Fun with Section 2701 – Planning Alternatives and Issues with Preferred Partnerships, Carried Interest Transfer Planning and Profits Interests

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[1] The views expressed in this outline are solely of the author and do not necessarily represent the view of Ernst & Young LLP or any other firm of the global Ernst & Young Global Limited organization.

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I. PREFERRED "FREEZE" PARTNERSHIPS

A. Introduction.

In its most basic form, a preferred "freeze" partnership (referred to in this outline as a Freeze Partnership) is a type of entity that provides one partner, typically a Senior Family Member, with a fixed stream of cash flow in the form of a preferred interest, while providing another partner with the future growth in the form of common interests in a transfer-tax-efficient manner. Preferred Partnerships[3] are often referred to as "Freeze Partnerships" because they effectively contain or "freeze" the future growth of the preferred interest to the fixed rate preferred return plus its right to receive back its preferred capital upon liquidation (known as the "liquidation preference") before the common partners. The preferred interests do not, however, participate in the upside growth of the partnership in excess of the preferred coupon and liquidation preference, as all that additional future appreciation inures to the benefit of the common "growth" class of partnership interests, typically held by the younger generation or trusts for their benefit.

A Freeze Partnership is quite different than a single or same economic class "family limited partnership," in that it divides the partnership into two or more distinct economic classes, based upon each partner's preferences for more secure preferred "cash-flow" interests or riskier common "growth" interests. In the family context, a Freeze Partnership can provide a very useful vehicle to match the different needs of different generational family members, in much the same way as those family members might orient their investments more heavily into equities or fixed income based upon their respective ages, cash-flow needs, risk tolerance and investment horizon.

In a typical application, a Freeze Partnership is created as a new entity, or perhaps an existing single economic class entity is recapitalized, as a result of which a parent or other Senior Family Member (referred to generally in this outline as "Senior Family Member") receives preferred interest in the Freeze Partnership. A child, grandchild or perhaps a trust for their benefit (referred to generally in this outline

[2] The author would like to thank Eric Fischer, Esq.; Shudan Zhou, Esq.; and Kenneth A. Pun, Esq. for their valuable assistance in preparing this outline. The author would also like to thank James R. Brockway, Esq., at partner at Withers Bergman LLP for his review of this outline.

[3] For purposes of this outline, the term Freeze Partnership shall also refer to preferred freeze limited liability companies, unless specifically indicated otherwise.

as "Junior Family Member") either contributes assets to the partnership in exchange for common interests (in the case of a capital contribution into a newly formed partnership), receives common interests in exchange for recapitalized common interests (in the case of a recapitalization), or perhaps the Senior Family Member initially owns both the preferred and the common interests and subsequently transfers (either by gift or sale or both) the common interests to the Junior Family Member (the Senior Family Member would typically also own a small percentage of common interest (ex. 1%) in the Freeze Partnership in order to ensure that he or she would be treated as a partner of the partnership).

It should be noted that although the most straightforward Freeze Partnership application will often involve individuals as the preferred and common partners, in some cases trusts and/or other entities may be partners in these entities. In such case, where individual Senior Family Members and/or Junior Family Members have actual or beneficial ownership interests in these trusts or entities, a general "look through" type of analysis is applied to determine the proper way to structure a Freeze Partnership under complex attribution rules that exist with respect to trusts, estates, corporations and partnerships under the Treasury Regulations promulgated under Section 2701.[4]

The Senior Family Member's preferred interest in the Freeze Partnership will typically (but not always) be structured as a "qualified payment right" under Section 2701 to ensure that a deemed gift is not triggered upon a capital contribution of assets to the Freeze Partnership, upon a recapitalization or upon the subsequent transfer of the common interest to a Junior Family Member under the application of the "zero valuation" rule of Section 2701. This qualified payment right generally will be structured to provide that the Senior Family Member receives a fixed-percentage payment return on the preferred capital, payable at least annually and on a cumulative basis.[5] In addition, the Senior Family Member would also have a liquidation preference, so that when the Freeze Partnership is liquidated, the Senior Family Member will receive a return of capital before any return to the common interest holders of their capital.

Because of these preferred rights that the Senior Family Member holds in the Freeze Partnership, he, she or it will not receive any of the upside growth above those rights (that is, except for any common interest that the Senior Family Member may hold). Rather, the Junior Family Member will receive the upside growth potential in the form of the common interests above the amount needed to pay the preferred coupon. Over time, assuming that the Freeze Partnership assets are invested in such a way so as to outperform the required coupon on the preferred interest, the common interest will appreciate in value, thereby enabling future growth of the

[4] The Internal Revenue Code of 1986, as amended, is hereafter referred to as the "Code." All references herein to a "Section" refer to the relevant Section of the Code. For purposes of this outline, the terms "Senior Family Member" and "Junior Family Member" shall refer to those persons individually and/or via a trust or other entity by application of these attributions rules.

[5] Section 2701(c)(3)(A).

partnership (above the preferred coupon) to be shifted to the Junior Family Members that hold the common interests.

B. Other Applications.

While individual parent and child partner ownership is the most straightforward application for a Freeze Partnership structure, there are various other applications where this type of vehicle can be utilized to leverage planning with other types of vehicles and entities. These different applications can provide advantages to enhance existing structures from a transfer tax, income tax or nontax standpoint, or perhaps a combination of thereof where it may be advantageous to contain the future growth of assets in one "bucket" in which it may be less efficient or desirable to have growth occur, and shift future growth into a more tax-efficient or desirable bucket. This outline will discuss several different applications for this versatile vehicle, including implementing Freeze Partnerships in connection with following:

- Basic Application
- Reverse Freeze Partnerships
- Qualified Terminable Interest Property ("QTIP") Trusts
- Grantor Retained Annuity Trusts ("GRATs")
- Charitable Lead Annuity Trusts ("CLATs")
- "Non-Vertical" fund carried interest transfer planning
- Profits Interests with Family Offices
- "Intentionally Defective" Preferred Partnerships

II. BIG PICTURE ISSUES IN STRUCTURING PREFERRED "FREEZE" PARTNERSHIPS [6]

A. Gift Tax Formation Issues.

There are various issues that must be considered in connection with the formation of a newly created Freeze Partnership. The most notable issue is Section 2701 of the Code, which generally can result in a deemed gift upon a Senior Family Member's capital contribution of assets into a Freeze Partnership in which he or she retains senior equity interests, unless very specific requirements are satisfied with respect to the Senior Family Member's preferred interest. A "transfer" that can potentially trigger a deemed gift under Section 2701 is broadly defined and includes

[6] For excellent comprehensive discussions of preferred partnership planning, *see generally* Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle*, 35-3 Univ. of Miami Law Center on Est. Planning (Jan. 2001). *See also* Paul S. Lee & John W. Porter, *Family Investment Partnerships: Beyond the Valuation Discount* (Sept. 2009), available at http://apps.americanbar.org/rppt/meetings_cle/joint/2009/Materials/Stand_Alone_Programs/LeeFamilyInvestmentPartnershipsOutlineSeptember2009.pdf.

not only traditional gift transfers, but also capital contributions to new or existing entities, redemptions, recapitalizations or other changes in the capital structure of an entity.[7]

B. Structuring the Preferred Interest.[8]

1. Qualified payment Right.

A Senior Family Member's preferred partnership interest is most typically, but not always, structured as a "qualified payment right" under Section 2701 to ensure that the Senior Family Member's contribution of assets to the Freeze Partnership is not considered a deemed gift under the Section 2701 "zero valuation" rule. The use of this "qualified payment right" structure will result in the Senior Family Member's retained preferred interest being valued under traditional valuation principles for gift tax purposes, and not under the unfavorable "zero valuation rule" of Section 2701.

This generally requires that the Senior Family Member's preferred interest be structured as a fixed percentage return on capital, that is payable at least annually and on a cumulative basis.[9] When a Senior Family Member retains a preferred interest that satisfies the requirements of a "qualified payment right," the Senior Family Member's preferred interest, or more accurately, the "distribution right" component of the preferred interest (that is, the right to receive distributions with respect to such equity interest) will not be valued at "zero" for gift tax valuation purposes, determined under a subtraction method of valuation, but, rather, such distribution right will be valued under traditional valuation principles.[10]

To ensure the preferred coupon does not fail to qualify merely because cash flow is not sufficient to make the preferred payment in a given year, the Code provides that each preferred coupon payment can be made up to four years after its original due date and the payment will still be considered to be made on a timely basis.[11] The interest rate compounds should a payment go unpaid for an extended period, so the accrued interest amount can become substantial, but the deferral ability does nevertheless provide some flexibility.[12]

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[7] Treas. Reg. § 25.2701-1(b)(2)(i).

[8] For a more detailed discussion of related technical rules, see infra Section IX. See also, N. Todd Angkatavanich and Edward A. Vergara, Preferred Partnership Freezes: They Come in Different "Flavors" and Provide a Menu of Creative Planning Solutions, TR. & EST. (May 2011).

[9] Section 2701(c)(3)(A).

[10] Treas. Reg. § 25.2701-2(a)(2).

[11] Section 2701(d)(2)(C).

[12] Section 2701(d)(2)(A)(i).

2. Liquidation Preference.

In addition to being entitled to a preferred coupon payment, typically, the preferred interest would provide the Senior Family Member with a priority liquidation right, meaning that upon liquidation, the Senior Family Member will receive a return of his or her capital before the common interest holders receive a return of their capital. The Senior Family Member, however, will not receive any of the potential upside growth in the Preferred Partnership based on his, her or its preferred interest.[13] Anything in excess of the amount needed to pay the preferred coupon and liquidation preference will accrue to the benefit of the common interest holders (i.e., child or a trust for the child's benefit).

C. Subtraction Method of Valuation.

If Section 2701 applies to a transfer, the value of an interest transferred to a Junior Family Member will be determined by subtracting from the value of all family held interests the value of the interest retained by the Senior Family Member. A deemed gift will occur from the Senior Family Member to the Junior Family Member to the extent of the value of all family held interests, less the value of any interests retained by the Senior Family Member, as determined under the Subtraction Method of valuation.[14]

D. Valuation of the Preferred Coupon.

Even if the Senior Family Member's preferred interest is properly structured to avoid the "zero value" deemed gift rule under Section 2701, there are still other gift tax issues to consider under traditional gift tax principals. Properly structuring the frozen preferred interest merely ensures that the distribution right component of the Senior Family Member's preferred interest is not valued at zero, under the Subtraction Method of valuation, for purposes of determining whether and to what extent a deemed gift has been made to Junior Family Members in connection with the transfer. However, there may still be a partial gift under traditional valuation principals if the Senior Family Member's retained preferred coupon is less than what it should be when measured against an arm's-length transaction. For example, if the Senior Family Member's retained coupon under the partnership agreement is a 5% coupon, but a 7% return is determined to be required to equal par, then a deemed gift has still been made by the Senior Family Member to the extent of the shortfall in value, despite the fact that the preferred interest is structured to not violate Section 2701; albeit such would not be as dramatic a gift as would occur if Section 2701 is violated and the "zero value" deemed gift rule is triggered.

[13] Typically, the Senior Family Member will also retain at least a 1% common interest to ensure that his or her preferred interest is not recharacterized as debt. Such common interest would participate by its terms in any upside experienced by the Freeze Partnership.

[14] Treas. Reg. § 25.2701-1(a)(2).

Vital to arriving at the proper coupon rate is the retention of a qualified appraiser to prepare a valuation appraisal to determine the preferred coupon required for the Senior Family Member to receive value equal to par for his or her capital contribution. In preparation of the appraisal, the appraiser will typically take into account the factors set forth by the IRS in Revenue Ruling 83-120.[15] The primary factors indicated are:

- Comparable preferred interest returns on high-grade publicly traded securities.

- The Freeze Partnership's "coverage" of the preferred coupon, which is the ability to pay the required coupon when due, and its coverage of the liquidation preference, which is its ability to pay the liquidation preference upon liquidation of the Freeze Partnership, will impact the required coupon.

  (1) Generally, a higher percentage of the Freeze Partnership interests being preferred interests, and correspondingly less common interests, puts greater financial pressure on the Freeze Partnership's ability to pay the coupon on time; this translates to weaker coverage of the coupon, and thus greater risk, and ultimately a higher required coupon to account for this greater risk.

  (2) Conversely, a Freeze Partnership that has a higher percentage of common interests relative to preferred would provide stronger coverage which would result in lower risk and consequently a lower required coupon. A lower coupon may be more desirable from a wealth transfer standpoint as growth above the lower coupon will shift to the younger generation owning the common interest.

- Valuation discounts and other relevant factors.

E. Lower of Rule.

Even if the preferred interest is structured as a qualified payment right, it is critical that no "extraordinary payment rights" be retained by the Senior Family Member, in order to avoid the "lower of" rule. These include discretionary rights, such as puts, calls, conversion rights and rights to compel liquidation, the exercise or non-exercise of which affects the value of the transferred interest.[16] Inadvertently retaining an extraordinary payment right along with a qualified payment right could still result in a deemed gift upon the Senior Family Member's capital contribution under the "lower of" rule, which essentially requires that the preferred interest be valued not at the determined value of the qualified payment right, but based upon

[15] Rev. Rul. 83-120, 1983-2 C.B. 170.

[16] Treas. Reg. § 25.2701-1(a)(2)((i).

the “lower of” the qualified payment right and any extraordinary payment rights, which could potentially be lower, perhaps significantly lower (for instance if the preferred contained a put right at a value that is lower than the value of the quailed payment right).[17]

F. Ensuring Preferred Equity Interest is not Recharacterized as Debt.

One issue to be considered is whether the IRS could assert that preferred interests should be recharacterized as debt, rather than as equity in the Freeze Partnership. This is largely a facts and circumstances determination that has been developed through a large body of case law and which considers a number of factors (not necessarily related to preferred equity specifically, but rather, equity interests in general). A compilation of these factors was originally included in Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle,* 35-3 Univ. of Miami Law Center on Est. Planning 3 (Jan. 2001), as follows:[18]

“(i) the denomination of the interests as debt or equity,

(ii) the presence or absence of a fixed maturity date,

(iii) the provision of a fixed interest rate or a specified market interest rate,

(iv) the unconditional or contingent nature of any payment obligation,

(v) the source of the payments,

(vi) the right to enforce the payment,

(vii) participation in management,

(viii) voting rights, if any,

(ix) subordination to the rights of general creditors,

(x) any securitization arrangements or the equivalent, such as the provision for a sinking fund,

(xi) thin or adequate capitalization,

(xii) the extent to which the identity of the preferred interest holders overlaps with the identity of the non-preferred interest holders,

(xiii) the general creditworthiness of the partnership,

(xiv) the degree of risk that payments or distributions will not be made, and

[17] Treas. Reg. § 25.2701-2(a)(3).

[18] *See also Fin Hay Realty Co. v. Comm’r*, 398 F.2d 694 (3d Cir. 1968); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); Gen. Couns. Mem. 38275 (Feb. 7, 1980).

(xv) the intent of the parties."

Unfortunately, there is no bright-line test as to what will constitute sufficient evidence that a preferred interest in a partnership is an equity interest. Ensuring that the preferred interest is structured taking into consideration of as many of the above factors as possible should help bolster the argument that the preferred interest is equity rather than debt. Some commentators have suggested "stapling" a participation feature to the preferred interest, thereby creating a hybrid interest that is more likely to be respected as an equity interest in the Freeze Partnership.

G. Section 2036 Considerations.

Given the Section 2036(a)(2) issues that currently exist with family limited partnership structures, it may be advisable for the parent to own nonvoting limited partnership interests in the Freeze Partnership, rather than general partner or voting interests in order to address the Section 2036(a)(2) "retained control" issue.[19]

Additionally, from a "bad facts" or "implied understanding" Section 2036(a)(1) perspective, it is important to ensure that the formalities of the Freeze Partnership arrangement are respected.[20] To bolster the legitimacy of the partnership structure, it is advisable to adhere to best practices in the administration of the vehicle, such as:

- Making sure that the preferred coupon is paid to the Senior Family Member on time, as scheduled, and if a payment is late, the Senior Family Member should take steps to ensure the payment is made.

[19] *See generally*, Douglas K. Freeman and Stephanie G. Rapkin, Planning for Large Estates 3–71 (LexisNexis 2016) (noting that the IRS could argue for inclusion under Section 2036(a)(1) to the extent that a partner also acts as the managing or general partner of the Freeze Partnership and retains control over, or the power to designate who may enjoy, the property of the Freeze Partnership). For more detailed discussions of the application of Section 2036(a)(2) to family limited partnerships and related planning considerations, *see* N. Todd Angkatavanich, James I. Dougherty and Eric Fischer, "Estate of Powell: Stranger Than Strangi and partially Fiction," *Trusts & Estates* (September 2017); N. Todd Angkatavanich and Eric Fischer, "Family Co-Investments in the Wake of Powell and Cahill: Time to Kick the Tires on Old Vehicles," *Tax Management Estates, Gifts and Trusts Journal (January 2019).* For further discussion, *see* Mitchell M. Gans and Jonathan G. Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153 (Sep. 1, 2003); Chanie S. Fortgang and Christine R.W. Quigley, *Help for Control Freaks*, TR & ESTS. (Oct. 2014).

[20] *Id. See also*, *Estate of Liljestrand v. Comm'r*, T.C. Memo 2011–259. In addition to a litany of bad facts that lead to an unfavorable result in *Liljestrand*, the Tax Court specifically held as follows:

"As part of the partnership agreement, Dr. Liljestrand was guaranteed a preferred return of 14% of the value of his class A limited partnership interest. Dr. Liljestrand's class A limited partnership interest was valued at $310,000, thus Dr. Liljestrand was guaranteed annual payments equal to $43,400. Moss-Adam's appraisal estimated the partnership's annual income would equal $43,000. We find this guaranteed return indicative of an agreement to retain an interest or right in the contributed property ... Dr. Liljestrand received a disproportionate share of the partnership distributions, engineered a guaranteed payment equal to the partnership expected annual income and benefited from the sale of partnership assets. The objective evidence points to the fact that Dr. Liljestrand continued to enjoy the economic benefits associated with the transferred property during his lifetime."

- Ensure the preferred coupon does not match anticipated partnership annual income.[21]

- Recall that Section 2701 does permit a four-year deferral for a qualified payment right preferred coupon payment.[22]

- A preferred payment can be satisfied through the issuance of a promissory note with a term no longer than four years.[23]

A Freeze Partnership is, economically, entirely different than the typical so-called "FLP" involved in the various cases decided under Section 2036(a)(1), since the parties from inception are entering into this type of transaction based upon an affirmative decision to split their economic arrangement into guaranteed preferred cash flow on the one hand and upside growth potential on the other. The decision to receive preferred or common interests will be guided by the relative needs of the Senior Family Member and the Junior Family Member, based upon a risk vs. reward analysis, taking into consideration each partner's relative investment horizon, appetite for risk and need for liquidity, much the same as those individuals would allocate their investment portfolios between fixed income and equities.

Thus, a decision to invest in a Freeze Partnership should itself provide a good argument that the "bona fide sale exception" to Section 2036 should be satisfied, since such decision is made in furtherance of a legitimate and significant nontax purpose. In the case of the creation of a new Freeze Partnership, the Junior Family Member will be making a significant and independent capital contribution of previously existing assets into the Freeze Partnership in exchange for common interests. This should support an argument that the Senior Family Member's transfer to the Freeze Partnership was made for "adequate and full consideration" and, therefore, falls within the statutory exception to Section 2036(a). To the extent that separate counsel is retained to represent the parties in connection with the negotiation and formation of the Freeze Partnership, and an independent appraisal is obtained to determine the adequacy of the preferred coupon, such should help to support this argument further.

H. The 2701 Attribution Rules**.**

Various attribution rules apply under Section 2701 with respect to equity interests indirectly owned by way of entities such as partnerships, corporations and LLCs,

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[21] *Id.; Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958) (noting that to avoid the reach of Section 2036(a), a payment obligation must, among other things, "not [be] determined by the size of the actual income from the transferred property at the time the payments are made").

[22] Section 2701(d)(2)(C).

[23] Treas. Reg. § 25.2701-4(c)(5). A debt obligation issued to satisfy a qualified payment must also bear compound interest from the due date of the qualified payment at the appropriate discount rate.

as well as through trusts.[24] In addition, these rules are further complicated by the fact that it is possible to have "multiple attribution" in which the rules determine an equity interest to be owned by different people for purposes of Section 2701. In such case, certain "tie-breaker" rules apply, which set forth ordering rules as to whom will be attributed ownership of a particular interest depending upon the particular generational assignment of certain individuals as well as whether the equity interest in question is a senior interest or a subordinate interest. Given the complexity of these rules and how seemingly insignificant variations in the facts can lead to different conclusions, it is critical that a Section 2701 analysis include proper consideration of these rules.

1. Entity Attribution Rules.

The attribution rules under Section 2701 applicable to entities such as corporations, partnerships and LLCs are relatively straightforward. The rules apply a proportionate ownership in the entity type of approach, which generally attributes ownership of an equity interest owned by an entity as owned by the owner of the entity to the extent of his or her percentage ownership in the entity.[25] In the case of entities that hold interests in other entities, the attribution rules have provisions to apply a "tiered" attribution approach.[26] An example is provided in the Treas. Regs as follows:

> *A, an individual, holds 25% by value of each class of stock of Y Corporation. Persons unrelated to A hold the remaining stock. Y holds 50% of the stock of Corporation X ... Y's interests in X are attributable proportionately to the shareholders of Y. Accordingly, A is considered to hold a 12.5% (25% x 50%) interest in X.*[27]

2. Corporations and Partnerships.

In the case of interests in corporations, the attribution rules refer to the fair market value of the stock as a percentage of the total fair market value of all stock in the corporation.[28] In the case of partnerships and other entities treated as partnerships for federal tax purposes, the rules attribute to a partner interests based upon the greater of a partner's profit percentage or capital percentage.[29] For example, if partner X makes a capital contribution of 10% of the partnership's assets and receives a 25% profits interest, and partner Y contributes 90% of the capital and receives a 75% profits interest,

[24] Treas. Reg. § 25.2701-6.

[25] Treas. Reg. § 25.2701-6(a)(1). If the individual holds directly and indirectly in multiple capacities, the rules are applied in a manner that results in the individual being treated as having the largest possible total ownership. *Id.*

[26] Id.

[27] Treas. Reg. § 25.2701-6(b), Ex. 1.

[28] Treas. Reg. § 25.2701(a)(2).

[29] Treas. Reg. § 25.2701-6(a)(3).

the attribution rules will treat X as having a 25% interest and Y as having a 90% interest in the Partnership; in each case the greater of the profit or capital percentage for each partner.

3. Trust Attribution Rules.

The attribution rules under Section 2701 with respect to trusts are not as straightforward as the entity attribution rules. This is because there are different sets of attribution rules that can apply and can result in multiple attributions, as well as a set of "tie-breaker" rules that can also apply.

A proper analysis of the trust attribution rules often involves a multi-step process. First, one must proceed through the so-called "basic" trust attribution rules. Then, if the trust at issue is recognized as a grantor trust under Code Section 671 *et seq.*, one must also consider the "grantor trust" attribution rules, followed by further analysis under the "tie-breaker" or "multiple attribution" ordering rules, which calls for an examination of both the grantor's and the beneficiaries' generational assignments and a determination regarding whether the trust's equity interest is subordinate or senior. When parsing through these rules it becomes apparent that seemingly negligible changes in any of the foregoing factors can produce quite different results under the trust attribution rules and, in turn, the Section 2701 analysis.

4. The "Basic" Trust Rules.

It is often difficult to express a trust beneficiary's interest in a trust with any degree of certainty; especially if there are multiple beneficiaries or if its trustees have been given substantial discretion with respect to distributions or other decisions affecting the beneficiaries' interests in the trust. In this sense (and many others), trusts are unlike entities where ownership percentages are more often readily determinable. This distinction is one of the underlying policy rationales for the above-referenced "basic" trust attribution rules, which generally provide that a person has a beneficial interest in a trust whenever he or she may receive distributions from the trust in exchange for less than full and adequate consideration.[30] The basic rules also attribute the trust's equity interests among its beneficial owners to the extent that they may each receive distributions from the trust, and based on a presumption that trustee discretion will be exercised in their favor to the maximum extent permitted.[31]

(a) There is one exception to this rule: the equity interest held by the trust will not be attributed to a beneficiary who

[30] Treas. Reg. § 25.2701-6(a)(4)(ii)(B).

[31] Treas. Reg. § 25.2701-6(a)(4)(i). These rules generally apply to estates as well, but for ease of discussion, the analysis herein will refer only to trusts.

cannot receive distributions with respect to such equity interest, including income therefrom or the proceeds from the disposition thereof, as would be the case, for example, if equity interests in the entity are earmarked for one or more beneficiaries to the exclusion of the other beneficiaries.[32]

(b) Ownership of the interest may be attributed to a beneficiary, even where the trust instrument states that he or she cannot own it or receive dividends or other current distributions from it, if he or she may receive a share of the proceeds received from its future disposition. Indeed, the Treas. Regs provide that a trust's equity interest may be fully attributed to its remainder beneficiaries.[33] A single equity interest owned by a discretionary trust could, therefore, be 100% attributable to *each* of its beneficiaries if only the "basic" trust attribution rule was considered. However, the above-mentioned grantor trust attribution and multiple-attribution ordering rules may very well modify this result in some cases, as is further discussed below.

5. <u>The Grantor Trust Attribution Rules.</u>

The grantor trust attribution rules attribute the ownership of an equity interest held by or for a "grantor trust" (i.e., a trust described under subpart E, part 1, subchapter J of the Code, regarding grantors and others treated as substantial owners of a trust) to the substantial owner(s) (or "grantor(s)") of such grantor trust.[34] Thus, a grantor of a grantor trust will also be considered the owner of any equity interest held by such trust for purposes of the Section 2701 analysis. However, if a transfer occurs which results in such transferred interest no longer being treated as held by the grantor for purposes of the grantor trust rules, then such shall be considered a transfer of such interest for purposes of Section 2701.[35]

6. <u>The Multiple Attribution Rules.</u>

If the "basic" and "grantor trust" attribution rules are both applied, ownership of an equity interest in an entity owned by a trust may often be attributable to the grantor *and* one or more beneficiaries of the same trust. To resolve such situations, one must look to the "tie-breaker" or "multiple attribution" rules. These rules resolve such situations by application of a rule that orders the interests held and thereby determines how ownership

[32] Id.

[33] Id.

[34] Treas. Reg. § 25.2701-6(a)(4)(ii)(C).

[35] Treas. Reg. 25.2701-1(b)(2)(C)(1).

should be attributed between the grantor, other persons and/or different beneficiaries. However, the way in which this ordering rule is applied will vary depending on whether the equity interest at issue is senior or subordinate, and the status of particular persons in relation to the Transferor.

(a) More specifically, if the above rules would otherwise attribute an "Applicable Retained Interest"[36] to more than one person in the group consisting of the Transferor and all "Applicable Family Members,"[37] the multiple-attribution ordering rules re-attribute such Applicable Retained Interest in the following order:

(i) to the person whom the grantor trust attribution rules treat as the holder of the Applicable Retained Interest (if the trust is a grantor trust)

(ii) to the Transferor of the Applicable Retained Interest

(iii) to the spouse of the Transferor of the Applicable Retained Interest

Or

(iv) pro rata among the Applicable Family Members

(b) By contrast, if the above rules would otherwise attribute a "subordinate equity interest" to more than one person in the group consisting of the Transferor, all Applicable Family Members and "members of the Transferor's family,"[38] the multiple-attribution ordering rules attribute such subordinate equity interest in the following order:

(i) to the transferee of the subordinate equity interest

(ii) pro rata among members of the Transferor's family

[36] *See supra* Part II, Section D.

[37] *See supra* Part II, Section C.

[38] *See supra* Part II, Section C (and note that "Applicable Family Member" and "member of the Transferor's family" have different meanings).

(iii) to the person whom the grantor trust attribution rules treat as the holder of the subordinate equity interest (if the trust is a grantor trust)

(iv) to the Transferor of the subordinate equity interest

(v) to the spouse of the Transferor of the subordinate equity interest

Or

(vi) pro rata among the "Applicable Family Members" of the Transferor of the subordinate equity interest

(c) The distinction between the two sets of ordering rules appears to be motivated by two goals: (1) maximizing the chance that ownership of an Applicable Retained Interest will be attributed to a Transferor (or related parties grouped with the Transferor for Section 2701 purposes); and (2) maximizing the chance that ownership of a subordinate equity interest will be attributed to a transferee (or younger generations of the Transferor's family). The net result in both cases is an increase in the likely applicability of Section 2701.

I. Selected Income Tax Issues.

Structuring a Freeze Partnership requires balancing competing factors from an income tax and transfer tax perspective. In drafting the provisions relevant to the preferred coupon, it is necessary to balance the following income tax and transfer tax concepts, which do not necessarily overlap smoothly:

1. Generally.

In addition to the Section 2701 gift tax issues, and the estate tax issues mentioned above, partnership income tax issues must be considered in connection with the formation of the partnership to ensure that no gain will be recognized as a result of the contribution of assets into the Freeze Partnership.

2. Diversification.

In the case of partnership assets consisting of securities there should be no recognition of gain as a result of the capitalization of the partnership if no "diversification" occurs under Section 721(b) as a result of a partner's capital contribution.[39] Accordingly, if both partners already have diversified portfolios,[40] then the contribution by them of their portfolios into the Freeze Partnership should not result in gain under the Section 721(b) diversification rule.

3. Investment Company.

Alternatively, if at least 20% of the partnership assets consist of real estate or other assets other than readily marketable securities, this too would avoid recognition of gain as a result of the capitalization.[41]

4. *De Minimis* Exception.

Under the so-called *de minimis* exception, if one of the partners contributes assets that are "insignificant" in amount as compared with the total assets of the partnership, the contribution of those assets does not result in diversification.[42] Although an example in the Treasury Regulations indicates that a contribution of less than 1% would be insignificant, private letter rulings have determined that up to a 5% contribution could be considered insignificant.[43]

5. "Disguised Sale" Rules.

The Treasury Regulations under Section 707 establish a presumption that a "disguised sale" exists any time a member contributes "built-in gain" property to an LLC or partnership and cash or other property is distributed to such contributing member within two years of the contribution.[44] If a disguised sale is considered to occur, the contributing member is deemed (for income tax purposes) to have sold all or part of the built-in gain property contributed (measured by the cash received versus the total value of the property contributed by the member).

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[39] More specifically, Section 721(b) provides that gain or loss will be recognized on the contribution of property to a partnership if the partnership would otherwise be considered an "investment company" within the meaning of Section 351(e) if the partnership were a corporation. In such an event the inside basis of such securities is equal to their fair market value at the time of the contribution. Section 723.

[40] A partner's portfolio generally will be considered to be diversified if (i) the securities of one issuer do not constitute more than 25% of the contribution, and (ii) the securities of five or fewer issuers do not constitute more than 50% of the contribution. Section 368(a)(2)(F)(ii). While a complete analysis of the diversification rules is beyond the scope of this outline, the Treasury Regulations provide detailed mechanical rules that should if a concern regarding diversification is present.

[41] Treas. Reg. § 1.351-1(c)(2), (3); Treas. Reg. § 1.351-1(c)(1)(ii).

[42] Treas. Reg. § 1.351-1(c)(5).

[43] *See, e.g.*, PLRs 9451035, 200006008.

[44] Treas. Reg. § 1.707-3(c)(1).

A disguised sale generally occurs if, based on all of the facts and circumstances (i) the distribution would not have been made but for the contribution of property to the partnership, and (ii) the distribution is not dependent on the entrepreneurial risks of the partnership.[45] The Treasury Regulations, however, provide an exception to disguised sale treatment for preferred returns where payments to the contributing member are "reasonable" and the facts do not "clearly establish" that the distribution is part of a sale.[46] The Treasury Regulations further provide a safe harbor, deeming a preferred payment "reasonable" if the preferred payment does not exceed (i) the member's unreturned capital in the partnership at the beginning of the year multiplied by (ii) 150% of the highest applicable federal rate.[47] This safe harbor notwithstanding, in light of the historically low interest rates and the valuation factors discussed above, it is all but assured that, in light of the factors set forth in Revenue Ruling 83-120, the valuation of the preferred coupon will exceed the regulatory safe harbor. As such, structuring a preferred partnership where the contributing partners are different taxpayers requires reconciling these two seemingly incompatible sets of rules.

Granted, when the 150% safe harbor for "reasonable" preferred returns was introduced in 1992, the highest applicable federal rate was 7.89%, meaning a preferred coupon as high as 11.83% could fall within the regulatory safe harbor. The potential abuse the safe harbor was attempting to address was one in which the preferred payment was *too high* (and therefore, not reasonable as a preferred payment, but rather more resembling a disguised sale), rather than *too low*. The current interest rate environment is at an unprecedented and historic low. This is likely something that was simply not envisioned at the time of the introduction of the reasonable payment safe harbor, and the incompatibility between the Section 707 and Section 2701 rules is likely something that was never anticipated, and even today is not fully appreciated by many practitioners.

(a) <u>Safe Harbor Approach with Qualified Payment Right Election</u>.

One approach to mitigating the risk of a disguised sale could be to structure the preferred coupon so as to restrict the payment of the preferred return for the first two years to not exceed 150% of the highest applicable federal rate, followed by a make-up payment in the third year in order to "true up" the preferred partner to the preferred coupon amount

[45] Treas. Reg. § 1.707-3(b)(1)(i), (ii).

[46] Treas. Reg. § 1.707-4(a)(2).

[47] Treas. Reg. § 1.707-4(a)(3)(ii).

required for the first two years.[48] However, while such a provision addresses the disguised sale rules, it is in direct conflict with the transfer tax requirement that the coupon be payable annually from the Freeze Partnership to the preferred interest holder (assuming the preferred coupon will be structured as a Qualified Payment Right under Section 2701). To address this issue, one could structure the preferred coupon to fall within the reasonable payment safe harbor, but intentionally not satisfy the requirements of a Qualified Payment Right, and instead make an election to treat the preferred interest as if it were a Qualified Payment Right on a timely filed gift tax return.[49]

(b) Alternate Safe Harbor Approach.

An alternative safe harbor to the reasonable payment is available for operating cash flow distributions, which are not presumed to be disguised sales unless the facts and circumstances clearly suggest otherwise.[50] An operating cash flow distribution is a transfer of money by a partnership to a partner that does not exceed the partnership's net cash flow from operations, multiplied by the lesser of (i) the partner's percentage interest in partnership profits for the tax year in question, or (ii) the partner's percentage interest in overall partnership profits for the life of the partnership.[51] This approach may permit practitioners to more readily structure the preferred coupon in a manner that avoids classification as a guaranteed payment, which could provide certain advantages from an income tax perspective.[52] Care should be taken if adopting this approach to ensure the partnership complies with the technical requirements of both the operating cash flow safe harbor and the Qualified Payment Right under Section 2701, including possibly making a protective Qualified Payment Right election.

(c) Non-Safe Harbor Reasonable Payment Approach.

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[48] Treas. Reg. § 1.707-4(c) specifically provides that a guaranteed payment or preferred return that is presumed not to be a disguised sale by reason of the safe harbor does not lose the benefits of such presumption merely because it is retained for distribution in a future year.

[49] Section 2701(c)(3)(C); Treas. Reg. § 25.2701(2)(c).

[50] Steven B. Gorin, Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications 215 (July 5, 2016), available by email at sgorin@thompsoncoburn.com.

[51] Treas. Reg. § 1.707-4(b)(2).

[52] Gorin, *supra* note 49, at 215.

Failure to satisfy the disguised sale regulatory safe harbor does not necessarily mean that a preferred payment is not "reasonable"; rather, it simply means that the safe harbor cannot be relied upon. Given that the rate of return is being determined by an independent appraisal to reflect a market rate of return, presumably based upon the IRS's articulated valuation factors, as set forth in Revenue Ruling 83-120, a good argument should exist that the preferred payment should be reasonable and, thus, the facts do not "clearly establish" that the payment of the preferred return is part of a disguised sale.

(d) Factors to Consider.

Based on the relative tax cost associated with failing to satisfy the Section 2701 valuation rules, as compared with the income tax consequences of triggering a disguised sale (which would be offset at least somewhat by an accompanying basis increase), a balancing of the relative risks will need to be undertaken to determine whether taking on the risk of disguised sale treatment is preferable to bearing the risk of a deemed gift under Section 2701. For instance, if the property to be contributed has significant appreciation such that triggering the disguised sale rules could have a larger income tax impact, perhaps relying upon the "safe harbor" approach coupled with a Qualified Payment Right election might be advisable. If instead, the contributed assets have a relatively high basis such that the consequence of triggering the disguised sale rules might be less, then the position that the preferred payment is a reasonable one, albeit outside of the safe harbor, might be an acceptable risk, and one that avoids needing to make a Qualified Payment Right election.

6. Guaranteed Payments.

Qualified Payment Rights are sometimes structured as guaranteed payments under Section 707(c) to take advantage of an exception of such payments from the zero valuation rule of Section 2701.[53] Broadly speaking, a guaranteed payment is a payment made by a partnership to a partner for services or for the use of capital to the extent such payments are determined without regard to the income or profits of the partnership.[54] In some circumstances, the IRS might attempt to argue that the preferred coupon is

[53] Treas. Reg. § 25.2701-2(b)(4)(iii).

[54] Section 707(c).

debt, rather than equity, because the payment of the guaranteed payment is fixed in both time and amount and is not dependent on the entrepreneurial success of the partnership; however, unlike debt, guaranteed payments need not actually be made when earned. Indeed, in most cases, the payment of a guaranteed payment from a partnership is deferred until sufficient liquidity is available to make the payment.

Conversely, it may sometimes be preferable to avoid structuring the preferred coupon as a guaranteed payment, because guaranteed payments are generally taxable to the recipient of the partner as ordinary income, regardless of whether the partnership has sufficient liquidity to actually make the payment.[55] A partnership making guaranteed payments is eligible for an offsetting deduction under Section 162(a). However, the deduction for the payment of guaranteed payments is subject to various limitations that may result in income inclusion for the preferred interest holder without the ability of the partners to currently deduct the full value of the guaranteed payment.[56]

To structure the preferred coupon in a manner that avoids guaranteed payments status, it is typically necessary to condition the payment of the preferred coupon on partnership profits.[57] As this structuring decision can arguably remove the preferred coupon from the statutory definition of a Qualified Payment Right under Section 2701, structuring the preferred coupon in this manner is often done in tandem with a Qualified Payment Right election.

III. REVERSE FREEZE PARTNERSHIP

A. General.

A "Reverse Freeze Partnership" is conceptually similar to a Freeze Partnership in that the entity can provide an effective means of shifting assets between different partners, based upon relative needs and risk tolerance. However, the economics with this type of vehicle are "reversed." Thus, instead of the Senior Family Member holding the preferred interest, as in the Freeze Partnership, the Senior Family Member retains the common "growth" interest and transfers the preferred "frozen" interest to the Junior Family Member, or perhaps these interests are received in connection with the initial capitalization of the Reverse Freeze Partnership. This

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[55] But see, Andrew Kreisberg, Guaranteed Payments for Capital: Interest or Distributive Share?, TAX NOTES (July 4, 2011).

[56] Depending on the characterization of the guaranteed payment, the partnership may be entitled to either fully deduct the guaranteed payment under Section 162(a), or may be required to capitalize the payment in accordance with Section 263.

[57] Because qualification as a guaranteed payment requires that the amount be payable without regard to partnership profits or income, conditioning the payment of the preferred coupon on the partnership having sufficient profits would likely disqualify the payment under Section 707(c).

can have the potential to provide fixed cash flow to the Junior Family Members in the form of preferred interests.

B. Section 2701 Not Applicable.

The use of a Reverse Freeze Partnership is attractive because, unlike a forward Freeze Partnership, it is generally not subject to Section 2701, which allows for greater flexibility in structuring the preferred payment. This is because in a Reverse Freeze Partnership, the Senior Family Member holds a "subordinate interest" in the form of the common interest, which excepts the Senior Family Member's interest from being a "distribution right" subject to the zero valuation rule under Section 2701.[58] In such case, however, it is critical to ensure that the Senior Family Member does not hold any Extraordinary Payment Rights in connection with the common interests, as such rights could still be valued at zero under Section 2701, even in the case of a Reverse Freeze Partnership.[59]

C. Valuation Considerations.

As with the forward Freeze Partnership, it is necessary to obtain an appraisal of the preferred interest to ensure that an adequate coupon percentage is being paid to the preferred interest holders. If the ratio of preferred versus common used in structuring the Reverse Freeze Partnership is higher such that it effectively increases the entity's preferred payment obligations, and consequently diminishes the strength of the entity's coupon coverage (thereby making the preferred interest a much riskier investment), such would increase, perhaps significantly under the factors set forth in Revenue Ruling 83-120, the coupon required to be paid to the Junior Family Members as the preferred interest holders. In the Reverse Freeze Partnership scenario, the preferred interest payment would increase the value that would have to be paid to younger generations (in the form of a much higher preferred coupon) and, consequently, may contain the extent of the future growth in the value of the common interests held by the Senior Family Members. If the entity does not grow at least at the rate of the preferred coupon required to be paid to the younger generation, it is possible that the common interests will actually decrease in value over time, which would reduce the asset value of the Senior Family Member; if the entity grows above the preferred coupon then that growth will inure to the benefit of the common interests owned by the Senior Family Member, thereby increasing his or her estate.

IV. FREEZING A QTIP TRUST

A. Advantages of Freezing a QTIP Trust.

A Freeze Partnership can be an effective vehicle to combine with a QTIP Trust during the lifetime of a surviving spouse/beneficiary. Properly created, a Freeze

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[58] Treas. Reg. § 25.2701-2(b)(3)(i).

[59] Treas. Reg. § 25.2701-2(b)(2).

Partnership in which a QTIP Trust holds a preferred interest could be advantageous in that it would provide a steady and mandatory income stream to the QTIP Trust that would be paid out to the surviving spouse/beneficiary. Additionally, the future growth of the QTIP Trust would be limited to the preferred coupon plus its liquidation preference; however, any further growth would occur in the common interest, which presumably would be held by other, more tax-efficient, owners (e.g., the children or perhaps a credit shelter trust). Because a QTIP Trust will necessarily be subject to gross estate inclusion upon the death of the surviving spouse/beneficiary under Section 2044, containing the future growth that occurs in the QTIP Trust in favor of a more tax-efficient recipient of the common interest growth, such as the next generation beneficiaries or trusts for their benefit, can be advantageous.[60]

B. QTIP Section 2519 Issue.

It is critical to consider Section 2519 when coupling a Freeze Partnership with a QTIP Trust. Section 2519 provides that if the income interest holder (i.e., the surviving spouse/beneficiary) of a QTIP Trust transfers the income interest, then the income interest holder will be deemed to have made a taxable gift of the entire interest of the QTIP Trust. In the context of a Freeze Partnership, the question is whether the creation of the partnership with the capital contribution by the QTIP Trust of its assets into the partnership will be considered to be a disposition of the surviving spouse's income interest in the QTIP Trust, thereby triggering a gift under Section 2519.

There is some guidance that, while not directly on point, should support the position that a properly structured Freeze Partnership should not be deemed a disposition of an income interest under Section 2519. In Field Service Advice (FSA)199920016, the IRS considered a situation where a QTIP Trust and various family members created a single economic class family limited partnership in which the QTIP Trust received limited partnership interests in exchange for its capital contribution. The partnership made regular distributions of income to its partners. Based upon these facts, the IRS determined that no disposition would be made under Section 2519 of the surviving spouse's income interest in the QTIP Trust. The conclusion of the IRS under Section 2519 was based upon the fact that the QTIP Trust was receiving regular distributions of income from the partnership so that there was no disposition of an income interest. Additionally, it was noted that the surviving spouse/beneficiary had the right to compel the QTIP Trustee to convert the QTIP Trust's assets into income producing property, which further supported that no disposition of an income interest occurred as a result of the capital contribution. Under the logic of this FSA, a good argument should exist that in the case of a Freeze Partnership, no Section 2519 disposition should occur upon the formation

[60] Practitioners should be aware that the surviving spouse who is the beneficiary of a QTIP Trust generally would have the right to compel the trustees to make trust property income-producing to satisfy the requirements of Treas. Reg. § 20.2056(b)-(5)(f)(1).

and capital contribution by a QTIP Trust, particularly in light of the fact that the QTIP Trust would be actually *entitled* to a preferred coupon payable on an annual basis cumulatively (rather than having a mere expectation or pattern of distributions), and those distributions would be required to be made before any distributions could be made to the common interest holders.

V. GRAT ETIP ISSUE: PREFERRED PARTNERSHIP GRAT [61]

A. The ETIP Issue.

GRATs can be very effective vehicles to transfer the future appreciation of assets with substantial appreciation potential to or for the benefit of the next generation in a gift tax efficient, or possibly gift tax free manner (as in the case of a so-called "zeroed out GRAT"). However, one of the perceived disadvantages of planning with GRATs is the general inability to allocate generation-skipping transfer ("GST") tax exemption to a GRAT during the annuity term, which effectively prevents planners from structuring a GRAT as a GST-Exempt Trust. This is because of the "estate tax inclusion period" rule (the "ETIP Rule"), which basically provides that GST exemption cannot be allocated to a trust during its trust term if the assets would otherwise be included in the grantor's estate if he or she died during that term.[62] In the case of a GRAT, if the grantor were to die during the annuity term, a portion or possibly all of the GRAT's assets would be included in his or her estate.[63] As a result, the ETIP Rule would preclude the grantor from allocating GST Exemption to a GRAT until the end of the ETIP (i.e., the end of the annuity term). Because of this limitation, there is little if any ability to leverage the grantor's GST Exemption with a GRAT. Any allocation of the grantor's GST Exemption to the trust at the end of the ETIP would have to be made based upon the then values of the GRAT's assets, and therefore would be an inefficient use of GST Exemption since the exemption cannot be leveraged. Because of this, GST Exemption is very often not allocated to a trust remaining at the expiration of a GRAT annuity term; and as a consequence, the GRAT's remainder will often be distributed outright to the grantor's children and subject to estate tax at their deaths, or will be held in a GST Non-Exempt Trust which will be subject to a GST tax upon a GST event at the second generation's death or distribution to a skip person. Because of these limitations, GRATs are generally regarded as only "two-generation" planning vehicles, not multigenerational.

B. Preferred Partnership GRAT to address ETIP Issue.

The creation of a so-called "Preferred Partnership GRAT," which involves the combination of a statutory GRAT with a statutory preferred Freeze Partnership,

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[61] N. Todd Angkatavanich and Karen E. Yates, *The Preferred Partnership GRAT: A Way Around the ETIP Issue?*, 35 ACTEC J. 290 (2009).

[62] Section 2632(c)(4).

[63] Treas. Reg. § 20.2036-1(c)(2)(i), (iii).

may provide a way to obtain the statutory certainty of a GRAT while at the same time shifting future appreciation into a GST-Exempt Trust. Additionally, this technique may also be effective to contain the amount of potential estate tax inclusion if the grantor dies during the GRAT term. This technique dovetails the planning advantages of the Freeze Partnership with the statutory certainty of a GRAT by combining these two statutorily mandated techniques.

With a preferred partnership GRAT, a parent could create a preferred partnership, initially taking back both common "growth" and preferred "frozen" interests. Thereafter, the parent would make gift transfers of preferred interests to a long-term zeroed-out GRAT, which would not trigger any gift taxes under Section 2702. The parent would also create a GST-Exempt Trust into which the parent would make taxable gifts of common interests, and would allocate GST Exemption; or perhaps a previously funded GST-Exempt Trust would be in existence. The GRAT would be structured so that the preferred payments made annually to the GRAT, as the preferred partner, would be sufficient to satisfy the annuity payments owed to the grantor. The GST-Exempt Trust owning the common interests would receive all growth above the preferred coupon payable to the GRAT and the GRAT's liquidation preference. At the end of the GRAT term, if the grantor is living, the GRAT remainder would be distributed to the remainder beneficiaries, however GRAT's assets would have been "frozen" or contained to the amount of the liquidation preference and the preferred coupon (this is advantageous, as the GRAT remainder would be paid in a non-GST-exempt manner). Any appreciation above the preferred coupon and liquidation preference would exist in the common interests owned by the GST-Exempt Trust.

Perhaps an even more significant advantage is potential to contain the mortality risk inherent with a GRAT under Section 2036. If the grantor dies during the GRAT's annuity term, the estate tax inclusion would be limited to the frozen preferred interest gifted into the GRAT. The preferred coupon paid to the GRAT would be either whole or in part distributed out of the GRAT to the grantor in satisfaction of the required annuity payment; so that the GST Non-Exempt GRAT remainder would be contained for the most part to the preferred interest's liquidation preference. Based upon the prevailing Section 7520 rate at the grantor's death, it is possible that the amount included in the grantor's estate could be even less than the value of the frozen preferred interest.[64] However, because the common "growth" interest would never have been held in the GRAT, having been originally obtained by the GST-Exempt Trust via initial capital contribution or gift, the grantor's death during the annuity term would become irrelevant with respect to the appreciated common interests.

C. "Rolling" Preferred Partnership GRAT.

A variation on the Preferred Partnership GRAT would be to make "rolling" annuity payments to the parent from the GRAT (that are in turn funded by the preferred

[64] Treas. Reg. § 20.2036-1(c)(2).

payments paid by the Freeze Partnership to the GRAT). That is, each time that the parent receives his or her GRAT payment(s), the parent could reinvest such payment(s) into the Freeze Partnership in exchange for additional preferred interests. If desired, the parent could then make additional gifts of the preferred payments into new GRATs.

VI. SECTION 2701 IN THE FUND CARRIED INTEREST PLANNING CONTEXT

A. Section 2701 in the Fund Context.[65]

When planning for transfers of carried interests in hedge funds or private equity funds, the primary Chapter 14 concern is with the deemed gift provisions of Section 2701 implicating various "transfers" of subordinate equity interests to or for the benefit of Junior Family Members when the Senior Family Member continues to own another class of interest, typically a senior interest. As discussed above, the value of the deemed gift under these provisions is determined by applying a "zero valuation" concept that very broadly assigns a value of zero to certain rights that are retained by Senior Family Members in a family controlled entity following a "transfer" of another interest in the entity generally to a Junior Family Member. In the context of planning with interests in a private investment partnership such as a hedge fund or private equity fund, triggering Section 2701 can result in a deemed gift of some portion (or potentially all) of the value of the Senior Family Member's interest in the fund under the "Subtraction Method" of valuation. There are, of course, numerous additional technical provisions and exceptions to this very broad description that are discussed elsewhere in this outline, but this is conceptually how Section 2701 operates. While reasonable minds may differ as to the application and the extent of the risks associated with Section 2701 and the relative merits of different planning approaches to address this Section of the Code, it is critical that carried interest transfer planning take into consideration the potential application of Section 2701 and the deemed gift tax pitfalls associated therewith.

B. The Vertical Slice.

In the wealth transfer arena, a discussion of carried interest transfer planning will just about always include the phrase "Vertical Slice" as a description of one way to make a transfer without running afoul of the deemed gift provisions of Section 2701. Simply put, under the Vertical Slice approach, a Fund Principal wishing to transfer a portion of his carried interest to family members must proportionately transfer a Vertical Slice of all his or her other equity interests in the fund. This may include capital invested in the GP, profits interests held by the GP, capital invested

[65] For a more detailed discussion of the possible application of § 2701 in the context of estate planning with carried interests, *see generally* N. Todd Angkatavanich and David A. Stein, *Going Non-Vertical With Fund Interests – Creative Carried Interest Transfer Planning: When The "Vertical Slice" Won't Cut It*, TR. & EST. (Nov. 2010) [hereinafter "Angkatavanich & Stein, *Going Non-Vertical*"].

as a limited partner in the Fund, and in certain circumstances possibly interests in the management company.

The Vertical Slice exception to Section 2701 is set forth in Treas. Reg. Section 25.2701-1(c)(4), which provides that "Section 2701 does not apply to a transfer by an individual to a member of the individual's family of equity interests to the extent the transfer by that individual results in a proportionate reduction of each class of equity interest held by the individual and all Applicable Family Members in the aggregate immediately before the transfer."

C. Example.

An example of the practical limitations that "Vertical Slice" planning can present is as follows:

> *Fund Principal has an interest in the GP of a Fund with an appraised value of $1m and also has LP interests in the Fund valued at $20m. Ideally, Fund Principal wants to gift 50% of the GP with the carried interest to his child. A Vertical Slice approach would require Fund Principal to gift 50% of both the GP ($500,000) and the LP interest ($10,000,000), thus resulting in a taxable gift of $10,500,000. Assuming a 40% gift tax and no remaining gift tax exemption, this would result in a gift tax of $4.2m.*

D. Limitations of the Vertical Slice.

Based on the legislative history underlying Section 2701, it is clear that Congress did not intend for transfers of carried interests in funds to be targeted by the statute. Instead, the aim was to prevent certain types of preferred partnership transactions that ended in overly generous wealth transfers without the attendant gift tax liability through the manipulation of rights in a family held entity.[66] The problem for estate planners, however, is that the language of the statute is overly broad. In light of the draconian consequences in the event of its application, Section 2701 has become a major concern for estate planners representing hedge and private equity fund principals in connection with the transfer of carried interests.

The logic behind the Vertical Slice exception, presumably, is that because by making a Vertical Slice transfer the parent has reduced every interest in the entity on a proportionate basis, and consequently, the opportunity to disproportionately shift wealth to the next generation through the retention of artificially inflated equity interests and the transfer of a different artificially depressed equity interest, does not exist. Instead, the Vertical Slice ensures that the younger generation and parent would share proportionally in the future growth, or decrease in value, of the entity and thus not allow for a shift in value away from the parent to the younger

[66] *See infra* Section XII(A).

generation by way of the non-exercise of discretionary rights. In essence, the Vertical Slice exception ensures that the economic positions of Junior Family Members and Senior Family Members will rise and fall together, thereby precluding any potential for a disproportionate wealth transfer.

Although there are advantages to this "safe harbor" approach, such as being relatively straightforward to implement, it can often prevent the client from fully accomplishing his or her wealth transfer objectives. The dilemma that often presents itself is that, due to the significant upside growth potential of carried interest, the Fund Principal often primarily wishes to transfer his or her carried interest, but does not wish to transfer limited partner interests in the fund or capital interests in the GP. This is both for economic reasons (the transferor wants to retain some portion of his capital investment in the fund) and gift tax reasons (the transferor does not want to make a taxable transfer of high-value assets). Because the Vertical Slice exception does not accommodate such a disproportionate transfer, fund principals are frequently advised to transfer a smaller percentage of the carried interest so that a proportional limited partner interest can be transferred in compliance with the Vertical Slice "rule" to avoid triggering a deemed gift.[67]

E. Freeze Partnerships for "Non-Vertical" Carried Interest Transfer Planning.[68]

While the Vertical Slice exception is generally considered to be the most elegant way to address Section 2701, it is not the only way to avoid its application. There are other ways that fund interest transfers could be structured to avoid the application of the zero valuation rule under Section 2701. These other approaches rely upon provisions in the Code and Treasury Regulations exempting from the deemed gift consequences of Section 2701 the Senior Family Member's retention of certain mandatory and quantifiable interests.[69]

[67] While beyond the scope of this outline, it is important to note that some uncertainty exists as to whether the Senior Family Member's interest in the fund management company should also be included when making a transfer of a Vertical Slice of all the equity interests. The analysis of whether an interest in the management company should be included in the Vertical Slice revolves around whether an interest in the management company would be considered to be an "equity interest" in the fund within the meaning of the Code. Arguably, an interest in the management company is not considered to be an "equity interest" in the fund. Sometimes the management company has a fee waiver or "cashless contribution" type of arrangement, whereby management fees to which partners of the management company are entitled are "waived" in favor of the application of those fees to the satisfaction of capital commitments due by the general partner, of which those management company partners are also partners. In such an instance, it becomes less clear whether interests in the management company should be considered equity interests in the fund that need to be included in the Vertical Slice. A fact-specific analysis is required to make this determination based upon the specific structure in question. While also beyond the scope of this outline, it should be noted nonetheless that the utilization of the Vertical Slice exception is not the only way to avoid the application of Section 2701 in the context of carried interest planning and that there are available other exceptions set forth in the statute and techniques that have been developed to capitalize on them. *See generally*, Angkatavanich & Stein, *Going Non-Vertical*, *supra* note 65.

[68] This section of this outline is descriptive of Angkatavanich & Stein, *Going Non-Vertical*.

[69] Conceptually, these exceptions are very similar to the logic applied under Section 2702 in the GRAT context where the parent has retained a "qualified interest" in creating a GRAT to avoid the application of similar zero valuation

1. Non-Vertical Holding Entity Approaches Generally.

One class of approaches involves the creation of a family holding entity such as an LLC or a limited partnership (the "Holding Entity"), into which the parent would first contribute all his or her Fund interests, both general and limited partnership interests. These approaches rely upon the application of the so-called "same class exception" in combination with another exception to Section 2701.[70]

2. Mandatory Payment Right Holding Entity.

In the first variation, the parent would contribute LP and GP interests to the Holding Entity in return for common and preferred interests. The preferred interest holder would be entitled to receive a sum certain on a fixed future date. The common interest holder would be entitled to all the upside beyond the amount needed to repay the preferred interest holder. The parent would then transfer some or all the common interests to younger generation family members.

If the parent continues to own common interests in the Holding Entity, those interests should fall within the same class exception and not be treated as an applicable retained interest. If properly structured, the parent's retained preferred interests should fall within the definition of a "mandatory payment right" and thus avoid classification as an Applicable Retained Interest pursuant to Treas. Reg. Section 25.2701-2(b)(4). Treas. Reg. Section 25.2701-2(b)(4)(i) defines a "mandatory payment right" as a "right to receive a payment required to be made at a specific time for a specific amount" and gives as an example a redemption right with respect to preferred stock that requires the stock to be redeemed at its fixed par value on a date certain. Because a mandatory payment right bears certain similarities to debt, care should be taken to ensure that a mandatory payment continues to qualify as equity, rather than debt, for tax purposes.[71]

Since neither the retained common interests nor the retained preferred interests would fall within the definition of an Applicable Retained Interest, Section 2701 should not apply to the transfer.

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deemed gift rules. If the interest retained by the parent is mandatory and quantifiable from inception, then the perceived "wealth shifting" abuse would not exist and would not warrant the application of the zero valuation deemed gift rule.

[70] The same class exception is provided under Treas. Reg. § 25.2701-1(c)(3), which states that "Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest."

[71] *See supra* Section II(F).

3. Qualified Payment Right Holding Entity.

A Qualified Payment Right means "a right to any periodic dividend on any cumulative preferred stock (or a comparable payment on partnership interest) to the extent such dividend (or comparable payment) is determined at a fixed rate."[72] This approach involves the same basic holding entity structure as the Mandatory Payment Right Holding Entity; however, the retained preferred interest would be structured to contain a Qualified Payment Right rather than a mandatory payment right. Flexibility can be built into the structure, as a qualified payment can be paid up to four years after its required due date and can be paid with a promissory note with a maturity of up to four years.[73]

Since a Qualified Payment Right is a Distribution Right in the context of a family controlled entity such as the holding entity, the preferred interest would become an Applicable Retained Interest at the time a parent transfers his common interest in the holding entity to the next generation and Section 2701 would apply to such transfer. Unlike other Distribution Rights, however, Treas. Reg. Section 25.2701-1(a)(2)(ii) exempts a Qualified Payment Right from zero valuation and allows it to be valued under traditional valuation principles. Thus, for purposes of calculating the amount of the parent's gift under Section 2701, the retained preferred interest would be accorded its full fair market value unless another provision of Section 2701 applied. In determining the preferred interest's fair market value, the rate set for the coupon will be critical. If deemed insufficient based on the holding entity's anticipated ability to make payments and on the current rate for coupons on similar interests in the market, the value of the preferred interest may be less than its par value and a deemed gift could still result.

One provision that may impose some practical limitation to this approach is the minimum value rule, which provides that the value of a junior equity interest cannot be less than its pro rata portion of 10% of the sum of (1) the total value of all equity interests, and (2) the total amount of indebtedness owed to the Transferor and Applicable Family Members.[74] Since the common interests would be junior equity interests, the rule would cause the value of the gifted common interests to be at least 10% of the total value of all equity interests. Thus, even if the zero valuation rule did not apply, the parent may still be treated as making a partial gift in excess of the fair market value of the interests transferred if the retained preferred interest exceeds 90% of the capitalization of the holding entity. Another variation would be for the parties to consider structuring the holding entity LLC as a

[72] Section 2701(c)(3)(A).

[73] Treas. Reg. § 25.2701-4(c)(5).

[74] Section 2701(a)(4)(A).

reversed preferred entity, in which the parent would hold the common and the family members would hold the preferred interest. In such cases, the parent's retained common interest should not trigger Section 2701. (Note, however, that no Extraordinary Payment Rights should be held by parent in order to avoid triggering the so-called "lower of" rule.)

4. Holding Entity with Debt.

This approach is essentially a variation on a traditional gift/sale transaction to a trust. It involves the same basic structure as the two holding entities discussed above, except, rather than making a capital contribution, the parent would sell the LP interests to the holding entity LLC in exchange for a promissory note. Since Section 2701 applies with respect to related equity interests but not debt, the parent's gift of LLC equity interests should not trigger Section 2701. Arguably, with the LLC approach, the traditional nine-to-one debt-to-equity ratio could be exceeded with less downside risk. If, for instance, the Internal Revenue Service successfully argued that the debt was disguised equity, it possibly could still qualify as a mandatory payment right and not be subject to zero valuation.

5. Holding Entity Pressure Points.

With all three holding entity approaches, one potential concern is that the IRS could argue that the parent's two distinct classes of retained interest should be viewed as a single, combined "super class" and argue that the same class exception would not be satisfied. Treas. Reg. Section 25.2701-7 provides some support for the proposition that these classes should be considered separate and not combined. Specifically, it states that the Treasury Secretary may, by regulation, revenue ruling, notice or other document of general application, prescribe rules under which an Applicable Retained Interest is treated as two or more separate interests for purposes of Section 2701 and notes that the Commissioner may, by ruling issued to a taxpayer upon request, treat any Applicable Retained Interest as two or more separate interests. While no regulations or other rules have been issued on this point and the implication from the latter half of the regulation is that the taxpayer may not merely elect to treat an Applicable Retained Interest as two or more separate interests, the legislative history appears to encourage the issuance of regulations to that effect.

VII. CONSIDERATION OF UNIQUE GIFT TAX ISSUES WITH NEXT GENERATION OWNERSHIP OF FAMILY OFFICE

Estate and gift planning for ultra-wealthy families often goes well beyond standard generation-to-generation transfers. Integral to the coordination of multigenerational estate planning when dealing with a family office structure is ensuring that ownership and transfer of interests in the family office entity or entities is properly structured from both a tax and nontax standpoint. These rules apply with equal vigor to any type of family held entity, including partnerships, corporations, limited liability companies or other entities. In the case where there is more than one class of equity in the family office entity, or perhaps if there is more than one entity involved with the overall integrated family office structure it is critical to consider the special valuation rules under Chapter 14 of the Internal Revenue Code before implementing any division of ownership between different generations.

When creating a family structure involving a profits interest that will be owned by or for the benefit of younger generation family members, such will potentially involve the application of the "deemed gift tax" rules under Section 2701 of the Internal Revenue Code. Specifically, Section 2701 of the Code contains extremely thorny deemed gift tax rules that can cause an unexpected deemed gift to occur upon a transfer of one class of equity ownership in a partnership, LLC or corporation between senior and junior generations of a family.

While there are many complexities with this section, in essence, the risk posed is that a transaction (referred to as a "Transfer") resulting in the ownership by younger generation family members ("Junior Family Members") of a "Subordinate" equity interest (sometimes, but not always, associated with a profits interest) in an entity, when the senior generational family member ("Senior Family Member") retains a "Senior" equity interest, could trigger an unanticipated deemed gift by the Senior Family Member of some portion or potentially even all of the equity interests that he or she still continues to own. In other words, the application of Section 2701 could cause the patriarch to be treated as if he made a taxable gift of some or potentially most or all of the equity interests that he did not actually give away; when the Senior Family Member owns substantial equity interests, such as the limited partnership interests in the various family partnerships triggering a deemed gift of those interests could have draconian results.

A. Section 2701 Generally.

Section 2701 can cause a deemed gift to occur typically in connection with a "Transfer" of Subordinate equity interest in an entity (such as family partnerships), to a Junior Family Member when certain other equity interests (typically, but not necessarily associated with preferred interests) are retained by a Senior Family Member. While not limited to this situation, the classic example of a transfer to which Section 2701 can potentially apply is when a parent who initially owns both common and preferred equity interests in a partnership transfers the common stock to his children (or trusts for their benefit) while retaining the preferred interest. The reach of the statute, however, is much broader than in just the preferred and common equity structure and, therefore, can apply in other situations such as when profits interests are issued.

Broadly speaking, Section 2701 applies and can cause a deemed gift to occur when a senior generation family member (referred to in the statute as an "Applicable Family Member") holds an "Applicable Retained Interest" after a "transfer" to a Junior Family Member (referred to in the statute as a "Member of the Family") or trusts for their benefit. For these purposes, a "transfer" is very broadly defined to include, not only a traditional gift transfer (e.g., I give my child 10 shares of common stock), but also capital contributions, redemptions, recapitalizations or other changes in the capital structure of an entity.[75]

There are two types of rights, the retention of which by a Senior Family Member can trigger the problematic Applicable Retained Interest status, and thus the Section 2701 zero valuation rule with respect to those retained rights: "Distribution Rights" (associated with a "Controlled Entity") and "Extraordinary Payment Rights." If Section 2701 is applicable and if the interest retained by the Senior Family Member is not a specific type of interest that fits into one of the exceptions to the statute, then these two types of rights associated with the Applicable Retained Interest held by the Senior Family Member are valued at "zero" for gift tax purposes. The impact of this zero valuation being ascribed to the equity that the Senior Family Member owns is that an inflated (perhaps extremely inflated) value can be ascribed to the interest that is transferred to the Junior Family Member for gift tax purposes.[76] This can result in some or perhaps even all of the Senior Family Member's retained interest in the entity being attributed to the interest that was transferred to the Junior Family Member, thereby causing a deemed inflated gift of some or potentially all of the interests that the Senior Family Member still continues to own.

The application of the rules of Section 2701 revolves around different definitions:

1. <u>Transfer.</u>

   The term "transfer" is broadly defined, and includes, in addition to a traditional transfer, a capital contribution to a new or existing entity, as well as a redemption, recapitalization or other change in the capital structure of an entity.[77]

2. <u>Applicable Retained Interests.</u>

   The application of a gift under Section 2701 occurs by way of mechanical rules that revolve around the definition of an "Applicable Retained Interest." Thus, Section 2701 applies to a transfer to a Member of the Family (essentially Junior Family Members or their trusts) if a Senior Family Member holds an "Applicable Retained Interest" immediately after the transfer.

   There are two types of rights the retention of which will cause an Applicable Retained Interest to exist: (1) Distribution Rights; and (2) Extraordinary Payment Rights.

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[75] Treas. Reg. § 25.2701-1(b)(2)(i).

[76] Treas. Reg. § 25.2701-2(a)(1) & (2).

[77] Treas. Reg. § 25.2701-1(b)(2)(i)

A Distribution Right is a right to receive distributions with respect to an equity interest in a Controlled Entity (subject however to exceptions for retention by the Senior Family Member of the "same class" or "subordinate class" as the interest transferred to the Junior Family Member).

An Extraordinary Payment Right includes puts, calls and conversion rights *the exercise or non-exercise of which would affect the value* of the transferred common interest when the holder of such rights has discretion as to whether (or when) to exercise them. A call right includes any warrant, option or other right to acquire one or more equity interest(s).

3. "Reversing" the Profits Interest.

There are various possible approaches to try to avoid the application of these potentially harsh rules when structuring the ownership of profits interest to be held by the Family Office, when the desire is for the Family Office to be owned by Junior Family Members. It should be noted, however, that many of these approaches are not considered to be "mainstream" approaches, and the design of these approaches will be bespoke and "untested." Essentially, the approach(es) to structuring the ownership of the Family Office with the profits interest by the Junior Family Members would involve restructuring the underlying family partnership entities so that the equity interest owned by the Family Office (which would be owned by or for the benefit of the Junior Family Members) would constitute a "Senior" equity interest (rather than a "Subordinate" equity interest); accordingly, the limited partnership interests in the family partnership (which are currently owned by both the Senior and Junior Family Members) would constitute the "Subordinate" equity interests – this would position the restructured entity in such a manner such that an exception to Section 2701 would presumably apply (that exception provides that Section 2701 will not be triggered if the Senior Family Member continues to own either a "same class" or "subordinate class" of equity as the Junior Family Member).

In addition, because it is anticipated that ownership of the Junior Family Member's interests would be via trusts for his or her benefit, which are currently "grantor trusts" as to the patriarch-Senior Family Member, in order for such an approach to be viable, the "grantor trust" status of these trusts would need to be "turned off." This is necessary in order to avoid the interests in these grantor trusts being attributable to the Senior Family Member/Grantor under the "Grantor Trust Attribution Rules," which would implicated the so-called Multiple Attribution Tie-Breaker Rules.

The first, and most typical, type of right that will result in an Applicable Retained Interest is a “Distribution Right,” which is the “right to receive distributions with respect to an equity interest” in a “Controlled Entity.”[78]

Thus, a limited partnership interest in a family partnership could be a Distribution Right in the absence of an exception applying. To this end, a Distribution Right does not include a right to receive distributions with respect to an interest that is of the “same class” as, or a class that is “subordinate to,” the transferred interest. So the retention by the Senior Family Member of the “same” equity class as is transferred to the Junior Family Member will not cause Section 2701 to apply generally (for instance, the transfer and retention of the same common equity class).[79]

Additionally, and relevant for our purposes, if a Senior Family Member retains an interest that is “subordinate” to the equity class transferred to the Junior Family Member, then such interest will **not** be considered a Distribution Right, and therefore will not trigger Section 2701.[80]

For these purposes, a “Subordinate Equity Interest” is defined as “an equity interest … as to which an Applicable Retained Interest is a Senior Equity Interest.” A “Senior Equity Interest” is defined as “an equity interest … that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.”[81] Based upon these definitions, to the extent that the Junior Family Member retains an interest that carries a right to distributions that are preferred as to distributions of either income or distribution of capital, such should be considered a Senior Equity Interest for purposes of Section 2701. In the most typical application of the rule, a Subordinate Equity Interest would be a common interest in a preferred partnership in which a preferred interest is the Senior Equity Interest.

[78] Treas. Reg. § 25.2701-2(b)(1)(ii) & (3). In the case of a limited partnership, the holding of any interest as a general partner by a broad group of family members, including Junior and Senior Family Members as well as siblings in the aggregate. Additionally, “in the case of any partnership, control means the holding of at least 50% of either the capital interest or the profits interest in the partnership.” Treas. Reg. § 25.2701-2(b)(5).

[79] Treas. Reg. § 25.2701-1(c)(3) provides that “Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of this section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (*e.g.*, section 704(b)) are non-lapsing differences with respect to limitations on liability. A right that lapses by reason of federal or state law is treated as a non-lapsing right unless the Secretary determines, by regulation or by published revenue ruling, that it is necessary to treat such a right as a lapsing right to accomplish the purposes of Section 2701. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.”

[80] Treas. Reg. § 25.2701-2(b)(3)(i).

[81] Treas. Reg. § 25.2701-3(a)(2)(ii) and (iii).

In the context of the restructuring of a family partnership, to the extent that the profits interest held by the Family Office (which would be owned by the trusts for the benefit of the Junior Family Members) is structured to satisfy the definition of a "Senior Equity Interest" (due to its right to distributions that are preferred as to income or capital), such should not trigger Section 2701 where the Senior Family Member retains limited partnership interests in the entities, which would be structured as Subordinate Equity Interests, and fall within the exception to a Distribution Right under Section 2701. Presumably, restructuring the partnerships to provide that the Family Office is entitled to a preferred return of both income and capital, such would bolster the argument that such interest is a Senior Equity Interest.

4. Subtraction Method.

If Section 2701 applies to a transfer, the value of an interest "transferred" to a Junior Family Member will be determined by subtracting from the value of the entire family-held interests the value of the interest retained by the Senior Family Member. Under this "Subtraction Method," a deemed gift will have occurred from the Senior Family Member to the Junior Family Member of the value of all family held interests less the value of the senior interests retained by the Senior Family Member.[82]

B. Section 2701 Applied to Profits Interests Held by Junior Family Member.

In Chief Counsel Advice (CCA) 201442053, the IRS determined that Section 2701 was triggered in connection with the recapitalization of an LLC. In the CCA, an existing single class LLC owned by mother, sons and grandchildren was recapitalized so that all future profits or gains would be allocated to the sons only, as consideration for the sons agreeing to manage the LLC. Following the recapitalization, the mother's only interest was the right to the return of her capital account upon liquidation based on her membership interest as it existed immediately prior to the recapitalization.

The IRS determined that the recapitalization was a Section 2701 "transfer" under Treas. Reg. Section 25.2701-1(b)(2)(B)(2). It reasoned that the mother held an Applicable Retained Interest (her "Distribution Right") both before and after the recapitalization, and that her sons' right to receive future profits was a subordinate interest.[83]

In an article criticizing the CCA, Richard L. Dees argues that the IRS should withdraw the CCA and criticizes it as containing a rather muddled analysis in determining that the mother's retained interest was an "Applicable Retained Interest" due to the fact that "[b]oth before and after the recapitalization, Donor

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[82] Treas. Reg. § 25.2701-1(a)(2).

[83] For a comprehensive and critical commentary on this CCA, *see* Richard L. Dees, *Is Chief Counsel Resurrecting the Chapter 14 'Monster'?* TAX NOTES (December 15, 2014).

held an Applicable Retained Interest, an equity interest in the LLC coupled with a Distribution Right." Dees argues that the mother's right to receive her capital account upon termination of the LLC was not an "Applicable Retained Interest;" rather, such would have been either a "Mandatory Payment Right" or a "Liquidation Participation Right," neither of which is subject to zero valuation under Section 2701. Additionally, he points out that the mother did not retain an "Extraordinary Payment Right" since she did not have the discretionary right to withdraw her capital interest from the LLC which was subject to a stated term. (Since the publication of Dees' article, it has since been determined that mother had a large enough percentage interest to unilaterally liquidate the LLC, which would have constituted an Extraordinary Payment Right.[84]) After the recapitalization, mother retained no rights to receive distributions with respect to her equity interests, but only the right to a return of her capital account.[85]

C. Vertical Slice Exception.

Perhaps the most elegant solution these draconian rules is for the transfer to the next generation to constitute a "Vertical Slice" or proportional reduction of each and every class of equity ownership owned by the senior generational family member. There are a number of other approaches to achieving the solution that does not implicate these harsh gift tax rules that are very complex and beyond the scope of this article, but the so-called Vertical Slice is the most elegant and easy to implement exception.

Essentially, this exception would involve the transfer resulting in proportionate ownership by the Senior and Junior Family Members of each and every class of equity interest. In the case of a family entity in which a profits interest is issued to the Family Office, proportional ownership of each interest would satisfy this exception. For example, 75%/25% ownership of the profits interest and limited partnership interests in a family limited partnership owned by the Senior and Junior Family Members respectively.

One practical limitation with this approach is that with large family entities, there are natural limitations on the ability to transfer ownership of a proportional limited partnership interest in a family limited partnership to the Junior Family Member without triggering a gift tax.

[84] Richard L. Dees, The Preferred Partnership Freeze And The Reverse Freeze (Part II) – IRC Section 2701 And The Regulatory Scheme, Forty-First Notre Dame Tax and Estate Planning Institute, at 6-39 (September 17-18, 2015).

[85] For an excellent in-depth discussion of CCA 201442053 and further analysis of Section 2701 generally, see generally, Richard L. Dees, The Preferred Partnership Freeze And The Reverse Freeze (Part II) – IRC Section 2701 And The Regulatory Scheme, Forty-First Notre Dame Tax and Estate Planning Institute (September 17–18, 2015).

D. The Section 2701 Attribution Rules.

Various attribution rules apply under Section 2701 with respect to equity interests indirectly owned by way of entities as well as through trusts.[86] In addition, these rules are further complicated by the fact that it is possible to have "multiple attribution" in which the rules determine an equity interest to be owned by different people for purposes of Section 2701. In such case, certain "tie-breaker" rules apply, which set forth ordering rules as to whom will be attributed ownership of a particular interest depending upon the particular generational assignment of certain individuals as well as whether the equity interest in question is a senior interest or a subordinate interest. Importantly, seemingly negligible changes in any of the foregoing factors can produce quite different results under the trust attribution rules and, in turn, the Section 2701 analysis.

VIII. INTENTIONALLY TRIGGERING SECTION 2701 – INTENTIONALLY DEFECTIVE FREEZE PARTNERSHIPS

Despite the conventional wisdom that triggering Section 2701 should be avoided when structuring a Freeze Partnership, in certain circumstances it may prove useful to intentionally cause a deemed gift under Section 2701.[87]

A. Utilizing Gift Tax Exemption During Lifetime.

If a Senior Family Member is not otherwise inclined to make taxable gifts during lifetime a Freeze Partnership may provide a way to take advantage of the gift tax exemption while providing cash flow to the Senior Family Member. One way to do this may be to form or recapitalize an "intentionally defective" Freeze Partnership that generates a taxable gift by intentionally triggering a deemed gift under Section 2701. The preferred interest could be structured to fall outside the "qualified payment" exception by, for example, providing for noncumulative preferred payments and a put right equal to the liquidation preference. Under the subtraction method of valuation, the distribution right attributable to the preferred interest would be given a value of zero, as would the put right as an extraordinary payment right, resulting in a taxable gift equal to nearly all, or perhaps all, of the full value of the parent's contribution to the partnership (taking into account any applicable valuation discounts).

While this may seem like a worst case scenario, as the retained preferred interests would trigger a deemed gift and would still be included in the parent's taxable estate at death, the Treasury Regulations under Section 2701 provide for an offsetting

[86] Treas. Reg. § 25.2701-6.

[87] These situations have been thoughtfully discussed in Michael N. Gooen & Tracy A. Snow, *Tasty Freeze: Preferred Partnership Tax Recipe*, 42 ESTATE PLANNING 5 (May 2015) and Christopher Pegg and Nicole Seymour, *Rethinking I.R.C. § 2701 in the Era of Large Gift Tax Exemptions*, 87 FL. BAR J. 9 (Nov. 2013).

adjustment for the prior taxable gift to prevent double taxation. The adjustment is equal to "the amount by which the initial transferor's taxable gifts were increased as a result of the application of Section 2701 to the initial transfer."[88] Stated differently, the adjustment permitted in the Treasury Regulations will effectively "net out" the value of the preferred interest included in the parent's taxable estate.[89] The noncumulative nature of the retained preferred interest permits the parent to retain a somewhat flexible income stream during his or her lifetime, although the potential implications of Section 2036 favor substantial compliance with the terms of the partnership agreement.

B. Maximizing the Value of DSUE in the Case of Multiple Deceased Spouses.[90]

Another scenario in which intentionally triggering Section 2701 would be beneficial is one in which a taxpayer has elected to take advantage of the benefits offered by "portability," which permits a surviving spouse to take advantage of the deceased spouse's unused transfer tax exemption amount. One negative aspect of portability, however, is that a surviving spouse who chooses to remarry will lose the deceased spousal unused exclusion ("DSUE") amount if she is predeceased by her new spouse. [91] However, lifetime gifts by a surviving spouse that use the first deceased spouse's DSUE amount are not recaptured or "clawed back" should the surviving spouse be predeceased by her new spouse.[92] This "use it or lose it" aspect of portability may conflict with the surviving spouse's reluctance to make a gift substantial enough to capture the entire DSUE amount. An "intentionally defective" Freeze Partnership, therefore, may present an opportunity for individuals who have elected portability from a deceased spouse and likely will require a stable stream of income from a gift that she would otherwise like to make outright as part of more conventional tax planning.

As with a typical Freeze Partnership, the surviving spouse would make contributions to a new partnership or recapitalize an existing entity, taking back two classes of equity interests – preferred interests and common interests. The preferred interests would be entitled to a fixed annual payment and would be retained by the surviving spouse, while the common interests would participate in the upside growth potential of the Freeze Partnership and would be gifted to the surviving spouse's descendants (or a trust for their benefit). However, instead of

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[88] Treas. Reg. § 25.2701-5(a)(3).

[89] Treas. Reg. § 25.2701-5(d)(3), Ex. 2.

[90] Section 2010(c)(2). *See generally,* Gooen & Snow, *Tasty Freeze*, *supra* note 85.

[91] *See* Section 2010(c)(4)(B) and Reg. 20.2010-3. This is the result of the operation of the "last deceased spouse" rule whereby Reg. 20.2010-1(d)(5) defines the "last deceased spouse" for purposes of porting DSUE as "the spouse the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse."

[92] Reg. 20.2010-3(b).

structuring the preferred interests to comply with the terms of Section 2701, they would either be structured to intentionally violate those terms (perhaps by making the preferred payments noncumulative) or an election would be made under Section 2701(c)(3)(C) to intentionally trigger the zero valuation rule. As a result, the retained preferred interest would be valued at zero and value of the gift made to the younger generation would be maximized, instead of minimized, using up as much as the first deceased spouse's DSUE as possible before the surviving spouse's second marriage. In addition, the surviving spouse would continue to enjoy a stream of income from the transferred assets by virtue of the preferred interest, as with a typical Freeze Partnership. As discussed above, the value of the preferred interest would be included in the surviving spouse's estate, but would be offset by the special adjustment rules under Section 2701 to avoid double taxation.

C. Modest Estates That Have Assets with Substantial Growth Potential.

For a taxpayer whose estate is under the estate tax threshold, but who owns assets with the potential for substantial appreciation, using a preferred partnership while intentionally triggering Section 2701 could have all the usual benefits of a Freeze Partnership (e.g., removing future growth from the older generation's estate, retaining a stream of cash flow and obtaining basis step-up.) while avoiding the various restrictions imposed by techniques designed to comply Section 2701.

If a particular estate is well under the estate tax threshold and the taxpayer has a significant amount of unused gift tax exemption, the deemed gift resulting from intentionally triggering Section 2701 is less unappealing because, to the extent the deemed gift is less than the taxpayer's unused gift tax exemption, no gift tax will actually be due upon the transfer. Accordingly, employing an intentionally defective Freeze Partnership without may provide an efficient way to obtain the some of the benefits of a Freeze Partnership, including retaining a stream of income from the underlying assets, freezing the estate and obtaining basis step-up, while lessening some of the compliance burdens ordinarily associated with such a structure. Moreover, as discussed above, Treas. Reg. Section 25.2701-5 would reduce the estate inclusion resulting from the retained preferred interest by an amount equal to the gift tax that was paid or credited earlier for the same transferred property, essentially providing a low-hurdle estate freeze while maintaining significant access to a steady stream of income.

IX. SECTION 2701 TECHNICAL RULES

There are a number of transfer tax issues that may arise under Internal Revenue Code (the "Code") Chapter 14 in connection with transfers of business interests or transfers in trust when family members are involved. Contained within Chapter 14 generally there are numerous gift and estate tax provisions that are designed to discourage certain types of transactions or arrangements entered into between members of the same extended family. The violation of one or more of these provisions can cause an unanticipated deemed gift or increase in the value of one's estate, which can potentially result in substantial gift or estate tax. Many of these Sections of the Code are written very broadly and are not intuitive and can unexpectedly apply even when a transaction has not been structured with the intention of achieving estate or gift tax savings, or in circumstances where wealth transfer may not even be the objective.[93]

Generally, Chapter 14 of the Code, which is divided into Sections 2701 through 2704, attempts to prevent perceived transfer tax abuses in the context of business or other interests held within a family. Chapter 14 achieves this by treating certain transactions as deemed gifts as well as through provisions that ignore certain agreements or restrictions that would otherwise affect the valuation of transferred interests. In very broad terms, the assumption underlying Chapter 14 is that a Senior Family Member will make decisions relating to the ownership and disposition of family business interests or other interests so as to shift value to younger family members with reduced or minimal transfer tax consequences. Chapter 14 discourages certain transactions by treating them as deemed gifts, and others by disregarding certain agreements or restrictions that would otherwise affect value. When structuring a preferred partnership between family members (or trusts for their benefit) it is critical that the deemed gift tax provisions under Section 2701 are carefully navigated in order to ensure that no unintended gifts are triggered.

Section 2701 can cause a deemed gift to occur typically in connection with a "transfer" of subordinate equity interest (i.e., common interests) in a corporation, partnership or LLC to a Junior Family Member when certain discretionary rights (typically associated with preferred interests) are retained by a Senior Family Member. The classic example of a transfer to which Section 2701 can potentially apply is when a parent who initially owns both common and preferred stock in a corporation (or the preferred interest in a partnership or LLC) transfers the common stock (or the common interest) to his children while retaining the preferred stock (or preferred interest).

For gift tax valuation purposes of the transferred common interest, the parent would want the retained preferred interest to have as high a value as possible so as to take the position that the value of the transferred common interest had a minimal value for gift tax purposes; determined under the assumption that the value of the preferred and common interests together make up 100% of the value of the entity so that the value of the transferred common is determined by first subtracting the value of the retained preferred (the "Subtraction Method").

A. The Perceived Abuse.

Congress enacted the special valuation rules under Chapter 14 of the Code (Section 2701 through 2704), effective for transfers after October 8, 1990, in an attempt to

[93] For excellent general commentaries and discussions regarding Chapter 14, *see generally,* Louis A. Mezzullo, "Transfers of Interests in Family Entities Under Chapter 14: Sections 2701, 2702, 2703 and 2704," 835-4th Tax Mgmt. (BNA) Estates, Gifts, and Trusts (2011); HOWARD M. ZARITSKY & RONALD D. AUCUTT, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS (2d ed. 1997); *Blattmachr on Anti-Freeze Provisions of the SECTION New Chapter 14* (91-08.18) (Mass. C.L.E. 1991); DOUGLAS K. FREEMAN & STEPHANIE G. RAPKIN, PLANNING FOR LARGE ESTATES (LexisNexis 2012); CHERYL E. HADER, ESTATE PLANNING & CHAPTER 14: UNDERSTANDING THE SPECIAL VALUATION RULES (Practising Law Institute, 2d ed. 2011).

prevent perceived abuses with respect to family transactions that would transfer wealth between family members (typically from senior to junior generations) with minimal gift and estate tax consequences through the perceived manipulation of value.

1. <u>Discretionary Rights.</u>

Prior to the enactment of Section 2701, in order to artificially increase the value of the retained preferred interests, the preferred interests might have been given certain *discretionary* rights, such as rights to noncumulative dividends and redemption or conversion rights. It was often expected that these discretionary rights would never actually be exercised, but, nonetheless, would be able to boost the value of the parent's retained preferred interest, thereby reducing the value of the gift of the common interest under a subtractive method of valuation. Section 2701 aims to discourage this perceived abuse by essentially ignoring the existence of such discretionary rights and, instead assigning a zero value to these retained rights in determining how much value or "credit" the Senior Family Member should get for gift tax purposes under the Subtraction Method of valuation. Under Section 2701, only specific types of *nondiscretionary* rights that fit within specific and narrow exceptions to the broader zero valuation rule will be given any consideration or "credit" when determining the value of the Senior Family Member's retained preferred interest.

2. <u>Example.</u>

The classic transaction that Section 2701 was designed to prevent involved parent forming a preferred partnership, or perhaps recapitalizing an existing single class partnership into a multi-class preferred partnership. Prior to Section 2701, the new or recapitalized partnership would have preferred "frozen" interests that provided for a fixed coupon, as well as common "growth" interests entitled to all the economic upside beyond the preferred coupon and liquidation preference. After forming the preferred partnership (or recapitalizing an existing one into a preferred partnership), parent would transfer by gift, sale, or perhaps a combination, the common "growth" interest to the younger generation (or a trust for their benefit), and would retain the preferred "frozen" interests. The preferred interest would be structured so as to include various *discretionary* rights, such as noncumulative preferred payment rights, rights to compel liquidation, puts and calls. When computing the value of the transferred common interests, these discretionary "bells and whistles" would artificially increase the value of the parent's retained preferred interest, and consequently, artificially depress the value of the transferred common interest; thus resulting in a "low ball" gift tax value of the gifted common interest. However, if the discretionary rights associated with parent's retained preferred interest were never actually exercised following the transfer of the common interest (or if preferred payments were never actually made), this would result in a shifting of value in the entity to the common interests then owned by the younger generation, thus achieving a gift tax-free shift of value.

Jerome Manning colorfully and succinctly described the perceived abuse associated with this type of arrangement as follows:

> *In the old days when restructurings were built with creative maneuvers ... to give the preferred [retained by the parent] a respectable facade for gift tax purposes [the preferred stock] was hung like a Christmas tree with voting rights, conversion rights, options to put and call, and liquidation opportunities.*[94]

Section 2701 was enacted in order to curtail this perceived abuse by manipulation of entity value by imposing a draconian "zero value" rule, which essentially ascribes a value of "zero" to certain components (known as "Distribution Rights" and "Extraordinary Payment Rights") of the preferred interest retained by the Senior Family Member. The consequence is to attribute more or perhaps even all of the entity value to the common interest when determining the gift tax value of transferred common under a "Subtraction Method" of valuation, even though only one class of interest (the common interest) is actually transferred.

Certain relatively narrow exceptions were worked into the statute that do allow value to be ascribed to certain components of the parent's retained preferred interest under limited circumstances when the parent's preferred interest is structured within certain strict parameters designed to ensure that the parent has retained rights that are essentially mandatory and quantifiable in nature. In other words, there is an implicit acknowledgement that if it can be determined that the parent must receive certain value (as opposed to discretionary rights) and such can be quantified then it makes sense that the parent should get proper "credit" for such mandatory and quantifiable rights (and thus, should not be valued at zero) under the subtraction method of gift tax valuation.

B. Overview of Application.

1. Deemed Gifts.

Broadly, Section 2701 applies and can cause a deemed gift to occur when a senior generation family member, typically a parent (the "Transferor") or other Senior Family Member (an "Applicable Family Member") holds an "Applicable Retained Interest" after a "transfer" to a "Member of the Family" of the Transferor has occurred. For these purposes, a "transfer" is very broadly defined to include, not only a traditional gift transfer (e.g., I

[94] MANNING ON ESTATE PLANNING, 10-67 (Practising Law Institute, 5th ed. 1995). Unless otherwise specified, all "Section" or "§" references herein are to the Code, or to the Treas. Regs (the "Regulations" or "Treas. Reg.") promulgated thereunder.

give my child 10 shares of common stock), but also a contribution to the capital of a new or existing entity, a redemption, recapitalization or other change in the capital structure of an entity.[95] Thus, it is quite possible for a potential Section 2701 transfer to occur without intending to make a gift or even being aware that a potential gift has been triggered, for instance in the context of a recapitalization or initial capitalization of an entity. Additionally, there is no intent requirement to the statute and ignorance of law is not a basis to determine the statute inapplicable. Thus, it is quite possible for a deemed gift to arise under the statute in the context of a transaction, such as the initial capitalization of an entity, when one might otherwise think that no gift tax component or implication existed at all. Indeed, the provisions of Chapter 14 in general, and certainly the provisions of Section 2701 are not intuitive and, consequently, present a number of thorny traps for the unwary.

2. Zero Valuation Rule.

There are two types of rights, the retention of which by the senior generation can trigger Applicable Retained Interest status, and thus the Section 2701 zero valuation rule with respect to those retained rights: "Extraordinary Payment Rights" and "Distribution Rights" (both of which are discussed further, below).

If Section 2701 is applicable and the interest retained by the Senior Family Member is not a "Qualified Payment Right" or other type of right to which the statute does not apply, certain rights associated with the retained interest are valued at zero in applying the Subtraction Method.[96] This essentially results in some or perhaps even all of the family held interests in the entity being attributed to the transferred interest (typically a common or subordinate interest), thereby causing a Deemed Gift of some or potentially all of the interests retained by the Senior Family Member.

C. General Definitions.

1. Transfer.

The term "transfer" is broadly defined, and includes, in addition to a traditional transfer, a capital contribution to a new or existing entity, as well as a redemption, recapitalization or other change in the capital structure of an entity.[97]

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[95] Treas. Reg. § 25.2701-1(b)(2)(i).

[96] Treas. Reg. § 25.2701-2(a)(1) and (2).

[97] Treas. Reg. § 25.2701-1(b)(2)(i).

2. Applicable Family Member.

The term "Applicable Family Member" includes the Transferor's spouse, any ancestor of the Transferor or his or her spouse and the spouse of any such ancestor.[98] (While this term is somewhat broader than just "Senior Family Members," sometimes in this outline that term will be used as a shorthand for "Applicable Family Member," as that is the most typical situation in which the definition would apply.)

3. Member of the Family of the Transferor.

The term "Member of the Transferor's Family" includes the Transferor's spouse, any lineal descendant of the Transferor or his or her spouse, and the spouse of such descendant.[99] (While this term is somewhat broader than just "Junior Family Members," sometimes in this outline that term will be used as a shorthand for "Member of the Family of the Transferor," as that is the most typical situation in which the definition would apply.)

4. Subtraction Method.

If Section 2701 applies to a transfer, the value of an interest transferred to a Junior Family Member will be determined by subtracting from the value of the entire family-held interests the value of the interest retained by the Senior Family Member, a deemed gift will have occurred from the Senior Family Member to the Junior Family Member of the value of all family held interests less the value of the senior interests retained by the Senior Family Member determined under the Subtraction Method.[100]

D. Applicable Retained Interests.

Section 2701 applies to a transfer to a Member of the Family of the Transferor if the Transferor or an Applicable Family Member, holds an "Applicable Retained Interest" immediately after the transfer. There are two types of rights the retention of which will cause an Applicable Retained Interest to exist; the existence of either of which will cause the zero valuation rule of Section 2701 to apply in valuing those retained rights: (1) Extraordinary Payment Rights; and (2) Distribution Rights.

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[98] Code § 2701(e)(2); Treas. Reg. § 25.2701-1(d)(2). For purposes of this discussion, the Transferor and Applicable Family Members are referred to as the "Senior Family Members," although this is not technically always the case.

[99] Code § 2701(e)(1); Treas. Reg. § 25.2701-1(d)(1) (*persons in any generation higher than the Transferor are NOT included in this group*). For purposes of this discussion, the Transferor and Members of the Family of the Transferor are referred to as the "Junior Family Members," although this is not technically always the case since the "spouse" of the Transferor is also included in this definition.

[100] Treas. Reg. § 25.2701-1(a)(2).

1. Extraordinary Payment Rights.

Generally, these include liquidation, put, call and conversion rights *the exercise or non-exercise of which would affect the value* of the transferred common interest when the holder of such rights has discretion as to whether (or when) to exercise them. A call right includes any warrant, option, or other right to acquire one or more equity interest(s).[101]

Because it is assumed that such discretionary Extraordinary Payment Rights would never be exercised by the Senior Family Member, so that greater value will pass to the younger generation family members holding common interests, they are given a value of zero in determining the worth of the retained preferred interest for gift tax purposes under the Subtraction Method.

2. Distribution Rights.

The second type of right that will result in an Applicable Retained Interest is a "Distribution Right," which is the right to receive distributions with respect to an equity interest. However, a Distribution Right does not include: (i) a right to receive distributions with respect to an interest that is of the "same class" as, or a class that is "subordinate to," the transferred interest, (ii) an Extraordinary Payment Right, or (iii) one of the other rights discussed below.[102]

3. Control Requirement.

Unlike Extraordinary Payment Rights, with respect to which the interest holder individually has the discretion to participate or not participate in the growth of the entity, any discretion associated with a Distribution Right is *not held by the interest holder.* Rather, such discretion to make or not make distributions is held by the entity itself. As such, a Distribution Right will only be considered to exist with respect to an Applicable Retained Interest if "control" of the entity exists in the family. Control exists for these purposes if the Transferor and family members (including both junior and senior and more remote family members) "control" the entity immediately before the transfer.

(a) "Control" means:

(i) In the case of any partnership, at least 50% of the capital or profit interest in a partnership, or, *any*

[101] Treas. Reg. § 25.2701-2(b)(2).

[102] Treas. Reg. § 25.2701-2(b)(3).

equity interest as a general partner of a limited partnership;[103] or

Query: whether an interest in a general partner constitutes an interest "as a general partner"?

(ii) In the case of a corporation, at least 50% (by vote or value) of the stock of the corporation.[104]

(b) The presumption here appears to be that a family-controlled entity that holds such discretion would not make discretionary distributions to Senior Family Members, so that greater value will remain in the entity, thereby benefiting the Junior Family Members holding the common interests. Presumably such would not be the case with an entity that is not family-controlled.

4. Section 2701 Applied to LLC Recapitalization.

(a) Facts.

In CCA 201442053, the IRS determined that Section 2701 was triggered in connection with the recapitalization of an LLC. In the CCA, an LLC was initially created by mother as a single class LLC, followed by gifts of LLC interests to her two sons and her grandchildren all of whom shared capital, profits and losses in proportion to their percentages interests. The LLC was later recapitalized, as a result of which all future profits or gains would be allocated to the sons only, as consideration for the sons agreeing to manage the LLC. Following the recapitalization, the mother's only interest was the right to the return of her capital account upon liquidation based on her membership interest as it existed immediately prior to the recapitalization.

(b) Conclusion.

The IRS determined that the recapitalization was a Section 2701 "transfer" under Treas. Reg. Sec. 25.2701-1(b)(2)(B)(2). It reasoned that the mother held an Applicable Retained Interest (her "Distribution Right") both before and

[103] Code § 2701(b)(2)(B).

[104] Code § 2701(b)(2)(A).

after the recapitalization, and that her sons' right to receive future profits was a subordinate interest.[105]

(c) Criticism.

In his article, Richard L. Dees argues that the IRS should withdraw the CCA and criticizes it as containing a rather muddled analysis in determining that the mother's retained interest was an "Applicable Retained Interest" due to the fact that "[b]oth before and after the recapitalization, Donor held an Applicable Retained Interest, an equity interest in Company coupled with a Distribution Right." Dees argues that the mother's right to receive her capital account upon termination of the LLC was not an "Applicable Retained Interest;" rather, such would have been either a "Mandatory Payment Right" or a "Liquidation Participation Right," neither of which is subject to valuation under Section 2701. Additionally, he points out that mother did not retain an "Extraordinary Payment Right" since she did not have the discretionary right to withdraw her capital interest from the LLC which was subject to a stated term. (Since the publication of Dees' article, it has since been determined that mother had a large enough percentage interest to unilaterally liquidate the LLC, which would have constituted an Extraordinary Payment Right.[106]) After the recapitalization, mother retained no rights to receive distributions with respect to her equity interests, but only the right to a return of her capital account.[107]

E. Exception to Distribution Right: "Qualified Payment Right."

The Code and Regulations contain an exception to the application of the zero valuation rule to a Distribution Right when the Distribution Right fits the definition of a "Qualified Payment Right."

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[105] For a comprehensive and critical commentary on this CCA, *see* Richard L. Dees, *Is Chief Counsel Resurrecting The Chapter 14 'Monster'?* TAX NOTES (December 15, 2014).

[106] Richard L. Dees, The Preferred Partnership Freeze And The Reverse Freeze (Part II) – SECTION §2701 And The Regulatory Scheme, Forty-First Notre Dame Tax and Estate Planning Institute, at 6-39 (September 17–18, 2015).

[107] For an excellent in-depth discussion of CCA 201442053 and further analysis of §2701 generally, see generally, Richard L. Dees, The Preferred Partnership Freeze And The Reverse Freeze (Part II) – SECTION §2701 And The Regulatory Scheme, Forty-First Notre Dame Tax and Estate Planning Institute (September 17–18, 2015).

1. "Qualified Payment Right" Defined, Section 2701 (c)(3):

(a) Any dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent that such dividend is determined at a fixed rate

(b) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount

Or

(c) Any Distribution Right for which an election has been made to be treated as a Qualified Payment[108]

Because Qualified Payment Rights are mandatory, and no discretion of the family-controlled entity to make or not make distributions exists with respect to a Qualified Payment Right, the perceived opportunity to manipulate value that Section 2701 was designed to prevent is not present with a Qualified Payment Right, and, therefore, the zero valuation rule will not apply.

A "Qualified Payment Right" is NOT an exception to an Extraordinary Payment Right; it is only an exception to a Distribution Right.

2. "Lower of" Rule – For Valuing a Qualified Payment Right Held in Conjunction with an Extraordinary Payment Right.

If an Applicable Retained Interest provides the holder with a Qualified Payment Right and one or more Extraordinary Payment Rights, the value of all of these rights is determined by assuming that each Extraordinary Payment Right is exercised in a manner resulting in the lowest total value being determined for all the rights.[109]

An example of the "lower of" rule is as follows, based upon Regulation Section 25.2701-2(a)(5):

Example: Dad, the 100% stockholder of a corporation, transfers common stock to Child and retains preferred stock which provides (1) a Qualified Payment Right having a value of $1,000,000; and (2) a right to put all the preferred stock to the corporation at any time for $900,000 (an Extraordinary Payment Right). At the time of the transfer, the corporation's value is $1,500,000. Under the "lower of" rule, the value of Dad's retained

[108] Treas. Reg. § 25.2701-2(b)(6)(i).

[109] Treas. Reg. § 25.2701-2(a)(3).

interest is $900,000, even though he retains a Qualified Payment Right worth $1,000,000. This is because his retained interests are valued under the assumption that Dad exercises his Extraordinary Payment Right (the put right) in a manner resulting in the lowest value being determined for all of his retained rights (i.e., in a manner that would yield him $900,000). As a result, Dad has made a gift of $600,000 ($1,500,000–$900,000), rather than $500,000 if the value of his preferred interest was based upon the $1,000,000 value of the Qualified Payment Right.

F. Minimum Value of Junior Equity Interest.

If Section 2701 applies, in the case of a transfer of a junior equity interest, such interest shall not be valued at an amount less than 10% of the total value of all of the equity interests, plus the total indebtedness of the entity to the Transferor or an Applicable Family Member.[110]

G. Rights that are Not Extraordinary Payment Rights or Distribution Rights.

Certain rights may be retained in connection with preferred interests that are neither Extraordinary Payment Rights nor Distribution Rights, and, therefore, are not "Applicable Retained Interests" that trigger the application of Section 2701. These kinds of rights may take any of the following forms:

1. <u>Mandatory Payment Rights.</u>

A "Mandatory Payment Right," which is a right to receive a required payment of a specified amount payable at a specific time (e.g., mandatory redemption required at certain date at certain value).[111]

2. <u>Liquidation Participation Rights.</u>

A "Liquidation Participation Right," which is a right to participate in a liquidating distribution[112] (this is in contrast to a *right to compel* liquidation).

Preferred partnerships are often structured to include a partnership term or fixed date upon which the partnership will terminate. This is done because certain rights may be retained in connection with the creation of a preferred interest that are not are not Applicable Retained Interests triggering the application of Code Section 2701. These rights include the "Liquidation Participation Right," which is the right to participate in a liquidating distribution (although not the right to compel liquidation). Under Code Section 2701, the value of a Liquidation Participation Right is its market

[110] Code § 2701(a)(4)(A).

[111] Treas. Reg. § 25.2701-2(b)(4)(i).

[112] Treas. Reg. § 25.2701-2(b)(4)(ii).

value of the right. Accordingly, if it were determined that the preferred interest constitutes an Extraordinary Payment Right, increasing the value of the preferred interest's Liquidation Participation Right would reduce the value of the deemed gift as determined under the zero valuation rule.

Accordingly, providing a fixed term for a preferred partnership can result in a greater value being ascribed to the preferred partner's right to participate in the liquidation of the entity. To the extent it is determined that the preferred partner holds an Applicable Retained Interest, the fixed term of the partnership would increase the value of the Liquidation Participation Right, thereby decreasing the value of any deemed gift under Code Section 2701. In the case of the LLC, however, we understand practical considerations counsel against including a fixed term for the partnership, as the nature of the LLC's planned real estate investments and the family's investment philosophy generally favors greater flexibility to hold assets for an indefinite term. In drafting the LLC agreement, therefore, caution was taken to mitigate the risk that an Applicable Retained Interest exists by carefully structuring the preferred coupon as a Qualified Payment Right.

3. Guaranteed Payment Rights.

A "Guaranteed Payment Right," which is a right to a guaranteed payment of a fixed amount without any contingency, under Section 707(c).[113]

Or

4. Non-Lapsing Conversion Rights.

A "Non-Lapsing Conversion Right," which is a right to convert an equity interest into a specific number or percentage of shares (if the entity is a corporation), or into a specified interest (if the entity is a partnership or other nonstock entity).[114]

H. Section 2701 Subtraction Method.

The methodology used to determine the amount of a gift resulting from any transfer to which Section 2701 applies is as follows:

1. Step 1: Valuation of family-held interests.

Determine fair market value of all family-held equity interests in the entity immediately after the transfer.

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[113] Treas. Reg. § 25.2701-2(b)(4)(iii).

[114] Treas. Reg. § 25.2701-2(b)(4)(iv).

Special rule for contributions to capital apply which direct that the "fair market value of the contribution" be determined.

2. <u>Step 2: Subtract value of senior equity interest.</u>

The value determined in Step 1 is reduced by:

(a) an amount equal to the sum of the fair market value of all family-held senior equity interests (other than Applicable Retained Interests held by the Transferor or Applicable Family Members) and the fair market value of any family-held equity interests of the same class or a subordinate class to the transferred interests held by persons other than the Transferor, members of the Transferor's family, and Applicable Family Members of the Transferor.

And/or

(b) the value of all Applicable Retained Interests held by the Transferor or Applicable Family Members.

Special rules for contributions to capital apply which instruct one to "subtract the value of any applicable retained interest received in exchange for the contribution to capital" determined under the zero valuation rule.

3. <u>Step 3: Allocate.</u>

Allocate the remaining value among the transferred interests and other family-held subordinate equity interests.

4. <u>Step 4: Determine the amount of the gift.</u>

The amount allocated in Step 3 is reduced by any adjustments for:

(a) minority discounts

(b) transfers with a retained interest

And/or

(c) consideration received by Transferor (in case of contribution to capital, any consideration received in the form of an Applicable Retained Interest is zero)

5. <u>Adjustment to Step 2.</u>

If the percentage of any class of Applicable Retained Interest held by Transferor and Applicable Family Members (i.e., spouse and ancestors, but not Junior Family Members) exceeds the highest percentage family held interests in the subordinate interests, the excess percentage is treated as not held by Transferor or Applicable Family Members.

6. <u>"Lower of" Rule Application.</u>

Election to treat Distribution Right as a Qualified Payment Right under Section 2701 (c)(3)(C)(ii).

Example:[115] Corporation X has outstanding 1,000 shares of $1,000 par value voting preferred stock, each share of which carries a cumulative annual dividend of 8% and a right to put the stock to X for its par value at any time. In addition, there are outstanding 1,000 shares of non-voting common stock. A holds 600 shares of the preferred stock and 750 shares of the common stock. The balance of the preferred and common stock is held by B, a person unrelated to A. Because the preferred stock confers both a qualified payment right and an extraordinary payment right, A's rights are valued under the "lower of" rule of Section 25.2701-2(a)(3). Assume that A's rights in the preferred stock are valued at $800 per share under the "lower of" rule (taking account of A's voting rights). A transfers all of A's common stock to A's child. The method of determining the amount of A's gift is as follows:

<u>Step 1</u>: Assume the fair market value of all the family-held interests in X, taking account of A's control of the corporation, is determined to be $1,000,000.

<u>Step 2</u>: From the amount determined under Step 1, subtract $480,000 (600 shares x $800).

<u>Step 3</u>: The result of Step 2 is a balance of $520,000. This amount is fully allocated to the 750 shares of family-held common stock.

<u>Step 4</u>: Because no consideration was furnished for the transfer, the adjustment under Step 4 is limited to the amount of any appropriate minority or similar discount. Before the application of Step 4, the amount of A's gift is $520,000.

I. Circumstances Where Section 2701 is Inapplicable.

Section 2701 does not apply in the following circumstances:

1. <u>Same Class.</u>

Where the retained interest and the transferred interest are of the "same class," meaning the rights associated with the retained interests are identical (or proportional) to the rights associated with the transferred interests,

[115] Treas. Reg. §25.2701-3(d), Ex. 1.

except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of this Section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (e.g., Section 704(b)) are non-lapsing differences with respect to limitations on liability.[116]

2. Market Quotations.

If there are readily available market quotations on an established securities market for either the transferred interest or the retained interest[117]

3. Proportionate Transfers.

Also known as the "Vertical Slice" approach, this occurs where the transfer results in a proportionate reduction of each class of equity interest held by the senior and Junior Family Members[118] (e.g., Dad transfers 5% of both of his common and preferred stock to child, so that Dad's interest in both his ownership of common and preferred is reduced by 5% for each class).

J. Limited Relief for Distribution Right Only: Election into Qualified Payment Right Treatment.

In the case of a Distribution Right, relief from the application of the zero valuation rule may be obtained by making an irrevocable election to treat such right *as if* it were a Qualified Payment Right.[119] No such relief is provided for Extraordinary Payment Rights.

- If an election is made, then under the Subtraction Method, the Distribution Right would *not* be valued at zero. Rather, the fair market value of such interests will be determined based upon traditional valuation principals, based upon facts assumed and agreed to in the election filed with the Transferor's gift tax return.

- An election is made by attaching a statement to the Transferor's timely filed Gift Tax Return on which the transfer is reported. Detailed information must be included in the statement describing the transaction and providing additional information as set forth in the Treasury Regulations.[120]

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[116] Code § 2701(a)(2)(B); Treas. Reg. § 25.2701-1(c)(3).

[117] § 2701(a)(2)(A); Treas. Reg. § 25.2701-1(c)(1) and (2).

[118] § 2701(a)(2)(C); Treas. Reg. § 25.2701-1(c)(4).

[119] Treas. Reg. § 25.2701-2(c)(2).

[120] Treas. Reg. § 25.2701-2(c)(5).

- An election assumes for Section 2701 purposes that a fixed annual payment will be made to the holder of the interest regardless of whether the entity has adequate cash flow. In the case of such an election, the Distribution Right will be treated as a Qualified Payment Right and, as such, some flexibility is therefore provided to extend the period for actually making these payments:

  (a) a four-year grace period to actually make a payment is permitted[121]

  (b) deferral is permitted by satisfying payment of a Qualified Payment with a debt obligation bearing compound interest from the due date at an appropriate discount rate, provided that the term of the debt obligation does not exceed four years[122]

  (c) if a Qualified Payment is not made within the four-year grace period, certain increases are made under the "compounding rule" upon the subsequent transfer of the interest by gift or death to account for such arrearages.[123]

K. Section 2701 Hypothetical.

Mom and Child form a partnership into which Mom contributes $8,000,000 and child contributes $2,000,000 in exchange for their respective partnership interests. Child receives common interests and Mom receives preferred interests. The preferred interests provide Mom with the ability to require the partnership at any time to redeem her interest and return her contribution, as well as a noncumulative priority preferred return equal to 5% annually provided that the partnership has adequate cash flow to satisfy the preferred return.

Section 2701 will apply to the hypothetical transaction outlined above for the following reasons:

- The transaction would constitute a "transfer" within the meaning of the regulations which specifically includes "a capital contribution to a new or existing entity"

- Mom has retained the following two types of "Applicable Retained Interests":

  (a) <u>Extraordinary Payment Right</u>. The preferred interest retained by Mom gives her the ability to require the

[121] Treas. Reg. § 25.2701-4(c)(5).

[122] Treas. Reg. § 25.2701-4(c)(5).

[123] *See* Treas. Reg. § 25-2701-4(c).

partnership to redeem her interest at any time, and return her investment contribution, which is considered an Extraordinary Payment Right.

(b) Distribution Right. In this case, Mom and Child are the only partners in the partnership and, therefore, they have the requisite "control" of the entity. In addition, Mom's preferred interest includes a Distribution Right which does not satisfy the definition of a Qualified Payment Right. A Qualified Payment Right requires, by its terms, cumulative, mandatory fixed rate payments on a periodic basis payable at least annually. In this case, the preferred return to mom is noncumulative and is a fixed rate payment, but it is not required to be distributed at least annually.

(c) Application. Consequently, in determining the value of Mom's retained interest under the Subtraction Method, the Extraordinary Payment Right and the Distribution Right will each be valued at zero. However, Mom may elect to treat the Distribution Right as if it is a Qualified Payment Right via a timely filed gift tax return. In such case, any gift would be determined by application of the "lower of" rule because mom would then have both a Qualified Payment Right and an Extraordinary Payment Right. The gift will be determined based upon the lower value of the Qualified Payment Right and the Extraordinary Payment Right being ascribed to mom's preferred interest in applying the Subtraction Method of valuation.