons and was therefore recognized for income tax purposes. In the latter case, the Service attempted to assess a gift tax based on a gift of two-thirds of the partnership. The Tax Court held that the bona fide nature of the transaction was established in the income tax case, which was determinative of the issue in the gift tax case, and that therefore there was no taxable gift.
about the same compensation they would have received as partners at a larger firm. It is safe to say that at this point in time the sons had considerable skill in the firm’s legal specialty.

As soon as the sons were proficient, a subtle change came about. The father’s two weeks per year in Florida became four, the four weeks became eight, and the eight weeks became six months. The father’s share of profits declined and the sons’ share of profits increased to reflect the changed contributions of time and effort. Finally, the father retired and his capital account was paid out. The net result was that the sons owned 100% of the law practice without a transfer tax ever having been paid. At least the sons in my example were eventually pulling their weight. The transfer of limited partnership interests, as in Carriage Square, presents an easier issue to resolve in favor of a taxable gift, although even on this issue there is some bothersome language to be found in case law, again in an income tax context. It involves the question of whether goodwill owned by an individual is transferrable.

In Bateman v. United States, the taxpayers transferred limited partnership interests in Bateman Brokerage Company (“BBC”), a food brokerage company, to trusts for their children. The district court held that the goodwill was a capital asset and belonged to BBC, not to the Bateman brothers personally. The Ninth Circuit majority held that the district court’s finding was not clearly erroneous, and thus affirmed its holding. The Ninth Circuit also upheld the conclusion that the goodwill capital was a material income producing factor, and therefore section 704(e) required the earnings to be taxed to the trusts, not to the Batemans. The troubling language of the opinion from the gift tax perspective is the following: “We agree with Judge Wright’s dissent to the extent that had the goodwill been personal to the Batemans, the transfers of interest to the trusts would not have received tax recognition.” This language, if not limited to the application of Code section 704(e), would indicate that personal goodwill is not transferrable.

Actual gift tax cases on transfer of partnership interests are old and generally not favorable to the government. In Rothrock v. Commissioner, two parents (themselves unrelated) brought their sons into their partnership, gradually increasing the sons’ partnership interests over the years. The taxable year at issue, 1941, was the year of the most recent amendment of the partnership agreement. The business of the partnership was dealing in foodstuffs on a brokerage and commission basis. The success of the business apparently depended on the personal relationships of the salesmen, primarily the four partners, and the food suppliers. The Tax Court, in holding for the taxpayer, avoided the issue of whether valuable contacts could be the subject of a taxable gift:

[T]he business by itself possessed no substantial element of future earning

72. 490 F.2d 549 (9th Cir. 1973).
73. Id. at 553.
74. Id.
power or good will, but that, on the contrary, its income was derived primarily from personal services, so that different participants with similar abilities, experience and contacts could have organized a comparable venture and enjoyed a parallel success from their contribution of time, skills, and services. This factor, coupled with the proven capacity of the respective sons and the value of the business of their contributions, results in our inability to discover any gift of interests, tangible or intangible, direct or indirect, to which the tax could attach. 76

It is not clear from the Rothrock opinion whether the fathers passed on contacts to the sons or whether the sons developed the contacts themselves, although there is some language that makes it appear that the sons developed their own contacts. 77

Cohn v. Commissioner 78 provides an easier justification for a taxpayer victory. The founder of the business and petitioner in the case, Sigmund Cohn, had a successful business of buying and selling rare metals to jewelry manufacturers. His son and nephew entered the business, and starting around 1920, expanded the business by beginning to manufacture made-to-order industrial fine wire and ribbon. Mr. Cohn, however, lacked the technical expertise for this new line of business. On an informal basis, Mr. Cohn compensated his son and nephew until an audit gave rise to a challenge by the Commissioner of the reasonableness of the compensation. After this challenge, Mr. Cohn formalized the partnership with the son and nephew to guarantee them a share of the profits. The Tax Court had an easy time holding that no gift resulted from the creation of the partnership:

[I]f we balance the improvements in position, if any, of Adolph [son] and Sidney [nephew] before the partnership against their definite losses upon entering into the partnership and their increased personal liability for the partnership, it is difficult to see that the two junior members of the partnership did anything but lose by the transaction. If, however, it might be contended that an improvement did result, certainly that improvement would be no more than these two men had earned by over twenty years of faithful service and hard work. As a result of that service and work they acquired experience, knowledge and business contacts that were in addition to their financial returns from their employment by Sigmund Cohn. When, at the time of the partnership they threw these additional assets into the partnership business they certainly more than paid for any imaginary advantage which the partnership brought to them. 79

The government's lone victory in these series of cases in the mid-1940s was

76. Id. at 858 (emphasis added).
77. Id. The partnership's primary business prior to 1940 was decimated by Federal Trade Commission victories against the Great Atlantic & Pacific Tea Company (A&P) and against the partnership with the result that the partnership was forced to rely on expansion of its relatively small business in government contracts, an expansion that proved successful. Id. at 854.
78. 6 T.C.M. (CCH) 865 (1947).
79. Id. at 869.
Gross v. Commissioner. In Gross, the petitioner had developed a successful skin product and a soap named, respectively, Mazon and Mazon Soap. He had previously brought his wife into the business as a 20% partner. In bringing their daughter and son-in-law into their partnership, the parents attempted to accomplish something of an early version of an asset freeze, at least to the point of trying to avoid gift taxes, by freezing the initial capital accounts of the parents at 100% of the then-capital accounts of the partnership and giving the daughter and son-in-law each a 10% of profits interest. Holding that the trade name, goodwill, and formula were the crucial assets of the business, the court found it irrelevant that the parents had retained existing capital:

That [trade name, goodwill, and formula were] what created the earnings. And that, under the agreement, must remain in the business even if petitioner withdraws. It follows that if we must isolate and identify what petitioner gave and the donees received, that can readily be done.

Other necessary elements are even more in evidence. The close family relationship supports inferences both of a lack of adequate consideration and of a donative intent. Nothing appears in the record to justify concrete findings as to the contribution made by the Eckerts [daughter and son-in-law], its precise nature, its value, or its function in the partnership’s organization. But if, even in the absence of evidence we speculate as to the purposes of the transaction, the assumption that the services of the Eckerts were of some value to the business advances us little. Although their previous compensation, presumably for the same services, had run to around $20,000 to $35,000 annually, they received between them a 20 percent interest in earnings, which, for the current year, and excluding officers’ salaries, were upward of $370,000 and, for the first year of the new arrangement, netted them over $100,000. It is not unreasonable to suppose that some part of the increase flowed from the newly acquired interest in the business itself and its principal asset, and that this, being inadequately supported by any consideration, was to some extent a gift.

A significant element of the case was that the tax court viewed capital as an income-producing factor and viewed with distrust the sudden increase in compensation.

It is not surprising that most of the cases discussed above arose as income tax cases rather than gift tax cases. Prior to 1976, there were highly progressive income tax rates and relatively modest gift tax rates. For each donor, the first $3000 per donee per year plus the first $30,000 lifetime were gift-tax free, after which rates began at 2 1/4%, did not exceed 30% until lifetime gifts exceeded $1,250,000, and did not exceed 50% until lifetime gifts exceeded $5 million. For married couples, the dollar figures were doubled if the couple

81. Id. at 837 (citations omitted).
82. I.R.C. § 2502(a), amended by Tax Reform Act of 1976, § 2001(b)(1), (d)(2), Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.). This compares with income tax rates in 1991, which do not exceed 31%, and gift tax rates, which start at 37% once the $600,000 lifetime unified credit is exceeded and exceed 50% over $2.5 million. I.R.C. §§ 1201(c).
elected to split gifts or if both spouses were wealthy enough to make their own gifts.

**G. Interest-Free Loans**

The Service had a good record of success while pursuing the gift tax on interest-free term loans. Once one established a market rate of interest, one could, by familiar net present valuation methods, calculate the present value of the required loan repayments, subtract that value from the proceeds loaned, and tax the difference as a gift. In *Crown v. Commissioner*, however, the taxpayer succeeded in persuading the Seventh Circuit that in the case of an interest-free demand loan, the gift was impossible to value since the loan could be recalled at any time. This followed a small number of taxpayer victories on the same issue. The Crown family had loaned $18 million to family trusts on an interest-free, demand note basis. When the Eleventh Circuit, in *Dickman v. Commissioner*, decided to the contrary, the United States Supreme Court resolved the conflict of circuits against the taxpayer. Shortly thereafter, Congress codified *Dickman*, at least in terms of monetary loans, in enacting Code section 7872.

Code section 7872 requires Congress to provide a federal rate for various loan periods: short term (under three years), intermediate term (three to nine years), and long term (over nine years). Term loans with an interest rate lower than the established federal rate result in an immediate gift of the difference between the amount of the proceeds and the value of the repayments using the applicable federal rate. With a demand loan, however, the gift is determined annually. The determination is made using the adjusted federal rate (short term), assuming that on the last day of the year the amount of interest was in fact paid to the lender who in turn made a gift back to the borrower. The statute thus has gift tax consequences in the case of a gift loan and income tax consequences in the case of either a gift loan or an employer-employee loan.

*Dickman*, however, went beyond monetary gifts. The Supreme Court spoke in terms of rights in property, expressly avoiding the question of applying gift

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83. See I.R.C. § 2513.
84. See, e.g., Blackburn v. Commissioner, 20 T.C. 204 (1953).
85. 585 F.2d 234 (7th Cir. 1978).
86. See, e.g., Johnson v. United States, 254 F. Supp. 73, 77 (N.D. Tex. 1966) ("The time has not yet come when a parent must suddenly deal at arm's length with his children when they finish their education and start out in life."); Dean v. Commissioner, 35 T.C. 1083, 1086 (1961) (holding that "an interest-free loan results in no taxable gain to the borrower").
88. See Dickman v. Commissioner, 465 U.S. 330 (1984); *supra* text accompanying notes 19-21 and accompanying text (discussing *Dickman*).
tax principles to the proverbial loan of a cup of sugar. Dickman, however, did not address the question of when gift tax liability attaches. Dickman would, by its terms, apply to the loan of a valuable painting to a child that hangs on the wall of the child's home. With its emphasis on property, however, it is not clear that Dickman applies to a loan of goodwill such as where the parent with valuable experience goes to work for a corporation owned by his minor children. This scenario is one of Professor Cooper's concerns and close to the facts of Crowley.

An experienced parent working for his child's corporation, however, runs some risk that the time invested in the corporation will be assigned to the parent. Under the assignment-of-income doctrine, income is taxed to the individual who earns it. Therefore, it is arguable that the time invested by the parents is the goodwill of the parent, and not of the child's infant corporation, which earned the money. Could the assignment-of-income doctrine be applied to a parent giving his child investment advice?

Professor Cooper gives the following example:

One planner, familiar with the activities of real estate speculators, described how such a person with whom he was acquainted diverts his talents to the benefit of his children. This planner explained that the speculator looks at a hundred deals for every one in which he finally invests. This screening process is a sophisticated full-time activity. By enabling his children to participate in the deal finally selected, the parent is in effect giving them immensely valuable services.

What is the value of the gift and when is it given? If assignment-of-income principles are not applicable, presumably one must find that the value of the gift is the value of the commissions or hourly time of the investment advisor. In Professor Cooper's example, there is no bargain sale of the purchased asset so that there is no gift element present in the form of a below-market purchase price. The assets are purchased in an arm's-length transaction from unrelated parties at fair market value.

Code section 2036(c) attempted to look at end results as opposed to time

92. I.R.C. § 2503(g) provides an express exemption for the loan of art work to a § 501(c)(3) organization other than a private foundation if the use of such work is related to its exempt purposes. By implication, the loan of art work to anyone else is a taxable gift, an implication with which the Senate Finance Committee agrees: "Present Law.—A loan of a work of art to a public charity or a private operating foundation is treated as a transfer subject to Federal gift tax. Although constituting a gift, such a loan is not a deductible charitable contribution for Federal gift tax purposes." REPORT OF THE SENATE COMM. ON FINANCE, S. REP. NO. 445, 100th Cong., 1st Sess. 402 (1988).
93. See supra notes 69-71 and accompanying text (discussing the facts and holding in Crowley v. Commissioner, 34 T.C. 333 (1960)).
95. Cooper, supra note 1, at 185 n.67.
value of money in section 7872. If a parent transferred rights to appreciation, and retained rights to income or voting, the parent was deemed to have retained the transferred interest until the parent disposed of his interest, the child transferred his interest outside of the family, or the parent died. This statute was geared to a specific wrong (asset freezes) although it encompassed a good many nonabusive situations.  

Newly enacted Chapter 14 of the Code\(^9\) reverts to exacting a transfer tax based on values at the time of transfer, but allows a backward look if facts prove otherwise. Chapter 14 provides that, with regard to corporate reorganizations, the retained interest must possess certain required characteristics or it will be valued at zero\(^9\) with the result that the amount of the gift will be deemed to be the value of the retained and transferred interests combined. Among the characteristics required is a certain return.\(^9\) The backward look comes if that certain return is not realized; in this situation there is a gift of the failure to receive the return, limited by any increase in the value of the enterprise after the initial gift. There is a similar rule with regard to split interest trusts but it excludes the backward look.\(^10\)

In sum, the Service's attempts to reach gifts of opportunity under the gift tax have met with mixed success. The Service, however, had a certain degree of success in its attempts to tax the gift of the use of property. Of greatest import is that nonproperty transfers, such as the transfer of business contracts, generally escape the gift tax system.

II. THE DIFFICULTY OF VALUATION

Valuation of businesses is another area that confounds the government's task of fairly taxing closely held businesses. The wealthiest of closely held business owners, however, can afford sophisticated tax advice, which can reduce their liability to a lower effective tax rate than smaller business owners may secure. Minority discounts, blockage, and lack of marketability are factors for

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\(^9\) It may be argued that all estate tax freezes are abusive, although I suggest that that is not the case. It is one thing where the senior generation is responsible for the growth of the business and remains active after transferring appreciation rights to children. Where the senior generation actually retires, however, it is defensible that all future growth should belong to the junior generation. See, for example, Cohn v. Commissioner, 6 T.C.M. (CCM) 865 (1947) (discussed supra notes 78-79 and accompanying text), where the transfer of a business to a junior generation already contributing to the business did not result in any tax liability for an alleged gift of opportunity. New Chapter 14 of the Code, I.R.C. §§ 2701-2704, should allow the nonabusive situation to be adequately treated.

\(^9\) I.R.C. §§ 2701-2704.


\(^9\) Under I.R.C. § 2701(c)(3), a "qualified payment" is a dividend determined at a fixed rate or a rate that bears a fixed relationship to a market rate. Under I.R.C. § 2702(b), however, for a retained interest in trust not to be valued at zero, it must be a "qualified interest" that consists of the right to receive a fixed amount payable not less frequently than annually or a fixed percentage of the fair market value of the property of the trust, determined annually.

which valuation discounts are permitted. Good tax planners, adept at manipulating these factors, can save taxpayers substantial sums.

Professor Cooper focused a considerable amount of attention on the problems with the current transfer tax structure, the difficulty of valuation, and the government's failure to get results that fit the underlying purposes of the transfer tax statutes.\textsuperscript{101} The government, according to Professor Cooper, comes into litigation now conceding too much.\textsuperscript{102} He calls it the case of disappearing value.\textsuperscript{103}

Removing closely held businesses from the transfer tax system does not produce perfect results. There are some very large closely held businesses that presumably have some passive investors.\textsuperscript{104} I suggest, however, that removing closely held businesses from taxation is a preferable alternative to the valuation difficulties existing in the transfer tax structure today.

\textit{A. Basic Valuation Principles}

The basic statement of the fair market value of a business is "the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest of a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."\textsuperscript{105} The difficulty with this definition is that within a family context, it is possible to place restrictions and conditions on shares or partnership interests, or to create minority interests, that would genuinely lower the value of the business to a disinterested purchaser. These involve rights that the family has no intention of exercising or restrictions that do not restrict anything the family may wish to do. It is the existence of preferred dividends that nobody intended to pay, or conversion rights of preferred stock to common stock that nobody intended to exercise, that were the concerns of the Service in its attack on asset freezes.

\textit{B. Minority Discounts, Blockage, and Lack of Marketability}

Among the factors acting to depress the value of closely held businesses for estate tax purposes are minority discounts, lack of marketability, and blockage. Minority discounts simply recognize that a lack of voting control may

\textsuperscript{101} Cooper, \textit{supra} note 1, at 201. For a contrary view, see Richard L. Dees, \textit{The Slaying of Frankenstein's Monster: The Repeal and Replacement of Section 2036(c)}, TAXES, Mar. 1991, at 151, 154.

\textsuperscript{102} Cooper, \textit{supra} note 1, at 201.


\textsuperscript{104} For example, in Newhouse v. Commissioner, 94 T.C. 193 (1990), the Service established that, without discounts, the value of Mr. Newhouse's interest in his corporation exceeded $1 billion.

\textsuperscript{105} Treas. Reg. § 20.2031-3 (1956).
inhibit a nonfamily buyer from buying into a family situation.\textsuperscript{106} Lack of marketability is a situation in which the stock may not be easily sold, thereby depressing its value.\textsuperscript{107} Blockage is a phenomenon unique to publicly traded shares. Blockage may occur when more shares are sold in a short amount of time than the market can absorb, and the bulk sale itself depresses prices. Restrictions on the disposition of the stock also depress values, either because of binding buy-sell agreements or because other classes of stock may have rights that affect the value of the shares to be valued. John A. Wallace, one of this country's leading estate planning practitioners, has suggested that deliberate tax planning to decrease valuation can produce favorable transfer tax results, and he has given some very well reasoned approaches.\textsuperscript{108}

C. Notable Taxpayer Victories

Professor Cooper cited some wonderful examples of valuation discounts that opened the door to wholesale abuse.\textsuperscript{109} It is not surprising that the examples keep coming. Professor Cooper cited \textit{Whittemore v. Fitzpatrick},\textsuperscript{110} where various discounts succeeded in having an effective rate of estate tax of 7\%,\textsuperscript{111} and \textit{Dean v. Commissioner},\textsuperscript{112} where the percentage savings was not as great but the amount of taxes saved was in the tens of millions of dollars.\textsuperscript{113}

In terms of sheer dollar amount, nothing will match the drubbing the Service took in \textit{Newhouse v. Commissioner}.\textsuperscript{114} Samuel Newhouse died in 1979, owning ten shares of Class A (voting) common stock and 990 shares of Class B (nonvoting) common stock of Advance Publications, Inc ("Advance"). Advance was a giant media conglomerate whose retained earnings from 1977 to 1979 averaged $460 million and whose operating income averaged just over $160 million for the same period.\textsuperscript{115} Newhouse owned all of the outstanding common stock of Advance at his death. Preferred shares were owned as fol-

\begin{itemize}
\item \textsuperscript{107} Central Trust Co. v. United States, 305 F.2d 393, 405 (Cl. Ct. 1962).
\item \textsuperscript{109} See Cooper, supra note 1, at 197-99.
\item \textsuperscript{110} 127 F. Supp. 710 (D. Conn. 1954).
\item \textsuperscript{111} Cooper, supra note 1, at 198.
\item \textsuperscript{112} 19 T.C.M. (CCH) 281 (1960).
\item \textsuperscript{113} Cooper, supra note 1, at 199.
\item \textsuperscript{115} Id. at 214.
\end{itemize}
BUSINESS OPPORTUNITY TAX

In 1974, the company and the preferred shareholders signed a shareholder agreement that severely limited the rights of preferred shareholders. The shareholder agreement provided for certain rights and restrictions. The agreement gave the company the following: (1) a right of first refusal over any sale to an outsider; and (2) the right to force a sale at an "agreed" price or as otherwise determined by Chemical Bank. In addition, upon the death of a preferred shareholder, the personal representative of the shareholder could require Advance to purchase the shares, but the price for this put could not exceed the estate's cost for taxes, funeral expenses, and administrative expenses. The preferred shares, however, were entitled to 78% of all dividends. The preferred shares had a liquidation preference of $187.25 per share. The common shares exclusively elected the Board of Directors. The preferred shares were entitled to vote on voluntary liquidations.

The estate reported the ten shares of Class A common stock at $8,595,000 and the 990 shares of class B common stock at $170,181,000. The Commissioner, however, valued the Class A common stock at $420 million and the Class B common stock at $811,800,000.

What allowed the low valuation? Two words: intentional confusion. The Tax Court described the state of the rights of the various classes of stock this way:

There are three basic methods for a shareholder to realize value from a corporation: (1) the redemption of stock, (2) the payment of dividends or distributions, and (3) a merger or liquidation in which stock is cashed out or exchanged for value. Consequently, the rights and privileges of the various classes of Advance stock determine the constraints on a purchaser of the Advance common stock in attempting to realize the value of his purchase. On February 29, 1980, a buyer of the Advance common stock could have elected the Board of Directors. The preferred stock, however, could vote on and block corporate liquidation. On February 29, 1980, the Advance preferred stock could not be redeemed without the preferred shareholders' consent. The preferred stock could vote on any charter change that affected its class rights or gave new class rights or authorized a new class of stock. The

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116. Id.
117. Originally, these included all but Mitzi, who signed the shareholder agreement in 1978. Id. at 203.
118. Id.
119. Id. at 202-03.
120. The Commissioner originally sought fraud penalties, but these penalties were conceded by the time the tax court rendered its decision. Id. Shares of Newhouse Broadcasting Company were also assets involved in the case. Id.
preferred shareholders were entitled to 78 percent of all dividends declared out of current and retained earnings; the common stock was entitled to 22 percent.

The allocation of all other rights and privileges pertaining to shareholders is unclear. The preferred shareholders might be entitled to participate equally in dividends declared from capital surplus. It is not clear whether a buyer of the Advance common stock could effect a merger to eliminate or cash-out the preferred shareholders. It is also unclear what price the common shareholders would have to pay to preferred shareholders in an appraisal proceeding or a fair value proceeding under New York law. The extent of the disagreement over the rights and privileges of the classes of Advance stock under New York law would be certain to result in litigation in the event that the common shareholder attempted to cash-out the preferred stock through a merger or otherwise attempted to effect a constructive redemption or liquidation that returned less than 78 percent of the value of Advance to the preferred shareholders.121

There is not the slightest indication that there was any hostility within the Newhouse family. Each time the corporate structure was reorganized, it was the result of a voluntarily signed agreement. Yet, using the willing-buyer—willing-seller standard, the value of the company was reduced by the uncertainty of corporate rights. The same argument could be used in valuing the preferred stock with the result that the whole would be greater than the sum of its parts.

What the government attempted to do was come to the proper state-law conclusion and value the shares accordingly. Notwithstanding some impressive expert testimony for the government, the Tax Court rejected the government's position. If experts could disagree on state law before the Tax Court, a prospective purchaser could not be certain of the rights of a stockholder.122

A second approach taken by the government and rejected by the Tax Court was a residual approach to valuing the common shares.123 In advocating the residual approach, the government valued the entire corporation, subtracted the value of the preferred shares, and took the position that the value of the common shares was this difference. The Tax Court, however, held that nobody would advise a willing buyer to buy on the residual approach.124

As commentators point out, "the moral of the story seems to be that the more complex a case is, the more confused the government is likely to get."125 The government refused to approach the case from the point of view of a willing buyer, notwithstanding the demands of the Supreme Court’s pro-

121. Id. at 203-04.
122. Id. at 232-33.
nouncement in *United States v. Cartwright* and its own regulations. As long as such a standard exists, and planning can be done such as in *Newhouse*, the government cannot win.

The government's losses do not always come from good planning by the taxpayer. In *Neff v. Commissioner*, the government lost from what must be described as either the finesse of the taxpayer's counsel or simply a bad decision.

One of the most basic tenets of valuation is that the best indicator of market value is actual arms' length sales within a reasonable time of the valuation date. In *Neff*, we are looking at the following dates and events:

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1981</td>
<td>Cash on hand at Rand McNally—$17,000,000 plus $5,000,000 note from Houghton Mifflin.</td>
</tr>
<tr>
<td>January 1982</td>
<td>78,858.5 shares were purchased at $32 per share from Frederick McNally, who wanted to be cashed out after he was fired. Total redemption price—$2,426,512.</td>
</tr>
<tr>
<td>April 7 to May 7, 1982</td>
<td>Rand McNally made an offer to purchase up to 236,672 shares for cash at $32 per share and to convert another 156,250 shares to preferred which would eventually be redeemed at $32 per share over the next four years.</td>
</tr>
<tr>
<td>June 8, 1982</td>
<td>Edwin Neff died owning 25,960 shares of Rand McNally in a revocable trust.</td>
</tr>
<tr>
<td>July, 1982</td>
<td>278 shares purchased from Chandler Everett at $32 per share.</td>
</tr>
</tbody>
</table>

127. 57 T.C.M. (CCH) 669 (1989).
128. See Estate of Andrews v. Commissioner, 79 T.C. 938, 941 (1982) ("In determining the value of unlisted stocks, actual arm's-length sales of such stock in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value.").
September 21, 1982

Marion Clow died owning 118,314 shares of Rand McNally. 129

The government argued, not surprisingly, for a value of $32 per share. The taxpayer argued that the April 7 to May 7 offer had expired, that the offer had involved a premium to assure its goal of reducing the number of shareholders, 130 and that a new buyer could not be certain that Rand McNally would be willing to purchase shares in the future. The court accepted the taxpayer's argument. The court then proceeded to go into standard analysis including capitalization of earnings and discounts for lack of marketability. The court concluded that the value of Neff's shares was $21 per share and the value of Clow's was $20 per share. 131 Rather than use actual, recent arms' length sales, the court hypothesized a different set of circumstances in the future. Amazing!

D. A Modest Government Victory

The Service has had one recent victory of sorts where the decedent gave away two small gifts of shares that were just enough to put her holdings below 50% of her estate eighteen days before her death. In Estate of Murphy v. Commissioner, 132 the decedent was advised to give away enough to make her interest in the corporation a minority interest and thereby lower the tax on the estate. In order to avoid granting a minority discount, the court had to find something of a step transaction—one transaction that the taxpayer has broken into two transactions solely for tax avoidance:

During the 18-day period between the lifetime gifts of the stock to decedent's two children and her death, decedent continued to be chairman of the board and her two children held the two top management positions. We believe that all concerned intended nothing of substance to change between the time of transfer and the time of her death and that nothing of substance did change. 133

There are some problems with the court's logic, although the result seems correct. It is difficult to conceive dying as the second part of a two-part, tax-avoidance step transaction. The concept of "gift in contemplation of death" under Code section 2035 was changed in 1976 for an automatic inclusion in the decedent's gross estate for gifts within three years of death. 134 Under either the contemplation-of-death rule or the automatic three-year rule, the tax-

129. Neff, 57 T.C.M. (CCH) at 671-73.
130. This would seem to argue in favor of a limitation on the shareholder that he offer all, but not less than all, of his shares. There is no indication that this was part of the offer.
131. Neff, 57 T.C.M. (CCH) at 676.
132. 60 T.C.M. (CCH) 645 (1990).
133. Id. at 659.
payer in *Murphy* would have clearly lost. The three-year rule of Code section 2035, however, was repealed with the Economic Recovery Tax Act of 1981.  

The Tax Court in *Murphy* had to make a significant stretch in logic to reach its conclusion of no minority discount. The court noted that certain Ways and Means Committee hearings indicated that the only effect of Code section 2035, after the unification of gift and estate tax rates, was to tax postgift appreciation, and for that limited purpose it was unnecessary to retain it in the Code. The court then proceeded to state that "we see no basis in the statute or legislative history for petitioner's view that Congress intended the control premium to escape transfer taxation because of the 1981 amendments to section 2035." The court never addressed the fact that the repeal of section 2035 took the concept of adding gift shares back to the donor's gross estate out of the law, notwithstanding that the abuse in *Murphy* was not one of the reasons behind repealing section 2035. The court went on to note that section 2035 still applied if what is given up is a retained life estate within three years of death, and further suggested that the decedent retained control of the corporation until her death. After making the suggestion, however, the court did not reach a conclusion based on the decedent's retained control, since neither of the parties argued the point. It is significant that the court made clear that it was not applying any sort of attribution rules. This single government victory, sustainable as a matter of overall policy, does not stand scrutiny in close analysis. The careful planning of the taxpayer should have worked. This case, taken in concert with the taxpayer victories, demonstrates the impossible position in which the Service finds itself under the current system. Some sort of departure from fair market value as a tax base is warranted, either in removing closely held businesses from the transfer tax system or basing the tax on something other than fair market value.

135. Pub. L. No. 34, 95 Stat. 172, 97th Cong., 1st Sess. § 424(a) (enacting I.R.C. § 2035(d)).  
137. *Id.*  
138. *Id.*  
139. See Janiga & Harrison, *supra* note 106, at 315 (arguing that, notwithstanding the Tax Court's statement that it was not applying attribution rules, "the court's reasoning is laced with language that suggests a family attribution theme"). The authors cite two cases that give some authority for attribution in determining minority discounts. In Blanchard v. United States, 291 F. Supp. 348 (D. Iowa 1968), 1048 out of 2000 shares of a corporation were owned by related entities. The taxpayer gave her 458 shares to six trusts for grandchildren and took a minority discount. Shortly thereafter, all 1048 shares, including the 458 recently given, were sold for a higher price. The district court held that the higher price was appropriate. *Id.* at 352. It is arguable whether this is attribution or application of the theory that proximate sales are the best evidence of value. In Driver v. United States, 76-2 U.S. Tax Cas. (CCH) ¶ 13,155 (W.D. Wis. Sept. 13, 1976), the sole owner of a corporation made two gifts of 40% interests in two consecutive years, for a total gift of 80% of the corporate shares. The district court in effect stepped the transactions and viewed the transfers as a single transfer of a controlling interest. *Id.*
III. ALTERNATIVE PROPOSALS

A number of proposals have surfaced from time to time to eliminate inequities in the current transfer tax system. They are not aimed exclusively at closely held businesses. As applied to closely held businesses and the abuses discussed in this Article, they meet with mixed success.

A. Valuation Proposals

In 1987, the House of Representatives passed a measure designed to curb valuation abuses. The House bill would have provided that the value of stock is presumed to be its pro rata share of all shares of that class, and that for the purpose of rebutting the presumption, an individual is deemed to own shares owned by his family. The provision died in joint committee. It should be noted that the 1987 proposal would not have helped the government in Newhouse, since Newhouse used different classes of stock.

Another proposal was to cumulate, for valuation purposes of each class of stock, all prior gratuitous transfers by the same owner. This has the merit of catching abuses such as those in Murphy without having to stretch logic as the Tax Court did. But again, this proposal will not prevent situations such as those in Newhouse. Not only was the problem in Newhouse that the corporation had different classes of stock, but the holdings of stock by the family were issued directly by the corporation in a manner in which it appears there was not a taxable gift under the gift tax or a transfer from the senior Newhouse under state property law.

B. Wealth Tax

Professor Cooper recommends a combination of a wealth tax with legislative reforms for valuation of closely held securities. His argument is that a periodic wealth tax is less intrusive than a periodic estate tax and will make wealth shifting less important. He has reiterated this suggestion before the New York Bar Association. These are two separate proposals. With regard to the gift of opportunity, the wealth tax will succeed in taxing the gain re-
gardless of who has it. With regard to a closely held business, a wealth tax will not solve the valuation problem. In fact, valuation plus the fear of a flight of capital are the primary practical problems with a wealth tax where it has been tried.\textsuperscript{149} Professor Cooper argues that one will not resist valuation disputes on a year-in and year-out basis for what amounts to a small net tax, whereas one will expend great effort on an estate tax that occurs once every generation.\textsuperscript{150}

The problem with Professor Cooper's valuation proposals is that one is still making assumptions about such things as loss of a key individual or lack of a market that one cannot know until later. An alternative to Professor Cooper's proposal is to have a set of rules for valuation based on capitalizing earnings, but then one might as well have an income tax. Professor Cooper also argues that a significant part of the wealth in America is in real estate.\textsuperscript{151} Real estate could have a separate rule without minority discounts. Professor Cooper's suggestion would solve the problems of \textit{Carriage Square} but not the problem of my friends inheriting a law practice from their father.

\textbf{C. Accessions Tax}

Another suggestion that has achieved some popularity is an accessions tax.\textsuperscript{152} Instead of basing a tax on the amount given or bequeathed by a single donor, one will tax on a cumulative, lifetime basis the amount received by a single donee. This has many advantageous features, including: (1) greater neutrality by putting a heavier tax on the one who receives the greatest amount of inheritance; (2) significantly easing the problems with the marital and charitable deductions; and (3) providing certainty for the determination of when a gift is complete.\textsuperscript{153} There are, however, issues to be worked out regarding generation-skipping transfers and the deferral of the tax by use of discretionary trusts.\textsuperscript{154}

In terms of closely held businesses and the gift of opportunity, the accessions tax will, under at least some circumstances, ease the problems of taxing closely held businesses. By placing property in trust, taxation is deferred, although some parts of the proposal attempt to adjust for that. To the extent that dividends are passed out to the beneficiaries of the trust, the accessions tax will have some of the same wait-and-see attributes that this Article recommends.\textsuperscript{155} To the degree that the distribution out of trust is shares of stock, the valuation problems are the same as under the current tax law.

\begin{itemize}
\item 149. See Verbit, \textit{supra} note 12, at 3.
\item 150. Cooper, \textit{supra} note 148, at 34.
\item 151. \textit{Id.} at 27.
\item 154. \textit{Id.} at 227-29.
\item 155. See Andrews, \textit{supra} note 152, at 600.
\end{itemize}
Another proposal involves a consumption tax. This suggestion includes gifts and bequests in income, with a deduction for nonconsumable receipts of gifts and bequests in-kind, such as closely held businesses. Receiving gifts and bequests of a business would be the equivalent of receipt of cash and full reinvestment. The asset received would receive a zero basis. This model would treat my friends taking over their father's law practice the same as a receipt of shares of stock in a closely held business. In line with this Article's recommendation, there would be no gift or death taxation of closely held businesses.

E. Comprehensive Tax Base

A variant on the consumption tax is the comprehensive tax base, which again includes gifts and bequests in income. The tax base consists of increases in wealth plus consumption. Apart from the practical difficulties such a tax might entail, it is not clear how it would treat closely held businesses. According to Prof. Joseph Dodge, such closely held businesses would theoretically be included in the tax base, although the proposal could be structured to exclude them.

Some of the suggested alternatives correct some of the problems of closely held businesses along the lines of this Article's recommendations. Some proposals do so with more far reaching ramifications. Other proposals do not address the problems at all. They compare with this Article's more modest solutions, which do not require overhaul of the existing transfer tax system.

IV. Solutions

Exempting closely held businesses from transfer taxation eliminates the disparate treatment between transfers of opportunity and service businesses on the one hand, and transfers of interests in closely held manufacturers and retailers on the other. Such an exemption also eliminates the insurmountable difficulties of valuing closely held businesses. Finally, exempting closely held businesses from transfer taxation promotes closely held businesses by not taxing them out of existence.

The question remains, however, that if one insists on taxing transfers of opportunity, what sorts of things should be taxed? I do not think anyone advocates taxing a parent's giving advice to his children and giving them the benefit of years of experience around the dining room table. In fact, recent changes in the gift tax show a public policy that exempts gifts of any education, even the gift of a college education from Princeton.

157. Id. at 1199.
158. Id. at 1183.
159. Id. at 1199-1200.
If one insists on taxing such advice, there is a further question of how and when to value such advice. The gift of one-hundred shares of General Motors common stock has an identifiable value and the transfer has an identifiable moment in time. Explaining to one's child over dinner the secrets of being a good salesperson or the principles of corporate finance is impossible to value, assuming one can prove that this advice is responsible for the child's success. To see if it is possible to tax these gifts at all, one must look at them in the context of what is taxed now.

Transfers of tangible property, publicly traded securities, and cash fit easily within the current transfer tax system. There is an identifiable moment of transfer (gift or death), and sections 2033 and 2511 of the Code are adequate to tax the transfers. There is always a difficulty with valuation, but this is inherent in any system of taxation, including the income tax. When one is talking about gifts of opportunity, it seems one would have to wait to determine any tax. Otherwise, how would one tax an opportunity given, but not utilized? If the first child passed on an opportunity, but the second child took advantage of it and made $1 million, has the parent made two $1 million gifts? Indeed, the idea of an open gift has gained some acceptance in the gift tax statutes. Code section 7872, Chapter 14 of the Code, and the now-repealed section 2036(c) of the Code give us examples where Congress felt that one way to tax a gift, at least in part, was a wait-and-see approach.\textsuperscript{160} If some sort of tax on closely held businesses must be collected, my solution is a combination of Code section 6166\textsuperscript{161} and a corporate income tax surcharge. Over a period of fourteen years,\textsuperscript{162} a tax should be paid by the corporation based on a tax base equal to the sum of:

- corporate taxable income, plus
- salaries paid to employees having a certain relationship to the decedent based on attribution rules, plus
- a percentage of purchases from entities owned by family based on attribution rules,

multiplied by a fraction, the numerator being the percentage of the corporation owned by the decedent and the denominator being 100%. If the corporation has multiple classes of stock, there should be alternative calculations based on number of shares or relative value of shares using whichever fraction is most favorable to the government.

\textsuperscript{160} See Dodge, supra note 8, at 255-60; supra notes 65-68 and accompanying text (discussing section 7872's coverage of below-market loans to children); supra text accompanying notes 32-36 (explaining section 2036(c)'s attempt to stop the use of preferred stock asset freezes to avoid transfer taxation).

\textsuperscript{161} I.R.C. § 6166, entitled, "Extension of time for payment of estate tax where estate consists largely of interest in closely held business," allows for a waiting period of five years and installment payments. I.R.C. § 6166. Where the estate of a decedent consists largely of closely held businesses, the tax may be paid in installments, the first installment no later than five years after the time for ordinary payment of estate taxes. \textit{Id.}

\textsuperscript{162} The period of 14 years is chosen only because it is the maximum deferral period allowed under I.R.C. § 6166.
The tax rate, however, should decline over the fourteen-year period. It should start at, say, 21% and decline 1 1/2% per year so that it phases out after fourteen years. Without a discount for the time value of money, the tax collected should be about 150% of one year's earnings, which, figuring a 50% maximum tax rate, means that the enterprise will be capitalized at three-times earnings.

If the business (or a part of the business) is sold before the fourteen-year period expires, one could add the proceeds to the taxable estate with a credit for income taxes paid to date. Presumably, income taxes will be lower if it is a division of a corporation that is being sold. If what has happened is a redemption, the corporate income tax will not stop at that point, although there will be a credit against the income tax based on the additional estate tax from the redemption.

Placing intrafamily purchases into the structure of the tax will have some effect on the use of multiple corporations or the gift of opportunity to children such as Mr. Crowley gave to his children. It could be applied to a partnership at the entity level and possibly reach my friends taking over their father's law practice. Whether the practicalities can be worked out is a matter to be determined, as both Mr. Crowley and my friends accomplished their results during life without the formal transfer of corporate shares or partnership interests.

The small business owner could opt to have a single tax at death, as under current rules, but without any discounts for blockage, minority interests, lack of a public market, or Newhouse-type confusion. The tax would be based on a fraction of the entire corporation, valued as if owned by a single shareholder with access to a public market. This would exempt from taxation estates that, including a closely held business with no discounts, have a net value of less than $600,000.

Real estate and nonbusiness assets would be taxed separately, with no minority discount. If the entire business is active real estate, the taxpayer would presumably elect to have the above rule apply to the balance of the business assets since the non-real estate assets would be minimal. This prevents the income producing properties of real estate from being doubly taxed without allowing the loophole of the taxpayer putting his residence in the business.

I do not suggest that such a change would be without difficulties. One must watch for situations where a residence is contributed to a business or for an overcapitalized lemonade stand whose only employee is age six, but that has a capital of $20 million in stock of Ford Motor Company or General Motors.


164. One must have some restrictions on intrafamily transactions. There is too much potential for abuse of a bargain sale in the context of an intrafamily transaction.
Section 6166 has attempted to deal with nonbusiness assets in a business, although there are no studies of its success. My justification could, of course, be extended to any income producing asset, but non-closely held business assets are in general easier to value and, because they are passive assets, do not promote the same entrepreneurial spirit of the closely held business.

Not subjecting closely held businesses to transfer taxation will put gifts of businesses and gifts of opportunity on more equal footing. If they must be taxed, taxing future success will be more accurate than the artful guessing that goes on under the current system.

CONCLUSION

Closely held businesses should not be subject to transfer taxation. Such taxation represents an undue hardship that is not warranted by the goal of gift and estate taxation. The goal of gift and estate taxation is to prevent undue accumulations of wealth. Most closely held businesses do not represent the sort of dynastic power of the Rockefellers, Carnegies, or du Ponts. The second generation will, in general, need to expend energy to preserve the closely held business. When one realizes that service businesses, such as my friends in the law partnership, can in general avoid transfer taxation altogether, there is significant unfairness in attempting to tax retailers and manufacturers but not lawyers. It is also unfair that people like Samuel Newhouse can, with expert tax advisers, obtain results that more modest businesses would never dream of attempting. The closely held business (manufacturer, retailer, professional practice, or farm) is something that ought to be encouraged and not taxed out of existence.

165. I.R.C. § 6166(b)(9) excludes passive assets from the value of the business for purposes of determining the amount of estate tax deferrable or the eligibility of the business for the benefit of I.R.C. § 6166.