

Estate freezes with 2701

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Overview of Chapter 14

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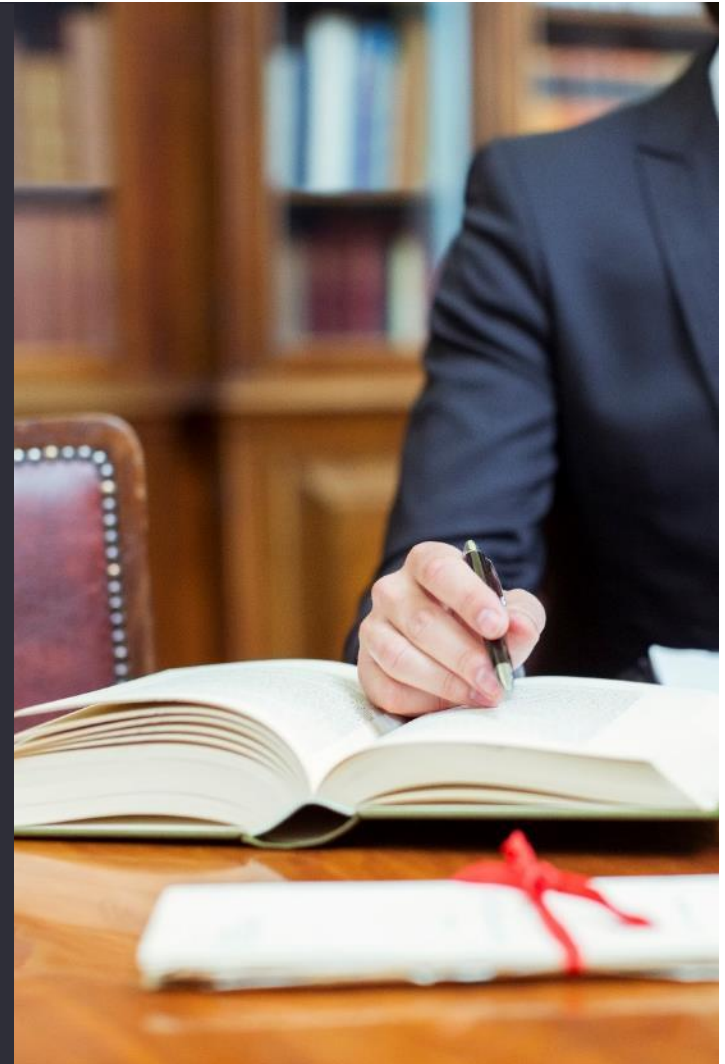
Effective October 9, 1990, replacing the repealed Section 2036(c), which was criticized for being overly vague, complex and unreasonable

2

Special valuation rules set forth in Sections 2701, 2702, 2703 and 2704

3

Attempts to prevent perceived transfer tax abuses in the context of business or other interests held within a family



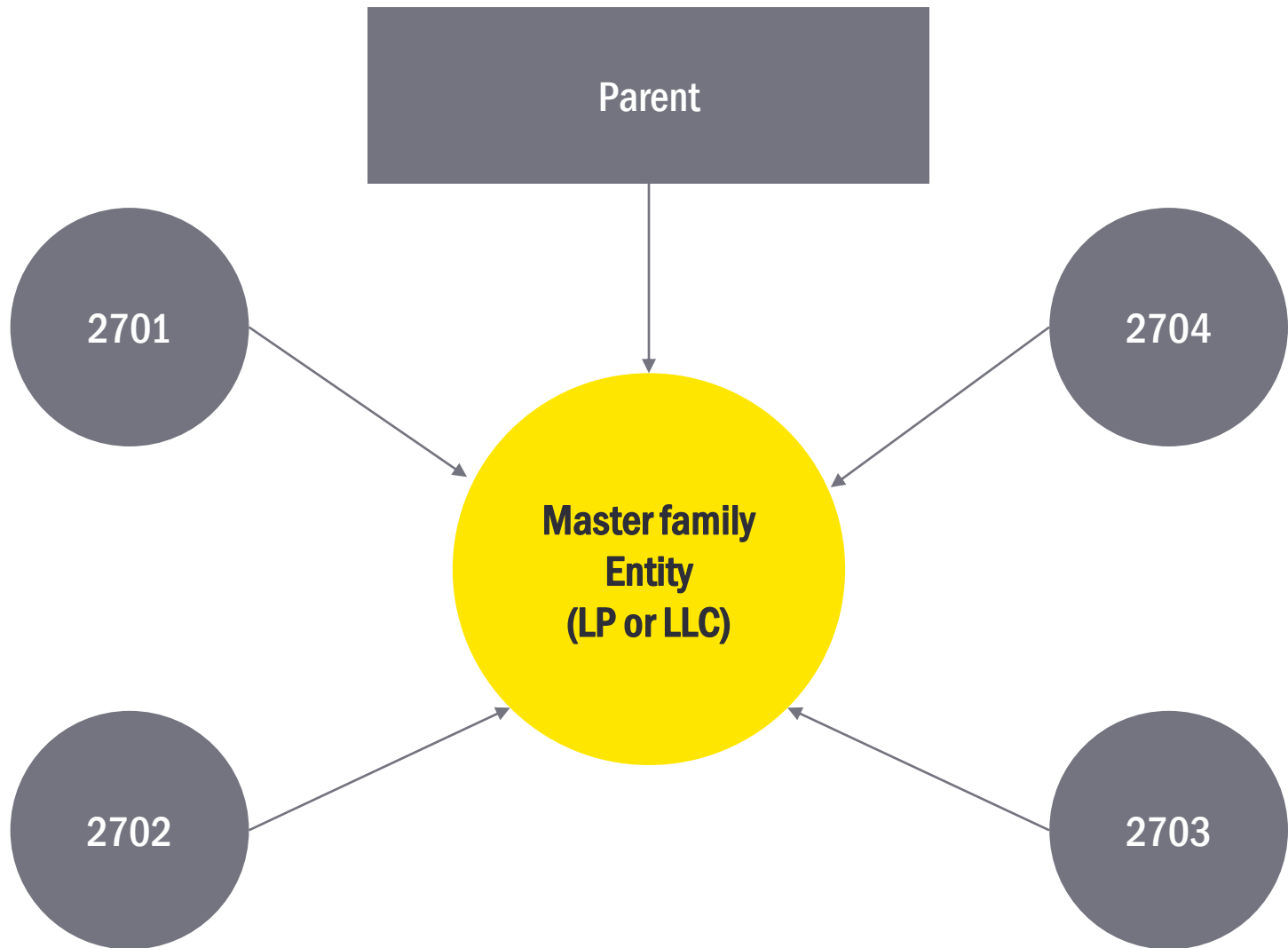
Where Chapter 14 may come into your practice

- Preferred partnerships/limited liability companies (LLCs)
- Family limited partnerships (FLPs)
- Capital contributions — recapitalizations
- Buy-sell and shareholder agreements
- Carried interest planning
- Profits interests
- Grantor retained annuity trusts (GRATs)/qualified personal residence trusts (QPRTs)/sales of remainder interests
- Sales to grantor trusts
- Valuation issues
- Joint purchases

Overview of Chapter 14

- Underlying assumption – senior family members will structure ownership and transfer of family business (and other) interests to shift value to younger family members at a reduced transfer tax cost.
- **Not always the case, but presumptions built into provisions. Pitfalls for the unwitting!**
- Important to note – very broad and can unexpectedly apply!





Overview of Chapter 14

1

Deemed gift provisions

- Section 2701
- Section 2702
- Section 2704(a)

2

Disregard provisions

- Section 2703
- Section 2704(b)

Section 2701



Section 2701 – overview

- Deemed gift provision – Even if no gift/full and adequate consideration under Chapter 12
- Perceived abuse – Manipulation of value between two classes of equity to shift value to junior generation while minimizing gift tax

Pitfalls and planning opportunities

- Preferred entities
- Profits interests
- Capital contributions and recaps
- Carried interest “vertical slice”
 - Different classes of equity
- Proactive planning:
 - Freeze partnerships to shift growth
 - GRATs, qualified terminable interest property trusts (QTIPs), non-exempt trusts



Historical background

Pre-October 9, 1990 planning

- **Suspect transaction**
— parent recapitalizes family company into preferred and common interests

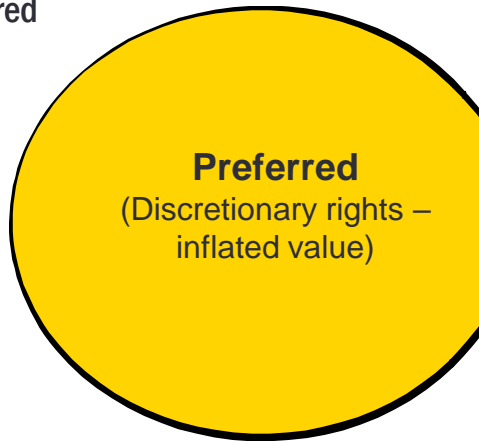
- **Preferred had discretionary rights to boost its value**

- **Thus, minimal valuation of gift of common (but with all upside potential)**

Pre-2701 planning

Valuation before gift

Parent retained preferred



Valued at \$9.5m

\$10m total

Common
(Deflated value)

Valued at \$500k

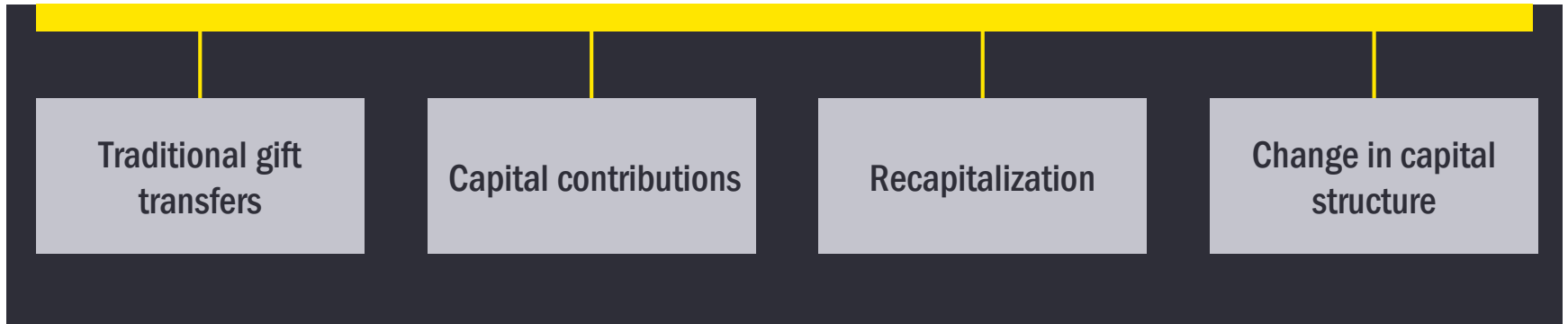
Common gifted to kids
(at depressed value)

Partnership agreement provisions

Congressional response — concept of applicable retained interest and zero value rule

- Section 2701 causes certain rights associated with senior equity interests (applicable retained interests) retained by senior member to be valued at zero
- Rationale: if discretionary rights unlikely to be exercised by G-1, why give “credit”?
- Section 2701 creates a fiction
- Resulting increase in value of the transferred interest to junior member
- Subtraction method

Transfers – broader than you think



Terminology: “Junior” and “Senior” family members

“Applicable Family Member”

- “Senior” member and spouse
- (Taxpayer’s spouse, ancestor of taxpayer or taxpayer’s spouse, and spouse of ancestor)

“Member of the Family”

- “Junior” member and spouse
- (Taxpayer’s spouse, lineal descendants of taxpayer or spouse, any spouse of a lineal descendant)

Equity Interests in a Controlled Entity

- “Senior” interest generally “Preferred”
- “Junior” interest generally “Common”

Section 2701 zero valuation rule applies if:

01

Transfer to a Member of the Family and after

02

Transferor or Applicable Family Member retains

03

Applicable retained interest

Applicable retained interest

- Two kinds of “tainted” rights cause applicable retained interest status:
- (Either)
 - Distribution right (only if “control”)
 - Right to receive distributions with respect to an equity interest
 - Unless has “same or subordinate” distribution rights as the transferred interest
- or
- Extraordinary payment right

Family “control” prerequisite for a distribution right

- Partnership — at least 50% of capital or profit interest or any equity interest “as a general partner” (question “in a general partner”)
- Corporation — at least 50% of the total voting power or total fair market value (FMV) of the equity interest of the corporation



Extraordinary payment right

Put, call, right to compel liquidation and other rights:

- The exercise or non-exercise of which affects the value of the transferred interest
- No “control” requirement — because held individually (not in entity)
- Assumption that older family member would not exercise their right

Qualified Payment Right (QPR)

- Mandatory and quantifiable (or otherwise subject to valuation)
- QPR
 - Cumulative payment
 - Payable at least annually
 - At a fixed rate
 - Lower of — Senior Member's equity interest is given the lower value

Rights that are not extraordinary payment rights or distribution rights under Section 2701



Circumstances when Section 2701 does not apply

- Marketable securities — market quotations on established securities market for either transferred or retained interest

- Same class exception — same class or proportional to
 - Non-lapsing differences in voting okay (e.g., Family Limited Partnership (FLP))

- “Vertical slice” proportionality rule

Chief Counsel advice 201442053 – Recapitalization

- Mom contributed real estate to single class limited liability company (LLC) and gifted interests to two sons and grandchildren; LLC had 20-year term
- LLC recapitalized – sons allocated all profits and losses; ownership interests held by Mom and grandchildren were only capital interests with right to distributions based on capital account balances at recapitalization



Chief Counsel advice 201442053 – Recapitalization

Conclusion of CCA: recapitalization was “transfer” from Mom to sons. Amount of transfer was determined pursuant to Treas. Reg. §25.2701-3(b)

- Both before and after recapitalization, Mom held applicable retained interest (right to compel liquidation – turned out not to be the case – before transfer and distribution right that was not a QPR)
- CCA valued Mom’s retained interest at zero

CCA did not ascribe any value to the retained capital interest (i.e., from “liquidation participation right”)

- In commentary, Richard Dees argues transfer more appropriately valued under Chapter 12 traditional gift tax principles
- Settlement with IRS apparently ascribed value to capital interest retained by Mom

Section 2701 attribution rules

- “Attribution to Estates, Trusts and other entities” – assuming maximum exercise of discretion
- “Grantor Trust Attribution Rules”
- “Multiple Attribution Rules” Treas. Reg. §25.2701-6(a)(5) – different tie-breaker ordering rules apply:
- Cast a wide 2701 net
 - As to applicable retained interests – attribute to Senior Member first (grantor of grantor trust first)
 - As to subordinated equity interests – attribute to Junior Member first

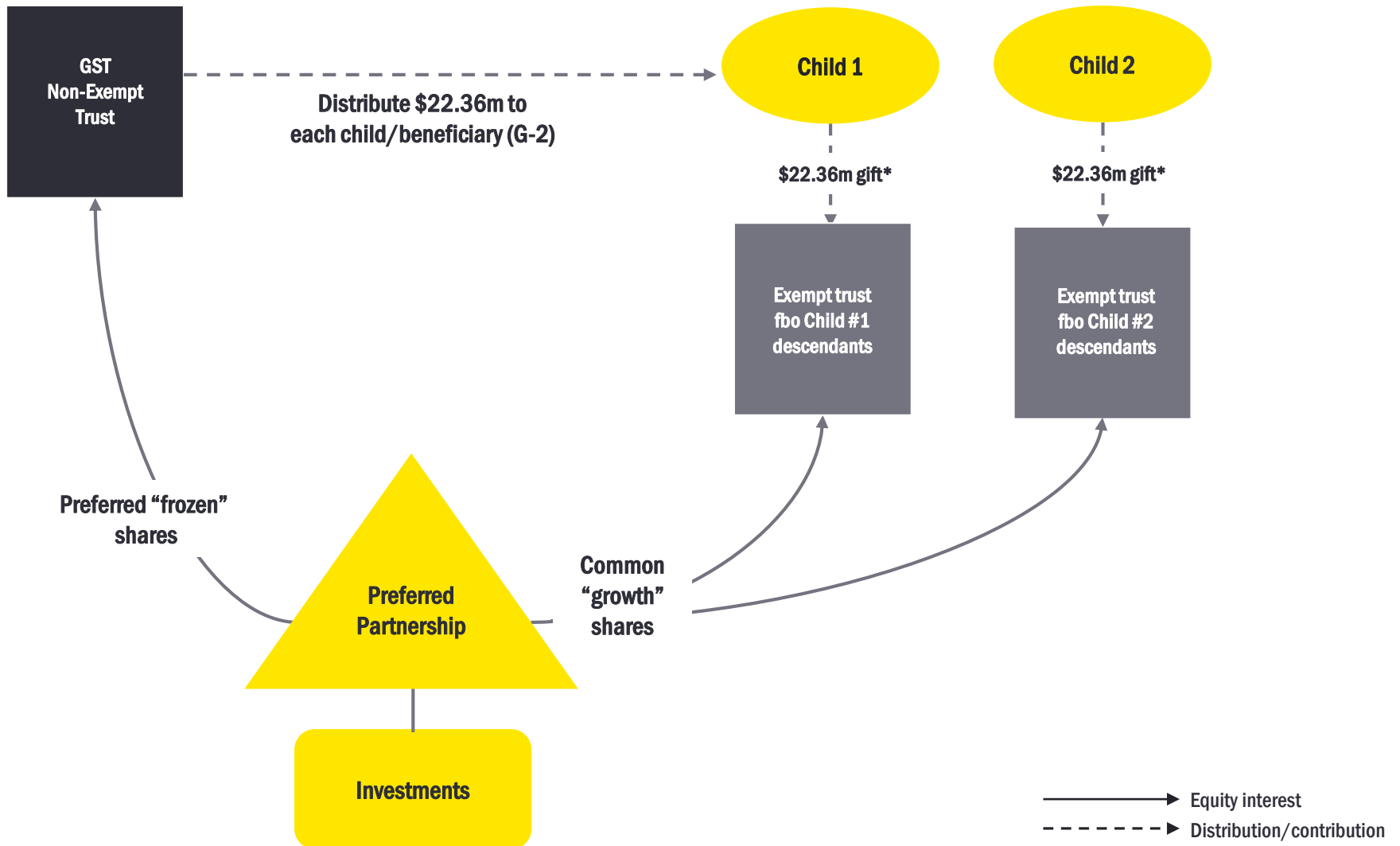
Pro-active planning with Section 2701 – Compliant entities

- Potential to “freeze” the growth and shift growth (above coupon and liquidation preference) to common interests
- Division of partnership or LLC interests into preferred “frozen” and common “growth” interests

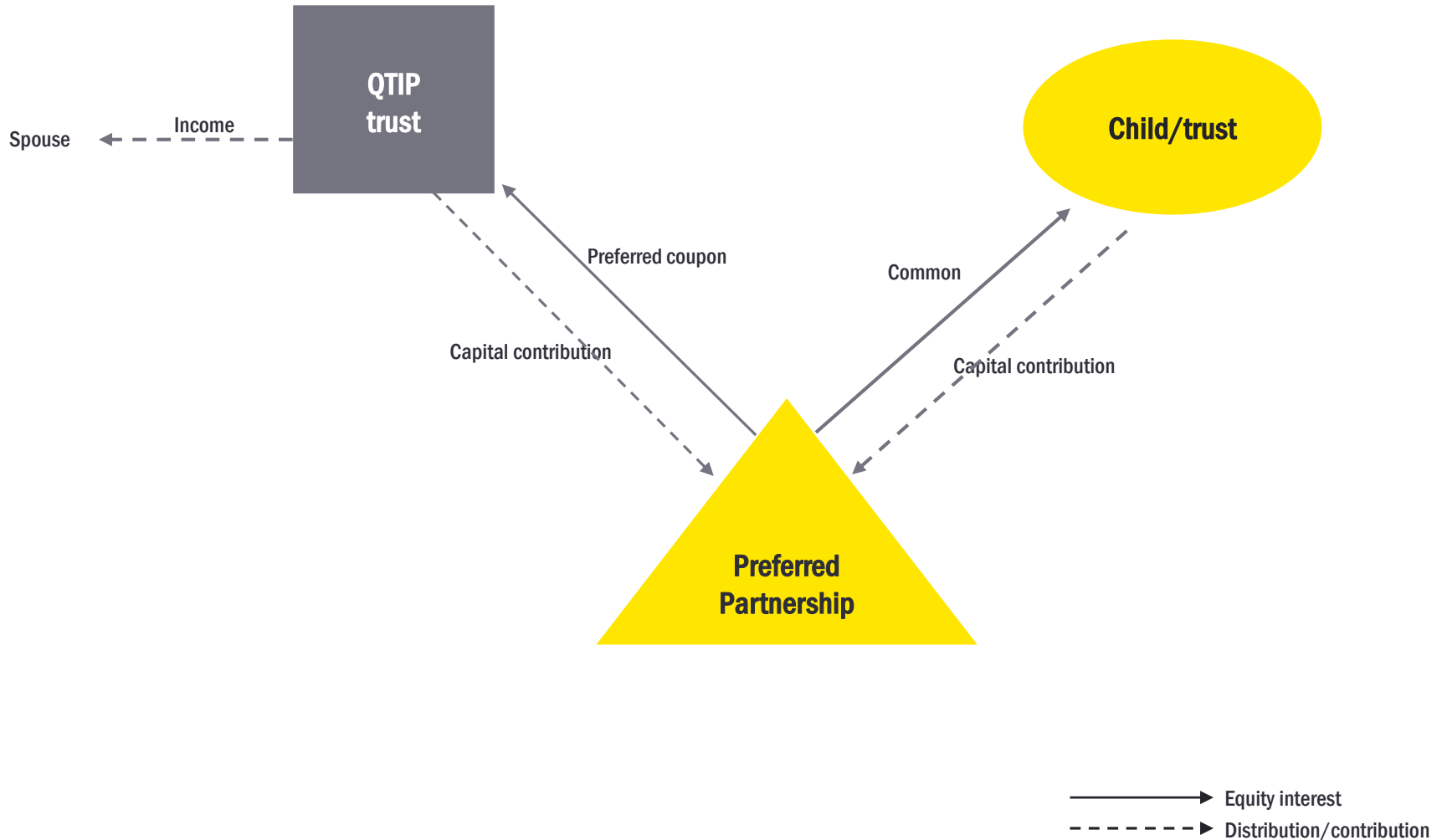
Pro-active planning

- Shifting growth —“pop” in value
 - QTIP
 - GRAT
 - Generation Skipping Tax (GST) Non-Exempt

Preferred partnership to contain growth of GST non-exempt trust

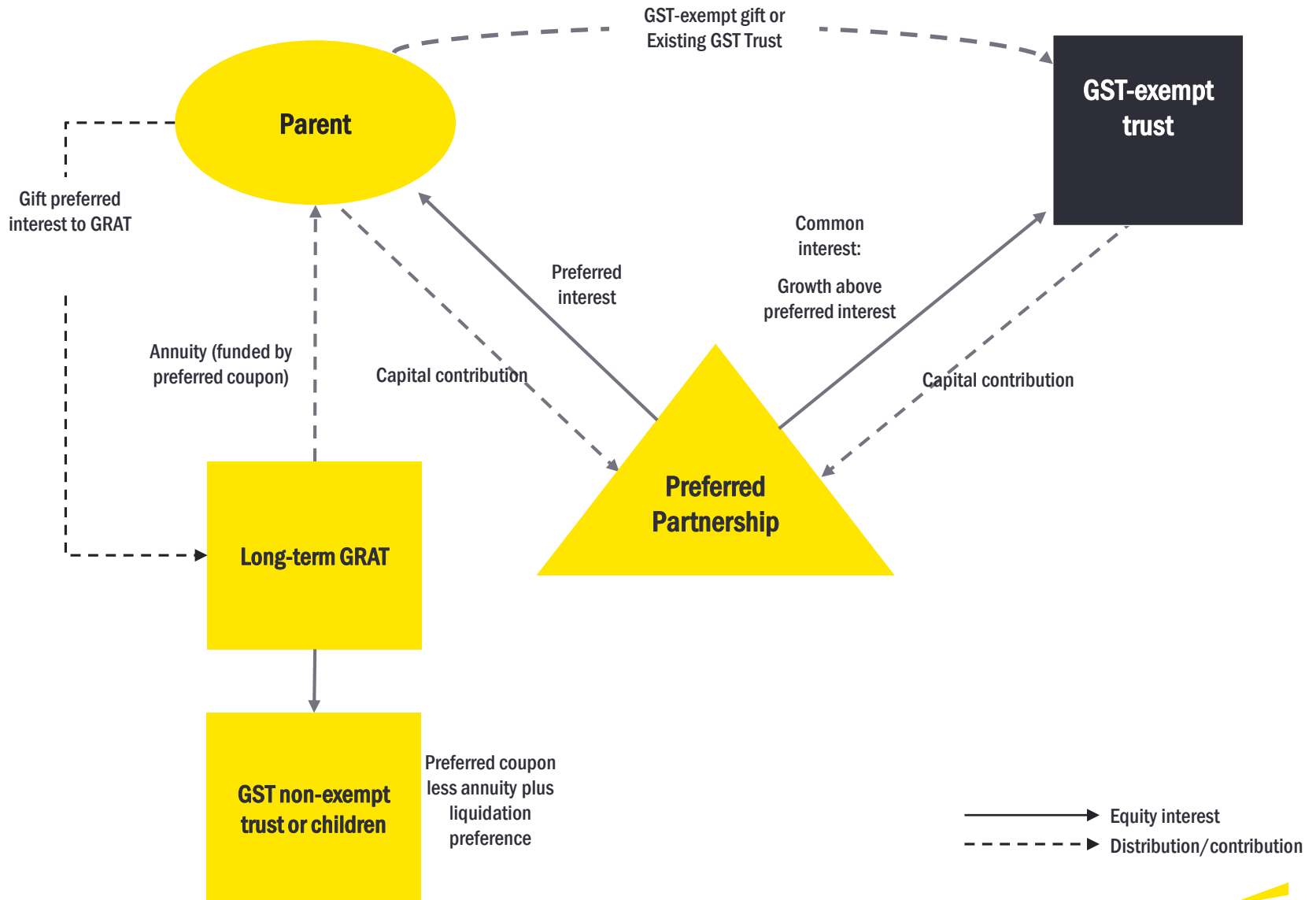


Preferred partnership with QTIP freeze

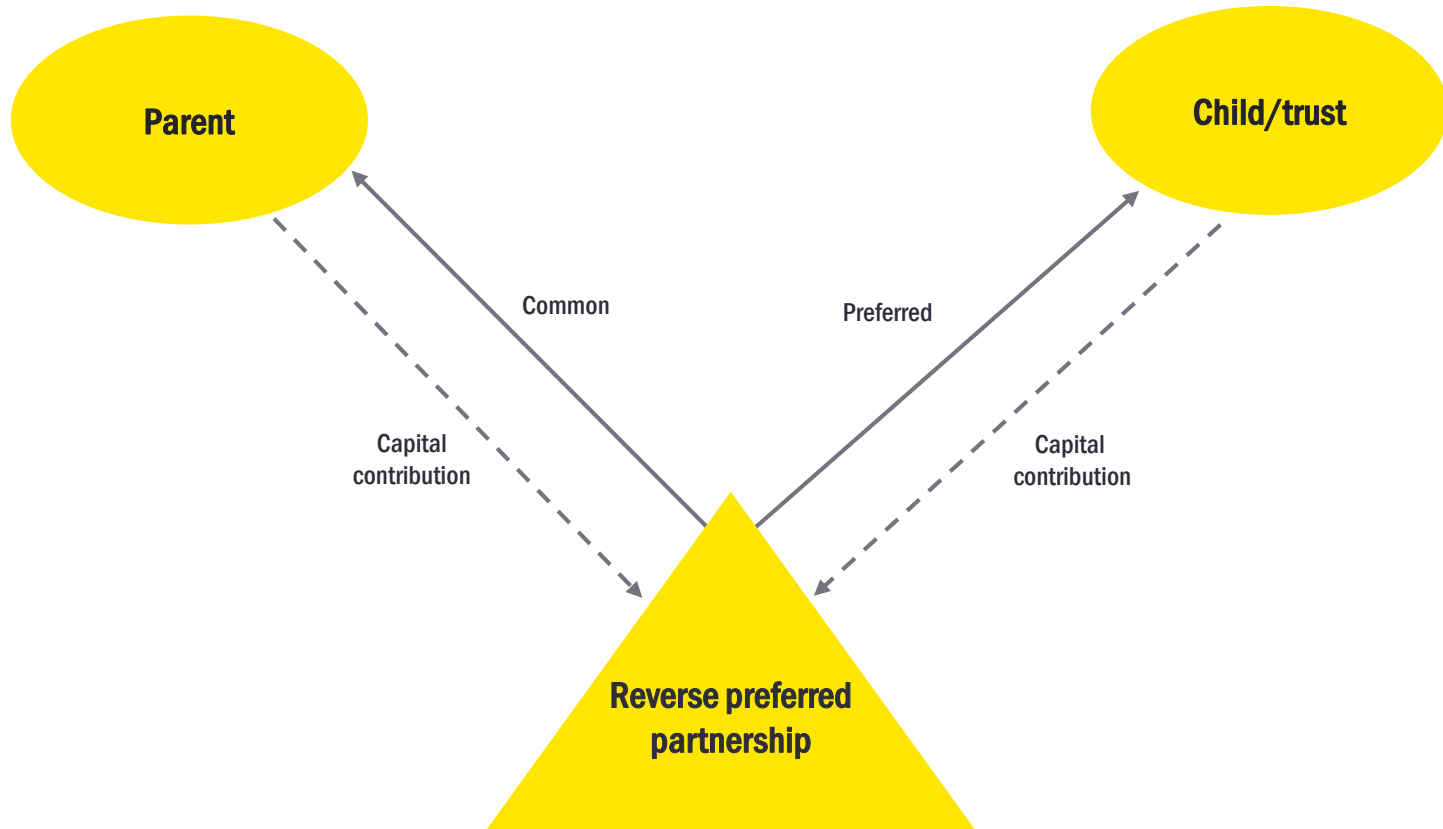


* Caveat – Consider potential Section 2519 argument on contribution.

Preferred partnership GRAT



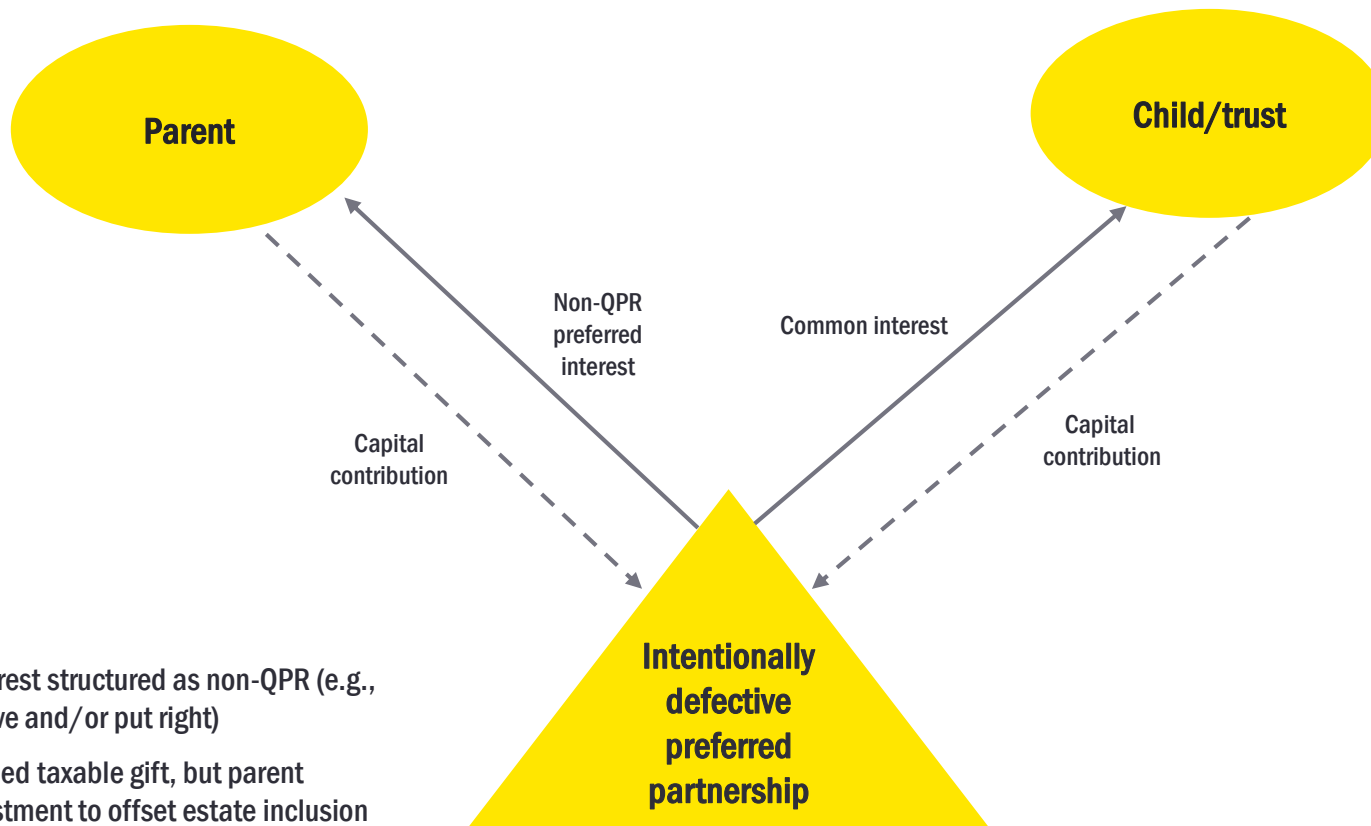
Reverse preferred partnership



* Section 2701 not applicable since parent holds subordinate common interest.

—————▶ Equity interest
-----▶ Distribution/contribution

Intentionally defective preferred partnership



- Preferred interest structured as non-QPR (e.g., non-cumulative and/or put right)
- Triggers deemed taxable gift, but parent receives adjustment to offset estate inclusion of preferred interest

—————> Equity interest
-----> Distribution/contribution

Valuing the preferred interest

1

- QPR avoids zero valuation rule
 - Value of preferred interest should equal “par”
 - Rev. Rul. 83-120 factors:
 - Yield as compared to risk-adjusted market comparables
 - Coverage of coupon
 - Dissolution protection
 - Voting rights
 - Lack of marketability

2

- De minimis rule
 - Common equity has to account for at least 10% of the capitalization

Other considerations

- Section 2036(a)?
- Bona fide sale exception
- Disguised sale “reasonable payment”

Section 2701 in context of carried interest planning — the vertical slice

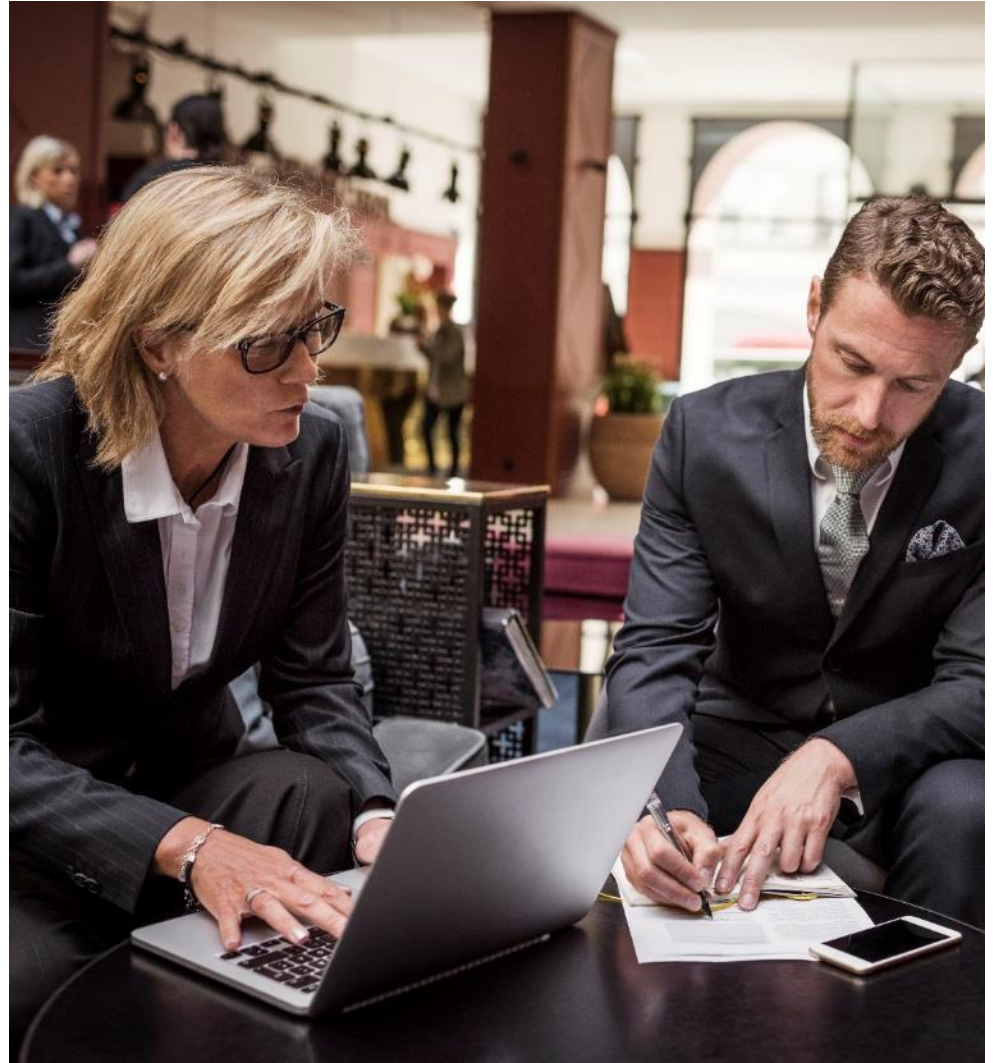


Introduction

- **Example: transfer of interests in general partner of private investment fund (the GP)**
 - **Significant potential for future appreciation associated with carried interest.**
 - If 1% capital contribution by GP is entitled to allocation of 20% of profits (the carried interest), significant potential for value of GP interest to grow.
 - If growth occurs in estate planning vehicle excluded from estate of the transferor (Fund Principal), result is transfer tax-efficient shift of future appreciation to next generation, or better in a generation-skipping tax-exempt trust.
 - Even more powerful if leverage is applied to transaction, particularly when interest rates are near historic lows.

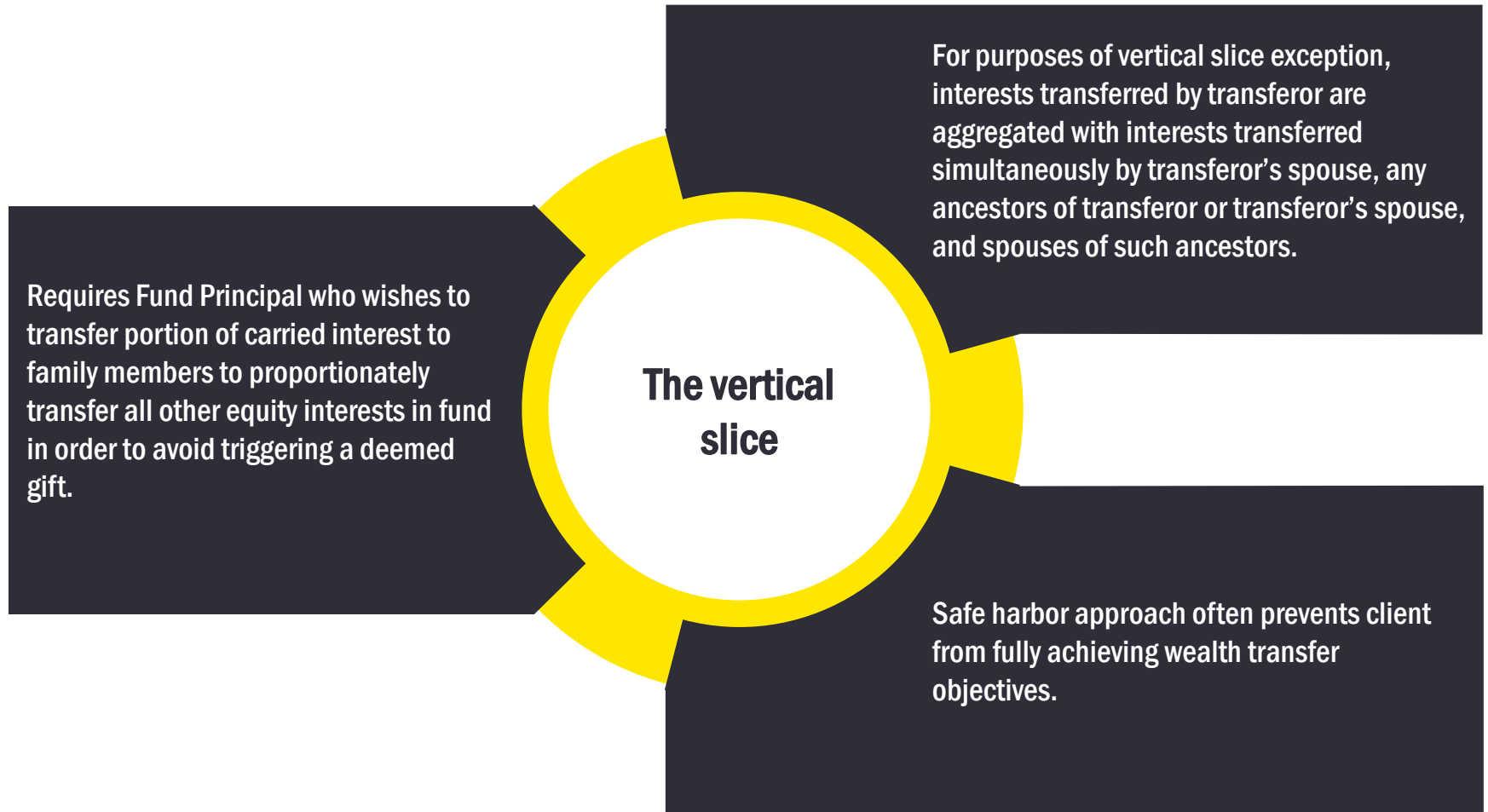
What is the vertical slice rule and why do we care?

- The most elegant solution to a draconian deemed gift tax rule under IRC Section 2701
- The rule is really just one (of several) safe harbor exceptions to Section 2701 – the proportionality exception
- Broadly requires a parent who wishes to transfer a percentage of his GP carried interest to children (or their trust) to also transfer a proportional interest of fund LP interest (e.g., 25% carry + 25% LP interest)
- Beware of bad vertical slices




Section 2701 in context of carried interest planning

The vertical slice



Chapter 14 issues

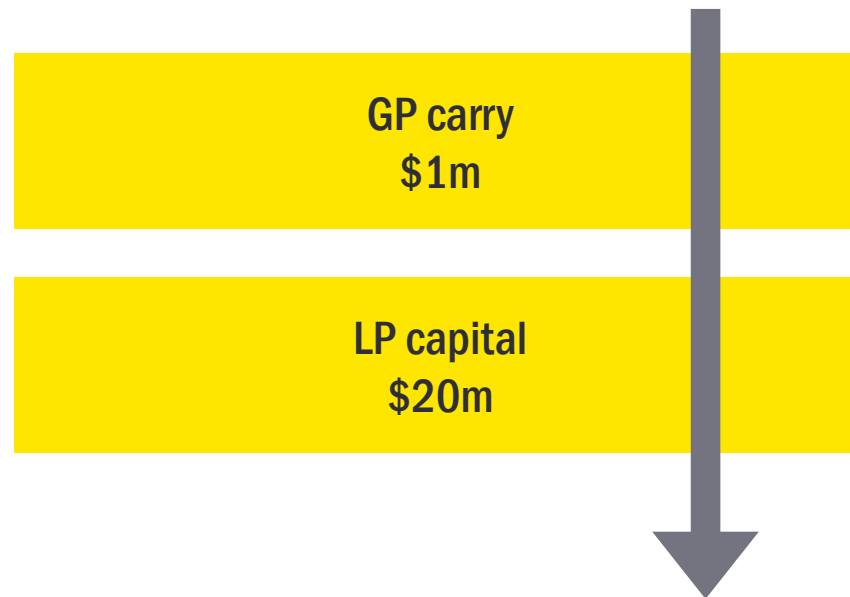
Vertical slice to make transfer without running afoul of deemed gift issues under Section 2701



- To qualify, Fund Principal transferring portion of carried interest to family members must transfer proportionate amount of other equity interests in fund
- Issue: Fund Principal wants to transfer all carried interest, but only some (or none) of LP interest or capital in GP, both for economic reasons (wants to retain portion of capital investment in fund) and gift tax reasons (does not want to make taxable transfer of high-value assets)
 - To comply with vertical slice safe harbor and avoid triggering deemed gift, Fund Principals are frequently advised to transfer smaller percentage of carried interest.

Carried interest vertical slice planning

Example



If parent makes a vertical slice gift of 50% of his \$1m GP interest (= \$500,000), he must also make a proportional gift of 50% of his \$20m LP capital (= \$10m). Total gift of \$10.5m x 40% gift tax rate = \$4.2m gift tax liability.

Section 2701 in context of carried interest planning

The vertical slice

- Section 2036 implications with vertical slice holding entity approaches
 - *Vertical slice holding entity.* IRS has challenged funding and subsequent transfer of interests in family limited partnerships.
 - Under Section 2036(a)(1) as a transfer with retained interest
 - Under Section 2036(a)(2) as a transfer with retained control
 - *Bona fide sale exception.* Avoid application of Section 2036(a)(1) and Section 2036(a)(2) by satisfying bona fide sale exception.
 - If Fund Principal's initial capital contribution to entity is considered a bona fide sale for adequate and full consideration, Section 2036 is not applicable.
 - A legitimate business purpose and/or substantial nontax purpose is required to establish that a bona fide sale existed.

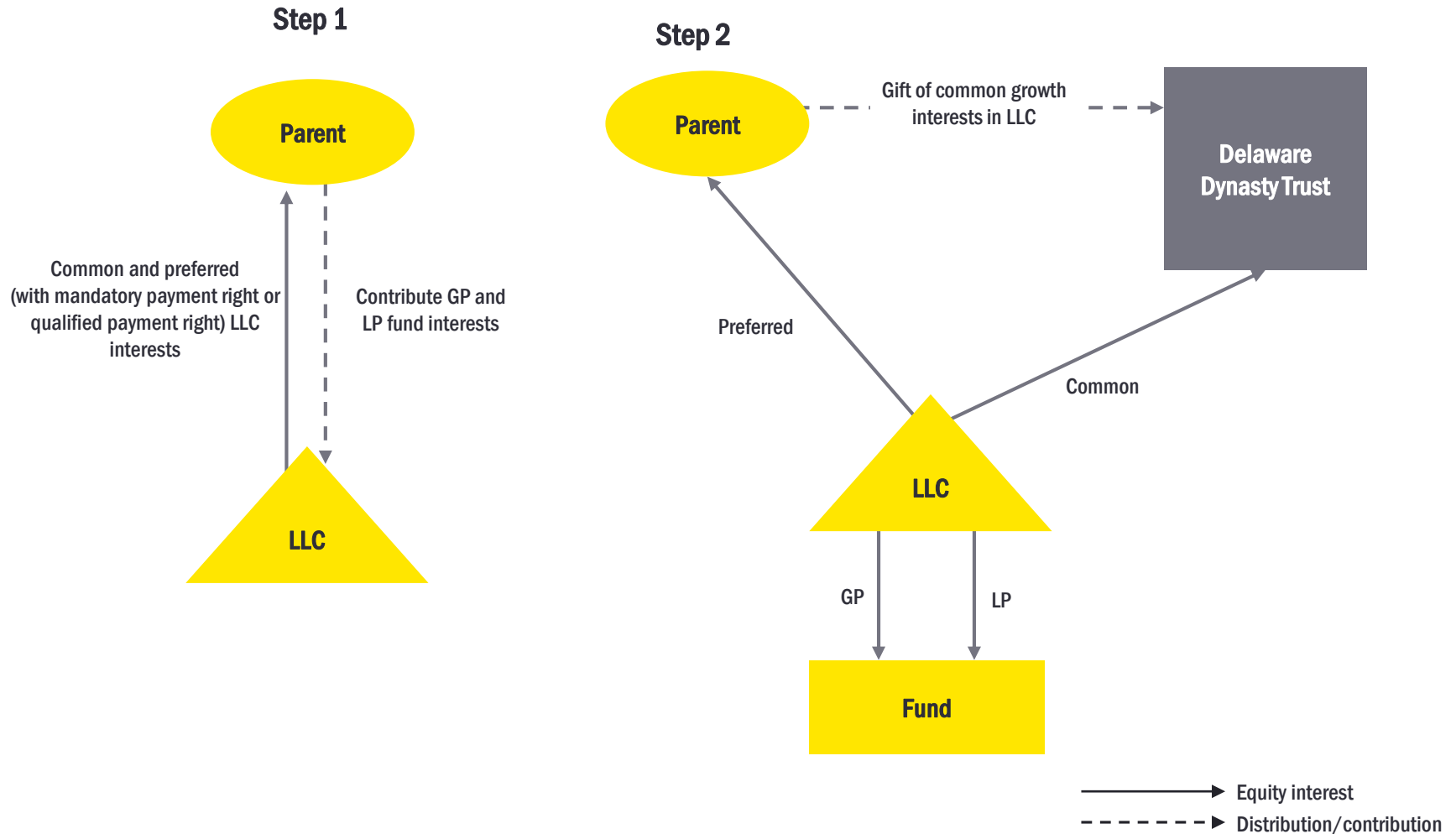
Section 2701 exceptions

Other options than vertical slice – non-vertical holding entity approaches



Holding entity approach

Parent's retained preferred interests structured as qualified payment right or mandatory payment right



Section 2701 exceptions

Other options than vertical slice – non-vertical holding entity approaches

- Structuring the non-vertical holding entity and valuation issues
 - Approaches rely on creation of some form of preferred partnership holding vehicle.
- Even if parent's preferred interest is properly structured to avoid application of Section 2701, could be partial gift under traditional valuation principles if Fund Principal's retained preferred coupon is less than what it would have been in arm's-length situation.
 - Vital to retain qualified appraiser to prepare valuation appraisal to determine preferred coupon required for parent to receive value equal to par value for capital contribution.
 - Factors set forth by IRS in Revenue Ruling 83-120:
 - Comparable preferred interest returns on high-quality publicly traded securities
 - Security of the preferred coupon
 - Size and stability of the partnership's earnings
 - Asset coverage
 - Management expertise
 - Business and regulatory environment and other relevant facts or features of preferred partnership

Section 2701 red flags

- Different classes of equity in family vehicle (“control” broadly defined)
- Preferred entities
- Parent (alone) retained put, calls, liquidation rights
- Profits interests
- Recap – capital contribution
- Carried interest transfer planning
 - Can still be done – but navigate issues

Speaker Biography

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N. Todd Angkatavanich is a Principal in Ernst & Young LLP's National Tax Department, where he serves in the Private Client Services practice. He was formerly a Partner at Withers Bergman LLP, where he served as Co-Head of the firm's US Private Client & Tax Group. Todd is a Fellow of the *American College of Trust and Estate Counsel (ACTECT)*, is a Fellow of the *American Bar Foundation* and is a member of the *Society of Trusts & Estates Practitioners*. Todd has published articles in publications such as *Trusts & Estates*, *ACTEC Law Journal*, *Estate Planning*, *BNA Tax Management*, *Probate & Property*, *STEP Journal* and other publications. He serves as Co-Chair of the Estate Planning & Taxation Committee of the Editorial Advisory Board of *Trusts & Estates* magazine, as well as Chair of the Advisory Board for *BNA/Tax Management Estates, Gifts and Trusts*. Todd is co-author of *BNA/Tax Management Portfolio No. 875*, entitled “*Wealth Planning with Hedge Fund and Private Equity Fund Interests*.” A frequent speaker, Todd has given presentations for a number of organizations including the *Heckerling Institute on Estate Planning*, the *Notre Dame Tax and Estate Planning Institute*, the *Duke University Estate Planning Conference*, the *Washington State Bar Association Annual Estate Planning Seminar*, the *ABA Real Property, Trusts and Estates Section* as well as numerous estate planning councils, CPA societies and family office groups. Todd is Co-Chair of the *Business Investment Entities, Partnerships, LLC's and Corporations Committee* of the *ABA/RPTE Business Planning Group* and serves as a member of the *ABA/RPTE Diversity Committee*. He is a member of the *Executive Committee* of the *Connecticut Bar Association, Estates and Probate Section*. He is the 2012 recipient of the award for “Private Client Lawyer of the Year” from *Family Office Review*. Todd has been included in *The Best Lawyers in America®* (for New York City, Greenwich and New Haven, Connecticut) and is also the recipient of the *Best Lawyers® 2015 Trusts & Estates “Lawyer of the Year”* award for New Haven, Connecticut. He has been rated AV Preeminent® by *Martindale-Hubbell® Peer Review Ratings*,™ has been ranked in *Chambers HNW*, has been listed in *Who's Who Legal: Private Client* and in *Super Lawyers*. Todd received his B.A., in Economics, *magna cum laude*, from Fairleigh Dickinson University, his J.D., Tax Law Honors, from Rutgers University School of Law, Camden, his M.B.A. from Rutgers University Graduate School of Management, and his LL.M, in Taxation, from New York University School of Law.

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