The IRC 2036(b) Trap

Take-Away: A simple lifetime gift of voting stock can still lead to estate tax problems for the donor if care is not taken to prohibit the direct or indirect ability to vote the transferred stock.

Background: Over the years these missives have covered, often in depth, the dangers of IRC 2036(a)(1) and (2) regarding a lifetime transfer with a retained interest that causes the value of the transferred asset to be included in the transferor's gross estate for federal estate tax purposes. Recall that IRC 2036(a) applies to cause estate inclusion when the transferor has retained the possession or the enjoyment of, or the right to the income of the transferred property [IRC 2036(a)(1)], or the right either alone or in conjunction with any other person, to designate the person who shall possess or enjoy the property or the income therefrom.[IRC 2036(a)(2).] Not covered in past missives is the impact of IRC 2036(b) which is a unique estate inclusion rule for corporate voting stock.

IRC 2036(b): IRC 2036(b) applies if the transferor of corporate voting stock retains the right to vote (directly or indirectly) any shares of a controlled corporation after making a lifetime transfer of those shares. If that is the case, the value of those transferred shares of voting stock will be included in the transferor's gross estate at death.

Control: For purposes of IRC 2036(b) a corporation will be considered to be *controlled* if at any time after the transfer of the stock and during the 3 years which end on the transferor's death, the transferor-decedent owned (ownership applying the Tax Code's attribution rules under IRC 318) or had the right, either alone or in conjunction with another person, to vote stock possessing at least 20% of the voting power of all classes of stock in the corporation. This rule is particularly a trap for closely held family corporations. Control is established if at any time after the transfer and within 3 years before his/her death the transferor owned, or had the right to vote, 20% or more of the combined voting power of the corporation. Consequently, the focus of IRC 2036(b) is not on record ownership of the voting stock, but solely on the transferor's 'right to vote' the stock.

Example: Dad is the sole owner of a closely held corporation. Dad gifts the 49% of the voting stock in the corporation to an irrevocable trust established for his young son who

works in the business. Dad claims a valuation discount because a minority interest in the corporation is the subject of his gift. Dad is not the trustee of the trust- he names his attorney as the trustee. However, Dad names himself as the trust director with respect to the corporation stock, with the right to vote the stock for a period of 10 years. If Dad dies, IRC 2036(b) will apply. The value of the stock previously transferred by Dad to the trust will be included in Dad's gross estate with no valuation discount, since Dad will be treated as owning 100% of the voting stock in the closely held business.

3-Year Rule: IRC 2036(b) was enacted back in 1976 to reverse a (in)famous Supreme Court ruling *United States v. Byrum,* which had found that the retained voting rights by a transferor would not constitute retained enjoyment causing estate inclusion under IRC 2036. IRC 2035 is the Tax Code section that treats the release of certain retained rights within three years of death as an includible transfer in the transferor's gross estate. Accordingly, if a transferor, like Dad in the above example, who retained the right to vote previously transferred stock in his capacity as trust director over investments, relinquished those same voting rights within three years of his/her death, the value of the transferred voting stock would nonetheless be included in the transferor's gross estate.

Retained Right to Vote: This is when the IRC 2036(b) 'trap' could arise with the transfer of stock with direct or *indirect* retained voting rights in normal estate planning. Consider:

(i) **Stock Voting Agreements:** A binding stock purchase agreement that contractually requires the transferor to continue to vote the shares even after the gift of the voting stock. That would cause an IRC 2036(b) problem.

(ii) **Trusts:** Voting stock is gifted to a trust and the transferor agrees to serve as a trust director over trust investments, as in the Dad example previously provided; as the trust director with control over the gifted stock's voting rights, Dad continues to possess the authority to vote or direct the trustee's voting of the transferred shares.

(iii) **Durable Powers of Attorney:** The transferor is the designated agent under the donee-recipient's durable power of attorney, where as agent the transferor can vote the gifted shares without any limitation or constraint by another. Dad retains the indirect right to vote the stock if the durable power of attorney is not a 'springing' durable power of attorney.

(iv) **Tie-Breaker Role:** A trust instrument or shareholder agreement contemplates an impasse in voting among the shareholders, or co-trustees, which instrument 'hardwires' the transferor's right, e.g., Dad, to step-in and cast the deciding vote, indirectly controlling the votes that he previously gave away .

Mitigating the 'Trap:' If voting stock is the subject of a lifetime gift, provisions need to be added that expressly prohibit any involvement by the transferor, either as trustee, trust director, or agent, from voting the transferred shares of an IRC 2036(b) controlled corporation that could otherwise trigger estate inclusion. Forget any perceived protections or the constraints of fiduciary duties held by others when dealing with the transfer of stock voting rights in this kind of context- it's the *direct or indirect with others* language of the statute that creates the problem that has to be addressed. It is best to include language in the trust, stock voting agreement, or durable power of attorney that expressly prohibits the transferor having any control rights to vote stock if it would implicate IRC 2036(b). Such prohibitions on the transferor should also include the spouse of the transferor. It might also be helpful to include language that there are no other arrangements, or side-deals, that confer voting rights on the transferor, or any such veto powers retained by the transferor over the voting rights of the transferred stock.

Conclusion: As noted above, closely held family corporations are ripe for IRC 2036(b) claims as parents move their voting stock out of their taxable estates as part of a comprehensive estate plan. Even sales of voting stock are at risk if the IRS finds a deemed gift if the purchase price is too low. As such, whenever an estate contains closely held business stock the implementing documents of that plan need to include protective language that prevents the application of IRC 2036(b), and acts as a constant reminder to be aware of how dangerous implied rights to vote the stock can be to the detriment of the transferor's estate plan.

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