Deconstructing Different Flavored Freezes: A Comparison of Popular Estate Freeze Techniques

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I. INTRODUCTION

This outline is intended to provide an overview of some of the most popular types of "estate freeze" transactions, and provide some historical context, technical discussions, practical applications and relative pros and cons of the different techniques. As a general proposition, all estate freeze transactions do share some common characteristics in that these transactions generally involve a senior generation family member (sometimes referred to as "Senior Family Member") making some form of a transfer of an asset and receiving back a type of cash-flow interest (e.g., a promissory note, a fixed annuity interest, or a preferred payment).

There are different "flavors" of freeze transactions that are employed to achieve this trade-off of interests in different ways, and there are relative pros and cons that are associated with different types of freezes. These transactions can be very advantageous from an estate planning standpoint in that they can provide a means to provide a more stable priority cash-flow interest to the Senior Family Member while shifting potential future growth above that cash-flow interest to or for the benefit of junior generation family members (sometimes referred to as "Junior Family Member(s)"), or perhaps trusts for their benefit. Thus, all of these freeze transactions involve some balancing of risk versus reward, which may fit nicely with the relative risk appetite and investment horizon of different family members.

These transactions are broadly referred to as "estate freezes" because the Senior Family Member's "cash-flow" interest will be limited to the specific type of interest received; but those interests will not participate in future growth potential above a fixed hurdle. The other interests, typically held by the Junior Family Members, will participate in the upside growth potential of the transferred asset. Thus, the Senior Family Member's interest is "frozen" for estate tax valuation purposes. Beyond this broad theme, the different techniques often implemented by planners will vary and will have relative pros and cons. It is the opinion of the author that there is not necessarily a superior freeze technique, but rather, the most appropriate technique in a certain client situation will be dependent upon a balancing of a number of factors, including cash-flow needs, investment horizon, appetite for certainty versus uncertainty and complexity, desired rate of return, and multigenerational considerations.

This outline will discuss some of the most popular freeze techniques: Grantor Retained Annuity Trusts (or “GRATs”), Sales to Intentionally Defective Grantor Trusts (“IDGTs”), and Preferred Partnerships. Finally, this outline will discuss some of the relative pros and cons that practitioners should consider when evaluating these different techniques in different client situations as well as practical applications.

II. GRANTOR RETAINED ANNUITY TRUSTS (GRATs)

A. GRATs Generally

A GRAT is a statutorily blessed vehicle under Section 2702, which can provide a means to essentially make a gift tax-free transfer of the future appreciation (above

the Section 7520 interest rate) of a gifted asset without triggering any gift tax.[2] This is accomplished by the transfer of assets by a Senior Family Member into an irrevocable trust, called a Grantor Retained Annuity Trust, or GRAT, which provides a mandatory stream of annuity payments to him or her for a selected term of years, with any remaining balance passing typically to or for the benefit of Junior Family Members. If the grantor survives the selected term of years, upon the termination of the annuity stream, the remaining assets pass to the remainder beneficiaries, typically Junior Family Members, either outright or perhaps in further trust.[3]

Properly structured, the Senior Family Member, as the grantor of the GRAT, will subtract from the value of the transferred asset the present value of the annuity stream, in order to determine the value of the taxable gift. In most cases, GRATs will be structured so that the present value of the annuity stream will equal nearly the entire value of the transferred assets, thereby resulting in a gift of nearly zero (typically less than one dollar). If however, the assets transferred into the GRAT appreciate above the amounts necessary to pay the annuity stream, as may very likely be the case if assets with appreciation potential are transferred (e.g., pre-IPO stock), the balance passing to or for the Junior Family Members will pass gift tax-free.

GRAT Example:

Senior Family Member transfers $10,000,000 of closely-held stock into a "zeroed out" GRAT that provides an annuity of 51.80810% each year for 2 years, with the remainder passing to children after the 2-year GRAT term. Assuming a September 2017 transfer and a Section 7520 interest rate of 2.4%, the present value of Senior Family Member's retained annuity is $9,999,999.46, thus resulting in a taxable gift of $0.54. If the GRAT is invested in highly appreciating assets, such that the average rate of return is 15%, then at the end of the 2-year GRAT term, assuming that Senior Family Member has survived that period, the remaining balance in the trust of $2,086,258.50 will pass to the children without imposition of additional gift taxes and will be excluded from Senior Family Member's gross estate.

Some of the features of GRATs are as follows:

1. <u>Gift Value</u>

   The value the gift is determined upon the GRAT's creation by calculating the present value of the remainder interest gift: the present value of the annuity stream payable to the grantor using the Section 7520 interest rate

[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.

[3] For purposes of this outline, references to the terms "Senior Family Member" and "Junior Family Member" shall mean those persons individually and/or a trust for their benefit.

applicable for the month of the funding of the GRAT.[4] If the GRAT is "Zeroed-out" (a "Zeroed-out GRAT"), which is typical, the present value of the annuity stream is structured to roughly equal the value of the assets transferred into the GRAT. This results in a gift of "zero" or, more accurately, near zero for gift tax purposes. However, if the assets in the GRAT are invested to grow in excess of the annuity stream required to be paid to the grantor/annuitant, and if the grantor outlives the selected trust term the GRAT's assets are removed from the grantor's estate, and the excess assets pass to the remainder beneficiaries (typically the grantor's children or trusts for their benefit) free of additional gift taxes; essentially providing for a gift-tax-free transfer of the future appreciation (if any) in the assets. Of course, the annuity payments paid to the Senior Family Member are included in his or her estate, but any upside growth passes to the remainder beneficiaries, assuming that Senior Family Member outlives the stated GRAT term.

2. *Walton* case and Example 5

Initially, some controversy existed with respect to the originally issued "Example 5" of the Treasury Regulations. Essentially, the original Example 5 provided that if a grantor attempted to create a GRAT in which the annuity was paid for a set term of years, such could not be "Zeroed-out" (so as to result in a gift of zero). This is because the value of the retained annuity interest was calculated as if the annuity would be received for the shorter of the grantor/annuitant's life or the fixed term. Thus, the value of the annuity was calculated to be worth less than the value of the annuity interest for the fixed term (as the value of the grantor's retained annuity interest was reduced to account for the fact that if he/she died before the end of the annuity term, he/she would not actually receive all of these payments) and, therefore, a GRAT could not be "Zeroed-out."

This issue was resolved in *Walton*[5] in which it was held that the original Example 5 was invalid. The *Walton* court determined that in calculating the present value of the grantor's retained annuity interest (and, thus, the resulting taxable gift), value will be given for both the value of the annuity payable to the grantor and to the grantor's estate if he/she dies during the annuity term, as both would constitute Qualified Interests under Section 2702. Thus, following *Walton*, it became possible to "zero out" a GRAT. After an initial period of uncertainty, the IRS acquiesced to this rationale

[4] I.R.C § 7520 Rate is equal to 120% of the Applicable Federal Rate ("AFR"). Accordingly, there is potential that the GRAT will underperform the Gift/Sale Transaction.

[5] *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq. in result*, I.R.S. Notice 2003-72, 2003-2 C.B. 964.

in Notice 2003-72. Example 5 was revised to conform to *Walton* in 2005.[6]

3. Adjustment Feature

Some practitioners consider GRATs to be more conservative planning vehicles (as compared to a Sale to an IDGT, etc.) because this technique is specifically authorized under Section 2702. Additionally, the Treasury Regulations specifically provide for a valuation adjustment feature to ensure that no unanticipated additional gift will occur as a result of the creation of a GRAT.[7] Thus, if the value of the asset contributed into a GRAT is increased on a gift tax audit, the amount of the annuity payment due will be automatically recalculated accordingly so as to result in a larger annuity payment due, but will still result in the same amount of gift (in the case of a Zeroed-out GRAT, will still result in a gift of roughly zero).

- Practice Point: This self-adjustment feature is one of the relative advantages of a GRAT that can be quite advantageous when planning to transfer hard-to-value assets, particularly when the potential value of those assets exceed the federal gift tax exemption. In contrast, as will be discussed in the section on Sales to Intentionally Defective Grantor Trusts, such self-adjustment features are generally not looked upon favorably by the IRS, as they are considered to be contrary to public policy (the rationale being that such a feature would disincentivize the IRS from pursuing gift tax audits since the consequence of any change in valuation of a transferred asset would still result in zero additional gift taxes).

4. Mortality Risk

While GRATs may in one sense be considered to be more conservative, there are relative pros and cons that should be considered. Inherent with a GRAT is the potential for some or possibly all of the transferred assets to be included in the grantor's estate in the event of his or her death before the end of the GRAT term. Mortality risk is perhaps the most significant downside to a GRAT: the grantor must outlive the trust term to remove all of the gifted assets from his or her estate under Section 2036(a)(1). If the grantor dies during the trust term, then a portion (or possibly all) of the assets necessary to produce the remaining annuity payments will be included in the grantor's gross estate. The Treasury Regulations under

[6] Treas. Reg. § 25.2702-3(e), *Ex*. 5 now provides as follows: "A transfers property in an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. The interest of A (and A's estate) to receive the unitrust amount for the specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years."

[7] Treas. Reg. § 25.2702-3(b)(2).

Section 2036 were finalized effective November 8, 2011[8] to clarify that the amount included in the grantor's estate in the event of death prior to the end of the GRAT term will be calculated based upon a formula, which calculates the amount of principal required to generate the remaining annual annuity payments, without reducing or invading principal, based upon the Section 7520 interest rate existing at the date of death. Prior to the finalization of these Treasury Regulations, the IRS took the view that the entire value of the GRAT's assets were included in the grantor's estate under Sections 2036 and 2039 in the event of such a premature death.[9]

5. Grantor Trust

During the term of the GRAT, it will be considered a "grantor trust" as to Senior Family Member for income tax purposes under Section 677(a)(1). Thus, Senior Family Member will be legally obligated to pay the income tax liability associated with the GRAT's income, which will reduce his or her otherwise estate taxable assets while at the same time allowing the GRAT to grow unencumbered by income tax liability. Thus, while not an actual gift, this functionally has the effect of being a tax-free gift each year in the form of the income taxes paid on behalf of the GRAT.

6. Carryover Basis

The remainder beneficiaries receive a carryover tax basis in the assets remaining at the end of the GRAT term under Section 1015(a).

7. Rolling GRATs

Many GRATs are structured as short-term (e.g., two or three year) GRATs, or as a series of "rolling" short-term GRATs in which annuity payments received from existing GRATs are used to fund additional short-term GRATs. This results in a reduction of the potential mortality risk by increasing the chance that the grantor will survive the term of each GRAT. In addition, the short-term nature of each of the GRATs allows for an opportunity to "lock-in" the upside of the volatile market, while reducing the potential negative effects of a volatile market's downside.

8. Greenbook Proposals

In the past, various proposals have been made to place some limitations on the use of GRATs, reflecting the Treasury Department and former Obama Administration's shared sentiment that the use of short-term GRATs to achieve a gift-tax-free shift of future appreciation provided too much of an opportunity for taxpayers to shift wealth free of gift tax.[10] Former

[8] 76 Fed. Reg. 69126-69131 (11/8/11).
[9] Treas. Reg. § 20.2036-1(c)(2)(i).

[10] *See* GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS, DEPT. OF THE TREASURY (Feb. 2015) (referred to as the "Greenbook").

President Obama's Greenbook proposal would have required GRATs to have: (a) a minimum annuity term of ten years, (b) a maximum annuity term of the annuitant's life plus ten years, and (c) would have also required any GRAT's remainder interest to have a minimum value of the greater of 25% of the value of the contributed assets or $500,000 (but not more than the value of the assets contributed), thus eliminating the Zeroed-out GRAT technique. Had these changes become law, the new minimum gift concept would have effectively eliminated the use of the Rolling GRAT technique, which relies upon the ability to "zero out" a GRAT.[11]

To date, the Trump Administration has not adopted any of these proposals and has been silent with respect to its views with respect to GRATs.

B. Section 2702 – The Statutory Basis for GRATs as an Exception to the Zero Valuation Rule

While many practitioners view Section 2702 as being the statutory authorization for the creation of GRATs, which is true, GRATs are merely one of the statutory exceptions to the general application of Section 2702, which was designed to be a punitive deemed gift tax provision. In other words, GRATs are a statutory carve-out that is permitted as an exception to the potentially draconian zero-value gift tax rules under Section 2702.[12]

Section 2702 is a deemed gift provision that generally provides that when an individual makes a transfer of an interest in trust to a family member in which such individual (or certain other Senior Family Members) retains an interest in the trust, in determining the amount of any resulting gift the value of the retained interest is valued at zero, unless the retained interest satisfies the definition of a "Qualified Interest." In the event that the retained interest is a "Qualified Interest" its value shall be determined actuarially under Section 7520, and not at zero.

1. The Perceived Abuse

The rationale behind the enactment of Section 2702 and the "zero valuation" rule was to prohibit certain perceived abuses in connection with common law grantor retained income trusts (GRITs) that were being created before the enactment of Chapter 14 of the Code, which took effect with respect to transfers after October 8, 1990. Before the enactment of Section 2702, a Senior Family Member would make an irrevocable

[11] *Id*. at 198.

[12] I.R.C. § 2702 and its definition of a "Qualified Interest" provides the statutory basis for many estate planning vehicles involving transfers to trusts, such as Grantor Retained Annuity Trusts ("GRATs") and Qualified Personal Residence Trusts ("QPRTs"). Additionally, I.R.C. § 2702(c) contains provisions with respect to certain joint purchases of property and other property interests being treated as transfers held in trust, which are likewise subject to the zero valuation rule. This Section may have important implications in the case of joint purchases between family members, when term interests are acquired, and should be considered whenever contemplating such a transaction.

transfer of assets into a GRIT and retain the right to receive any and all income generated by the trust for a term of years, with the remaining balance at the end of the GRIT term passing to younger family members. While the actual amount of income that would be generated could, of course, not be determined at the time of the gift, for gift tax calculation purposes, the Senior Family Member/grantor would approximate the present value of that income interest based upon the then prevailing interest rate, which, when subtracted from the value of the transferred asset, would result in the amount of the taxable gift under a "subtraction method" of valuation. Particularly in a high interest rate environment, this would enable the Senior Family Member to reduce the amount of the taxable gift significantly, therefore resulting in a relatively small taxable gift of the remainder interest, because it was assumed that Senior Family Member would receive back an income interest calculated based upon the then higher prevailing interest rate. If, however, following the funding of the GRIT, the trust was invested so as to produce more growth and less actual income, then Senior Family Member would receive less income (perhaps significantly less income) than Senior Family Member would have gotten "credit" for gift tax purposes, thus leaving less assets in his/her estate and more assets in the GRIT to ultimately pass to the remainder beneficiaries.

2. General Definitions

a) General Rule

Section 2702 applies the “zero valuation” rule to determine the amount of a retained interest and, thus, the resulting gift, when an individual makes a transfer in trust to or for the benefit of a “Member of the Family” and such individual or an “Applicable Family Member” retains an interest in the trust.[13]

If Section 2702 applies to a transfer and the retained interest is not a “Qualified Interest,” or some other exception does not apply, the retained interest is valued at zero and, under the subtraction method of valuation, the amount of the gift is equal to the entire value of the transferred property. If the retained interest is a “Qualified Interest,” its value is determined actuarially and subtracted from the value of the transferred interest to determine the amount of the taxable gift.[14]

b) Member of the Family

The term “Member of the Family” means with respect to an individual Transferor, such Transferor’s spouse, any ancestor or lineal descendant of

[13] Treas. Reg. § 25.2702-1(a).

[14] Treas. Reg. § 25.2702-1(b).

the Transferor or the Transferor's spouse, any brother or sister of the Transferor, and any spouse of the foregoing.[15]

c) Applicable Family Member

The term "Applicable Family Member" means with respect to the individual Transferor, the Transferor's spouse, and any ancestor of the Transferor or the Transferor's spouse, and the spouse of any such ancestor.[16]

d) Qualified Interest

Typically, a "Qualified Interest" is structured as a "Qualified Annuity Interest," which is an irrevocable right to receive a fixed amount, payable at least annually.[17] The value of a qualified annuity interest is determined under Section 7520.[18]

3. Section 2702 "Zero Valuation" Rule Hypothetical

Mom transfers a commercial building into an irrevocable trust in which she retains the right to receive all of the income (whatever income that may be) for 20 years with the remainder of the trust to pass to child at the end of the 20-year term. The building has a fair market value of $20 million (assume no debt) and produces rental income of $1 million per year. Because mom's retained income interest is not a "Qualified Interest," in determining the value of the gift, her interest is valued at zero under Section 2702. Thus, mom has made a gift of $20 million to the trust with no "credit" or reduction for the value of her retained income interest (despite the fact that there is some actual value attributable to her retained income interest).

If instead, mom had retained a right to receive a fixed annual annuity of $1 million for twenty years with the remainder to child, her retained interest would be a "Qualified Interest," that would be valued at zero under Section 2702. Thus, based on a Section 7520 interest rate of 2.4% as of September 2017, the value of her retained Qualified Interest would be $15,737,400 and the amount of the gift would be $4,262,600 (rather than the full $20 million). While the economics of these two deals would be quite similar, the gift tax consequences are dramatically different due to Section 2702.

[15] I.R.C. § 2704(c)(2); Treas. Reg. § 25.2702-2(a)(1).

[16] Treas. Reg. § 25.2701-1(d)(2).

[17] Treas. Reg. § 25.2702-3(b).

[18] Treas. Reg. § 25.2702-2(b)(2).

4. GRAT Technical Requirements

There are a number of technical requirements provided under Section 2702 and the Treasury Regulations thereunder that impose certain strict requirements or prohibitions when structuring a GRAT. It is critical when creating and administering a GRAT that none of these technical requirements are violated, as the consequences can be draconian, and can result in a significant deemed gift. Specifically, Treasury Regulation Section 25.2702(3)(b) provides that an interest is a Qualified Annuity Interest only if it meets a number of requirements, which primarily include the following:

a) Payment of Annuity Amount

A Qualified Annuity Interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.[19]

b) Fixed Amount

A "Fixed Amount" means either:

(1) A stated dollar amount, payable periodically (at least annually), but only to the extent the dollar amount does not exceed 120% of the stated dollar amount payable in the preceding year;[20] or

(2) A fixed fraction or percentage of the initial fair market value of the property transferred to the trust, payable periodically (at least annually), but only to the extent the fractional percentage does not exceed 120% of the fixed fractional percentage payable in the preceding year.[21]

c) Income in Excess of the Annuity Amount

An annuity interest does not fail to be a Qualified Annuity Interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the Qualified Annuity Interest. Nevertheless, the right to receive the excess

[19] Treas. Reg. § 25.2702-3(b)(1).

[20] Treas. Reg. § 25.2702-3(b)(1)(ii)(A).

[21] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

income is not a qualified interest and is not taken into account in valuing the Qualified Annuity Interest.[22]

d) Incorrect Valuations of Trust Property

If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of Section 1.664–2(a)(1)(iii) (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).[23]

e) Payment of the Annuity Amount Within Grace Period

An annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date.[24]

f) Additional Contributions Prohibited

The governing instrument must prohibit additional contributions to the trust.[25]

g) Term of the Annuity Interest

The governing instrument must fix the term of the annuity and the term of the interest must be fixed and ascertainable at the creation of the trust. The term must be for the life of the holder, for a specified term of years, or for the shorter (but not the longer) of those periods.[26]

h) Commutation

The governing instrument must prohibit commutation (prepayment) of the interest of the holder.[27]

i) No Use of Debt Obligations to Satisfy the Annuity Payment Obligation.

The trust instrument must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity payment obligation.[28]

[22] Treas. Reg. § 25.2702-3(b)(1)(iii).

[23] Treas. Reg. § 25.2702-3(b)(2).

[24] Treas. Reg. § 25.2702-3(b)(4).

[25] Treas. Reg. § 25.2702-3(b)(5).

[26] Treas. Reg. § 25.2702-3(d)(4).

[27] Treas. Reg. § 25.2702-3(d)(5).

C. Consequences of Violating GRAT Requirements

1. The numerous technical requirements for a GRAT must be strictly adhered to in order for it to be effective. The failure to satisfy any of these requirements, either at creation or in the subsequent administration of the GRAT, can have potentially harsh consequences. Arguably, the violation of any of these requirements will cause the initial transfer into the GRAT to fail the requirements of a Qualified Interest under Section 2702 and, accordingly, trigger the zero valuation rule with respect to the grantor's retained annuity interest. In such event, rather than the taxable gift equaling the actuarial value of the remainder interest (which, in the case of GRATs that are "zeroed out," is very close to zero), the taxable gift could instead be the entire value of the asset transferred into the GRAT from inception. While this issue has not been directly addressed in the context of a GRAT, in *Atkinson*,[29] the "operational failure" of a charitable remainder annuity trust (CRT) due to non-payment of annuity payments resulted in the CRT's disqualification.

2. Some practical issues to consider along these lines include the following:

a) As mentioned above, if the required annuity payment has not been paid on time, taking into consideration the 105 day grace period, the IRS could argue that this caused the annuity interest to not be a Qualified Interest in violation of Section 2702 and would be retroactive to the initial date of funding.

b) As mentioned above, GRATs are required to contain prohibitions against commutations (which are essentially early distributions), as well as additional contributions. Sometimes planners will recommend that a GRAT engage in a swap of assets between the grantor and the GRAT. While this can be achieved without recognition of gain due to the GRAT's grantor trust status, it is critical to be careful to not violate either of these prohibitions when swapping hard-to-value assets in or out of the GRAT. If a hard-to-value asset is determined by the IRS to be valued either higher or lower than the purported value used for purposes of the intended fair market value exchange via the swap, then it is possible that the IRS could argue that such constituted either an additional contribution or a commutation, as the case may be; in either case, in violation of Section 2702.[30]

[28] Treas. Reg. § 25.2702-3(d)(6)(i).

[29] *Estate of Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002), *cert. denied*, 540 U.S. 946 (2003).

[30] *See, generally*, Carlyn S. McCaffrey, *Techniques for Improving GRAT Performance*, 51 Ann. Heckerling Inst. On Est. Plan. (2017), for an excellent discussion of various drafting techniques in order to provide some savings language to address these risks.

D. Generation Skipping Transfer Tax Limitations with GRATs and the Preferred Partnership GRAT

1. The Estate Tax Inclusion Period ("ETIP") Issue [31]

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 Multigenerational, 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 under Section 2036 if he or she died during that term.[32] 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.

2. Preferred Partnership GRAT to Address ETIP Issue

The creation of a "Preferred Partnership GRAT," which involves the combination of a statutorily compliant GRAT under Section 2702 with a statutorily compliant preferred partnership under Section 2701, may provide a way to obtain the statutory certainty of a GRAT while at the same time shifting 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.

a) With this technique, Senior Family Member could create a preferred partnership, initially owning both common "growth" and preferred "frozen" interests. Thereafter, the Senior Family Member would make gift transfers of preferred interest to a long-term Zeroed-out GRAT, which would not trigger any gift taxes. Senior Family Member would also

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

[32] I.R.C. § 2632(c)(4).

create a GST-Exempt trust into which Senior Family Member 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 Senior Family Member is living, the GRAT remainder would be distributed to the remainder beneficiaries, however the preferred interest in the GRAT would have been "frozen" to the amount of the liquidation preference and the coupon; this is preferable since the GRAT remainder is GST non-exempt. Any appreciation above the coupon will exist in the common interests held by the GST-Exempt trust.

b) Perhaps an even more significant feature of the Preferred Partnership GRAT is the limitation on the mortality risk typically associated with a GRAT. 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 held by the GST-Exempt trust.

III. SALE TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

A. Intentionally Defective Grantor Trusts Generally

1. Sale Rather Than a Gift

A Sale to Intentionally Defective Grantor Trust (IDGT) is another popular type of estate freeze transaction utilized by planners. This technique generally involves Senior Family Member selling an asset, such as an interest in a closely held business or perhaps a family limited partnership, to a grantor trust (typically for the benefit of Junior Family Members and, possibly, spouse) in exchange for a promissory note. Because this transaction involves a sale to the IDGT, presumably for fair market value, in exchange for a promissory note in the amount of the fair market value sale price, no taxable gift should result, as the transaction is presumably a fair market value exchange rather than a gift.[33]

[33] In *Frazee v. Commissioner*, 98 T.C. 554 (1992), it was determined that the receipt of a promissory note in connection with the sale of assets would constitute adequate and full consideration and, therefore, not a gift, provided that the face amount of the note reflected the fair market value of the assets and adequate interest was provided pursuant to I.R.C. § 7872, requiring interest imposed based upon the applicable federal rate under I.R.C. § 1274.

2. No Income Tax Recognition

Additionally, because the Senior Family Member is selling an asset to a trust that is a grantor trust to him or her, the transaction should not result in a gain recognition event for income tax purposes since grantor trusts are ignored for income tax purposes.[34] It should be noted, however, that a deemed sale will occur in the event that the grantor "turns off" grantor trust status while the promissory note has an unpaid balance. Thus, the amount of the gain incurred will be the difference between the outstanding note balance and the grantor's basis of the asset sold.[35]

3. Cash Flow versus Growth

The cash flow component of the IDGT transaction going back to the Senior Family Member consists of the promissory note plus interest imposed based upon the appropriate AFR in effect for the month and year of the sale. However, any growth in the assets held by the IDGT above the repayment of the note and AFR interest occurs in the trust and is outside of the Senior Family Member's taxable estate.

4. GST-Exempt IDGT

Unlike in the case of a GRAT (which, as discussed above, does not allow for leveraging of the grantor's GST-Exemption due to the ETIP Rule), it is possible for the IDGT transaction to be structured to be GST-Exempt by selling the asset into an IDGT that is a GST-Exempt trust. Thus, one of the advantages of an IDGT transaction over a GRAT is the ability to effectuate the sale transfer of assets into a multigenerational GST-Exempt structure, thereby achieving a longer term wealth transfer structure than a GRAT, which is generally considered to be only "two generation" in nature.

5. Benefits of Grantor Trust Status

The ability to shift post-sale appreciation out of the grantor's estate and into the IDGT can be quite powerful. Furthermore, because of the grantor trust status, the Senior Family Member is obligated to pay the income taxes associated with the assets in the trust, which enables the trust's assets to essentially grow on an income tax-free basis. The Senior Family Member, as grantor, pays income taxes out of his or her own assets, which would otherwise be subject to estate or gift tax at some point in the future. In cases in which the assets in the trust have grown substantially, particularly where the trust has been leveraged by a sale or loan via a low interest rate note, it is quite possible for the payment of the annual income

[34] Rev. Rul. 85-13, 1985- 1 C.B. 184.

[35] Treas. Reg. § 1.1001-2(c), Ex. 5.

taxes on behalf of the trust to exceed the $11.18 million federal gift tax exemption (for 2018). Thus, in effect, the grantor trust status can be potentially even more valuable than the generous current gift tax exemption.

B. Rationale for IDGT Transaction

The rationale for the IDGT transaction is that, because the Senior Family Member is entering into a sale transaction with a trust that is considered to be a grantor trust as to him or her for income tax purposes within the meaning Sections 671-679, the sale will generally not be considered a recognition event for income tax purposes because it is treated as if the Senior Family Member is selling assets to himself or herself for income tax purposes.[36] The IDGT transaction is loosely based upon the IRS's rulings in PLRs 9436006 and 9535026, in which it was determined that sales of assets by grantors into a grantor trusts would not constitute deemed gifts under Section 2701 as "applicable retained interests" nor a "term interests" under Section 2702. It should be noted that in these rulings, the presumption is made that the notes involved were valid debt rather than some recharacterized form of disguised equity or disguised retained interest (see discussion below with respect to more recent arguments that have been made under these code sections).

The conventional wisdom with a sale to IDGT transaction is that the purchasing trust must have sufficient "seed equity" in order to support the debt service required under the promissory note that the trust will provide to the Senior Family Member as the seller. The working rule of thumb for many practitioners is that the trust must have a minimum of 10% in equity of the total value of the assets intended to be sold to the trust. Thus, seed equity of at least $1 million would be necessary in order to support a $9 million promissory note. This, however, is not at all a hard- and-fast rule, but rather is based upon the fact that 10% equity in the trust was involved in the above mentioned PLR 9535026. The rationale, however, for the 10% minimum seed is in order to counter an argument that the sale of assets in exchange for a promissory note was in essence some sort of retained interest in the sold assets, rather than debt.[37]

C. Estate Tax Considerations

The conventional wisdom is that estate tax exposure in the case of an IDGT transaction should be limited to the value of the promissory note owned by the Senior Family Member at his or her death. Said another way, the assets sold to the grantor trust should not be included in the estate in the absence of some type of retained string that the Senior Family Member continues to hold; only the promissory note should be included in the gross estate. However, it is possible that the IRS may raise an argument that the promissory note itself constituted a

[36] Rev. Rul. 85-13, 1985-1 C.B. 184.
[37] It should be noted that there is a 10% de minimis common equity requirement with respect to equity interests under I.R.C. § 2701(a)(4), which also presumably provides some additional indication of the origin of this working rule.

retained interest in the sold assets causing those assets to be included in the Senior Family Member's estate under Section 2036. In *Estate of Donald Woelbing,*[38] the IRS raised the argument that the sold stock was included in the grantor's gross estate under Section 2036(a)(1) under the theory that the promissory note was a retained income interest in the sold stock. It would seem that such an argument would be highly facts-and circumstances-based. Under the holding of the *Fidelity-Philadelphia Trust Co. v. Smith*[39] case, practitioners should be sure to structure the transaction so that the payments due under the note do not match the projected income generated by the sold assets. Practitioners are well advised to resist the urge to simply back into the amount of the note payments based upon the anticipated income generated off of the sold assets.

D. IDGT Does Not Self-Adjust

As mentioned above, one of the disadvantages of the IDGT transaction versus a GRAT is the lack of a self-adjusting feature enjoyed by the GRAT in the case of an adjustment to the reported gift tax value of the transferred asset. Thus, for instance, if a sale of an interest in a hard-to-value asset, such as a minority interest in a closely held business, is sold to an IDGT for an $8 million promissory note, based upon an independent valuation appraisal, and the value of the sold interest is adjusted to $10 million in connection with the gift tax audit, the seller will have made a taxable gift in the amount of the $2 million overage (in contrast, if the $8 million gift had been made to a GRAT and the value had been adjusted to $10 million on a gift tax audit, the consequence would be a corresponding increase in the amount of the annuity payments from the GRAT, but would not result in an additional taxable gift).

There are various ways that the valuation uncertainty of hard-to-value assets and the risk of a potential taxable gift tax in connection with an IDGT transaction can be addressed. However, each of these have their relative pros and cons so the practitioner must carefully consider these implications when advising the Senior Family Member on entering into a transaction. Determining the best approach for a particular transaction will require a nuanced discussion with the client in order to evaluate the relative risks and rewards associated with each approach. These approaches are discussed in paragraph F below, entitled "Planning Approaches for Hard-to-Value Assets."

E. Critical for Debt to Be Respected

1. Debt Challenges Generally

Critical to the IDGT transaction being successful is the promissory note being respected as valid debt because the rationale for the transaction not

[38] *Estate of Donald Woelbing v. Commissioner*, T.C. Docket No. 30261-13 (2013); *Estate of Marion Woelbing v. Commissioner*, T.C. Docket No. 30260-13 (2013)

[39] *Fidelity.-Philadelphia Trust. Co. v. Smith*, 356 U.S. 274 (1958).

resulting in a taxable gift is that Senior Family Member has sold the transferred property in exchange for the note in a fair market value exchange. If, however, the note is not respected as a valid debt and is instead disregarded as being illusory, then the transaction could result in a gift rather than a sale of the sold asset. There are different theories that the IRS has raised in an attempt to cause an IDGT transaction to constitute a gift. While there are different technical arguments raised by the IRS, they all involve in some form or another recharacterizing the promissory note as something other than true debt, such as a second class of equity or a transfer with retained interest.

Perhaps the most straightforward argument that the IRS has raised in connection with intra-family loans is that the parties did not actually intend to treat the note as true debt from inception. This has generally been heavily a facts and circumstances kind of inquiry based upon the post-loan conduct of the parties as an indication of the intention of the parties. Factors that have been taken into consideration generally include whether the payments required under the note were actually paid on time, whether the lender took appropriate actions to demand payments required under the loan in the case of late or nonpayment, whether interest payments required under the note were properly reported on the lender's income tax return, as well as other factors.[40]

Additional, more technical arguments have been made that the sale in exchange for a note should be recharacterized as a transfer in trust with a retained interest that does not constitute a qualified interest in violation of Section 2702. Alternatively, the IRS has attempted to recharacterize a note as a disguised second class of equity in the transferred entity interest, which would constitute a "distribution right" resulting in a deemed gift under Section 2701.

2. Debt Recharacterization Under Section 2702

a) *Karmazin v. Commissioner*[41]

In *Karmazin*, the IRS raised the argument that Section 2702 applied to an IDGT sale transaction. The IRS essentially argued that the sale of the limited partnership (LP) interest in a family limited partnership (FLP) by the taxpayer in exchange for a promissory note constituted a “transfer in trust” within the meaning of Section 2702. Under Section 2702, the value of a retained interest is zero unless it is a “qualified interest.” Accordingly, the IRS argued that a sale of LP interests in exchange for a promissory note was actually a deemed transfer in trust with a retained income interest that did not qualify as a “qualified interest” under

[40] *Miller v. Commissioner*, 71 T.C.M. (CCH) 1674 (1996).
[41] *Karmazin v. Commissioner*, T.C. Docket No. 2127-03 (2003).

Section 2702 and, therefore, the value of the Senior Family Member's retained interest was zero under the subtraction method. Thus, the IRS took the position that the value of the sold LP interests should be recharacterized as a gift to the IDGT, in exchange for an interest that was valued at zero; thus resulting in a taxable gift of all the LP interests sold (with no reduction for the promissory note received in exchange).

b) *Estate of Donald Woelbing; Estate of Marion Woelbing*

More recently, the IRS challenged a sale transaction in *Estate of Donald Woelbing* and *Estate of Marion Woelbing*, companion Tax Court cases that were ultimately settled, as subject to zero valuation under Section 2702 reminiscent of *Karmazin*. In *Woelbing*, Donald Woelbing sold stock in the family business, Carma Laboratories, Inc. (Carmex lip balm company) to a grantor trust in exchange for a promissory note with a face value of $59 million with interest imposed at the AFR. The trust had assets of over $12 million before the transfer, some of which were available to service the note in addition to the company shares, and two trust beneficiaries had signed personal guarantees for 10% of the purchase price. In addition to the Section 2702 argument, discussed above, the IRS also challenged the valuation of the sold stock, arguing that the stock's value was actually $117 million, not the stated sale price of $59 million – so, in any case, the excess was a gift.

It seems that the pivotal issue is whether or not the sale of the stock to the trust in exchange for a promissory note could be considered a transfer in trust with a retained interest within the meaning of Section 2702. Prior to *Karmazin*, it was generally assumed that a debt was not considered a "term interest" under Section 2702, so that Section 2702 should not be applicable to a sale to an IDGT.

3. Debt Recharacterization Under Section 2701

In *Karmazin*, the IRS also argued that Section 2701 applied to a sale of FLP interests to an IDGT. In the transaction, the taxpayer created an FLP and sold LP interests to an IDGT in exchange for a promissory note. The IDGT financed the entire purchase price with the promissory note.

a) The IRS argued that the promissory note was not debt, but rather disguised equity and recited the following factors in support of its position:

(1) the trust's debt-to-equity ratio was too high;

(2) there was insufficient security for the note to be considered debt;

(3) it was unlikely that the LP interests would generate sufficient income to make the note payments; and

(4) no commercial lender would make a loan under such conditions.

b) By treating the promissory note as equity and not debt, the IRS sought to apply the provisions of Section 2701 which would result in the amount of the taxable gift being the value transferred minus the value of any "qualified payment rights" under the subtraction method. The IRS' argument was that the taxpayer made a transfer of subordinate interests (the LP interests) to the IDGT and retained a senior interest (in the form of the recharacterized promissory note). It reasoned that, because the retained interest included a "distribution right" for Section 2701 purposes and because the note payments would not be considered a "qualified payment right," the taxpayer would be treated as having made a gift of the LP units while retaining an interest in the FLP (the disguised equity, in the form of the promissory note) worth zero. Thus, a gift of the entire FLP interest would result with no offset for the promissory note. In this matter, the note payments made to the Senior Family Member were not "fixed" and did not make payments at least annually, and thus, were not "qualified payment rights."

c) Note, that had the promissory note been structured with fixed, cumulative, annual payments, such that it was a "qualified payment right," this would have avoided the application of the zero valuation rule under Section 2701, but still would not have completely saved the transaction. The required return for a preferred equity interest would still likely be higher than the AFR provided under the promissory note, under the rationale set forth in Revenue Ruling 83-120, so the value of the taxable gift would be less than the full value, but still more than zero – thus, a partial gift.

d) Ultimately, the matter was settled. However, the Section 2701 argument remains an issue that needs to be considered when structuring Sales to Intentionally Defective Grantor Trusts. If the IRS is able to successfully argue that a promissory note received in connection with such a transaction is, in fact, disguised equity, and if LP interests transferred to younger generational family members (or trusts for their benefit) are considered as subordinate to the retained promissory note recharacterized as equity, then potentially Section 2701 could result in a deemed gift.

F. Planning Approaches for Hard-to-Value Assets

When planning for the lifetime transfer of hard-to-value assets, there is uncertainty as to the value that will be ultimately determined for gift tax purposes. Consequently, there is inherent risk that a transfer of assets that is intended to fall

within the Senior Family Member's available gift tax exemption may ultimately be determined for gift tax purposes to exceed that available exemption and may cause gift tax liability with respect to the overage. Additionally, in the case of a sale to an IDGT, there is also the risk that the sale price may ultimately be determined to be for less than fair market value (as the IRS argued in *Woelbing)*, which could lead to additional gift tax exposure to the extent of the shortfall in the purchase price.

Of course, this is not an issue that is new, and is one that estate planning practitioners have been grappling with for over 70 years, going all the way back to the *Procter* decision.[42]

Due to the inherent valuation uncertainty with respect to closely-held businesses and other hard-to-value assets, and the desire to avoid unnecessary payment of gift tax liability in connection with gift and sales of these interests, estate planning practitioners have, for many years, attempted to craft different approaches to minimize or eliminate the gift tax exposure associated with making gifts and sales of hard-to-value assets.

Assuming Senior Family Member owns shares of stock in a closely-held company, and he or she has not previously utilized any of his or gift tax exemption, some of the different approaches and the relative pros and cons are discussed below as follows:

1. <u>"Cushion" Approach</u>

   One approach would be to make a gift of shares, calculated based upon the per share appraised value, to be less than the available gift tax exemption of $11,118,000 (for 2018); for example, a gift of $8,000,000 worth of shares. If the IRS subsequently challenges the appraised value and attempts to increase the per share value of the transferred shares, the Senior Family Member would have some gift tax "cushion," in this case, $3,118,000, to "absorb" some, if not all, of the increased value as determined for gift tax purposes. Of course, this approach provides a "cushion" but not a guarantee that there will be no additional gift tax imposed. For instance, if the gifted shares have an appraised value of $8,000,000 and that value is increased on a gift tax audit to $13,000,000, then there would still be an excess taxable gift of $1,882,000 above the Senior Family Member's 2018 exemption of $11,118,000.

2. <u>Price Adjustment Approach</u>

   This approach would involve including a provision that if the gift of the shares is ultimately determined for federal gift tax purposes to exceed a certain amount (for instance, the Senior Family Member's available gift tax exemption), then he or she will be deemed to have sold such excess

[42] *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944).

amount to the donee in exchange for a promissory note, which the donee would deliver upon such determination being made. This approach, however, is not favored by the IRS which takes the position that such a provision is invalid and violates public policy as being a "condition subsequent."[43] There is, however, one case, *King vs. Commissioner*, in which this type of approach was upheld.[44]

3. Formula Allocation Provision

Another approach that has gained recent popularity following *Succession of McCord v. Commissioner*[45] and *Estate of Petter*[46] is a so-called value allocation provision.[47] Such a provision would involve the transfer by the Senior Family Member of asset number of shares of an entity (for instance shares in an FLP), with the shares to be allocated between a gift taxable donee (such as a trust for children) and a non-gift taxable donee (such as a charity, or perhaps a marital trust, GRAT or incomplete gift trust). Under this approach, Senior Family Member, as the donor, would make a gift of a determined number of units in the entity; the unknown would be how those shares would be allocated between the gift taxable and the non-gift taxable donees, since the allocation of those shares would be dependent upon the value of the shares as finally determined for federal gift tax purposes. Thus, the allocation would be determined conclusively once the final value of the shares is determined for gift tax purposes.

4. Formula Definition Approach

This type of approach has gained popularity and support over the past several years with the Tax Court's issuance of the *Wandry vs. Commissioner*[48] decision in 2012, in which the taxpayer successfully made a gift of a defined dollar amount worth of interests in an entity. At the time of the gift, the actual number of shares transferred would be unknown, as that number would be dependent upon the valuation of shares as finally determined for gift tax purposes. However, what would be known would be the dollar denominated value of the gift; for example, $11,118,000 worth of shares of an FLP. If the value per share of the FLP is increased, this would reduce the number of shares that would be determined to be transferred, but the value of the transferred shares will always equal $11,118,000. It should be noted that the IRS has indicated in a non-acquiescence pronouncement that it does not agree with *Wandry*.[49]

[43] See *Ward v. Commissioner*, 87 T.C. 78 (1986); *Estate of McLendon v. Commissioner*, 66 T.C.M. (CCH) 946 (1993).

[44] *King v. United States*, 545 F.2d 700 (10th Cir. 1976).

[45] *McCord v. Commissioner* 20 T.C. No. 13 (2003), rev'd, 461 F.3d 614 (5th Cir. 2006).

[46] *Estate of Petter*, 98 T.C.M. (CCH) 534.

[47] For an excellent discussion on value-allocation clauses *see* McCaffrey, *Formulaic Planning to Reduce Transfer Tax Risks*, 45 Ann. Heckerling Inst. On Est. Plan. (2011).

[48] *Wandry v. Commissioner*, 103 T.C.M. (CCH) 1472 (2012).

[49] I.R.S. Announcement 2012-46 I.R.B. 3.

Thus, the planner who is going to proceed with this type of approach should be mindful of the fact and advise their client that the IRS may challenge this approach. If the IRS were to challenge this approach, it would likely argue that the original number of shares estimated to be transferred was actually transferred at the adjusted gift tax value. If the IRS was successful, a gift tax would be imposed to the extent the value of those transferred shares exceeds the donor's lifetime gift tax exemption.

5. Cash Funding with Subsequent Swap

This approach would involve the Senior Family Member initially making a gift of cash or other readily marketable assets into a grantor trust. A gift tax return would be filed reporting the gift of the cash or the readily marketable securities at their readily determinable value. Thereafter, the grantor could sell or swap interests in the hard-to-value asset (such as an FLP interest) to the trust in exchange for either cash or those marketable securities, based upon the appraised value of those shares. Query whether or not in such case, the Senior Family Member should file an additional gift tax return disclosing the swap of assets and taking the position that the swap was made for fair market value and that no gift tax liability resulted?

G. To Report or Not to Report the Sale to IDGT?

An important consideration with an IDGT transaction is whether or not the sale component of the transaction should be reported on the seller's timely filed gift tax return. While certainly any "seed gift" to the trust would need to be reported on a gift tax return, a sale component is not necessarily required to be filed because, presumably, the transaction is a fair market value exchange rather than a gift. Many practitioners are of the view that it is advisable for the sale to the IDGT to, nonetheless, be reported on the taxpayer's gift tax return as a non-gift transaction in order to adequately disclose the transaction and start the three-year statute of limitations running under Section 6501 for the IRS to challenge the sale for gift tax purposes.[50] An important distinction should also be noted, that, while the adequate disclosure of a sale transaction on a gift tax return will start the statute of limitations running on the sale for gift tax purposes, such will not provide any insulation for purposes of any potential estate tax challenges that could arise at the Senior Family Member's death, for instance, under Section 2036.

For many practitioners, it has been considered the more favored approach to disclose the sale transaction on a gift tax return, so as to "bite the bullet" and address any gift tax issues associated with the sale currently rather than risk having those issues raised down the line, for instance, upon the death of the taxpayer, perhaps several decades in the future. However, such may not always

[50] Treas. Reg. § 301.6501(c)-1(f)(5) provides that the statute of limitations does not begin to run until the transfer is adequately disclosed on the taxpayer's' gift tax return.

necessarily be the correct approach. Particularly in the case of very large sale transactions, in the absence of some other effective approach to limit or eliminate the gift tax exposure in the event of the revaluation of a sold asset, there may be meaningful gift tax liability exposure if the sale transaction is determined to be for less than adequate consideration. Thus, advising as to the "right" approach for a client will require consideration of a number of unique factors such as age, health, appreciation potential, desire for closure of the gift tax issue and risk tolerance. For instance, in the *Woelbing* case discussed above, an IDGT transaction was entered into whereby stock was sold for a price of $59 million in exchange for a promissory note based upon a defined value sale approach. The IRS issued a notice of deficiency upon reviewing the sale transaction as disclosed on the taxpayer's gift tax return and determined that the value of the transferred stock was not $59 million but, rather, $117 million resulting in a gift of the overage (as discussed above, the IRS also argued that the note itself constituted a retained interest in the trust that violated Section 2702 and, therefore, was valued at zero, which would have resulted in an even larger taxable gift).

Whether or not it would have been preferable to not report the sale transaction on a gift tax return and instead allow the statute of limitations for assessment of gift taxes to remain open, and ultimately be subject to further review in connection with the Senior Family Member's estate tax return is debatable, and is difficult to determine in retrospect. However, the Woelbing case is a good illustration of the point that careful consideration should be given and discussed with the client as to whether or not a sale transaction should be reported on a gift tax return and the relative pros and cons associated therewith.

IV. PROACTIVE PLANNING WITH SECTION 2701 AND PREFERRED "FREEZE" PARTNERSHIPS[51]

A. Introduction

In its most basic form, a preferred "freeze" partnership (referred to in this outline as a "Freeze Partnership") is a type of entity that provides one partner, typically a Senior Family Member, with an annual fixed stream of cash flow in the form of a preferred interest, while providing another partner with the future growth in the form of common interests in a transfer-tax-efficient manner. Preferred Partnerships[52] are often referred to as "Freeze Partnerships" because they effectively contain or "freeze" the future growth of the preferred interest to the fixed rate preferred return plus its right to receive back its preferred capital upon liquidation (known as the "liquidation preference") before the common partners are entitled to anything. The preferred interests do not, however, participate in the upside growth of the partnership in excess of the preferred coupon and liquidation

[51] For excellent comprehensive discussions of preferred partnership planning, *see generally* Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle*, 35 Heckerling Inst. On Est. Plan. (2001). *See also* Paul S. Lee & John W. Porter, *Family Investment Partnerships: Beyond the Valuation Discount* (Sept. 2009), *available at* https://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/joint_fall/2009/lee_family_investment_partnerships_outline_september2009.authcheckdam.pdf.

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

preference, and all that additional future appreciation inures to the benefit of the common “growth” class of partnership interests, typically held by the younger generation or trusts for their benefit. Over time, assuming that the Freeze Partnership’s assets are invested in such a way so as to outperform the required coupon on the preferred interest, the common interest will appreciate in value, thereby enabling future growth of the partnership (above the preferred coupon) to be shifted to the Junior Family Members that hold the common interests.

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

In a typical application, a Freeze Partnership is created as a new entity, or perhaps an existing single economic class entity is recapitalized, as a result of which a Senior Family Member receives preferred interests in the Freeze Partnership. A Junior Family Member either contributes assets to the partnership in exchange for common interests (in the case of a capital contribution into a newly formed partnership), receives common interests in exchange for recapitalized common interests (in the case of a recapitalization), or perhaps the Senior Family Member initially owns both the preferred and the common interests and subsequently transfers (either by gift, sale or both) the common interests to the Junior Family Member.

The Senior Family Member's preferred interest in the Freeze Partnership will typically (but not always) be structured as a “qualified payment right” under Section 2701 to avoid a deemed gift being triggered upon a capital contribution of assets to the Freeze Partnership, upon a recapitalization or upon the subsequent transfer of the common interest to a Junior Family Member under the application of the “zero valuation” rule of Section 2701. This qualified payment right generally will be structured to provide that the Senior Family Member receives a fixed-percentage payment return on the preferred capital, payable at least annually and on a cumulative basis.[53] In addition, the Senior Family Member would also have a liquidation preference, so that when the Freeze Partnership is liquidated, the Senior Family Member will receive a return of capital before any return to the common interest holders of their capital.

Although the most straightforward Freeze Partnership application will often involve individuals as the preferred and common partners, in some cases trusts and/or other entities may be partners in these entities. In such case, where

[53] I.R.C. § 2701(c)(3)(A).

individual Senior Family Members and/or Junior Family Members have actual or beneficial ownership interests in these trusts or entities, a general "look through" type of analysis is applied to determine the proper way to structure a Freeze Partnership under complex attribution rules that exist with respect to trusts, estates, corporations and partnerships under the Treasury Regulations promulgated under Section 2701.

B. Gift Tax Formation Issues

There are various issues that must be considered in connection with the formation of a newly created entity or the restructuring of an existing entity into a Freeze Partnership. The most notable issue is Section 2701, which generally can result in a deemed gift upon a "transfer" by a Senior Family Member's in connection with a Freeze Partnership in which he or she retains senior equity interests, unless very specific requirements are satisfied with respect to the Senior Family Member's preferred interest. A "transfer" that can potentially trigger a deemed gift under Section 2701 is broadly defined and includes 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.[54]

C. Structuring the Preferred Interest.

1. Qualified Payment Right

A Senior Family Member's preferred partnership interest is most typically, but not always, structured as a "qualified payment right" under Section 2701 to safeguard against the Senior Family Member's contribution of assets to the Freeze Partnership being 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.[55] 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,

[54] Treas. Reg. § 25.2701-1(b)(2)(i).
[55] I.R.C. § 2701(c)(3)(A).

determined under a subtraction method of valuation, but, rather, such distribution right will be valued under traditional valuation principles.[56]

In case the 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.[57] 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.[58]

2. Liquidation Preference

In addition to being entitled to a preferred coupon payment, typically, the preferred interest would provide the Senior Family Member with a priority liquidation right, meaning that upon liquidation, 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.[59] 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).

D. 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.[60]

E. 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 avoids the distribution right component of the

[56] Treas. Reg. § 25.2701-2(a)(2).

[57] I.R.C. § 2701(d)(2)(C).

[58] I.R.C. § 2701(d)(2)(A)(i).

[59] 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.

[60] Treas. Reg. § 25.2701-1(a)(2).

Senior Family Member's preferred interest being 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.[61] The primary factors indicated are:

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

2. 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.

   a) 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.

   b) 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.

3. Valuation discounts and other relevant factors.

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

F. 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.[62] 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 interest contained a put right at a value that is lower than the value of the qualified payment right).[63]

G. Avoiding the Preferred Equity Interest Being 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:

> "(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,

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

[63] Treas. Reg. § 25.2701-2(a)(3).

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

(xi) thin or inadequate 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." [64]

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. In order to help bolster the argument that the preferred interest is equity rather than debt, the preferred structure should take into consideration as many of the above factors as possible. In addition to considering the various factors above, the planner might consider "stapling" a participation feature to the preferred interest, thereby creating a hybrid interest to further support the position that the preferred interest is an equity interest in the Freeze Partnership.

H. Section 2036 Considerations with Preferred Partnerships

Given the Section 2036(a)(2) issues that currently exist with family limited partnership structures, it may be advisable for the Senior Family Member 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.[65]

Additionally, from a "bad facts" or "implied understanding" Section 2036(a)(1) perspective, it is important to respect the formalities of the Freeze Partnership arrangement.[66] To bolster the legitimacy of the partnership structure, it is advisable to consider the following in the administration of the vehicle, such as:

[64] A compilation of these factors was originally included in Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle*, 35 Heckerling Inst. On Est. Plan. 3 (2001). *See also Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); I.R.S. Gen. Couns. Mem. 38275 (Feb. 7, 1980).

[65] *See generally*, DOUGLAS K. FREEMAN & STEPHANIE G. RAPKIN, PLANNING FOR LARGE ESTATES 3-71 (LexisNexis 2016) (1985) (noting that the IRS could argue for inclusion under I.R.C. § 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).

[66] *Id. See also Estate of Liljestrand v. Commissioner*, 102 T.C.M. (CCH) 440 (2011). In addition to a litany of bad facts that lead to an unfavorable result in *Liljestrand*, the Tax Court specifically noted the following with respect to the preferred payment:

> "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,

1. Make 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 enforce payment.

2. Avoid making the preferred coupon match the anticipated partnership annual income.[67]

3. Section 2701 does permit a four-year deferral for a qualified payment right preferred coupon payment.[68]

4. A preferred payment can be satisfied through the issuance of a promissory note with a term no longer than four years.[69]

A Freeze Partnership is, economically, very different than the typical so-called "FLP" involved in the various cases decided under Section 2036(a)(1) because 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 versus 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, because the 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 is supportive of 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

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."

[67] *Id.; Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958) (noting that to avoid the reach of I.R.C. § 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").

[68] I.R.C. § 2701(d)(2)(C).

[69] 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.

appraisal is obtained to determine the adequacy of the preferred coupon, could also be further support that the "bona fide sale exception" requirement has been met.

There should be a strong argument in favor of the bona fide sale exception to Section 2036 applying with respect to the initial contribution by Senior Family Member into the partnership in exchange for a priority cash flow preferred interest. Indeed, the economic arrangement of a preferred partnership is such that a bargain is being struck between the preferred and common partners such that the preferred partners receive a priority return but surrender any upside growth potential in favor of the common interest holders. Additionally, in the absence of particularly bad fact scenarios in which the preferred return has been reversed engineered so as to equal the partnership's anticipated income, a good argument exists that the preferred return should not constitute a "retained interest" under Section 2036(a).

In *Estate of Boykin,*[70] the Tax Court determined that the retention of non-voting preferred stock did not constitute a retained interest in connection with decedent's transfer of voting common shares to a trust for his children. The IRS argued that the decedent's retention of the non-voting preferred shares constituted his retention of "nearly all of the income from the transferred property," which it argued "constituted a retention of the enjoyment of the transferred voting common stock or a right to income from the transferred stock." The Tax Court rejected the IRS's argument, indicating that such ignored the legal distinction between the two separate classes of shares and the respective economic rights associated therewith. It stated:

> When decedent gave his voting shares to the trust for the benefit of his children… he transferred with the voting shares the right to receive all dividends and liquidating distributions that were subsequently declared on them. The only rights decedent retained were those accorded to the [Corporation's] nonvoting shares he retained, which were separate and distinct rights from the rights enjoyed by the voting shares that he transferred.[71]

Thus, in most cases, there should exist a strong argument that the holding of a preferred partnership interest should not constitute a transfer with a retained interest under Section 2036(a)(1).

I. 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 limited liability companies (LLCs), as well as through trusts.[72] In addition, these rules

[70] *Estate of Boykin v. Commissioner*, 53 T.C.M. 345 (1987).
[71] *Id* at 12.
[72] Treas. Reg. § 25.2701-6.

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

1. Entity Attribution Rules

The attribution rules under Section 2701 applicable to entities such as corporations, partnerships and LLCs are relatively straightforward. The rules apply a proportionate ownership in the entity type of approach, which generally attributes ownership of an equity interest owned by an entity as owned by the owner of the entity to the extent of his or her percentage ownership in the entity.[73] In the case of entities that hold interests in other entities, the attribution rules have provisions to apply a "tiered" attribution approach.[74] 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.*[75]

2. Corporations and Partnerships

In the case of interests in corporations, the attribution rules refer to the fair market value of the stock as a percentage of the total fair market value of all stock in the corporation.[76] 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.[77] 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

[73] 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.*

[74] *Id.*

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

[76] Treas. Reg. § 25.2701-6(a)(2).

[77] Treas. Reg. § 25.2701-6(a)(3).

and B as having a 90% interest in the Partnership; in each case the greater of the profit or capital percentage for each partner.

3. Trust Attribution Rules

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

A proper analysis of the trust attribution rules often involves a multi-step process. First, one must proceed through the so-called "basic" trust attribution rules. Then, if the trust at issue is recognized as a grantor trust under 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.

a) The "Basic" Trust Rules

It is often difficult to express a trust beneficiary's interest in a trust with any degree of certainty; especially if there are multiple beneficiaries or if its trustees have been given substantial discretion with respect to distributions or other decisions affecting the beneficiaries' interests in the trust. In this sense (and many others), trusts are unlike entities where ownership percentages are more often readily determinable. This distinction is one of the underlying policy rationales for the above-referenced "basic" trust attribution rules, which generally provide that a person has a beneficial interest in a trust whenever the person may receive distributions from the trust in exchange for less than full and adequate consideration.[78] 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 trustee discretion will be exercised in their favor to the maximum extent permitted.[79]

(1) 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

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

[79] 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.

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.[80]

(2) Ownership of the interest may be attributed to a beneficiary, even where the trust instrument states that he or she cannot own it or receive dividends or other current distributions from it, if he or she may receive a share of the proceeds received from its future disposition. Indeed, the Treasury Regulations provide that a trust's equity interest may be fully-attributed to its remainder beneficiaries.[81] 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.

b) The Grantor Trust Attribution Rules

The grantor trust attribution rules attribute the ownership of an equity interest held by or for a "grantor trust" to the substantial owner(s) (or "grantor(s)") of such grantor trust.[82] 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.[83]

c) 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 "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 whether the equity interest at issue is senior or

[80] *Id.*

[81] *Id.*

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

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

subordinate, and the status of particular persons in relation to the Transferor.

(1) More specifically, if the above rules would otherwise attribute an "Applicable Retained Interest" to more than one person in the group consisting of the Transferor and all "Applicable Family Members," the multiple-attribution ordering rules re-attribute such Applicable Retained Interest in the following order:[84]

(a) 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);

(b) to the Transferor of the Applicable Retained Interest;

(c) to the spouse of the Transferor of the Applicable Retained Interest; or

(d) pro rata among the Applicable Family Members.

(2) By contrast, if the above rules would otherwise attribute a "subordinate equity interest" to more than one person in the group consisting of the Transferor, all Applicable Family Members and "members of the Transferor's family," the multiple-attribution ordering rules attribute such subordinate equity interest in the following order:[85]

(a) to the transferee of the subordinate equity interest;

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

(c) 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);

(d) to the Transferor of the subordinate equity interest;

(e) to the spouse of the Transferor of the subordinate equity interest; or

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

[84] Treas. Reg. § 25.2701-6(a)(5)(i).
[85] Treas. Reg. § 25.2701-6(a)(5)(ii).

(3) 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.

J. Selected Income Tax Issues

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

1. Generally

In addition to the Section 2701 gift tax issues, and the estate tax issues mentioned above, partnership income tax issues must be considered in connection with the formation of the partnership to protect against the recognition of gain as a result of the contribution of assets into the Freeze Partnership.

2. Diversification

In the case of partnership assets consisting of securities there should be no recognition of gain as a result of the capitalization of the partnership if no "diversification" occurs under Section 721(b) as a result of a partner's capital contribution.[86] Accordingly, if both partners already have diversified portfolios,[87] then the contribution by them of their portfolios into the Freeze Partnership should not result in gain under the Section 721(b) diversification rule.

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

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

3. Investment Company

Alternatively, if at least 20% of the partnership assets consist of real estate or other assets other than readily marketable securities, this too would avoid recognition of gain as a result of the capitalization.[88]

4. *De Minimis* Exception

Under the so-called *de minimis* exception, if one of the partners contributes assets that are "insignificant" in amount as compared to the total assets of the partnership, the contribution of those assets does not result in diversification.[89] Although an example in the Treasury Regulations indicates that a contribution of less than 1% would be insignificant, private letter rulings have determined that up to a 5% contribution could be considered insignificant.[90]

5. "Disguised Sale" Rules

The Treasury Regulations under Section 707 establish a presumption that a "disguised sale" exists any time a member contributes "built-in gain" property to an LLC or partnership and cash or other property is distributed to such contributing member within two years of the contribution.[91] If a disguised sale is considered to occur, the contributing member is deemed (for income tax purposes) to have sold all or part of the built-in gain property contributed (measured by the cash received versus the total value of the property contributed by the member).

A disguised sale generally occurs if, based on all of the facts and circumstances (i) the distribution would not have been made but for the contribution of property to the partnership, and (ii) the distribution is not dependent on the entrepreneurial risks of the partnership.[92] The Treasury Regulations, however, provide an exception to disguised sale treatment for preferred returns where payments to the contributing member are "reasonable" and the facts do not "clearly establish" that the distribution is part of a sale.[93] The Treasury Regulations further provide a safe harbor, deeming a preferred payment "reasonable" if the preferred payment does not exceed (i) the member's unreturned capital in the partnership at the beginning of the year multiplied by (ii) 150 percent of the highest applicable federal rate.[94] This safe harbor notwithstanding, in light of the

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

[89] Treas. Reg. § 1.351-1(c)(5).

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

[91] Treas. Reg. § 1.707-3(c)(1).

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

[93] Treas. Reg. § 1.707-4(a)(2).

[94] Treas. Reg. § 1.707-4(a)(3)(ii).

historically low interest rates and the valuation factors discussed above, it is extremely likely, in light of the factors set forth in Revenue Ruling 83-120, that the valuation of the preferred coupon will exceed the regulatory safe harbor. As such, structuring a preferred partnership where the contributing partners are different taxpayers requires reconciling these two seemingly incompatible sets of rules.

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

a) Safe Harbor Approach with Qualified Payment Right Election

One approach to mitigating the risk of a disguised sale could be to structure the preferred coupon so as to restrict the payment of the preferred return for the first two years to not exceed 150% of the highest applicable federal rate, followed by a make-up payment in the third year in order to "true up" the preferred partner to the preferred coupon amount required for the first two years.[95] However, while such a provision addresses the disguised sale rules, it is in direct conflict with the transfer tax requirement that the coupon be payable annually from the Freeze Partnership to the preferred interest holder (assuming the preferred coupon will be structured as a Qualified Payment Right under Section 2701). To address this issue, one could structure the preferred coupon to fall within the reasonable payment safe harbor, but intentionally not satisfy the requirements of a Qualified Payment Right, and instead make an election to treat the preferred interest as if it were a Qualified Payment Right on a timely filed gift tax return.[96]

b) Alternate Safe Harbor Approach

An alternative safe harbor to the reasonable payment is available for operating cash flow distributions, which are not presumed to be disguised

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

[96] I.R.C. § 2701(c)(3)(C); Treas. Reg. § 25.2701-2(c).

sales unless the facts and circumstances clearly suggest otherwise.[97] An operating cash flow distribution is a transfer of money by a partnership to a partner that does not exceed the partnership's net cash flow from operations, multiplied by the lesser of (i) the partner's percentage interest in partnership profits for the tax year in question, or (ii) the partner's percentage interest in overall partnership profits for the life of the partnership.[98] This approach may permit practitioners to more readily structure the preferred coupon in a manner that avoids classification as a guaranteed payment, which could provide certain advantages from an income tax perspective.[99] Care should be taken if adopting this approach to confirm that the partnership complies with the technical requirements of both the operating cash flow safe harbor and the Qualified Payment Right under Section 2701, including possibly making a protective Qualified Payment Right election.

c) Non-Safe Harbor Reasonable Payment Approach

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

d) Factors to Consider

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

[97] Steven B. Gorin, STRUCTURING OWNERSHIP OF PRIVATELY-OWNED BUSINESSES: TAX AND ESTATE PLANNING IMPLICATIONS 215 (July 5, 2016), available by email at sgorin@thompsoncoburn.com.

[98] Treas. Reg. § 1.707-4(b)(2).

[99] Gorin, *supra* note 100, at 215.

the safe harbor, might be an acceptable risk, and one that avoids needing to make a Qualified Payment Right election.

6. Guaranteed Payments

Qualified Payment Rights are sometimes structured as guaranteed payments under Section 707(c) to take advantage of an exception of such payments from the zero valuation rule of Section 2701.[100] Broadly speaking, a guaranteed payment is a payment made by a partnership to a partner for services or for the use of capital to the extent such payments are determined without regard to the income or profits of the partnership.[101] In some circumstances, the IRS might attempt to argue that the preferred coupon is debt, rather than equity, because the payment of the guaranteed payment is fixed in both time and amount and is not dependent on the entrepreneurial success of the partnership; however, unlike debt, guaranteed payments need not actually be made when earned. Indeed, in most cases, the payment of a guaranteed payment from a partnership is deferred until sufficient liquidity is available to make the payment.

Conversely, it may sometimes be preferable to avoid structuring the preferred coupon as a guaranteed payment, because guaranteed payments are generally taxable to the recipient of the partner as ordinary income, regardless of whether the partnership has sufficient liquidity to actually make the payment.[102] A partnership making guaranteed payments is eligible for an offsetting deduction under Section 162(a). However, the deduction for the payment of guaranteed payments is subject to various limitations that may result in income inclusion for the preferred interest holder without the ability of the partners to currently deduct the full value of the guaranteed payment.[103]

To structure the preferred coupon in a manner that avoids guaranteed payments status, it is typically necessary to condition the payment of the preferred coupon on partnership profits.[104] As this structuring decision can arguably remove the preferred coupon from the statutory definition of a Qualified Payment Right under Section 2701, structuring the preferred coupon in this manner is often done in tandem with a Qualified Payment Right election.

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

[101] I.R.C. § 707(c).

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

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

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

K. REVERSE FREEZE PARTNERSHIP

1. 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.

2. 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 is an exception to the Senior Family Member's interest from being a "distribution right" subject to the zero valuation rule under Section 2701.[105] In such case, however, it is critical 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.[106]

3. Valuation Considerations

As with the forward Freeze Partnership, it is necessary to obtain an appraisal of the preferred interest to confirm 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

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

[106] Treas. Reg. § 25.2701-2(b)(2).

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.

Deconstructing Different Flavored Freezes – A Comparison of Popular Estate Freeze Techniques

N. Todd Angkatavanich

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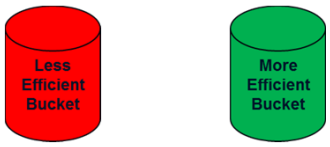
EY

Why Engage in Wealth Transfer "Freeze" Planning?

- Contain the value of assets in Grantor's taxable estate.
- Protect against possible future loss of valuation discounts.
- Shift future appreciation in asset to beneficiaries (perhaps in a multi-generational GST Exempt manner).
- Provide cash-flow to Grantor in the form of promissory note payments, annuity payments or "frozen" preferred coupon payments.

Freezes Generally

- "Freezes" contain asset growth in one less efficient "bucket" and shift growth into more efficient one



- Divide economics so as to match cash-flow, investment horizon and risk/reward profile of different parties
- Trade more secure cash flow (GRAT, Promissory Note, Preferred Coupon) vs. upside growth potential

Types of Freezes

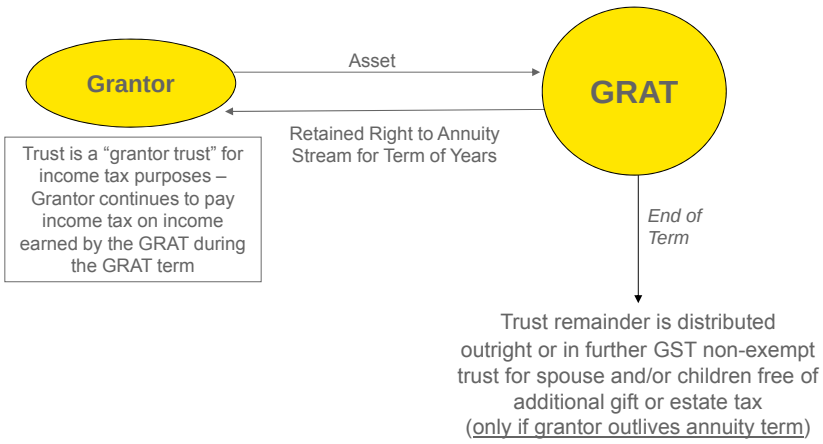
- Gifts
- GRATs
- Sales to “Defective” Grantor Trusts
- Preferred Partnerships

Grantor Retained Annuity Trusts

Grantor Retained Annuity Trust – The Basics

- A GRAT is a **trust planning technique** authorized under Code Section 2702.
- It involves making a **transfer of a future interest** in trust for the benefit of the beneficiaries (typically the Grantor's children or trusts for descendants), with the Grantor **retaining a specified annuity interest** for a fixed term of years.
- Grantor's/Parent's **taxable gift is reduced** by the present value of the annuity interest he/she retains in the transferred asset – so that under the "subtraction method" of valuation, only the value of the **remainder interest is subject to gift tax.**
- If Grantor/Parent outlives the selected annuity term, then the remaining assets (including appreciation) are removed from his/her taxable estate.

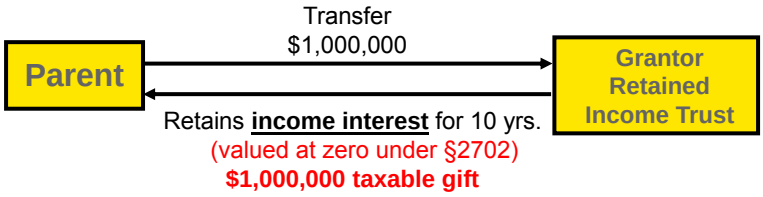
GRAT Basic Illustration



General "Zero Value" Rule under Section 2702

- A transfer into an irrevocable trust f/b/o a "member of the family" when the Grantor retains an interest will be fully subject to gift tax (unless an exception applies).
- No "credit" is given for the Grantor's retained interest (valued at "zero" for gift tax purposes under subtraction method).

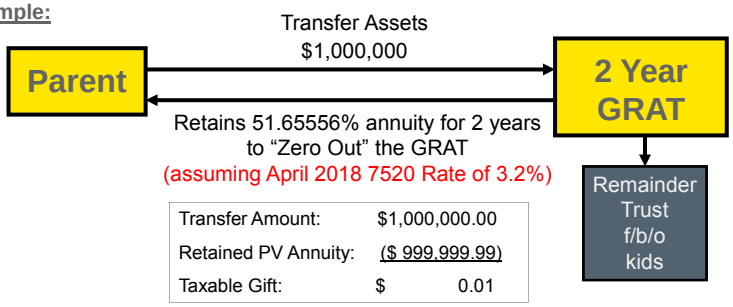
Example of Retained "Income Interest" Valued at Zero:



"Zeroed-Out" GRAT

- A GRAT is an exception to the zero valuation rule under Section 2702 when the Grantor's retained interest is a "Qualified Interest." Grantor gets "credit" for the PV of the annuity.
- If Parent's retained annuity is large enough for her retained interest to nearly equal the value of the transfer into the GRAT then parent's taxable gift will be close to zero.
- At end of annuity term, the value (if any) of the remaining GRAT assets above the annuity payments passes gift tax free to remainder beneficiaries.

Example:



Transfer Amount:	$1,000,000.00
Retained PV Annuity:	($ 999,999.99)
Taxable Gift:	$ 0.01

GRAT Technical Requirements

- Annuity must be a fixed amount (in dollars, percentage or fraction) paid at least annually to Parent/Grantor.
- Annuity amount (in percentage or dollar amount) may be increased up to 20% each year. This allows more assets to remain in the GRAT in the early years to allow trust's assets to grow.
- Annuity amount adjusts for incorrect valuations.
- Annuity payment cannot be satisfied by payment of a debt obligation option or similar financial arrangement issued by the GRAT to Parent/Grantor.
- No additional contributions to GRAT permitted.
- No commutation (pre-payment) of annuity interest permitted.
- Annuity payments must be paid within 105 days of due date.

GRAT Characteristics

Advantages

- Remove appreciating assets from the estate
- Shift capital appreciation above the annuity payments to remainder beneficiaries
- Provide annuity stream for set term of years
- Reduce taxable gift by present value of retained annuity stream
- Can be structured to nearly "zero-out" the taxable gift of the remainder interest
- Statutorily blessed under Section 2702
- Valuation adjustment feature
- Grantor pays income tax on GRAT's income – equivalent of a tax-free gift

Other Factors

- Annuity payments are added to grantor's estate
- A portion or all of GRAT's assets are included in grantor's estate if grantor dies before annuity term ends
- Violation of strict rules can have harsh results
- Cannot receive additional contributions
- To be successful, asset needs to appreciate at a rate greater than the IRS discount rate (§7520 Rate) in effect for the month of the transfer (e.g., April 2018 = 3.2%)
- Beneficiaries receive a carryover basis in property if grantor survives the GRAT term
- Multigenerational planning is very difficult due to ETIP rule.

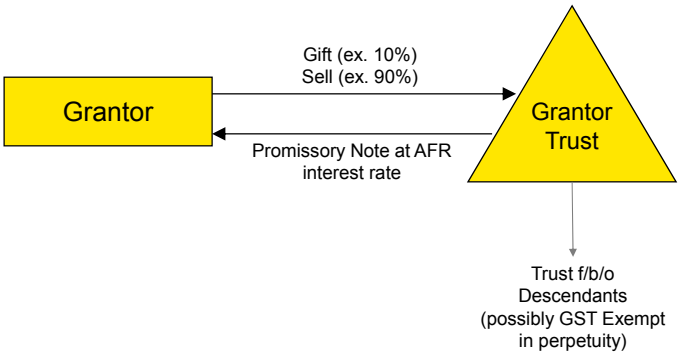
Sale to Intentionally Defective Grantor Trust (IDGT)

What is a Sale to an Intentionally "Defective" Grantor Trust?

Example:

- Parent/Grantor transfers assets (e.g. LP interests in an FLP) to a grantor trust
- Transfer consists of a gift of typically at least 10% of the total assets.
- Grantor makes a subsequent sale of the additional assets.
- Trust pays for the purchase component (ex. 90%) with a promissory note payable to the grantor.
- Transfers to grantor trust are "complete" for estate and gift tax purposes but disregarded for income tax purpose
  - Assets transferred to the grantor trust are not included in grantor's estate
  - Grantor pays trust's income tax – equivalent to tax-free gift
  - Grantor does not recognize gain on sale to trust and promissory note interest payments are not includible as income to grantor
- Planning Benefits:
  - Trust assets (and appreciation) excluded from Grantor's estate
  - Trust can be made GST exempt upon creation and therefore may provide "multi-generational" transfer tax protection

Gift/Sale to Grantor Trust Illustration



- Gift of up to $11.18M permitted by current unified credit
- Sale or loan of up to $100M @ AFR (April 2018 mid-term of 2.72%)

Sale to an Intentionally Defective Grantor Trust

Advantages

- Leverage lifetime gift and generation-skipping transfer tax exemptions
- Freeze value of assets at value of unpaid note balance (if unpaid at death) for estate tax purposes
- GST-Exempt planning can be achieved
- Post-sale capital appreciation passes to heirs gift tax free (possibly GST exempt)
- No gain or loss is recognized by the seller at the time of sale to the trust
- Low Applicable Federal Rate to service the note:
  - Example: Loans made in April 2018 - Mid-term AFR of 2.72%
- Grantor pays income taxes for trust

Other Factors

- Irrevocable gift
- Any unpaid portion of note at seller's death included in the gross estate for estate tax purposes
- Income tax consequences at Grantor's death if an unpaid note?
- Valuation uncertainty risks on sale and gift
- Possibly vulnerable to challenge as gift with retained interest
- Risk of economic loss to purchasing trust

Section 2701 and Karmazin

- TP created a partnership and sold LP interests to IDGT in exchange for promissory note. LP interests sold to trust were financed 100% by note.
- IRS argued that note was disguised equity, not debt.
- If promissory note is really equity and not debt, amount of taxable gift is value transferred minus value of qualified payment rights under the subtraction method of § 2701.

Karmazin v. Comm'r, T.C. Docket No. 2127-03 (settled).

Section 2701 and Karmazin

- While Karmazin was settled, the § 2701 argument remains a threat.
- If IRS can argue that promissory note received in connection with gift/sale transaction to grantor trust is disguised equity, and if common interests represented by LP interests are transferred to younger family members (or their trusts), then § 2701 could value note at zero and would cause gift of a deemed gift with respect to parent's retained interest.

Karmazin v. Comm'r, T.C. Docket No. 2127-03 (settled).

Section 2702 and Karmazin (and now Woebling)

- IRS argued - sale of the LP interest by the TP in exchange for note constituted a “transfer in trust” under §2702
- Under §2702, a retained interest has no value unless it is a “qualified interest”

Section 2702 and Karmazin (and now Woelbing)

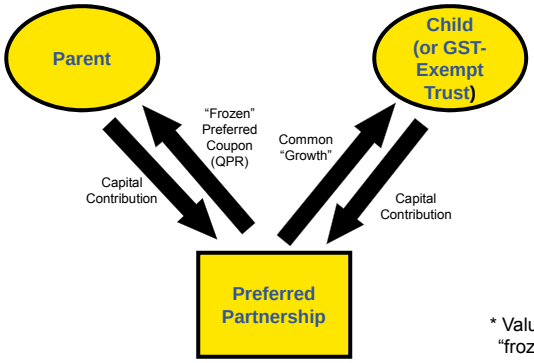
- The sold LP interest should be recharacterized as a gift to the IDGT, in exchange for a retained interest valued at zero, resulting in a taxable gift of all LP interests sold
- Estate of Woelbing - ultimately settled before trial.

Planning Opportunities with Preferred "Freeze" Partnerships

Preferred Partnerships to Shift Value

- Division of partnership or LLC interests into preferred "Frozen" and common "Growth" interests
  - Preferred interests have priority to cash flow (in the form of a set percentage return) and liquidation proceeds, but a cap on upside potential
  - Common interests are subordinate to income and liquidation rights of preferred interests, but capture all residual growth of partnership or LLC
- If older generation/parent owns preferred interests and younger generation (or, better, GST exempt trust) owns common interests, there is a potential to contain or "freeze" the growth in value of parent's preferred partnership interests and shift growth (in excess of preferred coupon) to common interests.

Basic Preferred Partnership



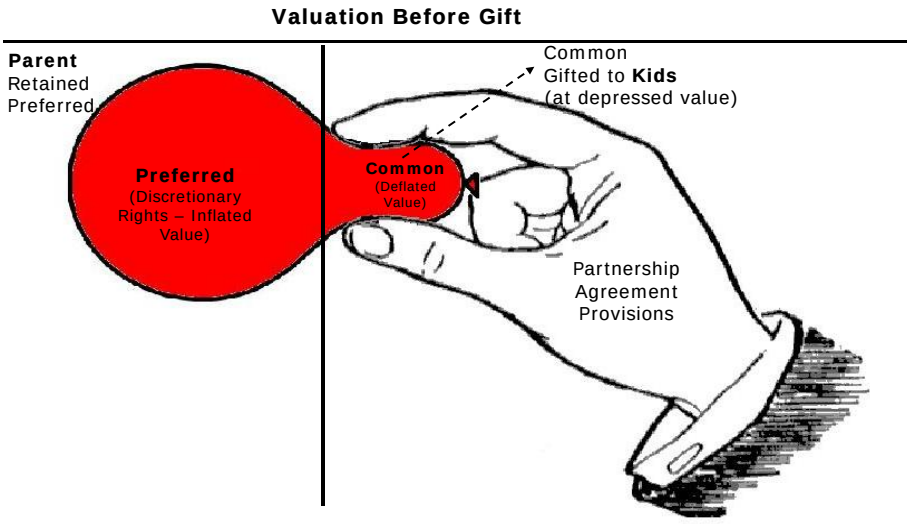
* Value of Parent's interest "frozen" at value of initial contribution

* Parent retains predictable cash flow

"Qualified Payment Right" ("QPR") – Statutory basis for most 2701 compliant preferred partnerships.

- Qualified Payment Right
  - Cumulative payment
  - Payable at least annually
  - At a fixed rate or at a rate bearing a fixed relationship to a specified market interest rate
- A preferred interest that is a QPR is valued under traditional valuation principals (not subject to "Zero Valuation").

Pre-2701 Preferred Partnership Perceived Abuse



IRC Section 2701 – Overview

- **Perceived Abuse** – Different generations work in concert to artificially minimize the value of assets transferred to younger generation.
- **Pre-2701 Transaction** – Older generation transfers interests in an entity (corporation or partnership) to members of younger generation while at the same time retaining certain types of interests in the same entity that soak up most of the value of the entity thus making the gifted interest worth very little.
- **What Section 2701 Can Do** – Cause the value of the gift to members of the younger generation to include the value of the interest retained by the older generation and in certain cases treat the value of the retained interest to be zero.
- **When Section 2701 Applies** – Any "transfer," which includes recapitalizations, capital contributions and changes in capital structure, if the older generation then has
  - senior distribution rights in a family controlled entity or
  - discretionary liquidation, put, call or conversion rights in any entity. (Retained rights that are mandatory and quantifiable typically are excluded.)

Valuing The Preferred Interest

- QPR avoids "Zero Valuation" rule, but still must be valued
- Value of preferred interest should equal "par" to avoid partial deemed gift under traditional "indirect gift" theory.
- Rev. Rul. 83-120 factors:
  - Yield as compared to risk-adjusted market comparables
  - Coverage of coupon
  - Dissolution protection
  - Voting rights
  - Lack of Marketability
- De minimus Rule - junior equity interest (i.e., common interest) deemed to have a minimum value equal to at least 10% of the gross assets of the entity under the subtraction method of valuation.

Section 2036 Considerations with Preferred Partnerships

- Preferred partnerships present similar risks as typical family limited partnerships
- Transferor should not retain control rights that might give rise to estate inclusion
  - Amend partnership agreement, control distributions, dissolve the partnership
- Special issues with respect to the preferred coupon
  - *Fidelity-Philadelphia Trust Co. v. Smith*
    - In the context of debt obligations, three-part test to avoid Section 2036: (i) promise must be a personal obligation of the transferee, (ii) obligation must not be specifically chargeable to transferred property, and (iii) size of payments must not be determined by the income generated by the transferred property
  - *Estate of Liljestrand v. Comm'r*
    - Decedent transferred almost all of his assets into a limited partnership, subsequently made gifts of limited partnership interests to trusts for his children
    - Among other bad facts, the preferred interest retained by the decedent was "engineered" such that it equalled the partnership's expected annual income
    - All assets of the partnership were included in the decedent's estate
  - But see *Estate of Boykin*
    - Preferred coupon is not necessarily a retained interest under Section 2036

Section 2036 Considerations with Preferred Partnerships

- 2701 Compliant Preferred Partnership is "statutory" for gift tax purposes only
- Potential 2036(a)(1) retained interest argument for estate tax purposes
  - Bonafide Sale exception
  - Need proper valuation of preferred coupon at par. If less than par is it for "adequate and full consideration"?
  - Negotiation of separate and distinct economic interests.
- Potential 2036(a)(2) "control" – Strangi, Turner, Powell

GRAT vs. Sale to Defective Grantor Trust vs. Partnership Freeze

GRAT	*Sale to Grantor Trust*	*Preferred Partnership Freeze*
Tax treatment most certain	Tax treatment less certain	Tax treatment more certain
Zero taxable gift possible	Some gift required	Possible gift
Annuity payment to grantor must be fixed (but may be structured to increase annually by up to 20%)	Note payments may be amortized or structured as interest-only with balloon (ex. 9 years, 15 years)	Preferred fixed and cumulative
Higher 7520 Rate (120% of AFR)	Lowest Rate: AFR Rate (mid-term)	Highest payout rate: Based off of Rev Ruling 83-120
Most mortality risk	Less mortality risk. But evolving 2036 argument as to Note	Less mortality risk Section 2036 considerations
GST Planning: No, generally due to ETIP	Multi-Generational Planning: Yes (Note: 90-year GST proposal)	Multi-Generational Planning: Yes (best with common interest)
Valuation Adjustment – If FMV of asset is adjusted	Valuation Risk – as to FMV of transferred asset	Valuation Risk – as to preferred coupon rate and as to value of capital contributions
Prior 2017 Greenbook (Obama Administration) proposed to limit the use of zeroed-out GRATs	Risk of sale recharacterization • Illusory debt • Section 2701 • Section 2702	Section 2701 considerations

Tax Implications

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Grounded in commercial rather than statutory terms; not statutorily blessed • Based upon PLR 9535026 and 9436006 • Structured to be "complete" for transfer tax purposes but "defective" for income tax purposes • Initial sale does not trigger any capital gains tax consequences to the grantor • Consequences at death	• More certainty – Section 2701 compliant • To avoid a deemed gift, the preferred interest must be structured as a qualified payment or other 2701 compliant interest	• Section 2702 compliant GRAT allows the present value of grantor retained annuity to be subtracted from total value to determining value of the gift

Gift required

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Generally requires a "seed" gift unless the trust has preexisting capital, so as to support the debt • The trust should have equity capital of at least 10% so as to support the debt (or guarantee instead)	• Parent typically sells or gifts the common "growth" interest to or f/b/o descendants while retaining the preferred "frozen" interest	• Zeroed-out GRAT: a gift of nearly zero can be achieved if the present value annuity equals the value of the transferred asset to determine the taxable gift • *Note, prior 2017 Greenbook (Obama Administration) proposed to limit the use of zeroed-out GRATs*

Payments

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Payments set by the terms of the promissory note • Payable with interest at AFR rate for a period of time is either straight amortized or interest only payments with a balloon payment of principal (*i.e.* 9-year or 15-year) • No grace period for late payments. Failed payments may support argument that it is not true debt	• Section 2701(d)(2)(C) allows a 4 year grace period for "qualified payments" • Qualified payments can be made with a 4 year promissory note • Allows any payment made during the 4 year period to be treated as being made on the due date • Allows some cash flow flexibility	• Annuity payments must be fixed • But the annuity payments can be structured so that they increase by as much as 20% per year during the term of the GRAT • 105-day grace period

Hurdle rate

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Interest at AFR rate (*i.e.*, 9-year, 15-year) • When interest rates are low, more attractive because any growth in the asset is more likely to out-perform the hurdle rate	• Appraisals determined by prevailing market rates and other factors and appraisal is required to determine the proper preferred coupon rate and other factors (See Rev. Ruling 83-120) • Tends to be a higher rate • If the client needs more cash this allows a higher payout	• Annuity payments to the Grantor is determined based upon 7520 rate • 120% of the midterm AFR (determined under section 1274) • Tends to be a higher rate than Sale to Grantor Trust

Mortality Risk

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Conventional wisdom is that sold assets are not included in estate, however the unpaid note is included in estate • If the grantor dies during the term of the sale, the balance on the installment note not paid off at the time of death will be included in the grantor's estate • But the sold assets should not be included in the grantor's estate • If grantor dies before the note is paid in full then there may be adverse income tax implications • Some risk: Note the evolving 2036 argument that the promissory note itself constitutes a retained income interest in the assets	• Less mortality risk • Query, can Section 2036 apply? Best practice is to ensure capital contribution in exchange for preferred interest satisfies bona fide sale exception • When the preferred partner dies, the estate will receive a step-up in tax basis	• Grantor must outlive the trust term to remove the gifted assets from estate under Section 2036(a)(1) • If the grantor dies during the term of the trust then a portion or perhaps all of the remaining assets will be included in the grantor's gross estate • Series of short term "rolling" GRATs can be used • *Note, prior 2017 Greenbook proposals (Obama Administration) would have limited the usefulness of a GRAT including instituting a minimum 10 year annuity term and making the remainder interest have a value of greater then zero*

Risk Level

Sale to Grantor Trust:	Preferred Partnership:	GRAT:

• Some risk
• Valuation risk
• If the investment return is not met then the gift tax exemption used to fund the trust will be lost
• Argument that not true debt
• Recharacterize note as a 2036 refund interest
• Recharacterization of note argument
  ◦ 2701
  ◦ 2702
	• Some risk
	• Section 2701 gift issues
	• Risk if the asset does not reach a growth rate in excess of the rate of return paid
	• 2036 Considerations
	• Income tax issue on formation
		• No risk with a Zeroed-out GRAT if the investment return is not met (no loss of gift tax exemption)
		• If no growth, then most of of the assets will be return to the grantor in the annuity payment
		• Grantor is in the same Position

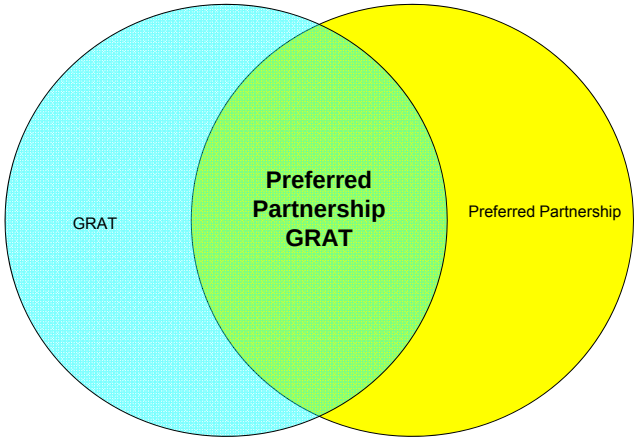
GST Implications

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Is often structured to be GST Exempt • Grantor can allocate GST exemption on which the seed gift to the trust is reported • Sale portion also GST exempt	• Common "growth" interest can be held in a GST trust for the benefit of children, grandchildren and remote descendants • Possible because of the divided ownership between common and preferred ownership	• It is generally not possible to create GRATs with a multi-generational structure because of estate tax inclusion period (ETIP) rule • GRATs are excellent vehicles for transferring assets to the next generation but not so effective for multi-generational planning • Consider possible alternative approaches

Valuation

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• If the value of the transferred assets exceed the note amount then the difference is a gift. Challenge with hard-to-value assets • Step transaction argument that seed gift and sold interest are a single transfer, so sale price cannot be full consideration • No regulatory safe harbor as there is with GRATs • Consider use of Defined Value Clause or Price Adjustment Clause to minimize risk	• Important to receive the proper valuation of the coupon rate to avoid a deemed gift • Revenue Ruling 83-120 provides guidance on the factors the IRS considers when relevant in determining the adequacy of the coupon.	• Section 7520 allows the annuity amount to be recalculated if the value of the initial trust is ever challenged. *See also* Regs. Sec. 25.2702-3(b)(2)

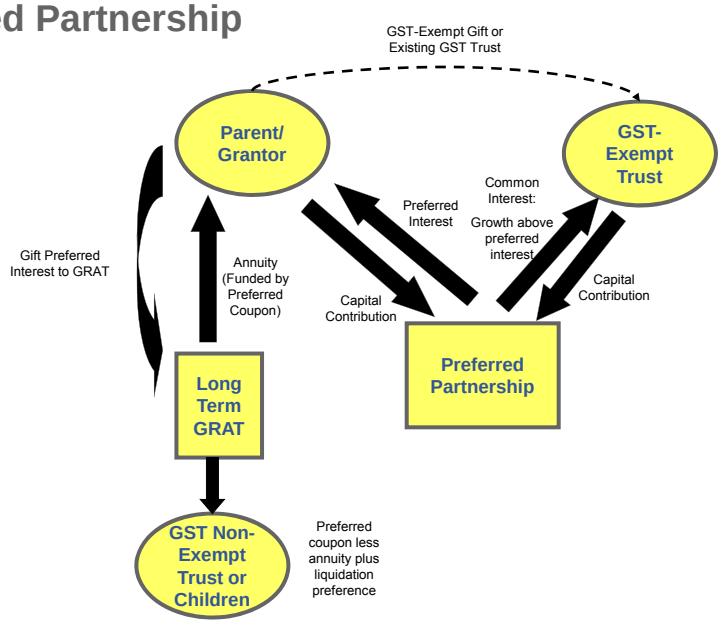
Combining Two Statutory Techniques GRAT and Preferred Partnership



What the Preferred Partnership GRAT does?

- Permits GRAT planning with a way to allocate GST Exemption from inception (rather than at ETIP Termination).
- GST Exempt Growth (above the preferred coupon) occurs in GST Exempt Trust rather than in GRAT (GST Non-Exempt).
- Accumulation of assets in the GRAT (GST Non-Exempt) is contained to the "frozen" preferred coupon, which is used to fund GRAT annuity payments, and the preferred liquidation preference.
- Section 2036 inclusion of some or all of GRAT's assets is contained to preferred "frozen" interest.
- If Greenbook 10 year minimum becomes law, advantages are more pronounced.
- For a detailed discussion see: N. Todd Angkatavanich & Karen E. Yates, *The Preferred Partnership GRAT: A Way Around the ETIP Issue?*, 35 ACTEC J. 290 (2009).

Preferred Partnership GRAT



Speaker Biography

N. Todd Angkatavanich

N. Todd Angkatavanich is a Principal in Ernst & Young LLP's National Tax Department, where he serves in the Private Client Services practice. He was formerly a Partner at Withers Bergman LLP, where he served as Co-Head of the firm's U.S. Private Client & Tax Group. 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) and is also the recipient of the *Best Lawyers*® 2015 Trusts & Estates "Lawyer of the Year" award for New Haven, Connecticut. He has been rated AV Preeminent® *by Martindale-Hubbell® Peer Review Ratings,*™ has been ranked in *Chambers HNW*, has been listed in *Who's Who Legal: Private Client* and in *Super Lawyers.* Todd received his B.A., in Economics, *magna cum laude,* from Fairleigh Dickinson University, his J.D., Tax Law Honors, from Rutgers University School of Law, Camden, his M.B.A. from Rutgers University Graduate School of Management, and his LL.M, in Taxation, from New York University School of Law.