SECTION 2704 TACKLES ESTATE FOR A CLAIMS COURT LOSS

SATURDAY, MARCH 03, 2012

EXECUTIVE SUMMARY: A company formed to operate an NFL franchise runs afoul of Section 2704 at the death of its principal stockholder. While the estate put forth some creative arguments to elude the grasp of Section 2704, the Claims Court sides with the IRS and applies Section 2704 to substantially increase the estate tax value of the decedent's shares of stock.

FACTS: The Five Smith's, Inc. was formed in 1965 to own and operate an NFL franchise. The decedent owned Class A common stock. Pursuant to a 1986 recapitalization, that stock had 11.64 votes per share, while the Class B common stock only had 1 vote per share. In 1991, third parties purchased Class B shares of 6% each. At that time, the company amended its Articles of Incorporation to provide that upon the decedent's death, or his sale or transfer of any of his Class A shares, the Class A shares would convert to Class B shares. The effect of the conversion would be a lapse of the enhanced voting power of the Class A shares.

The decedent died in 1997. The IRS disputed the estate tax value of the decedent's Class A shares. The IRS argued that Section 2704 applied, so that the enhanced voting power of the Class A shares should be included in valuing the shares. If Section 2704 applied, the estate and the IRS agreed that the the shares were worth $30 million on the date of death. The estate argued that Section 2704 did not apply. If that was correct, since the enhanced voting power disappeared at death it should not be included in value. This resulted in an agreed valuation of only $22.5 million.

The estate asserted several arguments, both as to whether Section 2704 applied, or if it did, whether its effects could be overridden by creating an inter vivos gift instead of a testamentary transfer, or by creating an arms-length exception to the statute. The Court

of Claims rejected all of the estate's arguments and applied Section 2704 to the valuation.

COMMENT: Section 2704 is a special valuation rule that favors the government, and one that planners seek to work around. It is rare to see a disputed case that fits so squarely within it. The case is interesting as a review of Section 2704 and its application, and for the creative arguments put forth by the taxpayer.

General Application of the Statute. Section 2704(a) reads as follows:

(1) In general.

For purposes of this subtitle, if-

(A) there is a lapse of any voting or liquidation right in a corporation or partnership, and

(B) the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity,

such lapse shall be treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate of the decedent, whichever is applicable, in the amount determined under paragraph (2).

(2) Amount of transfer.

For purposes of paragraph (1), the amount determined under this paragraph is the excess (if any) of-

(A) the value of all interests in the entity held by the individual described in paragraph (1) immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing), over

(B) the value of such interests immediately after the lapse.

(3) Similar rights.

The Secretary may by regulations apply this subsection to rights similar to voting and liquidation rights.

Thus, on its face, under the above facts there was a lapse of a voting right. Both before and after the decedent's death, his family held more than 80% of the voting power of the company, and thus meets the requirement for family control. For this purpose, the definition of control under Section 2701(b)(2) applies. Under Section 2701(b)(2)(A), in the case of a corporation "the term 'control' means the holding of at least 50 percent (by vote or value) of the stock of the corporation." Thus, applying Section 2704(a)(2)(A), the loss of value relating to the lapse of the extra voting power is disregarded, and the $30 million valuation applies.

Control Argument. Section 2704(a)(1)(B) requires that "such individual's family hold, both before and after the lapse, control of the entity." Section 2701(b)(2)A) defines control as "the holding of at least 50 percent (by vote or value) of the stock of the corporation."

Despite this simple definition of control, the estate asserted that for the family to have control, it must be able to reverse the lapsing of the voting power that occurred, if it wanted to. Since the family apparently did not have the power to do this after the decedent's death, the estate argued Section 2704(a) did not apply. The estate crafted this argument from the legislative history of Section 2704, which explicitly reflected the intent to overcome the Tax Court's ruling in *Estate of Harrison v. Commission*, 52 TCM (CCH) 1306 (1987). In *Harrison*, a decedent's partnership interest was valued at a lower value because the decedent's estate did not have the liquidation or dissolution rights that the decedent had prior to death as a general partner. However, the decedent's successors in *Harrison* did have the requisite control after the decedent's death to restore the lapsed liquidation right. Since the successors here did not have the requisite control or rights to restore the decedent's enhanced voting power, the estate argued that they did not have the requisite control to trigger Section 2704(a).

The Claims Court rejected this interpretation. It noted examples in the legislative history that applied Section 2704(a) while noting only that a power lapsed, without discussion

whether the successors needed the power to reinstate the lapsed power. Further, it distinguished *Harrison* as dealing with a liquidation right, which is different from a voting right. Lastly, it found no hint of any additional requirements in the statute or the regulations that would authorize the additional 'control' requirement that the estate sought to read into the law.

Timing of the Lapse. Alternatively, the estate sought to have Section 2704(a) apply in 1991, as a gift of the lapsed enhanced voting rights, instead of a testamentary transfer subject to estate tax. More particularly, the estate argued that the lapse occurred at the time the restriction was incorporated into the Articles of Incorporation, and not the later date (death) when the loss in voting power actually occurred.What did the estate have to gain by treating the transfer as a gift? No gift tax return was filed in 1991 to commence the statute of limitations on assessment of a gift tax for the year. Instead, the strategy of the estate was to assert that notwithstanding Section 2704(a) operating in 1991, no gift tax liability came into being because the changes in the Articles of Incorporation arose from an arm's length transaction. Thus, Treas. Regs. §25.2512-8 would void a taxable gift because the property transfer would have been for adequate and full consideration. The Claims Court did not need to address whether adequate and full consideration existed for this transfer and whether that would override Section 2704(a) and its special valuation rules, since it ruled that the transfer occurred at death.

The estate's argument of an *inter vivos* gift was not totally without merit. Treas. Regs. §25.2704-1(b) provides that "[a] lapse of a voting right occurs at the time a presently exercisable voting right is restricted or eliminated." Arguably, the voting rights were "restricted" in 1991, even though they were not eliminated until the later death.

However, examples in the Regulations convinced the court that the lapse occurred at death. For example, Treas. Regs. §25.2704-1(f), ex. 1. reads:

Prior to D's death, D owned all of the preferred stock of Corporation Y and D's children owned all the common stock. At that time, the preferred stock had 60 percent of the total voting power and the common stock had 40 percent. Under the corporate by-laws, the voting rights of the preferred stock terminated on D's death. The value of D's interest

immediately prior to D's death (determined as if the voting rights were nonlapsing) was $100X. The value of that interest immediately after death would have been $90X if the voting rights had been nonlapsing. The decrease in value reflects the loss in value resulting from the death of D (whose involvement in Y was a key factor in Y's profitability). Section 2704(a) applies to the lapse of voting rights on D's death. D's gross estate includes an amount equal to the excess, if any, of $90X over the fair market value of the preferred stock determined after the lapse of the voting rights.

Thus, the example supports a reading that a lapse in voting rights at death occurs at death and not on the adoption of the provision providing for the lapse. The court noted that Treas. Regs. §25.2704-1(f), ex. 3 also supports such a reading, as do excerpts from the committee reports for Section 2704.

Bona Fide Business Arrangement. The estate also argued that the 1991 limitations were a restriction on the sale of shares that invoked Section 2703. Since Section 2703(b)(1) excepts out from Section 2703 agreements, rights, and restrictions that are a bona fide business arrangement (if sections (b)(2) and (3) are also met), that exception should insulate the estate from Section 2704(a). The court was not convinced, finding that Section 2703 dealt with restrictions on the sale of shares. Instead, this case involved only the voting rights of the shares, and further Section 2704 specifically applies to lapses of voting rights.

It is uncertain from the opinion whether the decedent's planners were cognizant of the Section 2704 issue before the decedent's death. If they were, perhaps there were no other viable planning alternatives, they had comfort in the arguments they put forth in the Court of Claims, or otherwise thought they could eek out some favorable settlement from the IRS that perhaps never was offered.

Estate of Rankin M. Smith, Jr. v. U.S., 109 AFTR 2d 2012-XXXX (Ct Fed Cl), 2/13/12

Authored by Charles Rubin, Esq. Mr. Rubin is a Florida Bar Board Certified tax attorney with the firm of Gutter Chaves Josepher Rubin Forman Fleisher P.A. (www.floridatax.com) His practice focuses on protecting & enhancing individual, family & business wealth through: Planning to Minimize Taxes (U.S. & International) • Estate Planning, Charitable, Marital & Succession Planning • Business Structuring & Transactions • Trusts & Estates (Administration-Disputes-Drafting) • Creditor Protection. He can be reached at 561-998-7847 or at crubin@floridatax.com. This article was previously published at http://www.rubinontax.blogspot.com.