**Transfer Planning with Preferred Partnerships, Carried Interests   
and Profits Interests**

**N. Todd Angkatavanich**

**N. Todd Angkatavanich[[1]](#footnote-2)** is a Principal in Ernst & Young LLP’s National Tax Department, where he serves in the Private Client Services practice. He formerly served as Co-Head of the U.S. Private Client & Tax Group at the international private client law firm Withers Bergman, LLP.  Todd is a Fellow of the *American College of Trust and Estate Counsel,* is a Fellow of the *American Bar Foundation* and is a member of the *Society of Trusts & Estates Practitioners*.  Todd has published articles in publications such as *Trusts & Estates, ACTEC Law Journal, Estate Planning, BNA Tax Management, Probate & Property, STEP Journal,* and other publications.  He serves as Co-Chair of the Estate Planning & Taxation Committee of the Editorial Advisory Board of *Trusts & Estates* magazine, as well as Chair of the Advisory Board for *BNA/Tax Management Estates, Gifts and Trusts.*  Todd is co-author of *BNA/Tax Management Portfolio No. 875*, entitled *“Wealth Planning with Hedge Fund and Private Equity Fund Interests.”* A frequent speaker, Todd has given presentations for a number of organizations including the *Heckerling Institute on Estate Planning, the Federal Tax Institute of New England, the Notre Dame Tax and Estate Planning Institute, the Duke University Estate Planning Conference, the Washington State Bar Association Annual Estate Planning Seminar, the ABA Real Property, Trusts and Estates Section,* as well as numerous estate planning councils, CPA societies and family office groups.  Todd is Co-Chair of the *Business Investment Entities, Partnerships, LLC’s and Corporations Committee* of the *ABA/RPTE Business Planning Group* and serves as a member of the *ABA/RPTE Diversity Committee*.  He is a member of the *Executive Committee* of the *Connecticut Bar Association, Estates and Probate Section,* and on behalf of the Section also serves on the *Planning Committee* for the *Federal Tax Institute of New England.*  He is the 2012 recipient of the award for “Private Client Lawyer of the Year” from *Family Office Review*.  Todd has been included in *The Best Lawyers in America®* (for New York City, Greenwich and New Haven, Connecticut) andis also the recipient of the *Best Lawyers®* 2015 Trusts & Estates “Lawyer of the Year” award for New Haven, Connecticut.  He has been rated AV Preeminent® *by Martindale-Hubbell® Peer Review Ratings,*™ has been ranked in *Chambers HNW*, has been listed in *Who's Who Legal: Private Client* and in *Super Lawyers.*  Todd received his B.A., in Economics, *magna cum laude,* from Fairleigh Dickinson University, his J.D., Tax Law Honors, from Rutgers University School of Law, Camden, his M.B.A. from Rutgers University Graduate School of Management, and his LL.M, in Taxation, from New York University School of Law.

TABLE OF CONTENTS

[I. INTRODUCTION 1](#_Toc516827926)

[II. SECTION 2701—RECAPITALIZATIONS AND OTHER “TRANSFERS” OF BUSINESS INTERESTS. 3](#_Toc516827927)

[A. The Perceived Abuse. 3](#_Toc516827928)

[1. Discretionary Rights. 3](#_Toc516827929)

[2. Example. 4](#_Toc516827930)

[B. Overview of Application. 5](#_Toc516827931)

[1. Deemed Gifts. 5](#_Toc516827932)

[2. Zero Valuation Rule. 6](#_Toc516827933)

[C. General Definitions. 7](#_Toc516827934)

[1. Transfer. 7](#_Toc516827935)

[2. Applicable Family Member. 7](#_Toc516827936)

[3. Member of the Family of the Transferor. 7](#_Toc516827937)

[4. Subtraction Method. 7](#_Toc516827938)

[D. Applicable Retained Interests. 8](#_Toc516827939)

[1. Extraordinary Payment Rights. 8](#_Toc516827940)

[2. Distribution Rights. 8](#_Toc516827941)

[3. Section 2701 Applied to LLC Recapitalization. 10](#_Toc516827942)

[E. Exception to Distribution Right: “Qualified Payment Right.” 11](#_Toc516827943)

[1. “Qualified Payment Right” defined, Section 2701(c)(3): 11](#_Toc516827944)

[2. “Lower Of” Rule - For Valuing a Qualified Payment Right Held in Conjunction with an Extraordinary Payment Right. 12](#_Toc516827945)

[F. Minimum Value of Junior Equity Interest. 12](#_Toc516827946)

[G. Rights that are Not Extraordinary Payment Rights or Distribution Rights. 13](#_Toc516827947)

[1. Mandatory Payment Rights. 13](#_Toc516827948)

[2. Liquidation Participation Rights. 13](#_Toc516827949)

[3. Guaranteed Payment Rights. 13](#_Toc516827950)

[4. Non-Lapsing Conversion Rights. 13](#_Toc516827951)

[H. Section 2701 Subtraction Method. 13](#_Toc516827952)

[1. Step 1: Valuation of family-held interests. 14](#_Toc516827953)

[2. Step 2: Subtract value of senior equity interest. 14](#_Toc516827954)

[3. Step 3: Allocate. 14](#_Toc516827955)

[4. Step 4: Determine the amount of the gift. 14](#_Toc516827956)

[5. Adjustment to Step 2. 15](#_Toc516827957)

[6. Subtraction Method with “Lower of” Rule. 15](#_Toc516827958)

[I. Circumstances in Which Section 2701 is Inapplicable. 16](#_Toc516827959)

[1. Same Class. 16](#_Toc516827960)

[2. Market Quotations. 16](#_Toc516827961)

[3. Proportionate Transfers. 16](#_Toc516827962)

[J. Limited Relief for Distribution Right Only: Election into Qualified Payment Right Treatment. 16](#_Toc516827963)

[K. Section 2701 Hypothetical. 17](#_Toc516827964)

[III. THE 2701 ATTRIBUTION RULES](#_Toc516827965)**[.](#_Toc516827965)** [19](#_Toc516827965)

[A. Entity Attribution Rules. 19](#_Toc516827966)

[B. Corporations and Partnerships. 19](#_Toc516827967)

[C. Trust Attribution Rules. 20](#_Toc516827968)

[1. The “Basic” Trust Rules. 20](#_Toc516827969)

[2. The Grantor Trust Attribution Rules. 21](#_Toc516827970)

[3. The Multiple Attribution Rules. 22](#_Toc516827971)

[IV. CARRIED INTEREST TRANSFER PLANNING AND SECTION 2701 24](#_Toc516827972)

[1. Gift tax valuation uncertainty issues and how to best address that uncertainty; 25](#_Toc516827973)

[2. Chapter 14 deemed gift issues under Section 2701 of the Internal Revenue Code (the "Code") and the so-called "Vertical Slice," as well as "Non-Vertical Slice" planning alternatives; 25](#_Toc516827974)

[3. Incomplete gift issues associated with vested and unvested interests and retained interests; 25](#_Toc516827975)

[4. Estate tax inclusion risks; 25](#_Toc516827976)

[5. Trust and Entity Attribution Rules under Section 2701; and 25](#_Toc516827977)

[6. Coordination issues with planning techniques and related pressure points. 25](#_Toc516827978)

[A. The Section 2701 Issue 25](#_Toc516827979)

[1. Deemed Gift Problem. 26](#_Toc516827980)

[2. The “Vertical Slice” Approach. 26](#_Toc516827981)

[3. Limitations of the Vertical Slice Approach. 27](#_Toc516827982)

[B. Achieving “Verticality” 28](#_Toc516827983)

[1. Individual Slices. 28](#_Toc516827984)

[2. Holding Entity to Achieve Verticality. 28](#_Toc516827985)

[3. Getting Cut by a Bad Vertical Slice. 29](#_Toc516827986)

[C. Section 2036 Implications with Vertical Slice Holding Entity Approaches 30](#_Toc516827987)

[D. The Bona fide Sale Exception 30](#_Toc516827988)

[V. Preferred Partnership Approach to Carried Interest Transfer Planning 32](#_Toc516827989)

[A. Non-Vertical Holding Entities 33](#_Toc516827990)

[1. Mandatory Payment Right Holding Entity. 33](#_Toc516827991)

[2. Qualified Payment Right Holding Entity. 34](#_Toc516827992)

[3. Holding Entity with Debt. 35](#_Toc516827993)

[4. Holding Entity Pressure Points. 35](#_Toc516827994)

[VI. Proactive Planning with Section 2701 and Preferred “Freeze” Partnerships. 37](#_Toc516827995)

[1. Structuring the Preferred Interest. 38](#_Toc516827996)

[2. Valuation of the Preferred Coupon. 38](#_Toc516827997)

[B. Gift Tax Formation Issues. 39](#_Toc516827998)

[C. Structuring the Preferred Interest. 40](#_Toc516827999)

[1. Qualified Payment Right. 40](#_Toc516828000)

[2. Liquidation Preference. 41](#_Toc516828001)

[D. Subtraction Method of Valuation 41](#_Toc516828002)

[E. Valuation of the Preferred Coupon. 41](#_Toc516828003)

[F. Lower of Rule. 43](#_Toc516828004)

[G. Ensuring Preferred Equity Interest is not Recharacterized as Debt. 43](#_Toc516828005)

[H. Section 2036 Considerations. 44](#_Toc516828006)

[VII. REVERSE FREEZE PARTNERSHIP 46](#_Toc516828007)

[A. General. 46](#_Toc516828008)

[B. Section 2701 Not Applicable. 46](#_Toc516828009)

[C. Valuation Considerations. 47](#_Toc516828010)

[VIII. FREEZING A QTIP TRUST. 47](#_Toc516828011)

[A. Advantages of Freezing a QTIP Trust. 47](#_Toc516828012)

[B. QTIP Section 2519 Issue. 48](#_Toc516828013)

[IX. GRAT ETIP ISSUE: PREFERRED PARTNERSHIP GRAT.](#_Toc516828014) [49](#_Toc516828014)

[A. The ETIP Issue. 49](#_Toc516828015)

[B. Preferred Partnership GRAT to address ETIP Issue. 49](#_Toc516828016)

[C. "Rolling" Preferred Partnership GRAT 50](#_Toc516828017)

[X. INTENTIONALLY TRIGGERING SECTION 2701 – INTENTIONALLY DEFECTIVE FREEZE PARTNERSHIPS. 51](#_Toc516828018)

[A. Utilizing Gift Tax Exemption During Lifetime 51](#_Toc516828019)

[B. Maximizing the Value of DSUE in the Case of Multiple Deceased Spouses 52](#_Toc516828020)

[C. Modest Estates That Have Assets with Substantial Growth Potential. 53](#_Toc516828021)

[XI. Consideration of Unique Gift Tax Issues With Next Generation Ownership of Family Office 53](#_Toc516828022)

[A. Section 2701 Generally. 54](#_Toc516828023)

[1. Transfer 55](#_Toc516828024)

[2. Applicable Retained Interests 55](#_Toc516828025)

[3. “Reversing” the Profits Interest: 56](#_Toc516828026)

[4. Subtraction Method 58](#_Toc516828027)

[5. Section 2701 Applied to Profits Interests Held by Junior Family Member 59](#_Toc516828028)

[6. Vertical Slice Exception 60](#_Toc516828029)

[7. The Section 2701 Attribution Rules. 60](#_Toc516828030)

# INTRODUCTION

There are a number of transfer tax issues that can arise under Chapter 14 of the Internal Revenue Code[[2]](#footnote-3) in connection with transfers of business interests or transfers in trust when family members are involved. Contained within Chapter 14 generally 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 inadvertently cause a deemed gift or an increase in the value of one’s estate, which can potentially result in the imposition of an unanticipated gift or estate tax, or an increase in such taxes. Many of these sections of the Code are written very broadly and can unexpectedly apply, even in circumstances where a transaction has not been structured with the intention of achieving estate or gift tax savings or where wealth transfer may not even be the objective.[[3]](#footnote-4)

Generally, Chapter 14 of the Code, which is comprised of Sections 2701 through 2704, attempts to prevent perceived transfer tax abuses in the context of business or other interests held within a family. In very broad terms, the assumption underlying Chapter 14 appears to be that a senior family member will make decisions relating to the ownership and disposition of a family business and 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 for transfer tax purposes.

The “Deemed Gift Provisions” are found in three sections of the Code: Section 2701, relating to recapitalizations and other types of “transfers” of business interests where different economic classes of equity are involved;[[4]](#footnote-5) Section 2702, relating to transfers (and deemed transfers) to trusts with retained interests and joint purchases of property;[[5]](#footnote-6) and Section 2704(a), relating to lapses of liquidation or voting rights.[[6]](#footnote-7) Generally, the deemed gifts determined under these provisions are created by applying a “zero valuation” concept (except for Section 2704(a), which determines the value of a deemed gift, or increases the value of an asset for estate tax purposes by measuring the difference in the value of the interest immediately prior to the lapse of a right versus its value immediately after the lapse), which assigns a value of zero to an interest in a business or trust that is held or retained by senior family members. These provisions have the potential to result in a deemed gift of some or perhaps even all of the value of the business or other interests in connection with transfers of certain interests in which another interest is retained.

The “Disregard Provisions” refer to the Chapter 14 provisions that have the effect of ignoring or disregarding, for transfer tax purposes, certain agreements or restrictions that would otherwise artificially assign a lower value to a business interest or would artificially reduce its value for estate or gift tax purposes. These provisions are included in Code Sections 2703 and 2704(b).

# SECTION 2701—RECAPITALIZATIONS AND OTHER “TRANSFERS” OF BUSINESS INTERESTS.

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 Limited Liability Company (LLC) to a junior family member when certain discretionary rights (typically, but not necessarily, associated with preferred interests) are retained by a senior family member. The classic type of transaction to which Section 2701 can potentially apply is when a parent, who initially owns both common and preferred stock in a corporation (or 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 subtracting the value of the retained preferred (the “Subtraction Method”) from the entire value of the entity.

## The Perceived Abuse.

Congress enacted the special valuation rules under Chapter 14 of the Code (Sections 2701 through 2704), effective for transfers after October 8, 1990, in an attempt to prevent perceived abuses with respect to family transactions involving the transfer wealth between family members (typically from senior to junior generations) with minimal or reduced gift and estate tax consequences through the perceived manipulation of value.

### Discretionary Rights.

Prior to the enactment of Section 2701, in determining the value of gifted common interests, in order to artificially increase the value of the parent’s retained preferred interests, the preferred interests might have been given certain *discretionary* rights, such as rights to non-cumulative 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 Subtraction Method of valuation. If, however, parent was ascribed “credit” for gift tax purposes for those discretionary rights, but subsequently those rights were never actually exercised by parent, this would result in a shifting of value to the common interest (then owned by the children) without a corresponding imposition of gift tax.

Section 2701 aims to discourage this perceived abuse by essentially ignoring the existence of such discretionaryrights 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. Thus, under Section 2701, only specific types of *non-discretionary* rights (essentially rights that are mandatory and quantifiable) 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.

### Example.

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 single class partnership into a Preferred Partnership), parent would transfer by gift, sale, or perhaps a combination thereof, 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 non-cumulative 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.[[7]](#footnote-8)

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 strict parameters designed to provide 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 that can be taken or not taken) 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.

## Overview of Application.

### 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 give my child ten 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.[[8]](#footnote-9) 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.

### 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 (discussed below) certain rights associated with the retained interest are valued at zero in applying the Subtraction Method.[[9]](#footnote-10) 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.

## General Definitions.

### 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.[[10]](#footnote-11)

### 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.[[11]](#footnote-12) (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.)

### 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.[[12]](#footnote-13) (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.)

### 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.[[13]](#footnote-14)

## 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.

### 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).[[14]](#footnote-15)

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 value of the retained preferred interest for gift tax purposes under the Subtraction Method.

### 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.[[15]](#footnote-16)

#### *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.

##### “Control” means:

###### In the case of any partnership, at least 50% of the capital or profit interest in a partnership, or, *any equity interest as a general partner* of a limited partnership;[[16]](#footnote-17) or

Comment: one issue that is not clear to practitioners is whether for these purposes an interest in a general partner constitutes an interest “as a general partner”?

###### In the case of a corporation, at least 50% (by vote or value) of the stock of the corporation.[[17]](#footnote-18)

##### 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.

### Section 2701 Applied to LLC Recapitalization.

#### *Facts*.

In CCA 201442053,[[18]](#footnote-19) the Internal Revenue Service (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.

#### *Conclusion*.

The IRS determined that the recapitalization was a Section 2701 “transfer” under Treas. Reg. § 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.[[19]](#footnote-20)

#### *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 been determined that mother had a large enough percentage interest to unilaterally liquidate the LLC, which would have constituted an Extraordinary Payment Right.[[20]](#footnote-21)) 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.[[21]](#footnote-22)

## 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.”

### “Qualified Payment Right” defined, Section 2701(c)(3):

#### 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;

#### 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

#### Any Distribution Right for which an election has been made to be treated as a Qualified Payment.[[22]](#footnote-23)

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.

### “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.[[23]](#footnote-24)

#### An example of the “Lower Of” rule is as follows, based upon Treas. Reg. § 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 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.

## 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.[[24]](#footnote-25)

## 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 valued at zero under Section 2701. These kinds of rights may take any of the following forms:

### Mandatory Payment Rights.

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);[[25]](#footnote-26)

### Liquidation Participation Rights.

A “Liquidation Participation Right,” which is a right to participate in a liquidating distribution[[26]](#footnote-27) (this is in contrast to a *right to compel* liquidation);

### 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);[[27]](#footnote-28) or

### 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 non-stock entity).[[28]](#footnote-29)

## 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:

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

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

Special rules for contributions to capital apply which direct that the “fair market value of the contribution” be determined.

### Step 2: Subtract value of senior equity interest.

The value determined in Step 1 is reduced by:

#### 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

#### 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.

### Step 3: Allocate.

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

### Step 4: Determine the amount of the gift.

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

#### minority discounts;

#### transfers with a retained interest; and/or

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

### Adjustment to Step 2.

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.

### Subtraction Method with “Lower of” Rule.

*Example:*[[29]](#footnote-30) 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 Treas. Reg. § 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:

Step 1: 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;

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

Step 3: 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.

Step 4: 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.

## Circumstances in Which Section 2701 is Inapplicable.

Section 2701 does not apply in the following circumstances:

### Same Class.

Section 2701 does not apply in circumstances 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, 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.[[30]](#footnote-31)

### Market Quotations.

Section 2701 does not apply if there are readily available market quotations on an established securities market for either the transferred interest or the retained interest;[[31]](#footnote-32) and

### 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[[32]](#footnote-33) (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).

## 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.[[33]](#footnote-34) However, 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.[[34]](#footnote-35)

#### 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 four-year grace period to actually make a payment is permitted;[[35]](#footnote-36)

##### 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; and[[36]](#footnote-37)

##### 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.[[37]](#footnote-38)

## 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 non-cumulative 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”:

##### *Extraordinary Payment Right*. The preferred interest retained by Mom gives her the ability to require the partnership to redeem her interest at any time, and return her investment contribution, which is considered an Extraordinary Payment Right.

##### *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 non-cumulative and is a fixed rate payment, but it is not required to be distributed at least annually.

##### *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.

# 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, as well as through trusts.[[38]](#footnote-39) 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 the attribution rules.

## 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.[[39]](#footnote-40) In the case of entities that hold interests in other entities, the attribution rules have provisions to apply a “tiered” attribution approach.[[40]](#footnote-41) An example is provided in the Treasury Regulations 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.*[[41]](#footnote-42)

## 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.[[42]](#footnote-43) 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.[[43]](#footnote-44) For example, if a 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, the attribution rules will treat X as having a 25% interest and Y as having a 90% interest in the Partnership (in the aggregate more than 100%); in each case the greater of the profit or capital percentage for each partner.

## Trust Attribution Rules.

The attribution rules under Section 2701 with respect to trusts are not as straightforward as the entity attributions rules. This is because there are different sets of attribution rules that can apply and can result in multiple attribution of an equity interest to more than one person, as well as a set of “tie-breaker” rules that can also apply to resolve such cases of multiple attribution.

A proper analysis of the trust attribution rules often involves a multi-step process. First, one must apply the “basic” trust attribution rules. Then, if the trust at issue is treated 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.

### The “Basic” Trust Rules.

It is often difficult to express a trust beneficiary’s interest in a trust with any degree 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 appears to be one of the underlying policy rationales for the above-referenced “basic” trust attribution rules, which generally provide that a person is treated as having a beneficial interest in a trust whenever they may receive distributions from the trust in exchange for less than full and adequate consideration.[[44]](#footnote-45) The basic rules also attribute the trusts equity interests among its beneficial owners to the extent that they may each receive distributions from the trust, and based on a presumption that a trustee’s discretion will be exercised in the beneficiary’s favor to the maximum extent permitted.[[45]](#footnote-46)

#### There is one exception to this rule: the equity interest held by the trust will not be attributed to a beneficiary who 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.[[46]](#footnote-47)

#### Ownership of an equity 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 Treasury Regulations provide that a trust’s equity interest may be fully-attributed to its remainder beneficiaries.[[47]](#footnote-48)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.

### The Grantor Trust Attribution Rules.

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.[[48]](#footnote-49)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.[[49]](#footnote-50)

### The Multiple Attribution Rules.

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 so-called “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 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: (1) whether the equity interest at issue is senior or subordinate; and (2) the generational status of particular persons in relation to the Transferor.

#### More specifically, if the above rules would otherwise attribute an “Applicable Retained Interest”[[50]](#footnote-51) to more than one person in a group consisting of the Transferor and all “Applicable Family Members,”[[51]](#footnote-52) then the multiple-attribution ordering rules re-attribute such Applicable Retained Interest in the following order:

##### 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);

##### to the Transferor of the Applicable Retained Interest;

##### to the spouse of the Transferor of the Applicable Retained Interest; or

##### pro rata among the Applicable Family Members.

#### By contrast, if the above rules would otherwise attribute a “subordinate equity interest” to more than one person in a group consisting of the Transferor, all Applicable Family Members and “members of the Transferor’s family,”[[52]](#footnote-53) then the multiple-attribution ordering rules attribute such subordinate equity interest in the following order:

##### to the transferee of the subordinate equity interest;

##### pro rata among members of the Transferor’s family;

##### 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);

##### to the Transferor of the subordinate equity interest;

##### to the spouse of the Transferor of the subordinate equity interest; or

##### pro rata among the “Applicable Family Members” of the Transferor of the subordinate equity interest.

#### 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.

# CARRIED INTEREST TRANSFER PLANNING AND SECTION 2701

Wealth transfer planning generally involves making a transfer of an asset (typically via gift, sale or a combination) that has appreciation potential in a manner so as to remove it from the grantor/parent's gross estate and hopefully allow post-transfer appreciation to occur outside of the estate in the hands of the next generation(s) or trusts for their benefit. Ideally, when selecting assets to transfer, the estate planner will want to identify assets that have the greatest potential for appreciation in the future and at the same time have characteristics that would support a current lower valuation, perhaps due to the uncertain or speculative nature of the asset and/or due to the fact that the target interest may be of a non-controlling nature. The gift tax is imposed based upon the fair market value of the assets on the date of transfer, and not on the subsequent appreciation. Therefore, if a taxpayer transfers an asset when it has a relatively low (or lower) value, for gift tax purposes the transfer will be considered to have been made at that lower value, regardless of the magnitude of post-gift appreciation. However, the potential for future growth of the asset will be a relevant factor that is taken into consideration by a valuation appraiser, as well as the IRS, in determining the current fair market value of that asset.

Estate planners often implement a variety of different techniques to “freeze” the value of the taxpayer’s estate by locking in, or “freezing” the value of an asset at its current value, while shifting the future appreciation potential into the hands of the recipients. These estate freeze techniques are generally effective from a transfer tax (i.e., estate, gift and generation-skipping taxes) standpoint when the actual rate of return on the assets transferred will exceed a “hurdle” rate – generally, the Section 7520 Rate or the Applicable Federal Rate, depending upon the type of vehicle used.

Because of the significant potential for future appreciation associated with carried interest in a private investment vehicle, an interests in the general partner of a fund are often considered good candidates for wealth transfer planning. Specifically, in a typical fund where, for instance, a 1% capital contribution by the fund general partner may be entitled to an allocation of 20% of the profits, (the "carried interest") there is great potential for the value of the general partner interest to grow, perhaps exponentially (throughout this outline, the entity that is the general partner of a fund, which receives the special profit allocation or carried interest is sometimes referred to as the "GP" and the donor/parent who decides to transfer that interest is sometimes referred to as the "Fund Principal"). If that growth occurs in an estate planning vehicle that is excluded from the Fund Principal’s estate, then this will result in a very transfer-tax efficient shift of future appreciation to or for the benefit of the next generation(s). If leverage is applied to the transaction, the planning becomes even more powerful potentially resulting in a much greater shift of appreciation particularly when interest rates are lower.

While there is nothing particularly unique about an interest in a private investment vehicle as an asset from a wealth transfer standpoint, for those practitioners who represent hedge or private equity fund clients in connection with gift planning with their carried interests, there are nonetheless a number of unique planning issues and pitfalls that must be carefully considered and navigated. These issues include the following:

### Gift tax valuation uncertainty issues and how to best address that uncertainty;

### Chapter 14 deemed gift issues under Section 2701 of the Internal Revenue Code (the "Code") and the so-called "Vertical Slice," as well as "Non-Vertical Slice" planning alternatives;

### Incomplete gift issues associated with vested and unvested interests and retained interests;

### Estate tax inclusion risks;

### Trust and Entity Attribution Rules under Section 2701; and

### Coordination issues with planning techniques and related pressure points.

## The Section 2701 Issue[[53]](#footnote-54)

Based on the legislative history surrounding 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 within a family held entity.[[54]](#footnote-55)

The problem for estate planners, however, is that the language of the statute is overly broad. Coupled with the draconian consequences in the event of its possible application, Section 2701 has thus become a major concern for estate planners representing hedge and private equity Fund Principals in connection with the transfer of carried interests.

### Deemed Gift Problem.

If Section 2701 were to apply to the transfer of a general partner interest (that receives a carried interest) in a fund, the Transferor may be deemed to have made a gift for gift tax purposes of not just the carried interest actually transferred, but, perhaps significantly more, of his or her interests in the fund (e.g., general partner interest and limited partner interest). Because a fund principal often invests a sizeable amount of capital into a fund as a limited partner (either directly or perhaps via his or her interest in the general partner) such a deemed gift could be problematic from a gift tax perspective – if the amount of the principal’s investment as a limited partner in the fund is large enough, the amount of the deemed gift could be dramatic and could cause a significant deemed gift tax liability; despite the fact that the principal had not actually transferred his or her limited partner interest nor intended to do so.

### The “Vertical Slice” Approach.

To date, the most elegant and straightforward solution adopted by the estate planning community in this area is to structure the transfer of the carried interest within the proportionality exception to the statute (colloquially referred to as making a so-called “Vertical Slice” transfer of all of the Transferor’s interests in the fund). Indeed, in the wealth transfer planning context, the term “carried interest” is rarely uttered without being followed by the words “Vertical Slice.”

Simply put, making a Vertical Slice transfer requires the Fund Principal who wishes to transfer a portion of his or her carried interest to his or her family members to proportionately transfer all of his or her other equity interests in the fund in order to avoid triggering a deemed gift.

#### The Vertical Slice exception to Section 2701 is provided for in Treas. Reg. § 25.2701-1(c)(4), which provides that “§ 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.”[[55]](#footnote-56)

#### For purposes of the Vertical Slice exception, it is interesting to note that the interests transferred by the Transferor are aggregated with any interests transferred simultaneously by the Transferor’s spouse, any ancestors of the Transferor and the Transferor’s spouse, and the spouses of any such ancestors. Thus, if a Transferor owned 100% of the common interests in an entity and only 25% of the preferred interests, with the other 75% of the preferred interests being owned by the Transferor’s parent, a transfer to a junior family member by the Transferor of 50% of the common interests and 25% of the preferred interests could be aggregated with an additional transfer of 25% of the preferred interests by the Transferor’s parent to satisfy the Vertical Slice exception.

#### The logic behind this exception, presumably, is that by making a Vertical Slice transfer parent has reduced every equity interest in the fund on a pro-rata basis, consequently, the opportunity to disproportionately shift wealth to the next generation, through the retention of some artificially inflated equity interests and the transfer of an artificially depressed different interest, does not exist. Instead, the Vertical Slice results in the younger generation and parent sharing proportionally in the future growth, or decrease, in value, of the fund and thus prevents a shift in value away from the parent to the younger generation by way of the non-exercise of discretionary rights.

### Limitations of the Vertical Slice Approach.

While this approach has the advantage of being relatively straightforward to implement and easiest conceptually to digest, it often prevents the client from fully achieving his or her wealth transfer objectives. The problem is that very often the principal wants to transfer all or most of his or her carried interest but only some or none of his or her limited partner interest, for both economic reasons (Transferor wants to retain some portion of his or her capital investment in the fund) and gift tax reasons (Transferor does not want to make a taxable transfer of high-value assets). Because a disproportionate transfer does not fit within the Vertical Slice exception, fund principals are frequently advised to transfer a smaller percentage of the general partner interest so that a proportional limited partner interest can be transferred in compliance with the Vertical Slice exception without triggering a deemed gift.[[56]](#footnote-57)

## Achieving “Verticality”

### Individual Slices.

If the client desires to make a transfer of his or her fund interests using the Vertical Slice approach, verticality can be achieved in a number of different ways. First, the Vertical Slice could be achieved by making a transfer of a proportionate interest of each interest that the client has in the fund and related entities. For instance, the Fund Principal could make a transfer of his interest in the GP (including a proportional transfer of the capital and profits interest), and a proportional LP interest in the fund in such a way that reduces his interest in each of these entities, separately, by the same percentage (e.g., a 25% reduction across the board). This approach can be quite involved and cumbersome, however, and may provide a greater chance of this proportional ownership being disrupted in the future after the initial transfers are made; and the resulting risk of such an event potentially constituting a subsequent “transfer” for Section 2701 purposes at that time. Also, to the extent that additional transfers are desired in the future, further transfers would again need to be coordinated with fund counsel and perhaps require additional approvals or other compliance aspects to be addressed, not to mention a new Section 2701 analysis at that time.

### Holding Entity to Achieve Verticality.

Another method of achieving verticality may be through the implementation of a holding vehicle such as a limited partnership or an LLC (referred to in this outline as “Vertical Slice Holding Entity”). In this instance, the Fund Principal would transfer some or perhaps all of his interest in all the entities related to the Fund as an initial capital contribution into Vertical Slice Holding Entity, which would be structured as a single class entity. Subsequently, Fund Principal would make a transfer of an interest in Vertical Slice Holding Entity to child or perhaps a trust for child’s benefit. By placing the ownership of the fund entity interests within Vertical Slice Holding Entity, a gift of a Vertical Slice may be achieved in a more streamlined fashion by way of a simple transfer of a percentage ownership interest in the holding entity. In addition, going forward, this will ensure that the same proportional ownership is maintained. Further transfers in the future could be achieved by making additional transfers of interests in the Vertical Slice Holding Entity. Additionally, these should not require an additional round of approvals, qualifications and/or consents at the fund level, as what would be transferred would be interests in Vertical Slice Holding Entity, rather than interests in the fund entities.

### Getting Cut by a Bad Vertical Slice.

As noted above, Section 2701 is a very thorny and draconian provision that can apply in a number of situations, even where it might seem that no gift tax intention or implications would exist. To complicate matters even further, within the context of Vertical Slice planning, it is possible, due to the exceptionally broad and hyper-technical provisions of the statute, that a Fund Principal could, after consideration of all the options, decide and fully intend to make a Vertical Slice transfer, yet still unintentionally violate Section 2701.

Section 2701 applies when a transfer has been made by the Transferor to a Member of the Transferor’s Family, after which time the Transferor or an Applicable Family Member retains an Applicable Retained Interest. In the context of carried interest transfer planning, if, for instance, the Fund Principal makes a Vertical Slice transfer of a percentage of some or all of his interests in the fund entities to his children or their trusts, but the Fund Principal’s parent or the Fund Principal’s spouse’s parent, both of whom are Applicable Family Members, continues to own an interest in the LP, then the deemed gift tax rules under Section 2701 could still be implicated. This is because the Fund Principal, as the Transferor, has made a transfer of an interest (albeit an attempted Vertical Slice transfer of his interests); however, the Transferor’s parent or in-law, who is also an Applicable Family Member, has retained a limited partnership interest in the fund, which could be the retention of a Distribution Right and, therefore, an Applicable Retained Interest, subject to the zero valuation rule.

When analyzing this issue, it is also critical to consider the attribution rules under Section 2701, as discussed in Section V above.

The long and short of the analysis is that, even when attempting to apply this more straightforward Vertical Slice approach, it is extremely important that the practitioner be mindful of these technical rules and how they may thwart an otherwise intended Vertical Slice transfer.

## Section 2036 Implications with Vertical Slice Holding Entity Approaches

The creation of a Vertical Slice Holding Entity to achieve a Vertical Slice can be an efficient way to address the Section 2701 issue in the context of carried interest transfer planning. However, the creation of a holding entity to achieve such verticality also presents unique issues that should be considered under Section 2036(a). The IRS has had a history of challenging the funding and subsequent transfer of interests in so-called family limited partnerships under a number of different theories; the most notable and successful of these challenges being under Section 2036(a)(1) as a transfer with retained interest and to a lesser extent under 2036(a)(2) as a transfer with retained control. While the typical so-called “FLP” that the Service has challenged has often involved entities formed for much different reasons than a Vertical Slice Holding Entity contemplated herein, nonetheless, the creation of an entity with subsequent transfers of interests should be examined in this light. Even in the event that an argument could be sustained that Section 2036(a) applied to the capitalization of Vertical Slice Holding Entity, the consequence would be blunted by Section 2043, which would provide a partial estate tax offset to the extent that adequate and full consideration was paid to the decedent.

In a number of cases the IRS has been able to successfully argue that Section 2036(a)(1) applied to cause inclusion in a decedent’s gross estate of assets that he or she contributed into an FLP (despite the fact that the decedent may have transferred those partnership interests out of his name prior to his death) under the theory that the decedent transferred assets into the FLP subject to an implied understanding that he would continue to have enjoy of those assets until his death.

## The Bona fide Sale Exception

One possible way to avoid the application of Section 2036(a)(1) and Section 2036(a)(2) altogether is to satisfy the “bona fide sale” exception to that section. In the context of creating a Vertical Slice Holding Entity, if the Fund Principal’s initial capital contribution to the entity is considered to be a “bona fide sale” for “adequate and full consideration” then Section 2036 is not applicable. If this exception is satisfied, then, as a technical matter, the retained “control” issue under Section 2036(a)(2) as well as any “implied understanding” issues under Section 2036(a)(1) should not be an issue, because the application of Section 2036 to the transfer of assets into the entity should be “off the table.” This exception, however, is not simple to satisfy, and, in practice, it appears that the analysis of the courts of whether a decedent’s contribution of assets into a partnership constituted a bona fide side for adequate and full consideration appears, at least in part, to be somewhat intertwined with a determination as to whether an “implied understanding” existed under Section 2036(a)(1). Indeed, in only one case on this issue did the Court first determine that the bona fide sale exception was not satisfied, but nevertheless next determined that there was not an implied understanding under Section 2036(a)(1).[[57]](#footnote-58) In all of the other relevant cases, once it was determined that the bona fide sale exception was not satisfied, the court further went on to determine that an implied understanding existed so as to cause estate tax inclusion under Section 2036(a)(1).

The cases on this issue have made clear that in order to avoid the application of Section 2036(a) under the “full and adequate consideration” exception, there must exist both “adequate and full consideration” and a “bona fide sale.”[[58]](#footnote-59) A legitimate business purpose and/or substantial non-tax purposes is required to establish that a “bona fide sale” existed. On this point, while family transactions may satisfy this standard, they are generally subject to a greater level of scrutiny.[[59]](#footnote-60)

What is clear from the jurisprudence over approximately the past 20 years in the family limited partnership arena is that to the extent that it can be shown that the initial transfer of assets by the parent into a family limited partnership or limited liability company in connection with the initial capitalization constitutes a “bona fide sale for adequate and full consideration,” then such will satisfy the exception to the application of Section 2036(a) and the assets transferred (the Fund entity interests) into the entity (in this context, the Vertical Slice Holding Entity), will not be included in the gross estate of the decedent. The case law that has come out over the past 15 years has clarified that in order to satisfy this exception, there must be a showing by the estate that the transfer of assets into the entity was made in furtherance of a legitimate business purpose and/or substantial and non-tax purposes. Thus, in the context of fund carried interest planning, if it can be demonstrated that the capital contribution of fund entity interests into the Vertical Slice Holding Entity was made in furtherance of a legitimate and significant non-tax business purpose, this should eliminate the Section 2036 estate tax exposure.

Historically, FLP vehicles have been created for a number of reasons. However, they have typically provided some estate or gift tax advantages in the form of potential for valuation discounts. A Vertical Slice Holding Entity created for purposes of creating an efficient and streamlined approach to comply with the Vertical Slice exception to Section 2701 and provide a vehicle to continue to be used in the future for such purposes without having to go through the compliance and approval process in the future would appear to provide a meaningful distinction from a “garden variety” FLP. Of course, one of the downsides with attempting to rely upon the bona fide sale exception is that there is no way to actually determine with any degree of certainty whether this exception to Section 2036(a) has been satisfied or not satisfied; that is, until the Fund Principal has passed away and the estate is in the midst of an estate tax audit and is arguing that Section 2036(a) does not apply because of the satisfaction of this exception.

# Preferred Partnership Approach to Carried Interest Transfer Planning**[[60]](#footnote-61)**

As previously noted, the Vertical Slice exception is not the only statutory way to comply with Section 2701. There are a number of other ways that Fund entity interests 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 the parental retention of certain mandatory and quantifiable interests.[[61]](#footnote-62)

In other circumstances, the Treasury Regulations also acknowledge that if a parent has not retained certain types of suspect interests in the entity, then the zero valuation rule likewise should not apply. For example, the zero valuation rule does not apply if the parent transfers interests of the same class as those retained. This “same class” exception offers trust and planners yet another way to avoid the zero valuation rule. It is within these various other exceptions that the authors suggest that additional planning opportunities may exist with respect to the transfer of carried interests. These potential opportunities exist not as a replacement of the Vertical Slice approach, but as other approaches to consider when structuring carried interest transfers.

## Non-Vertical Holding Entities

Non-Vertical Holding Entity approaches involve the creation of a family holding entity such as an LLC or a limited partnership, into which the parent would first contribute all of his 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. The same class exception is provided under Treas. Regs. § 25.2701-1(c)(3), which states that "§ 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."

### Mandatory Payment Right Holding Entity.

In the first variation, the parent would contribute his 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 of the upside beyond the amount needed to repay the preferred interest holder. The parent would then transfer some or all of the common interests to younger generational 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. Regs. § 25.2701-2(b)(4). Treas. Regs. § 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.

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

### Qualified Payment Right Holding Entity.

Same class exception with qualified payment right (QPR). A QPR 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." 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 QPR 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.

Since a QPR 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. Regs. § 25.2701-1(a)(2)(ii) exempts a QPR 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 can't 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. 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 didn't apply, the parent may still be treated as making a partial gift in excess of the FMV 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 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 shouldn't trigger Section 2701. (Note, however, that no Extraordinary Payment Rights should be held by parent.)

### Holding Entity with Debt.

Same class exception 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 and not debt, the parent's gift of LLC equity interests shouldn't 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 could still qualify as a mandatory payment right and not be subject to zero valuation.

### 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 wouldn't be satisfied. Treas. Regs. § 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.

#### Structuring the Non-Vertical Holding Entity

The three Non-Vertical Holding Entity approaches discussed essentially rely upon the creation of some form of a Preferred Partnership holding vehicle created within the statutory confines of Section 2701 and the exceptions thereunder. Such interests are preferred vis-à-vis the common interests in that they have priority over the common interests with respect to the payment of a fixed coupon on the holder’s investment and in the event of a bankruptcy. They do not, however, participate in the upside growth of the partnership as all the future appreciation in excess of the preferred coupon inures to the benefit of the other class, the common class, of partnership interests, typically held by the younger generation or trusts for their benefit. The preferred interests are usually held by a senior generation family member.

#### Valuation of the Preferred Coupon

Even if the Parent’s preferred interest is properly structured to avoid the potentially draconian aspects of Section 2701, there are still deemed gift issues to consider as the foregoing structuring merely ensures that the Fund Principal's preferred interest is not valued at “zero” for purposes of determining Fund Principal’s gift to younger generation family members. There may still be a partial gift under traditional valuation principals if the Fund Principal’s retained preferred coupon is less than what it would have been in an arms’-length situation. For example, if the Fund Principal’s retained coupon under the partnership agreement is a 5% coupon but a 7% return would be required in an arms’-length transaction then a deemed gift has still been made by the Parent to the extent of the shortfall; albeit not as potentially dramatic a gift as would occur by violating Section 2701.

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 parent to receive value equal to par value 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. The starting point under this guidance is to analyze comparable preferred interest returns on high quality publicly-traded securities. Additional factors for consideration include the security of the preferred coupon, the size and stability of the partnership’s earnings, asset coverage, management expertise, business and regulatory environment and any other relevant facts or features of the Preferred Partnership. The 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 partnership, will impact the required coupon. A higher percentage of the partnership interests being preferred interests, and correspondingly less common interests, puts greater financial pressure on the 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. Conversely, a 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 interests.

# Proactive Planning with Section 2701 and Preferred “Freeze” Partnerships.[[62]](#footnote-63)

Preferred Partnerships are often referred to as “Freeze Partnerships” because such partnerships effectively “freeze” the return of one class of partnership interests at a fixed rate. Such interests are preferred relative to the common interests in that they have priority over the common interests with respect to the payment of a fixed coupon on the holder’s investment and up liquidation of the entity. They do not, however, participate in the upside growth of the partnership as all the future appreciation in excess of the preferred coupon and liquidation preference inures to the benefit of the common “growth” class of partnership interests, typically held by the younger generation or trusts for their benefit. The preferred interests are typically held by the senior generation family member.

### Structuring the Preferred Interest.[[63]](#footnote-64)

A parent’s Preferred Partnership interest is typically structured as a “qualified payment right” in accordance with Section 2701 to prevent the parent’s contribution of assets to the Preferred Partnership from being a deemed gift under the Section 2701 “zero valuation” rule. To be a qualified payment right, the parent generally must receive a fixed percentage payment on his or her capital contribution, payable at least annually and on a cumulative basis. The use of this “qualified payment right” structure will result in the parent’s preferred interest being valued under traditional valuation principles for gift tax purposes, and not the unfavorable “zero valuation rules” of Section 2701.

#### Typically, the preferred interest would also provide Parent with a priority liquidation right in addition to the preferred coupon; meaning that upon liquidation, parent will first receive a return of his or her capital before the common interest holders receive their capital. Parent, however, will not receive any of the potential upside growth in the Preferred Partnership above his or her preferred interest.[[64]](#footnote-65) Anything in excess of the amount needed to pay the preferred coupon will accrue to the benefit of the common interest holders (*i.e.*, child, or trust for the child’s benefit).

### Valuation of the Preferred Coupon.

Even if the parent’s preferred interest is properly structured to avoid the draconian aspects of Section 2701, there are still deemed gift issues to consider as the foregoing structuring merely makes the parent’s distribution right component of the preferred interest not valued at “zero” for purposes of determining parent’s deemed gift to younger generation family members. However, there may still be a partial gift under traditional valuation principals if the parent’s retained preferred coupon is less than what it would have been in an arm’s -length situation. For example, if the parent’s retained coupon under the partnership agreement is a 5% coupon but a 7% return would be required in an arm’s-length transaction then a deemed gift has still been made by the parent to the extent of the shortfall; albeit not as dramatic a gift as would occur by violating Section 2701.

#### 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 parent to receive value equal to par value for his or her capital contribution. In preparation of the appraisal the appraiser should take into account the factors set forth by the IRS in Revenue Ruling 83-120.[[65]](#footnote-66) The starting point under this guidance is to analyze comparable preferred interest returns on high quality publicly-traded securities. Additional factors for consideration include the coverage of the preferred coupon and liquidation preference, the size and stability of the partnership’s earnings, asset coverage, management expertise, business and regulatory environment and any other relevant facts or features of the Preferred Partnership.

#### The 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 partnership, will be important factors in determining the required coupon. A higher percentage of the partnership interests being preferred interests, and correspondingly less common interests, puts greater financial pressure on the 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. Conversely, a 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 interests.

## 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 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 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.[[66]](#footnote-67)

## Structuring the Preferred Interest.[[67]](#footnote-68)

### 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.[[68]](#footnote-69) 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.[[69]](#footnote-70)

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.[[70]](#footnote-71) 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.[[71]](#footnote-72)

### 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, Senior Family Member will receive a return of his or her capital before the common interest holders receive a return of their capital. 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.[[72]](#footnote-73) 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).

## 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.[[73]](#footnote-74)

## 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.

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.[[74]](#footnote-75) 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.

##### 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.

##### 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.[[75]](#footnote-76)

## 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.[[76]](#footnote-77) 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 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).[[77]](#footnote-78)

## 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 takes into account a number of factors (not necessarily related to preferred equity specifically, but rather, equity interests in general), such as:[[78]](#footnote-79)

"(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

(xv) the intent of the parties."

Unfortunately, there is no black and white 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.

## 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 limited partnership or non-voting interests in the Freeze Partnership, rather than general partner or voting interests in order to address the Section 2036(a)(2) “retained control” issue.[[79]](#footnote-80)

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.[[80]](#footnote-81) 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.

#### Ensure the preferred coupon does not match anticipated partnership annual income.[[81]](#footnote-82)

#### Recall that Section 2701 does permit a four-year deferral for a qualified payment right preferred coupon payment.[[82]](#footnote-83)

#### A preferred payment can be satisfied through the issuance of a promissory note with a term no longer than four years.[[83]](#footnote-84)

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 partners’ 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 non-tax 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.

# REVERSE FREEZE PARTNERSHIP

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

## 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 prevents the Senior Family Member’s interest from being a “distribution right” subject to the zero valuation rule under Section 2701.[[84]](#footnote-85) 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.[[85]](#footnote-86)

## 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.

# FREEZING A QTIP TRUST.

## 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 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.[[86]](#footnote-87)

## 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 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 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 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.

# GRAT ETIP ISSUE: PREFERRED PARTNERSHIP GRAT. [[87]](#footnote-88)

## The ETIP Issue.

The general inability to allocate generation skipping transfer (“GST”) tax exemption to a GRAT is another negative planning aspect, as it effectively prevents practitioners from structuring GRATs as multi-generational, GST-Exempt trusts, in a tax-efficient manner. 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. If the grantor were to die during the annuity term, a portion of the GRAT assets would be included in his or her estate. 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 would be little if any ability to leverage the grantor’s GST exemption with a GRAT. 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 trust’s assets, and therefore would be an inefficient use of GST exemption. As a result, GST exemption is very often not allocated to a trust remaining at the expiration of a GRAT annuity term; as a consequence, such assets will typically be subject to estate tax at the death of the second generation beneficiaries or will be subject to a GST tax upon a GST event at the second generation’s death.

## Preferred Partnership GRAT to address ETIP Issue.

The creation of a “Preferred Partnership GRAT,” which involves the combination of a statutory GRAT with a statutory Preferred Partnership, 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 and, perhaps even containing the amount of potential estate tax inclusion if the grantor dies during the GRAT term. This technique dovetails the planning advantages of the Preferred Partnership with those of a GRAT by combining these two statutorily mandated techniques.

With this technique, parent could create a Preferred Partnership, initially owning both common “growth” and preferred “frozen” interests. Thereafter, the parent would make gift transfers of preferred interest to a long-term Zeroed-Out GRAT, which would not trigger any gift taxes. Parent would also create a GST-Exempt trust into which parent would make taxable gifts of common interests, and would allocate GST exemption. The GRAT would be structured so that the preferred payments made annually to the GRAT would be sufficient to satisfy its annuity payments to the grantor. The GST-Exempt trust owning the common interests would receive all growth above the preferred coupon payable to the GRAT. At the end of the GRAT term, if the parent is living, the GRAT remainder would be distributed to the remainder beneficiaries, however these assets would have been “frozen” to the amount of the liquidation preference and the coupon (as this would be payable in a non GST-Exempt manner). Any appreciation above the coupon will exist in the common interests held by the GST-Exempt trust.

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. However, because the common “growth” interest would never have been held in the GRAT, but, rather, it was obtained by the GST-Exempt trust via initial capital contribution, the grantor’s death during the annuity term would become irrelevant with respect to the appreciated common interests.

## "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 payments paid by the Freeze Partnership to the GRAT). That is, each time that the parent receives his or her GRAT payment(s), 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.

# 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.[[88]](#footnote-89)

## 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 non**-**cumulative 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 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."[[89]](#footnote-90) 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.[[90]](#footnote-91) The non-cumulative 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.

## Maximizing the Value of DSUE in the Case of Multiple Deceased Spouses[[91]](#footnote-92)

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. [[92]](#footnote-93) 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.[[93]](#footnote-94) 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 structuring the preferred interests to comply with the terms of Section 2701, would either be structured to intentionally violate those terms (perhaps by making the preferred payments non-cumulative) 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.

## 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, etc.) 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. § 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.

# 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 non-tax 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/she still continues to own. In other words, the application of Section 2701 could be to 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.

## 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 ten shares of common stock), but also capital contributions, redemptions, recapitalizations, or other changes in the capital structure of an entity.[[94]](#footnote-95)

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.[[95]](#footnote-96) 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:

### 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.[[96]](#footnote-97)

### Applicable Retained Interests

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.

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 include 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).

### “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 their 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.”[[97]](#footnote-98)

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).[[98]](#footnote-99)

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.[[99]](#footnote-100)

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.”[[100]](#footnote-101) 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.

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 so as 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.

### 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.[[101]](#footnote-102)

### Section 2701 Applied to Profits Interests Held by Junior Family Member

In 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. § 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.[[102]](#footnote-103)

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 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.[[103]](#footnote-104)) 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.[[104]](#footnote-105)

### 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.

### 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.[[105]](#footnote-106) 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.

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 organization.     [↑](#footnote-ref-2)
2. The Internal Revenue Code of 1986, as amended, is hereafter referred to as the “Code.” Unless otherwise indicated, each reference to a “section” is a reference to a section of the Internal Revenue Code of 1986; and each reference to “Treas. Reg. §” is a reference to a regulations section. The “IRS” or the “Service” means either or both the US Department of the Treasury and Internal Revenue Service, as the context may require. [↑](#footnote-ref-3)
3. 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 IRC 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 (Practicing Law Institute, 2d ed. 2011). [↑](#footnote-ref-4)
4. *See* Code Section 2701. [↑](#footnote-ref-5)
5. *See* Code Section 2702. [↑](#footnote-ref-6)
6. *See* Code Section 2704(a). [↑](#footnote-ref-7)
7. Manning on Estate Planning, 10-67 (Practicing Law Institute, 5th ed. 1995). [↑](#footnote-ref-8)
8. Treas. Reg. § 25.2701-1(b)(2)(i). [↑](#footnote-ref-9)
9. Treas. Reg. § 25.2701-2(a)(1) & (2). [↑](#footnote-ref-10)
10. Treas. Reg. § 25.2701-1(b)(2)(i). [↑](#footnote-ref-11)
11. Code Section 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. [↑](#footnote-ref-12)
12. Code Section 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. [↑](#footnote-ref-13)
13. Treas. Reg. § 25.2701-1(a)(2). [↑](#footnote-ref-14)
14. Treas. Reg. § 25.2701-2(b)(2). [↑](#footnote-ref-15)
15. Treas. Reg. § 25.2701-2(b)(3). [↑](#footnote-ref-16)
16. Code Section 2701(b)(2)(B). [↑](#footnote-ref-17)
17. Code Section 2701(b)(2)(A). [↑](#footnote-ref-18)
18. I.R.S. CCA 201442053 (Oct. 17, 2014). [↑](#footnote-ref-19)
19. 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). [↑](#footnote-ref-20)
20. 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). [↑](#footnote-ref-21)
21. 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). [↑](#footnote-ref-22)
22. Treas. Reg. § 25.2701-2(b)(6)(i). [↑](#footnote-ref-23)
23. Treas. Reg. § 25.2701-2(a)(3). [↑](#footnote-ref-24)
24. Code Section 2701(a)(4)(A). [↑](#footnote-ref-25)
25. Treas. Reg. § 25.2701-2(b)(4)(i). [↑](#footnote-ref-26)
26. Treas. Reg. § 25.2701-2(b)(4)(ii). [↑](#footnote-ref-27)
27. Treas. Reg. § 25.2701-2(b)(4)(iii). [↑](#footnote-ref-28)
28. Treas. Reg. § 25.2701-2(b)(4)(iv). [↑](#footnote-ref-29)
29. Treas. Reg. §25.2701-3(d), Ex. 1. [↑](#footnote-ref-30)
30. Code Section 2701(a)(2)(B); Treas. Reg. § 25.2701-1(c)(3). [↑](#footnote-ref-31)
31. Code Section 2701(a)(2)(A); Treas. Reg. § 25.2701-1(c)(1) & (2). [↑](#footnote-ref-32)
32. Code Section 2701(a)(2)(C); Treas. Reg. § 25.2701-1(c)(4). [↑](#footnote-ref-33)
33. Treas. Reg. § 25.2701-2(c)(2). [↑](#footnote-ref-34)
34. Treas. Reg. § 25.2701-2(c)(5). [↑](#footnote-ref-35)
35. Treas. Reg. § 25.2701-4(c)(5). [↑](#footnote-ref-36)
36. *Id.* [↑](#footnote-ref-37)
37. *See* Treas. Reg. § 25-2701-4(c). [↑](#footnote-ref-38)
38. Treas. Reg. § 25.2701-6. [↑](#footnote-ref-39)
39. 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.* [↑](#footnote-ref-40)
40. *Id.* [↑](#footnote-ref-41)
41. Treas. Reg. § 25.2701-6(b), Ex. 1. [↑](#footnote-ref-42)
42. Treas. Reg. § 25.2701(a)(2). [↑](#footnote-ref-43)
43. Treas. Reg. § 25.2701-6(a)(3). [↑](#footnote-ref-44)
44. Treas. Reg. § 25.2701-6(a)(4)(ii)(B). [↑](#footnote-ref-45)
45. 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. [↑](#footnote-ref-46)
46. *Id.* [↑](#footnote-ref-47)
47. *Id.* [↑](#footnote-ref-48)
48. Treas. Reg. § 25.2701-6(a)(4)(ii)(C). [↑](#footnote-ref-49)
49. Treas. Reg. § 25.2701-1(b)(2)(C)(1). [↑](#footnote-ref-50)
50. See discussion in Part II, Section D, above. [↑](#footnote-ref-51)
51. See discussion in Part II, Section C, above. [↑](#footnote-ref-52)
52. See discussion in Part II, Section C, above (and note that “Applicable Family Member” and “member of the Transferor’s family” have different meanings). [↑](#footnote-ref-53)
53. For a more detailed discussion of the possible application of Section 2701 in the context of estate planning with carried interests, *see generally* N. Todd Angkatavanich & 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*”]. [↑](#footnote-ref-54)
54. 136 Cong. Rec. S15629, S15681 (Oct. 18, 1990). [↑](#footnote-ref-55)
55. Treas. Reg. § 25.2701-1(c)(4). [↑](#footnote-ref-56)
56. While beyond the scope of this outline, it is important to note that some uncertainty exists as to whether the fund principal’s interest in the management company should also be included when making a transfer of a Vertical Slice of all of his or her equity interests in the fund. 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. Arguably, an interest in the management company should not considered to be an “equity interest” in the fund since typically the relationship between the fund and the management company is more of a contractual arrangement to be paid a percentage of assets under management as a fee.

    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 address the application of Section 2701 in the context of carried interest planning. There are other exceptions as set forth in the statute and techniques that have been developed that might be considered, each of which have their relative pros and cons. *See* *generally*, Angkatavanich & Stein, *Going Non-Vertical*, *supra* note 47. [↑](#footnote-ref-57)
57. *Kelly v. Comm’r*, T.C. Memo. 2012-73. See: Akers, *Estate Planning Current Developments and Hot Topics*, December 2012. [↑](#footnote-ref-58)
58. *Thompson v. Comm’r*, T.C. Memo 2002-246 (Sept. 26, 2002), aff’d 382 F.3d 367 (3d Cir. 2004); *Strangi v. Comm’r*, T.C. Memo. 2003-145 (May 20, 2003). [↑](#footnote-ref-59)
59. *Stone v. Comm’r*, T.C. Memo. 2003-309 (Nov. 7, 2003); *Bongard v. Comm’r*, 124 T.C. 95 (2005). [↑](#footnote-ref-60)
60. This section of this outline is descriptive of Angkatavanich & Stein, *Going Non-Vertical*. [↑](#footnote-ref-61)
61. 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 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. [↑](#footnote-ref-62)
62. 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 [↑](#footnote-ref-63)
63. For a more detailed discussion of planning with Preferred Partnerships, *see generally* N. Todd Angkatavanich & Edward A. Vergara, *Preferred Partnership Freezes: They Come in Different “Flavors” and Provide a Menu of Creative Planning Solutions*, Tr. & Est. (May 2011). [↑](#footnote-ref-64)
64. Typically, the parent will also receive a 1% common interest to make his or her preferred interest not re-characterized as debt. Such common interest would participate by its terms in any upside experienced by the Preferred Partnership. [↑](#footnote-ref-65)
65. Rev. Rul. 83-120, 1983-2 C.B. 170. [↑](#footnote-ref-66)
66. Treas. Reg. § 25.2701-1(b)(2)(i). [↑](#footnote-ref-67)
67. For a more detailed discussion of related technical rules, see *infra* Section IX. *See also,* N. Todd Angkatavanich & Edward A. Vergara, *Preferred Partnership Freezes: They Come in Different “Flavors” and Provide a Menu of Creative Planning Solutions*, Tr. & Est. (May 2011). [↑](#footnote-ref-68)
68. Section 2701(c)(3)(A). [↑](#footnote-ref-69)
69. Treas. Reg. § 25.2701-2(a)(2). [↑](#footnote-ref-70)
70. Section 2701(d)(2)(C). [↑](#footnote-ref-71)
71. Section 2701(d)(2)(A)(i). [↑](#footnote-ref-72)
72. 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. [↑](#footnote-ref-73)
73. Treas. Reg. § 25.2701-1(a)(2). [↑](#footnote-ref-74)
74. Rev. Rul. 83-120, 1983-2 C.B. 170. [↑](#footnote-ref-75)
75. On August 2, 2016, the Department of the Treasury issued proposed regulations under Sections 2704 and 2701 that are expected to have a significant impact on the valuation of family controlled entities. 81 Fed. Reg. 51413 (Reg. 163113-02) Aug. 4, 2016. Taken in conjunction with Rev. Rul. 83-120, these proposed regulations could arguably be read as having the potential to improve coupon coverage for certain Freeze Partnerships, thereby reducing the required preferred payment. However, at the time of writing this outline, the proposed regulations have not been finalized and it remains to be seen what (if any) impact they will have on the valuation of Freeze Partnerships. [↑](#footnote-ref-76)
76. Treas. Reg. § 25.2701-1(a)(2)((i). [↑](#footnote-ref-77)
77. Treas. Reg. § 25.2701-2(a)(3). [↑](#footnote-ref-78)
78. 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). *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). [↑](#footnote-ref-79)
79. *See generally*, Douglas K. Freeman & 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). [↑](#footnote-ref-80)
80. *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 percent 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." [↑](#footnote-ref-81)
81. *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"). [↑](#footnote-ref-82)
82. Section 2701(d)(2)(C). [↑](#footnote-ref-83)
83. 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. [↑](#footnote-ref-84)
84. Treas. Reg. § 25.2701-2(b)(3)(i). [↑](#footnote-ref-85)
85. Treas. Reg. § 25.2701-2(b)(2). [↑](#footnote-ref-86)
86. 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). [↑](#footnote-ref-87)
87. N. Todd Angkatavanich & Karen E. Yates, *The Preferred Partnership GRAT: A Way Around the ETIP Issue?*, 35 ACTEC J. 290 (2009). [↑](#footnote-ref-88)
88. 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 Christoher Pegg and Nicole Seymour, *Rethinking I.R.C. § 2701 in the Era of Large Gift Tax Exemptions*, 87 Fl. Bar J. 9 (Nov. 2013). [↑](#footnote-ref-89)
89. Treas. Reg. § 25.2701-5(a)(3). [↑](#footnote-ref-90)
90. Treas. Reg. § 25.2701-5(d)(3), Ex. 2. [↑](#footnote-ref-91)
91. Section 2010(c)(2). *See generally,* Gooen & Snow, *Tasty Freeze*, *supra* note 85. [↑](#footnote-ref-92)
92. *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." [↑](#footnote-ref-93)
93. Reg. 20.2010-3(b). [↑](#footnote-ref-94)
94. Treas. Reg. § 25.2701-1(b)(2)(i). [↑](#footnote-ref-95)
95. Treas. Reg. § 25.2701-2(a)(1) & (2). [↑](#footnote-ref-96)
96. Treas. Reg. § 25.2701-1(b)(2)(i) [↑](#footnote-ref-97)
97. 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 percent of either the capital interest or the profits interest in the partnership.” Treas. Reg. § 25.2701-2(b)(5). [↑](#footnote-ref-98)
98. 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.” [↑](#footnote-ref-99)
99. Treas. Reg. § 25.2701-2(b)(3)(i). [↑](#footnote-ref-100)
100. Treas. Reg. § 25.2701-3(a)(2)(ii) and (iii) [↑](#footnote-ref-101)
101. Treas. Reg. § 25.2701-1(a)(2) [↑](#footnote-ref-102)
102. 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). [↑](#footnote-ref-103)
103. 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). [↑](#footnote-ref-104)
104. 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). [↑](#footnote-ref-105)
105. Treas. Reg. § 25.2701-6. [↑](#footnote-ref-106)