A Meltzer, Lippe, Goldstein & Breitstone, LLP White Paper:

The Entity Freeze Solution

Income and Transfer Tax Planning for Negative Capital

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Income and Transfer Tax Planning for Negative Capital – The Entity Freeze Solution[1]

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Introduction

Entity freezes are an often overlooked method of shifting wealth without tax friction. This type of wealth shift can avoid income, estate, gift or generation skipping taxes. However, the entity freeze must be used in the appropriate circumstances for it to work efficiently. Before choosing the entity freeze, a comparison must be made with the litany of alternative freezing methods such as grantor retained annuity trusts ("GRATs"), installment sales to intentionally defective grantor trusts ("IDGTs"), outright gifts, grants of "carried" or "profits" interests, spin offs and split ups and more. It is essential to select the right freeze method for the right situation. As will be explained below, in the appropriate circumstance the entity freeze technique can be extremely compelling and effective. It can avoid many of the pitfalls of other techniques – especially from an income tax perspective.

Perhaps the most compelling fact pattern where the entity freeze may be advantageous is when planning for highly leveraged low basis real estate held in a partnership or limited liability company. For these types of assets, the entity freeze may be the best method to eliminate the negative capital account or liabilities in excess of basis upon the death of the holder. These considerations are discussed in considerable detail below.

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History of the Entity Freeze

Prior to the enactment of section 2701[3] in 1990 as part of the Chapter 14 regime, entity freeze techniques were referred to as "capital freezes."[4] This term was a reflection of the fact that under the state of the art planning of that time, capital was typically all that needed to be "frozen" to accomplish the intended objectives. Freezing income was not typically contemplated because prior to the enactment of section 2701 it was much easier than it is today to simply "shift" income to the next generation. There was no need to freeze what could simply be shifted.

A capital freeze typically involved the recapitalization of a business entity (whether a partnership or a corporation) into separate classes of ownership interests. Typically, there would be a preferred interest and a common interest. The preferred interest would be entitled to a liquidation preference so that it would be entitled to a priority return of capital upon the occurrence of a liquidity event. However, unlike under current law, there was no need to provide for preferred dividends that would actually be paid. The preferred dividends could be non-cumulative so that if not paid in one year (or for several years) the holder of the preferred interest would not be entitled to a makeup distribution in future years. The non-paid current dividend would be lost – or perhaps more aptly put – shifted to the holders of the junior equity. Moreover, the rights to a liquidation preference could be illusory. Under the entity's organizational documents, the right to the liquidation preference could lapse under certain circumstances, such as upon the death of the holder of the preferred interest. Likewise, the holder of the preferred interest could have a lapsing right to "put" its interest to the entity for a fixed price or to a "call" its capital from the entity in a redemption. However, these rights would seldom be exercised in the family context. They were mainly inserted into the transaction as window dressing so appraisers would attribute a high value to the preferred interest which would reduce or, more likely, negate a gift upon the grant of the junior equity to members of the younger generation.

Within the family context, there thus existed the opportunity to shift income and value to the holders of the junior equity interests since they would benefit from the nonpayment of

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[3] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended as of the date of this publication.

[4] *See* Revenue Reconciliation Act of 1990, passed by Congress on October 27, 1990 and signed by President George H.W. Bush on November 5, 1990.

dividends on the senior preferred, the lapsing liquidation rights, etc. While an appraisal of the preferred interest would recognize these rights as enhancing the value of the preferred interest, that value would be illusory. It was also the case that an appraisal could value the preferred interest at 100% of the value of the entity leaving no value to be allocated to the junior interest. Any option value to the junior interest would typically be ignored even though it constituted real 4
economic value. Clearly, outside of the family context the option value was meaningful since it represents the rights of the holders of the junior equity to participate in the growth in value or upside of a business enterprise. As a result of the manner in which the junior interest would have been valued under pre-chapter 14 authorities, the transfer of the common interest would have little to no gift tax value – even though in reality, its represented a significant shifting of wealth to the holders of the junior equity.

Those were the good old days. Today, there are a number of provisions set forth in Chapter 14, mostly in section 2701, that were specifically designed to preclude this type of planning. Section 2701 was enacted to preclude certain perceived abuses involving entity freezes that were condoned by case law.[5] These cases involved, inter alia, rights belonging to the senior preferred interest holder that lapsed upon death but which were allowed to be taken into account in determining whether there was a gift.[6] Section 2701 has reigned in many of these types of abuses. However, section 2701 now provides a clear set of rules that should eliminate much of the uncertainty surrounding this particular method of freezing asset values.

Another historical development in the tax law that impacts the use of the entity freeze is section 1274 of the Code which specifies the applicable federal rate ("AFR"). This provision was enacted in 1984 to combat certain perceived abuses involving either interest free loans (section 7872) or low interest purchase money indebtedness used on property acquisitions to inflate the depreciation deductions and thus increase the tax shelter resulting from the purchase of income producing properties. Prior to the enactment of section 1274, artificially low interest rates could be charged so that the same level payment would support a higher nominal purchase

[5] *See Estate of Harrison v. Comm'r*, 42 T.C.M. 1307 (1987); *Estate of Watts v. Comm'r*, 51 T.C.M. 60 (1985), aff'd, 823 F.2d 483 (11th Cir. 1987); *Estate of John G. Boykin*, 53 T.C.M. 345 (1987).
[6] *See* IRS Tech. Adv. Mem. 8510002, (Nov. 26, 1984) and IRS Tech. Adv. Mem. 8401006, (Sept. 28, 1983). (holding that decedent taxpayer's voting control should be taken into account in valuing stock for estate tax purposes where the taxpayer owned voting shares in a family-owned corporation that became nonvoting at his death).

price for such property. The higher nominal purchase price also resulted in inflated depreciation deductions which could be made available to offset unrelated income – thus a tax shelter.

The enactment of section 1274 has had a significant impact on freeze techniques that was likely unintended. This impact has been amplified in the current exceptionally low rate environment. This is because the preferred return that must be paid in the entity freeze is determined by market forces by appraisal. Other freeze techniques may rely on the AFR which is typically a far lower rate. Thus, GRATs must use the section 7520 rate (which is 120 percent of the midterm AFR) in determining the annuity payments that must be made to the grantor. Installment sales to intentionally defective grantor trusts must pay interest at not less than the AFR. Currently, the AFR may be a fraction of what a market rate of return would be on a preferred interest.

The availability of the unrealistically low "hurdle" rates associates with other freeze techniques such as GRATs and installment sales and makes those techniques far more advantageous in many, but not all, situations. The situations where those techniques may not work as well as the entity freeze are explored below.

What is a Freeze?

A freeze is a subtle method to transfer value. Different types of ownership interests have different characteristics. Assuming the transaction does not run afoul of an applicable tax regime such as section 2701, these different economic characteristics can favor one party to a transaction over another without amounting to a "transfer" subject to taxation. Contrast the freeze, which is subtle, with an outright transfer, which is overt. An outright transfer will usually trigger a tax consequence from the transfer or realization event.

Freezes can take a variety of forms. What all freezes share is a shifting of risk and reward from one party to another. The party who assumes greater risk typically has greater opportunity for reward (or punishment). One method of increasing the possibility for reward is the use of leverage. Leverage typically entails earning profits on capital furnished by another party. The party employing the leverage takes greater risk because that party will typically subordinate its return in order to induce another party to provide the capital. The party providing the capital will typically insist upon getting more safety of return on capital and return of capital. But the party employing the leverage will have greatly increased rates of return once the priorities of the capital provider are satisfied.

The basic economics of a freeze are illustrated by the following examples. The first example shows the economics absent a freeze – straight up allocations. The second example shows the contrasting economics when a freeze is employed.

What is a Freeze?

• **Assume:**		
• **90/10 Partnership between Senior and Junior**		
• **Property X**		
• **Current FMV**	**$10,000,000**	
• **Projected FMV(5 years)**	**$15,000,000**	
• **Projected income**	**$ 500,000 per year**	
• **Senior Share after 5 years:**		
• **Income**	**$450,000 x 5 =**	**$ 2,250,000**
• **Sales Proceeds**	**90% of $15,000,000 =**	**$13,500,000**
• **Senior's total take**		**$15,750,000**
• **Junior Share after 5 years:**		
• **Income**	**$ 50,000 x 5 =**	**$ 250,000**
• **Sales Proceeds**	**10% of $15,000,000 =**	**$ 1,500,000**
• **Senior's total take**		**$ 1,750,000**

These economic outcomes can be altered materially by restructuring the arrangement as an entity freeze. Thus, even though the underlying assets perform in an identical manner, the amounts earned by the senior generation (the "Senior") vis a vis younger generation (the "Junior") can be materially altered by the structure of the entity.

The following example illustrates how a simple entity freeze would work.

What is a Freeze (cont.)?

- Assume Partnership is converted into a freeze partnership in year 1
- Senior gets preferred partnership interest entitled to 90% of current value ($9 million) and a preferred return of 5.5% per year (which approximately equals $500,000)
- Junior gets common interest (all excess cash flow and all proceeds from a disposition in excess of $9 million)
- Senior Share after 5 years:

Income	$500,000 x 5	$ 2,500,000
Sales Proceeds	$9 million	$ 9,000,000
Senior's total take		$11,500,000

- Junior Share after 5 years:

Income	$ 0	$ 0
Sales Proceeds	$15 million - $9 million =	$ 6,000,000
Junior's total take		$ 6,000,000

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As illustrated below, the freeze in effect shifted $4.3 million from Senior to Junior without incurring any transfer tax consequences.

Comparison of Freeze v. No Freeze

No Freeze:		
Senior Take		$15,750,000
Junior Take		$ 1,750,000
	Total	$17,500,000
Freeze:		
Senior Take		$11,500,000
Junior Take		$ 6,000,000
	Total	$17,500,000

- Freeze shifted $6,000,000 - $1,750,000 = $4,300,000 from Senior to Junior
- There is no recognition event in going from the straight partnership to the freeze partnership as long as there is no capital shift and no debt shift.
- If it was a corporation entity, recapitalization should qualify as a Type "E" reorganization.
- There is no taxable gift as long as the requirements of IRC section 2701 are satisfied.

Note that in this example the freeze is a zero sum gain. No new value is created. This is for purposes of illustration only. In a real life example, there may be significant nontax benefits to the freeze technique. Senior may wish more immediate and certain income from the entity to support current lifestyle needs. Junior, on the other hand, may be more willing to take risks and wait longer for the rewards. By granting the disproportionate appreciation to Junior, Junior may gain an incentive to invest the time (and perhaps capital) necessary to promote the growth of the business. However, Senior should beware. While Junior may be attempting to grow the business, he or she may be doing so by putting Senior's capital at greater risk. The priority return and liquidation preference Senior obtains from the entity freeze will be of greatly diminished value if the business flounders under Junior's stewardship. Moreover, the retention of controls by Senior may be of limited benefit if Senior is not willing and able to exercise such controls. Thus if Senior is elderly or infirm, he or she may lack the capabilities to rescue the business from imprudent management by Junior.

The moral is that the fundamentals of a successful business transition must be present whether or not the freeze is employed. However, through the use of the entity freeze there would at least exist the prospect for a clean transition of the business from Senior to Junior with minimal tax friction.

Note that going from the straight up partnership to the freeze partnership should not be an income tax recognition event as long as there is neither a "capital shift" nor a "debt shift." Whether a capital shift occurs is measured on the date of the freeze recapitalization. In general, a capital shift occurs when the capital of one partner's share of capital, based upon a hypothetical liquidation value, is enhanced at the expense of another either at the time of a capital contribution or at the time of a recapitalization.[7] Such a shift of capital could result in a taxable gift or a taxable grant of a capital interest as compensation for services performed by Junior.

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[7] See discussion *infra*.

Comparison with Alternative Freeze Techniques: GRATs and IDGTs

The two principal freeze techniques that must be considered as alternatives to the entity freeze are the grantor retained annuity trust ("GRAT") and the installment sale to an intentionally defective grantor trust (the "IDGT"). GRATs are governed by section 2702 and will not be analyzed in detail herein. However, there are couple of key characteristics of the of the GRAT technique that should be mentioned. First, the GRAT involves a transfer of assets to a "grantor trust" within the meaning of section 672.[8] As such, and as discussed below in greater detail, if the transfer is treated as a sale in part (which would typically be the case if the transferred property is subject to liabilities in excess of basis) this sale is disregarded until the trust ceases to be a grantor trust. Thus, the income tax consequences of the sale are deferred – but not necessarily permanently. Second, the GRAT is required, under section 2701, to base the annuity retained by the grantor on the section 7520 rate, which is 120 percent of the AFR as determined under section 1274. The AFR is a rate that is based upon the rate paid on certain instruments issued by the Federal government – which historically, and we hope for the future, will pose a very low risk of nonpayment or default. Consequently, the AFR is typically lower than market rates of return for comparable risks. The AFR for the month of November 2011 is as follows:

[8] Rev. Rul. 85-13, 1985-1 C.B. 184 (stating for income tax purposes no sale is deemed to occur as long as a trust remains a grantor trust).

REV. RUL. 2011-25 TABLE 1

- Applicable Federal Rates (AFR) for November 2011

Period for Compounding:	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	**.19%**	.19%	.19%	.19%
120% AFR	.23%	.23%	.23%	.23%
Mid-term AFR	**1.20%**	1.20%	1.20%	1.20%
120% AFR	1.45%	1.44%	1.44%	1.44%
Long-term AFR	**2.67%**	2.65%	2.64%	2.64%
120% AFR	3.21%	3.18%	3.17%	3.16%

The section 7520 rate should be viewed as a hurdle rate[9] in determining the viability of the technique. For the GRAT to be successful, the assets in the GRAT must earn a return that exceeds that hurdle rate. Thus, for example, if the midterm AFR is 1.2%, then the section 7520 rate would be 1.44%. Since the grantor's retained annuity will earn a return of 1.44%, if the underlying assets transferred to the GRAT earn a return greater than 1.44% (and assuming the grantor outlives the term of the GRAT), the excess earnings will pass to the remaindermen. The "freeze" is the retention of the annuity. The growth is what inures to the remaindermen. With a hurdle rate of 1.44%, for example, the bar is relatively low for the GRAT to successfully transfer wealth.

Contrast the GRAT with the entity freeze which pays a return to the Senior that is determined by appraisal and which must take into account bona fide market considerations. That rate will be considerably higher than the section 7520 rate. If, for example, the appraisal

[9] A hurdle rate is the minimum amount of return that a person requires before they will make an investment in something.

determines that the rate that must be payable to avoid a deemed transfer under section 2701 is 8% because comparable instruments pay a comparable rate in the marketplace, the underlying investments must earn more than 8% for the freeze to be successful. If the return is below 8% nothing will pass to the owners of the junior equity interest.

The IDGT presents an even more compelling contrast. It is generally believed that the note taken back in an installment sale does not have to bear interest at a rate that is higher than the AFR, which is lower than the section 7520 rate. Even if the underlying assets transferred in the IDGT in exchange for an installment note are highly risky assets so that an arm's length lender would charge a significantly higher interest rate, the AFR seems to work as a safe harbor.

The extremely low rates of interest that are permitted in both the GRAT and the IDGT are in stark contrast with the rates of return required to be paid on a preferred interest in a section 2701 entity freeze. One source of guidance for how to determine the appropriate yield for a preferred interest in a closely held entity is set forth in Revenue Ruling 83-120.[10] While Revenue Ruling 83-120 predates section 2701, it is nevertheless instructive. In general, Revenue Ruling 83-120 adopts a facts and circumstances approach. However, it does specifically look to a number of criteria to determine the appropriate market rate of return. These criteria include yield, preferred return coverage, dissolution protection, and to a lesser extent, voting rights and lack of marketability. The liquidation preference apparently reduces the extent to which marketability has a negative impact on fair market value.

Market conditions are thus the starting point for determining the appropriate return on preferred interests. One reputable appraisal firm provided the following table which enumerates market returns on preferred stocks of certain publicly traded real estate holding entities:

[10] 1983-2 C.B. 170.

Preferred Stock Returns in the Market

• Hotels	7.32% to 10.93%	Median – 8.96%
• Retail	6.81% to 9.97%	Median – 8.09%
• Multi-Family	6.64% to 8.22%	Median – 8.08
• Office	7.01% to 8.45%	Median – 7.73%

Market data courtesy of Anchin LLC

In the context of a privately held business entity, the lack of marketability and potentially greater risk profile would likely require somewhat higher rates of return – to be determined by appraisal. The comparatively high rates of return that must be paid on preferred interests to avoid the negative gift tax consequences under section 2701 are the reason the entity freeze is often referred to as a "leaky freeze." This term alludes to the fact that compared to other types of freeze techniques, where the returns that must be paid on the frozen interest are artificially low since they are tied to the AFR, the return that must be paid on the retained senior preferred interest to avoid a deemed gift under section 2701 must be a market rate of return for similar investments.

It may take considerable structuring to make the entity freeze work as a freeze. In some instances it might not work. However, in the appropriate case it is worth the cost of admission to make it work.

Income Tax Challenges of GRATs and IDGTs

Aside from the differing income tax consequences of a GRAT or IDGT on the one hand and the entity freeze on the other, there are significant differences in the income tax consequences of these techniques compared to the entity freeze. While the entity freeze technique may be employed in conjunction with a grantor trust that would be disregarded for income tax consequences, the use of a grantor trust is central to the theme of the GRAT or IDGT. With the GRAT or the IDGT, the transfer is essentially ignored for income tax purposes.[11] Consequently, if there were a transfer that would otherwise generate income tax consequences, those consequences are avoided (or perhaps better stated, deferred) at inception. For example, a sale of appreciated property for an annuity may generate taxable gain. Likewise, a sale of an appreciated asset to a trust would, absent the grantor trust rules, result in gain recognition. Contrast an outright gift to a trust that would not normally result in a taxable gain. Yet outright gifts are not usually considered optimal since they do not entail leverage. GRATs and IDGTs do involve leverage so that more appreciation may be transferred if the asset appreciates after the transfer. Lifetime gift exemptions, and other gift exemptions, can be significantly leveraged through these techniques contrasted with the outright gift.

Even an outright gift can trigger income tax consequences if the transferred asset is subject to liabilities in excess of basis. Nonetheless, if the transfer is made to a grantor trust, the income tax consequences can likewise be avoided, at least at inception.

The problem with transfers to grantor trusts is that if the trust ceases to be a grantor trust, the tax consequences that were avoided at inception may be triggered. The following section discusses when and if these tax consequences may be incurred.

The entity freeze, if properly structured, can avoid the tax consequences associated with transfers to grantor trusts, whether those consequences are incurred at inception or at the termination of trust's grantor trust status. The entity freeze technique normally does not depend upon a transfer to a grantor trust to avoid the income tax consequences of its creation. For example, if the entity freeze involves a partnership, or limited liability company taxed as a

[11] *See Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984) and Rev. Rul. 85-13.

partnership, the initial transfer would normally be treated as a contribution to a partnership rather than a transfer to a grantor trust. The rules governing contributions of appreciated property to partnerships are very different from the grantor trust rules. Contributions to partnerships in exchange for partnership interests are normally entitled to nonrecognition under section 721. Even if the property is subject to liabilities in excess of basis, in general, gain will not be 14
recognized at inception under the interplay between section 704(c) and section 752, both of which are discussed in greater detail below.

Moreover, the entity freeze does entail leverage in a manner that is similar to a GRAT or an IDGT. In the GRAT an annuity is retained and appreciation over the annuity is transferred to the remainderman. The leverage results in the transfer of appreciation in excess of the annuity to the remainderman. By taking back the annuity, the amount of the taxable gift is greatly reduced, or eliminated entirely.

The leverage with the IDGT is even more straightforward. The most common example of leverage is to earn profits with borrowed funds. The installment note taken back by the transferor represents a borrowing by the grantor trust. The appreciation is captured by the trust as long is it is able to eventually repay the installment note.

Note that one of the frequently touted estate planning benefits of grantor trusts is that the income tax on income earned by the trust is payable by the grantor. The fact that the grantor pays tax on income earned by the trust is considered to be tantamount to an indirect gift to the trust – which gift is not recognized as a taxable gift. It should be noted that largely the same benefits can be structured with the partnership freeze. Since the grantor retains ownership of a preferred partnership interest, the grantor will be taxable on the income allocable to that interest. When a highly leveraged low basis asset is contributed to a freeze partnership, section 704(c) will, in general, require all or substantially all of the income of the partnership to be allocated to the contributing partner over time to compensate the other partners for the shortfall of basis resulting from the contribution of the appreciated property. This phenomenon will be discussed further below. Moreover, if there is income that exceeds what is required to be allocated to the contributing partner under section 704(c), and if the junior equity is held by a grantor trust, that income will also be allocable to the grantor. Through proper structuring, substantially all of the income tax benefits that can be achieved through grantor trusts can be achieved through the freeze partnership. However, as will be discussed below, the income tax disadvantages and uncertainties that are associated with the use of grantor trusts can be avoided with the freeze partnership. Perhaps most notably, the freeze partnership, if properly structured, can entirely eliminate the risk that the built-in gain on liabilities in excess of basis will be triggered at the termination of the grantor trust or upon the death of the grantor. Moreover, with the freeze partnership technique there are significant prospects for obtaining a basis step-up under section 1014 on the liabilities in excess of basis plus any equity value of the senior preferred interest retained. As discussed below, there is a school of thought that such a basis step-up might occur with the grantor trust, but that conclusion is not iron clad. 15

With the partnership freeze, the holder of the junior equity (which may or may not be a grantor trust) leverages the preferred interest. All of the income and appreciation goes to the holder of the junior equity as long as the preferred interest holder receives its preferred return.

Freeze Partnerships for Leveraged Low Basis Real Estate Investments

The central thesis of this article is that the partnership entity freeze (or "partnership freeze") is the preferred method of planning for assets with liabilities in excess of basis – mostly investment real estate. Failure to appropriately plan for the inherent income tax consequences of property with liabilities in excess of basis can have devastating tax consequences. The following example is illustrative: 16

> AB Partnership holds real property X with a fair market value of $10 million, subject to a mortgage of $8 million. X has an adjusted income tax basis of $1 million. If X were sold for its fair market value, the resulting income tax liability could exceed the equity in the property depending upon the tax rate on the transaction. If the tax rates were straight capital gains rates of 15%, the tax would be $1.35 million. While that is less than the equity value of $2 million, it is 67.5% of that equity. If the gain constituted unrecaptured section 1250 gain, the tax rate would be 25%. At 25% the tax would be $2.25 million, which exceeds the value of the equity. State and local taxes would also come into play where applicable.

This type of scenario is relatively common for real estate interests where cash proceeds of refinancing have been taken or where the property has been fully depreciated. The triggering of this gain can often result in an income tax liability to the transferor that is greater than the potential estate tax savings, or perhaps, the equity values that were the initial motivation for the creation of the GRATs, IDGTs, etc.

In planning for assets with these characteristics, the potential savings in estate, gift and generation skipping transfer taxes must be weighed against the loss of a basis step-up under section 1014 upon death – or even worse, the possibility of incurring an income tax on the built-in gain resulting from use of the planning technique. It is in this context that the benefits of the freeze partnership may take hold. Avoiding these negative income tax consequences can be far more valuable than where the offsetting cost of an increased hurdle rate applies to the freeze partnership. In fact, if properly structured, the costs of the greater hurdle rate can be greatly mitigated. Moreover, as in the context of the reverse freeze described below, the greater hurdle rate may even be a benefit that enhances the planning for certain types of assets – particularly, low yielding assets.

Planning with Grantor Trusts

As discussed above, both GRATs and IDGTs are, if correctly drafted, grantor trusts within the meaning of section 671. As a consequence of being a grantor trust, income earned by the GRAT or IDGT is deemed to be earned by the grantor and thus taxed to the grantor. When the grantor sells assets to the grantor trust (or when assets are deemed sold where liabilities exceed basis) the grantor is treated as having retained ownership of the asset so that as long as the trust remains a grantor trust no sale is deemed to occur for income tax purposes.[12] Also note that while the grantor is treated as having retained ownership of the assets, the transfer can be deemed completed for gift, estate and generation skipping taxes purposes.

The corollary to this non-recognition-of-gain tax treatment is that the taxable event avoided at the time of transfer may be triggered later on the termination of grantor trust status. For a GRAT, this occurs on the expiration of the GRAT term if the grantor survives the term. For an IDGT, termination occurs on the grantor's death, or perhaps sooner if grantor trust status is otherwise terminated.[13] As discussed below, there is some disagreement among commentators as to whether gain is triggered, or if a basis step-up is obtained, upon the death of the grantor.

Normally, when a gift is made there is no basis step-up under section 1015. Section 1015 provides that a donee's basis in gifted assets is the lesser of the assets' fair market value or the donor's basis in the assets. The lack of a basis step-up can be a reasonable tradeoff for saving transfer taxes in the long run. Yet where liabilities exceed basis, the loss of the step-up can significantly reduce the benefits of such planning. It is debatable whether it is even possible to transfer assets that are so encumbered to a succeeding generation without triggering gain on liabilities in excess of basis. In the context of leveraged real estate with liabilities in excess of basis, the loss of a stepped-up basis can be fatal to an otherwise sensible plan.

[12] Rev. Rul. 85-13.

[13] Some of the key features that would cause a trust to be a grantor trust include: (i) grantor or a nonadverse party having a power to direct the beneficial enjoyment of the trust income or principal without the approval or consent of any adverse party, (ii) grantor, in a non-fiduciary capacity, having the power to reacquire trust property, by substituting property of equivalent value without the approval or consent of any person in a fiduciary capacity, and (iii) grantor having the power to revest title to trust property. *See* IRC §§ 671-679.

The use of GRAT or IDGT transactions may preclude the basis step-up that would otherwise occur upon the death of the grantor, which step-up would eliminate the phantom income attributable to liabilities in excess of basis or negative capital. This can be a major disadvantage when planning involves leveraged low basis real estate or interests in partnerships holding such assets.

Grantor Trusts - Death of the Grantor

The income tax treatment of a grantor trust upon the death of the grantor is a matter of some debate among the commentators. In order to comprehend the debate, it is necessary to summarize the basics.

As mentioned above, termination of grantor trust status during the grantor's lifetime will trigger gain if the grantor trust assets are subject to liabilities in excess of basis.[14] The law is not 100% clear on whether or not the death of the grantor should likewise be deemed a sale triggering gain. The IRS has recently noted that the death of the grantor generally does not cause income recognition.[15] Some commentators have asserted in their writings that termination of grantor trust status as a result of the death of the grantor should have a similar result to a testamentary transfer.[16] These commentators reason, in essence, that the retained interest for income tax purposes is sufficient to deem the termination of grantor trust status by reason of the grantor's death to be a testamentary transfer.[17] However, other commentators do not

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[14] *See* Treas. Reg. § 1.1001-2(c), Ex. 5 (providing grantor recognizes gain upon termination of grantor trust status equal to the excess of his relief from partnership debt over the basis in his partnership interest). *See also Madorin v. Comm'r*, 84 T.C. 667 (1985) (upholding Ex. 5 in Treas. Reg. § 1.1001-2(c) on similar facts where the grantor realizes gain from debt relief on disposition of trust assets at the moment when grantor trust status ceases and trusts became separate taxable entities); Rev. Rul. 77-402, 1977-2 C.B. 222 (ruling grantor recognizes gain on cessation of grantor trust status as a taxable disposition of partnership interest measured by the difference between the basis in the partnership and his share of partnership liabilities).

[15] *See* CCA 200923024 (stating "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event").

[16] *See generally* Jonathan G. Blattmachr, Mitchell M. Gans and Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. Tax'n. 149 (2002). *See also Crane v. Comm'r*, 331 U.S. 1 (1947)(many commentators believe *Crane* is the basis for the "no gain on death" rule).

[17] *See* Treas. Reg. § 1.1001-2(c) Example 5 (adopting tax fiction that the grantor owns a partnership interest that, in fact, is owned for all non-income tax purposes by the trust, and, based on this fiction, subject the grantor to the

agree. According to these other commentators, the death of the grantor will trigger a taxable gain where the initial sale was not recognized as a result of grantor trust status.[18]

The related question is whether death of the grantor would give rise to a basis step-up under section 1014. The language of section 1014 implies that a condition of the trust's basis step-up upon the death of a grantor is that the grantor generally must have the types of rights over the trust property that would result in inclusion in the grantor's gross estate for estate tax purposes. The implication is that the termination of grantor trust status by reason of the grantor's death should not be viewed as a testamentary transfer unless the grantor retained the type of rights that would result in estate tax inclusion.[19] The IRS has made it clear that its position would be that section 1014 does not apply in this situation because section 1014 requires that the asset in question be included in the decedent's estate for estate tax purposes.[20]

Some commentators believe that even if section 1014 is not be applicable to the termination of grantor trust status by reason of death where there is no estate tax inclusion, section 1012 should apply a basis step-up since the recipient of the property assumes or takes subject to the debt. This theory is often referred to as the *Crane* doctrine since it is derived from the 1947 United States Supreme Court decision in *Crane v. Comm'r*.[21] In *Crane*, the beneficiary inherited an asset that was encumbered by a liability exactly equal to its fair market value. The government argued that since there was no equity in the property, the recipient should not acquire a basis step-up. The court was faced with the dilemma as to whether it is necessary for there to be "equity" in the property for it to be considered to have been acquired from the decedent by inheritance (which would result in a basis step-up under a predecessor to section

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Subchapter-K income tax rules that apply only to taxpayers who actually own a partnership interest). *See also Estate of DiMarco v. Comm'r*, 87 T.C. 653 (1986) (treating the grantor of a lifetime trust as having made a testamentary transfer for tax purposes even though it clearly would have been viewed as lifetime in character for all other purposes).

[18] *See generally* Carol A. Cantrell, *Gain Is Realized at Death,* Trusts & Estates, (Feb. 2010); Deborah D. Dunn and David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95 J. Tax'n. 49 (2001). *See also* IRC § 684 (codifying that losing grantor trust status on foreign grantor trust results in recognition of gain). Treasury Regulations extend the rule of foreign grantor trusts to domestic grantor trusts. Treas. Reg. § 1.684-2(e)(2), Ex. 2. These commentators argue that death of the grantor of a domestic grantor trust should have the same result as a foreign grantor trust. *See* Rev. Rul. 77-402, 1977-2 C.B. 222 (holding that gain is recognized where a trust ceases to be a grantor trust by reason of expiration or lapse of powers).

[19] *See* Treas. Reg. § 1.1014-2(a)(1) (stating that there will be a basis step-up on property acquired from a decedent only if the property is included in the decedent's gross estate for estate tax purposes).

[20] See CCA 200937028.

[21] 331 U.S. 1 (1947)

1014. The Court found that it is not necessary for there to have been "equity" in the property. The Court also noted that a basis step-up should be allowed since the property was transferred subject to nonrecourse debt. The court analogized to the acquisition of property by purchase subject to nonrecourse debt. In that situation, the recipient would be entitled to a cost basis that includes the indebtedness to which the property is subject. The court applied similar principles to the acquisition of property by inheritance subject to nonrecourse indebtedness so long as the property is worth more than the debt.[22] The Court could have treated the transfer as a sale and given the legatee a cost basis for the purchase under the predecessor of section 1012. Instead, the Court treated the transfer as a devise and therefore basis was determined under the predecessor to section 1014 which provides that basis is equal to asset's estate tax value (fair market value).[23]

Note that the central issue in *Crane* was not whether there would be gain upon death where the property is subject to liabilities in excess of basis. Nevertheless, the conclusion in *Crane* certainly implies that would be the rule. This implication is the basis for the widely recognized no gain upon death or Crane doctrine.

Applied in the context of a grantor trust, commentators stack the principles of Revenue Ruling 85-13, which delays the recognition of gain on a sale to a grantor trust until the grantor

[22] *Id.* at n. 37 (finding "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case"); *see also id.* at n. 42 (stating "In the course of the argument some reference was made, as by analogy, to a situation in which a taxpayer acquired by devise property subject to a mortgage in an amount greater than the then value of the property, and later transferred it to a third person, still subject to the mortgage, and for a cash boot. Whether or not the difference between the value of the property on acquisition and the amount of the mortgage would in that situation constitute either statutory or constitutional income is a question which is different from the one before us, and which we need not presently answer").

[23] There is an exception to the *Crane* doctrine for liability encumbered gifts made during donor's lifetime. *Diedrich v. Comm'r*, 457 U.S. 191 (1982). In *Diedrich*, the Court qualified the rule by creating an exception for liability encumbered gifts. *See also Ebben v. Comm'r*, 783 F.2d 906 57 (9th Cir. 1986) (holding, without citing *Diedrich*, that a gift to a charity of property encumbered by a liability should be treated as a sale for the purpose of section 1011(b)). However, many commentators argue that this exception has never been applied to testamentary gifts and it makes sense to distinguish between them. In the absence of the exception, a taxpayer could borrow against an asset up to its value and then make a gift of the asset subject to the liability without recognizing gain, in effect converting the asset to cash on a tax-free basis. Such a concern does not apply to testamentary gifts because taxpayers seeking to enjoy the benefit of the no-gain-at-death rule must die first in order to come within its scope.

trust status is terminated, with the Crane doctrine to conclude that there should be no gain recognition upon the termination of grantor trust status by reason of the death of the grantor.[24]

In the context of an installment sale to a grantor trust, commentators suggest that there may be gain recognition of the unpaid installment notes upon the death or the grantor or other termination of grantor trust status.[25] Even if gain is not recognized at the time of death[26], gain recognized after death is income in respect of a decedent ("IRD") when the note is paid.[27] Under such installment sale reporting, the successor in interest reports the deferred gain as installment payments are made. This result occurs because under Revenue Rule 85-13 the original installment sale to the grantor trust was not deemed a sale for federal income tax purposes and thus the decedent did not report income under the installment method during his lifetime. Thus, payments subsequent to the decedent's death constitute gain.

Partnership Freeze Solution

If there is one principle to take away from the foregoing discussion it is that where property is subject to liabilities in excess of basis and such property has been transferred to a grantor trust, the tax consequences upon the death of the grantor are somewhat uncertain. Respected commentators reason that upon the death of the grantor there would be no gain recognized and there may be a basis step-up. However, other commentators believe there may be gain recognition upon death and only in where gain is recognized will there be a basis step-up. It appears that the IRS view is that there would be no gain upon death and no basis step-up.

As described below, the freeze partnership technique can avoid this uncertainty and attendant risk. This technique should be carefully considered among the alternative planning techniques for low basis leveraged real estate. This is because a retained frozen interest in a

[24] *See* Blattmachr, note 17; *but see* Cantrell, note 19 (arguing that it is inappropriate to suggest that *Crane* is indicative of a general no-gain-on-death rule since *Crane* is about a testamentary transfer and not a deemed transfer of ownership which only existed with respect to income tax purposes).
[25] *See, e.g.*, Carol A. Cantrell, *Income Tax Problems When the Estate or Trust is a Partner*, for ALI-ABA Planning Techniques for Large Estates, May 16-20, 2011 (November 2010).
[26] *See* IRC § 453B(c).
[27] IRC § 691; Treas. Reg. § 1.451-1(b)(2).

freeze partnership will be entitled to a basis step-up upon death. Moreover, if properly structured, the liabilities in excess of basis can be allocated to the frozen interest so that the basis step-up can eliminate the inherent gain attributable to liabilities in excess of basis or negative capital.

The freeze partnership can thus transfer appreciation and, perhaps, values out of the estate without foregoing the basis step-up that is necessary to eliminate the phantom income attributable to liabilities in excess of basis (in the case of outright real estate ownership) or negative capital accounts (for real estate owned by a partnership or limited liability company). Moreover, by employing the leveraging techniques described herein it should be possible to overcome the higher hurdle rates necessary to be paid under this technique. Alternatively, the higher hurdle rates can provide a planning benefit for low yielding assets through the use of the reverse freeze technique.

Elements of the Freeze Partnership under Section 2701

Briefly stated, the freeze partnership typically has two classes of partnership interests:

1. Preferred interest, which is entitled to a preferred return and a liquidation preference (like preferred stock).

2. Junior equity interest, which is entitled to growth and appreciation (like common stock).

In the normal freeze partnership, the preferred interest is typically retained and the junior equity interest must be worth at least 10% of the value of the partnership at the time of the transfer. The transaction is called a freeze partnership because the value of the preferred interest is frozen at the time the junior interest is transferred or otherwise acquired. Assuming the hurdle rate is met and the preferred return is paid, only the junior equity interest appreciates in value over time as the partnership assets appreciate in value.

Within the family context (meaning with a family controlled entity), section 2701 imposes certain requirements to avoid a deemed gift which can be as much as the entire value of the entity even though a preferred interest is retained. Section 2701 applies where the junior equity interest (or any equity interest under the literal wording of the statute) is transferred in a family controlled corporation or partnership to a member of the transferor's family (generally, of an equal or lower generation). Treasury Regulation section 25.2701-1 sets forth the general rules. Certain technical definitions apply.[28]

Treasury Regulation section 25.2701-1(a) sets forth the scope of section 2701 as follows:

> *In general*—(1) *Scope of Section 2701*. Section 2701 provides special valuation rules to determine the amount of the gift when an individual ***transfers*** an equity interest in a corporation or partnership to ***a member of the individual's famil***y. For section 2701 to apply, the transferor or an ***applicable family member*** . . . must, immediately after the transfer, hold an ***applicable retained interest*** (a type of equity interest defined in §25.2701–2(b)(1))(emphasis added).

This excerpt highlights key terms which must be understood to work safely within the framework of section 2701. Those terms are "transfer", "applicable retained interest, "member of the individual's family", and "applicable family member."

As a threshold matter, for section 2701 to apply there must be a "transfer." Even if no actual gift has occurred, as where there is a transfer for full and adequate consideration, there can be a transfer for purposes of section 2701 resulting in a deemed gift. The term "transfer" includes transactions such as contributions to the capital of a corporation (or partnership), recapitalization of a corporation (or a partnership), redemptions and certain other terminations of an interest in such entities. Thus the creation of a partnership among family members where each member contributes its share to capital must satisfy the requirements of section 2701 to avoid a deemed gift even if no gift was intended.

[28] Partnership freezes are not the only estate freeze techniques which may be subject to Section 2701. If the IRS believes that a note to the grantor of an IDGT is equity rather than debt, it will argue that the trust is a preferred partnership interest subject to section 2701. Unless the retained interest includes a qualified payment right, the interest is valued at zero causing the transferred asset to be a taxable gift valued at full fair market value. *See Karmazin v. Comm'r*, T.C. Docket No. 2127-03. *See also* IRS Priv. Ltr. Rul. 9535026.

Another element necessary for section 2701 to apply is that the transferor must retain either (i) an "extraordinary payment right" or (ii), in the case of a controlled entity, a "distribution right." These terms are defined in section 25-2701-2 of the Treasury Regulations.

Extraordinary payment right is, in general, any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the value of the transferred interest. A call right includes any warrant, option, or other right to acquire one or more equity interests.[29]

Distribution right. A distribution right is the right to receive distributions with respect to an equity interest but not any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest.[30] Thus, it is by operation of this definition that partnerships that provide strictly proportionate allocations are generally not subject to section 2701.[31] Guaranteed payments, as such term is defined in section 707, are not considered distribution rights for purposes of section 2701. Under section 707, guaranteed payments are payments made to a partner by a partnership without regard to the income of the partnership. An example of a guaranteed payment is the payment of interest on capital invested by a partner.

Section 2701 applies if there is a transfer by an "applicable family member" to a "member of the individual's family."[32] Applicable family members generally include the transferor, the transferor's spouse, either of their ancestors and the spouse of either of their ancestors.[33] Members of the transferor's family ("recipients") generally include the transferor, the transferor's spouse, any of their lineal descendants and the spouse of any of their lineal descendants.[34]

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[29] Treas. Reg. § 25.2701-2(b)(3).
[30] *Id.*
[31] Treas. Reg. § 25-2701-2(b)(4) provides as follows: "Rights that are not extraordinary payment rights or distribution rights. Mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under section 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights."
[32] IRC § 2701(a)(1)(B).
[33] IRC § 2701(e)(2).
[34] IRC § 2701(e)(1).

Note that section 2701 does not apply unless the entity in question is a controlled entity.[35] For purposes of Section 2701, a controlled entity is a corporation or partnership controlled, immediately before a transfer or by the transferor and the transferor's applicable family members either directly or by attribution.[36] In the case of a corporation, control means the holding of at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation.[37] In the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership.[38] Any right to a guaranteed payment under section 707(c) of a fixed amount is disregarded in making this determination. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner.[39]

There is a "look through rule" which provides that an individual is treated as owning a proportionate share of equity interest held by a corporation, partnership, trust or other entity in which the individual holds an interest.[40] Family control of a top tier entity is not required by literal terms of section 2701(e)(3). Private Letter Ruling 9639054 seems to indicate that there is no look through if the top tier entity is not family controlled.[41] This is especially important with regard to a potential transfer of membership interests in a corporate general partnership or limited liability company that is the general partner or managing member of a private equity, venture capital, real estate or other fund entity. Typically, the managers of these funds will hold a carried interest and an investor interest in the same fund. Private Letter Ruling 9639054 has been cited for the proposition that if a fund manager holds a non-controlling interest in an entity that is a general partner of a fund structured as a limited partnership that fund manager will not be treated as holding control for purposes of section 2701. Unfortunately, there is an absence of authority that can be relied upon for this notion. A Private Letter Ruling can only be relied upon by the party who obtained it.

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[35] IRC § 2701(b)(1).
[36] IRC § 2701(e)(3) (providing that an individual is treated as holding any interest to the extent such interest is held indirectly by such individual through a corporation, partnership, trust, or other entity).
[37] IRC § 2701(b)(2)(A).
[38] IRC § 2701(b)(2)(B)(i).
[39] IRC § 2701(b)(2)(B)(ii).
[40] IRC § 2701(e)(3).
[41] IRS Priv. Ltr. Rul. 9639054 (June. 21, 1996).

Section 2701 is not applicable unless the specific family control requirements are met. Thus, more aggressive, old-style freeze partnerships may still be used where the family members receiving junior equity interests are nephews or cousins. For example, payments do not have to be cumulative and there is no minimum value for the junior equity interests. However, even in these situations care must be exercised to avoid some of the valuation abuses of the past. There is a greater awareness of these types of abuses than there was prior to section 2701.

Whether or not section 2701 applies, the government has developed other lines of attacking family partnerships. Most notably the government has had success in some cases invoking section 2036 to bring the assets of the family partnership back into a decedent's estate. This line of attack has been successful where use and enjoyment of the partnership assets are retained by the senior generation or where the family cannot demonstrate that the partnership has a substantial business or other non-tax purpose.[42] These doctrines could be found applicable to an abusive freeze partnership whether or not 2701 is applicable.

In *Estate of Thompson v. Comm'r*,[43] the Third Circuit included the entire value of Family Limited Partnership ("FLP") assets in the decedent's estate based on its finding under section 2036 that at the time of transfer there was an implied agreement that decedent would retain lifetime enjoyment and economic benefit of the transferred assets.[44] The decedent transferred ninety-five (95%) percent of his assets to two FLPs when he was ninety-five years old and made inter vivos gifts of partnership interests in the years following the FLP's formation. The Court substantiated its finding of an implied agreement on its assertion that the decedent did not retain sufficient assets to support himself for the remainder of his life. The Court came to this conclusion despite that at the time of his death the decedent owned controlling interests in the FLPs, the decedent's children made substantial contributions to each partnership and the general partner of each FLP was a separate corporation in which neither the decedent nor his children held more than a forty-nine (49%) percent interest.

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[42] *See, e.g., Estate of Bigelow v. Comm'r*, 503 F.3d 955 (9th Cir. 2007); *Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005); *Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004).
[43] 382 F.3d 367, 375 (3d Cir. 2004).
[44] *See* IRC § 2036(a)(1) (providing that property is included in a decedent's gross estate under 2036 if the decedent retained the possession or enjoyment of the right to income from transferred property either by express or implied agreement).

The *Thompson* case is illustrative of the need to develop a comprehensive planning strategy for the freeze partnership. Sufficient assets other than an interest in the freeze partnership should be retained to meet the likely needs of the holder of the senior preferred interest even if the preferred interest is expected to generate an income stream.

The best scenario to avoid or fend off such attacks would be respecting the formalities of the entity, avoiding indicia of an implied understanding and the retention of sufficient assets outside of the freeze partnership for the senior generation to meet reasonably foreseeable living expenses without having to rely upon access to the family partnership assets. 27

Structuring the Freeze Partnership: The Forward Freeze

In the typical situation, unless the provisions of section 2701 are followed, the preferred interest is valued at zero, thereby inflating the value of the transferred junior equity interest to the entire value of the partnership. This treatment acts as a penalty by artificially inflating the amount subject to gift taxation. Retained interests are given a zero value unless they include a right to receive a qualified payment.[45] Qualified payment rights are valued according to fair market value ("FMV"). If a qualified payment right is held along with an extraordinary payment right, the rights are valued as if each was exercised in the manner resulting in the lowest value for all such rights.

Qualified payments rights can be: (i) periodic dividends on cumulative preferred stock; (ii) any comparable payment from a partnership interest; or (iii) any other payment where an irrevocable election is made to treat the other payment as a qualified payment.[46] The payment of any qualified payment made (or deemed made) either before or during the four-year period beginning on the due date of the payment but before the date of the taxable event is treated as having been made on the due date.[47]

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[45] IRC § 2701(a)(3)(A).
[46] IRC § 2701(c)(3).
[47] IRC § 2701(d)(2)(C); Treas. Reg. § 25.2701-4(c)(5).

Section 2701(d) provides for a deemed gift if and to the extent qualified payments are not paid within a four year period of when they were accrued. In general, the deemed gift will be the amount of the unpaid qualified payments increased by a compounding rate equal to the underlying payment rate of the qualified payment, provided the amount of the gift does not exceed the equity value of the underlying entity.[48]

If the requirements of Section 2701 are satisfied, the retained preferred interest will not be valued at zero but rather the fair market value of the retained preferred interest is deducted from the fair market value of the partnership capital. The difference is the gift tax value of the junior equity interest. This calculation is made in accordance with Treasury Regulation 25.2701-3. The regulations contain certain biases. These biases can have a significant impact upon the planning.

The Treasury Regulations employ the "subtraction method," a four-step method for determining the value of the transferred interest.

> Step 1 – Value the entire family-held interest.
>
> Step 2 – Subtract the value of senior equity interests held by the family.
>
> Step 3 – Allocate the remaining value among the transferred interests and other family-held subordinate equity interests.
>
> Step 4 – Apply certain discounts and other reductions as provided for by Treasury Regulation 25.2701-3(b)(4). The value of the junior equity interest, so determined, less any consideration paid for that interest, will be a taxable gift.

Notwithstanding the foregoing calculation, section 2701 deems the junior equity interest to have a value of not less than ten-percent (10%) of the sum of: a) the total value of all equity interests in the entity, and b) the total amount of indebtedness of the entity to the transferor.

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[48] IRC § 2701(d).

Special Valuation Challenges under Section 2701 Regulations

Section 25.2701-3(b)(1) goes beyond the statutory requirements by imposing an additional valuation stricture. In determining the starting point for the subtraction method, the regulations require that the fair market value of all family held interests must be determined "by assuming that the interests are held by one individual, using a consistent set of assumptions." This assumption is apparently designed to preclude valuation discounts such as discounts for lack of control and lack of marketability from being applied in Step 1 of the subtraction method. If the entity is family controlled and all family held interests are deemed held by one individual that individual must not hold a minority or non-controlling interest. Likewise if all family held interests are considered to be held by one individual, it would normally be the case that that individual would have the ability to compel a liquidation of the entity. If an individual can compel a liquidation, there would normally be no discount for lack of marketability since that individual would usually have the ability to force a sale of the entity's underlying assets. Note that if a nonfamily member's consent would be required to compel liquidation, even if the entity is family controlled, the family may not have the ability to unilaterally compel a liquidation.[49]

Step 1's requirement that all family-held interests be valued as though they are "held by one individual" probably represents a position which was once taken by the IRS but which has subsequently been reversed. For many years prior to the issuance of the section 2701 regulations the IRS contended that all family-held interests should be aggregated for valuation purposes.

This so-called "family attribution" argument was still the formal litigation position of the IRS when the section 2701 regulations were issued in 1992. However, the courts had repeatedly rejected the IRS's family attribution argument.[50] Yet approximately one year after the promulgation of the section 2701 regulations the IRS relented and acknowledged in Revenue

[49] *See generally* Milford B. Hatcher, Jr. & Gregory E. Kniesel, *Preferred Limited Partnerships – Now the FLPs of Choice?*, 89 J. Tax'n 325, 333 (Dec. 1998); Rev. Ruling 93-12. *See* Milford B. Hatcher, Jr., *Preferred Partnerships – The Neglected Freeze Vehicle* (2002).

[50] *See Estate of Lee v. Comm'r*, 69 T.C. 860 (1978); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981) (en banc.); *Estate of Andrews v. Comm'r*, 79 T.C. 938 (1982); *Minahan v. Comm'r*, 88 T.C. 492 (1987) (costs assessed against the IRS for its continued litigation of family attribution); and *LeFrak v. Comm'r*, T.C. Memo. 1993-526.

Ruling 93-12 that family attribution is inappropriate and that intra family discounting can be appropriate.[51]

The issuance of Revenue Ruling 93-12 was probably a turning point in tax planning. It spawned the widespread use of family partnerships and other family controlled entities to create discounts. It is likely that the IRS regrets having issued that ruling. Nevertheless, it was likely necessary in light of the case law developments. It is the province of legislature to impose a family attribution rule.

Since the issuance of Revenue Ruling 93-12 the IRS has attempted to constrain the use of family controlled partnerships and other entities to create discounts and to facilitate tax planning. More recently, the IRS has had some success upsetting ill-conceived and poorly executed estate plans that attempt to create discounts by employing family partnerships where no significant business or nontax purpose was a driving force for the plan.[52] Nevertheless, the cases where the IRS has succeeded represent the exception to the general rule that there is no proper legal basis for the IRS to impose a family attribution rule absent an act of legislature. It is likely that the provision in Treasury Regulation 25.2701-3(b)(1) imposing a form of family attribution would be vulnerable to a judicial challenge. The "family attribution" approach taken in Step 1 thus appears to be an historical vestige which reflects a position which is no longer being taken by the IRS and which has consistently been rejected by the courts.

It should be noted that under the subtraction method the absence of discounting may not have an overwhelming impact upon valuations. Ultimately, the undiscounted value would be attributed to the retained senior equity interest. Business appraisers tend not to impose large discounts upon preferred interests due to their inherent attributes.

The regulations contain an exception to the family attribution rule for "contributions to capital." In the case of a contribution to capital, Step 1 permits the use of fair market value as an exception to the family attribution rule. This exception seems to apply to property contributed to a partnership which would normally not be discounted upon contribution. Under normal partnership accounting principles, partners' capital accounts are credited with the fair market

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[51] 1993-1 C.B. 202.
[52] See *supra* note 41

value of contributed property. This rule is set forth in the section 704(b) regulations.[53] Yet if the property contributed is an interest in an entity or a fractional interest, it would appear that normal valuation discounts would be applicable as the measure of the contribution to a freeze entity.

Income Tax Consequences of the Partnership Freeze

There are significant income tax consequences to the formation and operation of a freeze partnership or LLC. A command of the partnership income tax rules contained in Subchapter K of the Code is required to properly design and implement the freeze. The taxation of partnerships is one of the more complex areas of the Internal Revenue Code. Failure to involve a professional with the necessary income tax expertise can result in unintended and, perhaps, unfortunate tax consequences. Moreover, a working knowledge of Subchapter K can be valuable in maximizing this technique.

One of the principal concerns arises from the fact that this technique is most advantageous when planning for high leverage low basis property – especially real estate. This is where income tax planning and the estate planning converge. As already discussed, the stakes for obtaining a basis step-up upon death, and to avoid gain recognition during lifetime, are much greater for this type of asset. The freeze partnership can facilitate both objectives.

The objective is to structure contributions of appreciated property to the partnership so that the maximum amount of built-in gain and liabilities in excess of basis (or negative capital) will be allocated to the senior preferred interest. While Subchapter K has an operating framework that can facilitate this objective, it will not necessarily happen by itself. Careful structuring is required.

Contributions of appreciated property to a partnership are generally entitled to nonrecognition treatment pursuant to section 721.

[53] Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1).

However, there are two principal areas of sensitivity that can trigger gain. Care must be exercised to avoid a capital shift and a liability shift.

Capital Shifts

A capital shift results when a contribution of property by one partner enhances the capital value of one partner's interest at the expense of another's. 32

Determination of whether a capital shift has occurred in a recapitalization requires determining the amount each of the senior generation member and the junior generation member would receive if the partnership were to liquidate immediately prior to the recapitalization, assuming all of the partnership assets were sold on that date for their fair market values and the proceeds of the sale were distributed in complete liquidation of their partnership interests. If immediately following the recapitalization the same liquidation test were applied, the amounts each of the partners would receive should remain unchanged. If members of the junior generation would receive more post-recapitalization than pre-recapitalization, then a shift of capital to such members has occurred. Such a shift of capital could result in a taxable gift or a taxable grant of a capital interest as compensation for services performed.

In a freeze partnership the junior equity interest has many of the characteristics of a partnership profits interest. While the grant of a mere profits interest in partnership is generally not considered a taxable event, if the profits interest is accompanied by a shift of partnership capital to the recipient, there will be a taxable event. This is the case whether or not the grant is in connection with the performance of services. If the grant is in connection with the performance of services, the recipient will be taxable on the value of the interest so received. If the grant is not in connection with the performance of services, it will likely be a gift. Within the context of a family controlled business entity it is possible there will be some combination of compensation and gifting.

The taxation of grants of a partnership interest for services presents significant conceptual difficulties for both the government and taxpayers. Yet these rules are directly relevant to the question of whether there has been a capital shift which impacts the taxation of freeze partnerships.

The taxation of compensatory grants of partnership interests has been one of the most difficult areas for the government to develop a comprehensive and intellectually pure set of strictures.[54] The taxation of grants of partnership profits interests, which is often integral to real estate partnership structures, has posed administrative and conceptual difficulties for at least four decades. The most recent administrative attempt to regulate this area came in 2005 and has largely stalled.[55] Moreover, these transactions come dangerously close to the types of transactions that have been firmly in the sights of the Obama Administration through its proposals to increase the incidents of taxation of so-called "carried interests." While these measures have not passed as of the date of this writing, they may resurrect themselves in a subsequent Congress.[56]

Closely analogous to the taxation of the formation of a freeze partnership is the taxation of a partnership recapitalization. Either transaction can be subject to section 2701. If a junior equity interest is to be granted within the framework of an existing partnership in order to create the frozen preferred interests, it will likely be necessary to elect to book-up the capital accounts of the partners under section 1.704-1(b)(2)(iv)(f) and (g) in order to prevent an unintended capital shift. Such a book-up is a restatement of partners' capital accounts to reflect the liquidation value of their interests as the time of the book-up event. Generally, it is necessary for there to be a grant of a partnership interest in connection with a contribution of capital to the partnership, a grant of a compensatory profits interest or a liquidation or redemption of a

[54] *See generally* Stephen M. Breitstone & José L. Berra, *Practical Drafting Considerations for Partnership Agreements and Operating Agreements in the Closely Held Context*, NYU, 66th Institute on Federal Taxation, Chapter 8 (2008).
[55] In 2005, when the proposed section 83 regulations were introduced, Treasury also issued a proposed revenue procedure that would make Rev. Proc. 93-27 and Rev. Proc. 2001-43, *Doc 2001-20855, 2001 TNT 150-11*, obsolete on finalization of the regulations (see Notice 2005-43, 2005-1) C.B. 1221, *Doc 2005-11236, 2005 TNT 98-37*). The new rules would apply to grants of compensatory profits interest issued on or after the date of the final regulations. As of this writing, the final regulations have not been issued and it appears that they are neither imminent nor likely to resemble the proposed regulations.
An in-depth discussion of past and present law governing the taxation of partnership interests is set forth in Breitstone & Berra, *Practical Drafting Considerations for Partnership Agreements and Operating Agreements in the Closely Held Context*.
[56] *See generally* Breitstone, *Carried Interest Bill -- Impact on Real Estate Partnerships*, 2010 TNT 45-5, March 9, 2010; Breitstone, *Carried Interest Bill -- a 'Death Trap' for Real Estate Partnerships*, 2009 TNT 118-8, June 22, 2009.

partnership interest in connection with a distribution of capital in order to be able to book-up the capital accounts under this provision.[57]

Liability Shifts

Gain can also be triggered upon the contribution of property to a partnership or upon a recapitalization if there is a shift in the manner in which partnership liabilities are shared among the partners under the rules set forth in section 752 and the regulations thereunder. It should be noted that, in general, if the partnership liabilities are nonrecourse (meaning recourse is limited to the property that secures the debt) and are not guaranteed by any of the partners, a liability shift, in general, will not occur to trigger gain recognition at the time of contribution or reorganization. However, in other situations, a liability shift may occur.

Even if there is no liability shift upon the contribution of low basis leveraged property to a partnership, obtaining a full basis step-up that will eliminate the built-in gain attributable to liabilities in excess of basis requires additional structuring. If the junior equity is to be held by a grantor trust, or if the junior equity is to be issued initially to the senior generation and then subsequently gifted to the junior generation, a portion of the liabilities will be allocated to the junior equity. To the extent the junior equity is then transferred, the allocable share of liabilities will come along to the transferee. If the transfer is by reason of an outright gift to an individual member of the junior generation, such a gift may be treated as a part sale/part gift triggering immediate recognition of gain on the liabilities in excess of basis. This consequence can be avoided by making the gift or transfer to a grantor trust since the grantor will be considered to have retained ownership of the transferred interest for income tax purposes. However, since a portion of the liabilities will be deemed allocable to the transferred interest when the grantor trust status ends, such as upon the death of the grantor, a portion of the step-up may be lost. It is also possible that some gain will be recognized at that time, depending upon your views on this topic.[58] This is due to the fact that the grantor will be considered to have one partnership interest and one capital account. If the interest is actually owned by the senior generation or is deemed owned by that generation under the grantor trust rules, any junior interest given away will be

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[57] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)
[58] *See* discussion supra at note 22.

considered to be a portion of the senior generation's initial partnership interest including a share of the liabilities that otherwise would have been allocable to the senior preferred interest. To avoid this result, at least two separate partnership interests must be created. One should be issued in exchange for the encumbered property. Normally, this will be the senior equity interest. The other interest should be granted to a different taxpayer in exchange for cash or other unencumbered assets. The interest can even be granted to a nondisregarded entity owned mostly by the senior grantor. Since that latter interest would be granted in exchange for unencumbered property or cash, it should not be allocated a share of the liabilities.

Even where the ultimate transferee of the junior interest is to be a grantor trust, it should be possible to structure the partnership so that the liabilities will remain allocated to the senior generation. For example, if the junior equity interest is initially issued to a nondisregarded entity such as an LLC, and that interest is granted in exchange for a contribution of capital by the junior family members or a grantor trust for their benefit, it should be possible to force all of the negative capital to remain with the senior generation. The death of the senior generation should result in a basis step-up that eliminates that negative tax history.

Contributions of Low Basis Leveraged Real Estate to a Partnership

Generally, section 721 affords nonrecognition treatment upon the contribution of appreciated property to a partnership. This treatment applies whether the contribution occurs at the time of formation or to an existing partnership. It also applies regardless of the percentage of the partnership received in exchange for the contribution.[59] If the contributed property has a fair market value in excess of its adjusted income tax basis, section 704(c) will come into play to require that certain allocations be made to avoid shifting the precontribution gain to the noncontributing partner.

Under section 752, an assumption of debt by the partnership from contributed property is treated as a distribution of cash to the contributing partner. Under the regulations, simultaneously with the deemed distribution there will be a deemed contribution reflecting the

[59] *Compare with* section 351 which conditions nonrecognition upon transfer or appreciated property to a corporation upon the transferors having "control" immediately after the contribution. Control is defined as ownership of 80 percent or more of the combined classes of stock immediately after the contribution.

contributing partner's share of partnership indebtedness determined immediately after the contribution. If the partner is allocated a share of post-contribution indebtedness not less than the deemed distribution plus any basis in the contributed property there will be no gain recognition at the time of contribution. If the contributing partner's net debt share is reduced in connection with the contribution, and the contributed property is subject to liabilities in excess of basis, the contribution will result in a "debt shift." The net reduction in the contributing partner's share of debt can result in taxable gain under section 731(a). Under some circumstances, there can also be ordinary income if the property is subject to depreciation recapture under section 751.

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Section 752 governs how the partnership indebtedness is allocated among the partners. Recourse debt is allocated to the partner who bears the economic risk of loss. A different set of rules applies for nonrecourse debt since the partners do not bear the risk of economic loss.

Normally when property is contributed subject to nonrecourse indebtedness, the default provisions of the section 752 regulations preclude such a debt shift. However, if the property is subject to recourse indebtedness, if the indebtedness is guaranteed by one of the partners, or if the lender is a related party to the partnership, a debt shift is a possibility. Normally, in the context of a freeze partnership where the contributing partner is a member of the senior generation making a contribution in exchange for a preferred partnership interest, if the contributing partner is personally liable for the debt or is a guarantor, there will be no debt shift because the liabilities will be allocated to the contributing partners.

Allocations of Partnership Liabilities

Section 752 governs the manner in which partnership liabilities will be allocated among the partners. In general, section 752 maintains parity between inside and outside basis by coordinating adjustments to the partners' outside bases with increases and decreases in partnership liabilities. The liability-sharing rules of section 752 closely track the economic effect analysis under the 704(b) regulations.

The sharing of recourse liabilities is determined by identifying which partners would bear the economic risk of loss based on the consequences of a constructive liquidation (a hypothetical event in which all partnership assets become worthless and the partnership liquidates). Generally, this can be determined by asking, if the partnership defaulted on its obligation, to what extent (if any) would a partner be obligated to pay the liability from personal funds without the right to reimbursement.[60] If no partner would bear the economic risk of loss the liability is classified as nonrecourse. The rules governing the allocation of nonrecourse liabilities are very flexible and taxpayer friendly. The rules generally allow such liabilities to be allocated based on the manner in which the partners share the profits that would presumably be used to repay such liabilities.

Under section 752, a liability affects the outside basis only to the extent that it creates or increases the basis of the property or gives rise to a current deduction or a nondeductible non-capital expenditure.[61] A liability is recourse to the extent that any partner bears the economic risk of loss with respect to such liability.[62] A partner's share of partnership recourse liabilities equals the portion of such liabilities for which he bears the economic risk of loss.[63] In general, a partner bears the economic risk of loss with respect to a partnership liability to the extent that the partner would be obligated to make a net payment or a net contribution with respect to such liability upon a hypothetical liquidation of the partnership.[64] A partnership liability is nonrecourse to the extent that no partner bears the economic risk of loss for that liability. [65]

Allocations of Nonrecourse Debt

Under the section 752 regulations, nonrecourse liabilities are allocated in three tiers - the first two are priority tiers. The first tier looks to a partner's share of "minimum gain" as determined under section 704(b).[66] In general, minimum gain is the amount of gain that would be recognized if property subject to nonrecourse debt were sold for the amount of the indebtedness. That is the minimum amount of gain that would be recognized upon such a disposition. Each partner has a share of minimum gain which is based upon the previous

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[60] *See* IRC § 752(c); Treas. Reg. § 1.752-1(d)-(e).
[61] *See* Treas. Reg. § 1.752-1(a)(4)(i) (liability defined); Rev. Rul. 88-77; Rev. Rul. 95-26, 1995-1 CB. 131 (short sale of securities).
[62] *See* Treas. Reg. § 1.752-1(i); Treas. Reg. § 1.752-2(f), Ex. 5.
[63] Treas. Reg. § 1.752-2(a).
[64] *See* Treas. Reg. §§ 1.752-2(b)(1), (5), (6); -2(b)(2)(i).
[65] Treas. Reg. § 1.752-1(a)(2).
[66] Treas. Reg. § 1.752-3(a)(1).

nonrecourse deductions allocated to that partner and any proceeds from nonrecourse financings distributed to that partners.[67]

The second tier is a partner's share of partnership minimum gain as determined under 704(c) regulation concerning allocation of nonrecourse deductions. This tier is most relevant to the creation of freeze partnerships for leveraged appreciated real estate with low income tax basis. A partner's share of minimum gain is the amount of taxable gain that would be allocated to a partner under 704(c) principles if the partnership disposed of all property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of such liabilities and for no other consideration.[68]

In order to understand the allocation of nonrecourse indebtedness secured by appreciated contributed property, it is unnecessary to have some understanding of section 704(c). Section 704(c)(1)(A) requires that income, gain, loss and deduction with respect to contributed property be shared among the partners so as to take account of any difference between basis and value at the time of contribution. The Regulations provide detailed rules for allocation with respect to "704(c) property" which is defined as property which has a book value different from its tax basis at the time of contribution.[69] In general, such allocations must be made using a reasonable method that is consistent with the purpose of 704(c), i.e. to prevent shifting of built-in gain or loss.[70]

To understand the workings of section 704(c) it is necessary to understand how capital accounts are maintained under section 704(b) and the regulations thereunder.[71] The regulations

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[67] Treas. Reg. § 1.704-2(g)(1)(i).
[68] Treas. Reg. § 1.752-3(a).
[69] Treas. Reg. § 1.704-3(a)(3).
[70] Treas. Reg. § 1.704-3(a)(1).
[71] The regulation set forth three alternative methods that are deemed reasonable methods for allocations to reflect the reconciled book and tax bases.

Traditional Method

The first method is known as the "traditional method." The traditional method requires that any built-in gain or loss attributable to contributed property be allocated to the contributing partner to the extent possible. *See* Treas. Reg. § 1.704-1(b)(4)(i),-1(b)(5), Ex. 17. Under the traditional method, there is a prohibition upon allocating more than the normal tax items that would otherwise be available. This rule is known as the ceiling rule. Thus, if the book depreciation allocable to the noncontributing partners is greater than the available tax depreciation, the limit on what can be allocated to the noncontributing partner would be the amount of tax deprecation. *See* Treas. Reg. § 1.704-3(b)(1).

If the ceiling rule applies, phantom income may be allocable to the noncontributing partners. This is because the noncontributing partners (generally the partners who contribute cash) may be deprived of the full depreciation deductions to which they would otherwise be entitled. This can create certain distortions that may be significant in structuring the partnership. Of course, if these distortions occur between a grantor and a grantor trust, this would not likely be a concern. Under the traditional method, ceiling rule distortions will be remedied only upon the sale or liquidation of the partners' partnership interests.

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Traditional Method with Curative Allocations

The second section 704(c) method allowed under the regulations is the "traditional method with curative allocations." The regulations permit reasonable curative allocations to reduce or eliminate distortions attributable to the ceiling rule. A curative allocation is any allocation of tax items that differs from the allocation of corresponding book items. *See* Treas. Reg. § 1.704-3(c)(1). Generally, a curative allocation is considered reasonable only if it does not exceed the amount necessary to offset the effect of the ceiling rule and consists of tax items of the same type or character as the item limited by the ceiling rule. *See* Treas. Reg. § 1.704-3(c)(3). Notwithstanding the character restriction, a curative allocation of gain from sale of 704(c) property is generally considered reasonable to cure ceiling-rule limitations on depreciation. *See* Treas. Reg. § 1.704-3(c)(3). If the partnership does not have sufficient tax items to cure the ceiling rule disparity in the year it occurs, subsequent curative allocations to remedy the initial disparity are permitted only if made either (i) over a reasonable period (such as the property's economic life), or (ii) on the sale of the contributed property.

Remedial Allocation Method

The third section 704(c) method is the "remedial allocation method." This method is a variation of a deferred sale approach. Under a deferred sale approach, the partnership would be treated as if it had purchased the contributed property for its fair market value on the date of contribution, but the contributing partner's built-in gain or loss would be deferred until subsequent events, e.g., disposition of the property. Because of character and timing differences, the deferred sale approach was considered too generous to the contributing partner so instead the regulations provide for the remedial allocation method which accomplishes a similar result as the deferred sale approach with respect to the noncontributing partners. Noncontributing partners receive, in effect, a cost basis in their share of the contributed property. This approach eliminates ceiling rule distortions by creating fictional tax items that exactly offset the ceiling-limited items in amount and character. *See* Treas. Reg. § 1.704-3(d)(4). In the case of depreciable 704(c) property a special rule applies for the purposes of recovering book basis under the remedial allocation method. *See* Treas. Reg. § 1.704-3(d)(2),-3(d)(7), Ex. 1.

The remaining built-in gain or loss at the time of the distribution depends on the 704(c) allocation method used by the partnership. *See* Treas. Reg. § 1.704-4(a)(5), Ex. 2 (traditional method); -3 (remedial allocation method).

Section 704(c) can also trigger tax consequences that must be considered if the contributed property is to be distributed within the seven year period following its contribution. Section 704(c)(1)(B) may require recognition of gain if 704(c) property is distributed to another partner within seven years of contribution. Section 704(c)(1)(B) is intended to prevent circumvention of the 704(c) allocation rules when property contributed by one partner is distributed to another partner within seven years after contribution. If the provision applies, the contributor recognizes taxable gain or loss equal to the amount that would have been specially allocated to him under 704(c) upon a deemed sale of the property for its fair market value at the time of the distribution. *See* Treas. Reg. § 1.704-4(a)(1).

Like section 704(c)(1)(B), section 737 is intended to prevent circumvention of the 704(c) allocation rules. Section 737 can trigger gain recognition to a contributing partner when other partnership property is distributed to the contributing partner within the seven year period following the contribution. If the provision applies, the contributor recognizes a taxable gain equal to the lesser of the excess distribution or the partner's net precontribution gain. *See* IRC § 737(a).

Another section 704(c) rule impacts the ability to deduct losses attributed to contributed property. In 2004, Congress amended section 704(c)(1) to prevent a potential shifting of losses among partners in connection with a contribution of built-in loss property. Under section 704(c)(1)(C), a built-in loss may be taken into account only by the contributing partner and not by other partners. The term built-in loss is defined as the excess of the adjusted tax basis of the contributed property over the fair market value of such property at the time of contribution. With respect to non-contributing partners, such property is treated as having a basis equal to its fair market value at the under section 704(b) require capital accounts of partners who contribute appreciated property to be credited for the fair market value of the appreciated property – not the tax basis. It is thus necessary to maintain one set of books to reflect the fair market value of appreciated property and the depreciation deductions computed on the basis of that fair market value. Simultaneously, books must be maintained reflecting historical income tax basis and depreciation deductions calculated on that amount. Section 704(c) is designed to create allocations that will bring the book tax basis and historical cost tax basis into harmony – over time. If they are not ultimately brought into harmony, section 704(c) will, in general, require gain to be allocated to the contributing partner upon a disposition of the contributed assets.

The third tier of partnership liabilities is referred to as "excess nonrecourse liabilities," i.e. the residual category left after initially allocating the partnership's nonrecourse liabilities to the two priority tiers. These liabilities may be allocated in any manner consistent with the manner in which any significant partnership item is allocated provided the allocation of that item has substantial economic effect as determined under the regulations under section 704(b). [72]

A partner's share of nonrecourse liabilities equals the sum of his shares of partnership minimum gain, 704(c) minimum gain and excess nonrecourse liabilities. In accordance with the *Crane* rule, the regulations include the nonrecourse liabilities in the partnerships inside basis and the partners' outside bases. The underlying theory is that a partner who receives a disproportionate allocation of nonrecourse deductions should also receive a corresponding share of the *Crane* basis generated by the nonrecourse liability.

Coordinating Sections 704(c) and 752

Upon the formation of the freeze partnership where leveraged real estate with a low income tax basis is contributed in exchange for the senior preferred interest, it is generally the case that the section 704(c) minimum gain will cause the nonrecourse debt to be allocated to the

time of contribution. When the contributing partner's partnership interest is transferred or liquidated, any remaining section 704(c) built-in loss is eliminated. IRC § 704(c)(1)(C).
[72] *See* Treas. Reg. § 1.752-3(a).

contributing partner. A partner who contributes property subject to a nonrecourse liability is allocated an amount of liability at least equal to the section 704(c) minimum gain (i.e. the excess of the nonrecourse liability over the tax basis of the property).[73] This taxable gain is the minimum amount that would be allocated to the contributing partner if the encumbered property were sold for no consideration other than relief of the nonrecourse liability.

Rules Governing Disguised Sale of Property under Section 707(a)(2)(B)

The disguised sale of property rules contained in section 707(a)(2)(B) are also of concern when contributing appreciated property to a freeze partnership. These rules are of particular concern where property is contributed within two years of a nonrecourse borrowing. It is also of concern if qualified payments can be viewed as sale proceeds rather than a reasonable return on the senior preferred capital.

Congress enacted section 707(a)(2)(B) in the Deficit Reduction Act of 1984.[74] Section 707(a)(2)(B) reads:

> Under regulations prescribed by the Secretary--… If (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated as a transaction [between the partnership and a partner not in its capacity as a partner] or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership. (Emphasis added).

The regulations provide that where a contribution and distribution are not simultaneous, the transfers will be treated as a sale if the facts and circumstances indicate that (1) the transfer of money would not have been made but for the transfer of the property, and (2) the distribution was not dependent on the "entrepreneurial risks" of the partnership's operations.[75] Additionally, if within a two-year period there is a contribution by and distribution to a partner, the transfers

[73] Treas. Reg. § 1.752-3(a)(2)
[74] Pub. L. No. 98- 69.
[75] Treas. Reg. § 1.707-3(b)(1).

are presumed to be a sale of the property to the partnership. This presumption is rebuttable only if "the facts and circumstances clearly establish that the transfers do not constitute a sale."[76]

There are a number of issues presented by the disguised sale rules in structuring freeze partnerships where leveraged low basis property is contributed. First, it must be considered whether the payment of a guaranteed payment on the senior interest or a preferred return could be treated as sales proceeds under the disguised sale rules.

In general, the disguised sale regulations do not treat a guaranteed payment for capital (see section 707(c)) as proceeds from a sale of property. A payment of money to a partner that is (i) characterized by the parties as a guaranteed payment for capital, (ii) determined without regard to the income of the partnership, and (iii) "reasonable" is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.[77] Under the regulations, a payment is "reasonable" if (1) the payment is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and (2) the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.[78] A payment is reasonable in amount if the sum of any guaranteed payment for capital (and preferred return) that is payable for that year does not exceed the amount determined by multiplying the partner's unreturned capital at the beginning of the year, or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid guaranteed payment or preferred return that is payable to the partner for any prior year) by the safe harbor interest rate for that year. The safe harbor interest rate equals 150-percent of the highest AFR in effect at any time from the time that the right to the guaranteed payment for capital is first established pursuant to a binding written agreement.[79]

Of particular concern in structuring a freeze partnership is the treatment of preferred returns under the disguised sale rules. However, if the preferred return is not considered to be

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[76] Treas. Reg. § 1.707-3(c)(1).
[77] Treas. Reg. § 1.707-4(a)(1)(ii).
[78] Treas. Reg. § 1.707-4(a)(3)(i).
[79] Treas. Reg. § 1.707-4(a)(3)(ii).

"reasonable" under the disguised sale regulations, the payments could be viewed as part of a disguised sale.

The final regulations define the term "preferred return" to mean a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain. A distribution of money to a partner that is characterized by the parties as a preferred return and that is "reasonable" is presumed not to be part of a sale of property to the partnership.[80] This presumption can only be rebutted by facts and circumstances (including the likelihood and expected timing of the matching allocation of income or gain to support the preferred return) that clearly establish that the transfer is part of a sale. Whether a preferred return is reasonable is determined in the same manner as is a guaranteed payment for capital; thus, the safe harbor rate of 150-percent of the AFR applies.[81] Presumably, if the partners agree to a reasonable preferred return that is not expected to be matched with allocations of income until the distant future, the payment of the preferred return may be treated as disguised sale proceeds.

Under the regulations, a distribution of net operating cash flow is presumed not to be part of a sale of property contributed to the partnership. Transfers of money by a partnership to a partner during a taxable year will constitute operating cash flow distributions to the extent that (1) such distributions are not presumed to be guaranteed payments for capital, (2) such distributions are not reasonable preferred returns, (3) such distributions are not characterized by the parties as distributions to the recipient partner acting in a capacity other than as a partner, and (4) such distributions do not exceed the product of (a) the net cash flow of the partnership from operations for the year multiplied by (b) the lesser of the partner's percentage interest in "overall partnership profits" for that year and the partner's percentage interest in "overall partnership profits" for the life of the partnership. This presumption can only be rebutted by facts and circumstances that clearly establish that the distribution is part of a disguised sale transaction.[82]

As a safe harbor, in lieu of determining a partner's interest in "overall partnership profits" for a taxable year, the regulations permit the use of the partner's smallest percentage interest

[80] Treas. Reg. § 1.707-4(a)(2).
[81] Treas. Reg. § 1.707-4(a)(3)(ii).
[82] Treas. Reg. § 1.707-4(b).

under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year.[83]

Impact of Borrowings on Disguised Sale Treatment

It is possible to effect a disguised sale by borrowing against low basis property and then contributing the encumbered property to a partnership. Economically, this transaction can closely resemble a sale since the contributing partner is at least partially cashed out. In creating a freeze partnership it is essential to be aware that if a refinancing of the contributed property has occurred, the proceeds of the refinancing could be considered disguised sale proceeds. This is especially the case when the refinancing resulted in a cashing out by the contributing partner either within the two years prior to the contribution or within the two years following the contribution. The disguised sale rules do contemplate this scenario and provide that certain types of borrowings will not be considered part of a disguised sale.

One exemption under the disguised sale regulations applies to so called qualified liabilities. Under the regulations, qualified liabilities assumed or taken subject to or in connection with a transfer of property to a partnership generally are not treated as part of a sale. This rule applies to both recourse and nonrecourse loans whether incurred by a partner prior to contribution or by the partnership post-contribution.

The regulations contemplate four categories "qualified liabilities."[84] The first type of qualified liability is a liability incurred by the partner more than two years before the contribution of the property to the partnership (or when there was a commitment to make the contribution).[85]

Second, a liability is a qualified liability if the liability was not incurred in anticipation of the transfer of the property to the partnership but was incurred by the partner within the two-year

[83] Treas. Reg. § 1.707-4(b)(2)(ii).
[84] Treas. Reg. § 1.707-5(a)(6)(i).
[85] Treas. Reg. § 1.707-5(a)(6)(i)(A).

period prior to the contribution.[86] However, there is a presumption that a liability incurred within the two-year period prior to the contribution was incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary.[87]

The third category of qualified liabilities is comprised of liabilities allocable under the interest-tracing rules of Treasury Regulation section 1.163-8T to capital expenditures with respect to the transferred property. Thus, acquisition or improvement debt constitutes a qualified liability.[88]

Under the fourth category, a liability is a qualified liability if the liability was incurred in the ordinary course of the trade or business in which the property contributed to the partnership was used or held, but only if all of the assets related to the trade or business are transferred, other than assets that are not material to a continuation of the trade or business.[89]

The disguised sale regulations also specify rules governing liabilities that are not qualified liabilities which may or may not be treated as part of a disguised sale. In general, these rules provide that in the case of a transfer of property in which the partnership assumes or takes subject to a liability other than a "qualified liability," the share of the liability shifted to other partners is treated as an amount realized from a disguised sale, regardless of whether the partner receives any cash from the partnership.

Generally, the rules for determining the portion of the liability treated as shifted to other partners depend on whether the liability is recourse or nonrecourse.[90] For liabilities that are recourse, the rules under section 752 and the disguised sale rules are the same.[91] The regulations under section 752 provide that a partner's share of a recourse liability equals that portion of the liability for which such partner (or an affiliate of the partner) bears the economic risk of loss.

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[86] Treas. Reg. § 1.707-5(a)(6)(i)(B).
[87] Treas. Reg. § 1.707-5(a)(7)(i).
[88] Treas. Reg. § 1.707-5(a)(6)(i)(C).
[89] Treas. Reg. § 1.707-5(a)(6)(i)(D).
[90] *See generally* Mark J. Silverman and Aaron P. Nocjar, *Partnership Disguised Sale Rules, Practicing Law Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-offs, Joint Ventures, Financings, Reorganizations and Restructurings* (June 2006).
[91] Treas. Reg. § 1.707-5(a)(2)(i).

The disguised sale rules diverge from the section 752 regime in their treatment of nonrecourse liabilities. As discussed below, the regulations under section 752 adopt a three tiered approach to allocating nonrecourse liabilities. First, nonrecourse liabilities are allocated based upon each partner's share of partnership minimum gain as determined under the regulations under section 704(b). Second, they are allocated based upon each partner's share of section 704(c) minimum gain. Last, they are allocated in accordance with a residuary sharing method tied to partnership items that have significant economic effect are allocated. The disguised sale rules skip the first two tiers of allocations which makes it significantly more difficult to avoid disguised sale treatment for nonqualified liabilities incurred within two years before or after the encumbered property is contributed to the partnership. 46

If the disguised sale rules adopted a parallel set of rules to the section 752 regime, it would be simple to avoid disguised sale treatment in connection with the contribution of low basis high leveraged real estate to a freeze partnership. Just as the normal operation of the section 752 regulations makes it relatively simple to avoid a liability shift upon the contribution of property encumbered by nonrecourse debt, it would also make avoiding a disguised sale relatively simple. However, the disguised sale regulations adopt a different tact.

In lieu of the normal three tiered approach under the section 752 regulations, under the disguised sale rules, a partner's share of a partnership nonrecourse liability is determined under the third tier allocation rule alone.[92] The third-tier allocation rule provides that a partner's share of the excess nonrecourse liabilities, those not allocated under Treasury Regulation section 1.752-3(a)(1) and (2), are determined in accordance with the partner's share of partnership profits, taking into account all facts and circumstances. Alternatively, excess nonrecourse liabilities may be allocated in accordance with the manner in which deductions attributable to those liabilities will be allocated among the partners.[93]

[92] *See* Treas. Reg. § 1.707-5(a)(2)(ii) which incorporates Treas. Reg. § 1.752-3(a)(3)(the third-tier allocation rule).
[93] Treas. Reg. § 1.752-3(a)(3).

Valuation Considerations

Although a comprehensive discussion of estate and gift tax valuation is beyond the scope of this article, a brief discussion of the basics is relevant to the discussion. Valuation is at the 47
heart of structuring freeze partnerships. When structuring a real estate freeze partnership there is an additional level of inquiry. Real estate may be viewed as an investment or as an operating business. If the real estate is not actively managed, underlying market values of the real estate will be the primary consideration in determining values – subject to lack of marketability and lack of control discounts. If, on the other hand, real estate is actively managed so that the value of an interest in the entity will be more closely tied to the particular management structure and style in place, a valuation based upon earnings and distributions will carry greater weight. Some of the relevant authorities are discussed below.

The discussion of valuation must begin with Revenue Ruling 59-60.[94] Revenue Rule 59-60 provides guidance for valuing shares of stock in closely held corporations for estate and gift tax purposes. The general approach, methods and factors outlined in Revenue Ruling 59-60 also apply to the valuation of business interests of other types, including partnerships and proprietorships.[95]

The rulings establish that all relevant factors affecting fair market value must be considered when valuing the stock of closely held corporations or other corporations where market quotations are not available. A determination of fair market value will depend upon the circumstances in each case. Revenue Ruling 59-60 sets forth the following list of fundamental factors that should be analyzed carefully in each case:

1. The nature of the business and the history of the enterprise from its inception;

2. The economic outlook in general and the condition and outlook of the specific industry in particular;

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[94] 1959-1 C.B. 237
[95] Rev. Rul, 68-609, 1968-2 C.B. 327.

3. The book value of the stock and the financial condition of the business;
4. The earning capacity of the company;
5. The dividend-paying capacity;
6. Whether or not the enterprise has goodwill or other intangible value;
7. Sales of the stock and the size of the block of stock to be valued; and
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Depending on the circumstances in each case, certain of these factors carry more weight than others because of the nature of the company's business. For example, an appraiser may accord primary consideration to earnings when valuing stock of a company that sells products or services to the public (*i.e.*, the capitalization approach); conversely, in an investment or holding-type company, the appraiser may accord the greatest weight to the assets underlying the security to be valued (*i.e.*, the net worth approach). The ruling goes on to say:

> [t]he value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of the appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. *For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity*. (Emphasis added).

Revenue Ruling 59-60 favors use of the net worth approach for valuing an interest in a closely held real estate holding company. Revenue Ruling 59-60, however, does not address the valuation of a closely held real estate company that is actively managed by the owners, and thus has more characteristics of an operating company than an investment company. Case law, on the other hand, supports considering a combination of the capitalization approach and the net worth approach when valuing a closely held company that owns and operates real estate in an active manner and not merely as a passive investor.

In *Estate of Andrews v. Comm'r,*[96] the Tax Court held that the fair market value of a decedent's shares of stock in four closely held corporations that owned, leased and managed commercial real estate is determined by considering the net value of the assets owned by the corporations, the corporations' earnings and dividend-paying capacity and other relevant factors. In that case, the real estate holdings included warehouses, apartment buildings, factories, offices and retail stores. To handle their management and maintenance responsibilities, the corporations together employed approximately twenty-two persons in addition to the decedent and his two brothers, who together managed the four corporations. The Court held that the corporations could not be characterized for valuation purposes as solely investment companies or solely operating companies. According to the Court:

> [t]he cases cited by respondent, which involved corporations holding only cash, commercial paper, or marketable securities, are readily distinguishable on the ground that the corporations involved here were actively engaged in the real estate management business. But cases dealing with corporations owning factories and other industrial or commercial operations are also not directly on point. Unlike many industrial companies, where the value of the manufacturing equipment and plant is tied to the nature of the manufacturing operation, here, the value of the underlying real estate will retain most of its inherent value even if the corporation is not efficient in securing a stream of rental income. (Citations omitted).[97]

Furthermore, according to the Tax Court in *Andrews*, regardless of whether the corporations were primarily operating companies or investment companies, courts should not restrict consideration to only valuation approach, such as capitalization or net asset values. As the Court stated, "the degree to which the corporation is actively engaged in producing income rather than merely holding property for investment should influence the weight to be given to the values arrived at under different approaches but it should not dictate the use of one approach to the exclusion of all others."[98] Some of the value attached to the corporations must be based upon

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[96] 79 T.C. 938.
[97] *Id.* at 944.
[98] *Id.* at 945

the operating nature of the businesses, with attention paid to their earnings and dividend history, management, and prospects for growth.

At issue in *Estate of Etta H. Weinberg v. Comm'r*[99] was the value of a limited partnership interest over which the decedent had a general power of appointment on the date of death. The partnership owned and operated an apartment complex that consisted of an 11-story building containing 188 apartment units, an office suite, a parking garage, and a swimming pool. The estate argued that the value of the interest was $971,838 and the IRS argued that it was worth $1,770,103. The estate's appraiser valued the limited partnership interest using both the capitalization of income approach and the net asset value approach. He weighted the capitalization approach by 75-percent and the net asset value approach by 25-percent, based on his belief that a 3-to-1 ratio adequately emphasized the fact that the capitalization approach was the more important approach for this partnership interest.

Interestingly, the IRS's appraiser valued the subject limited partnership interest using only the capitalization of income approach. According to the appraiser, the net asset value approach was inappropriate for valuing the limited partnership interest because the partnership's underlying asset was income-producing real estate. He argued that the net asset value was irrelevant because a hypothetical buyer could not control the sale of the underlying property or the liquidation of the partnership.

The Tax Court agreed with the estate that a weighted average of 75-percent for the capitalization approach and 25-percent for the net asset value approach adequately reflected the attributes of the partnership. The Court believed that some weight should be given to net asset value because the value of the underlying real estate would retain most of its value even if the partnership was not efficient in securing a stream of rental income. Nevertheless, the Court held that the limited partnership interest was worth $1,309,650.64 on the date of death, because it disagreed with certain other aspects of the estate's appraisal.

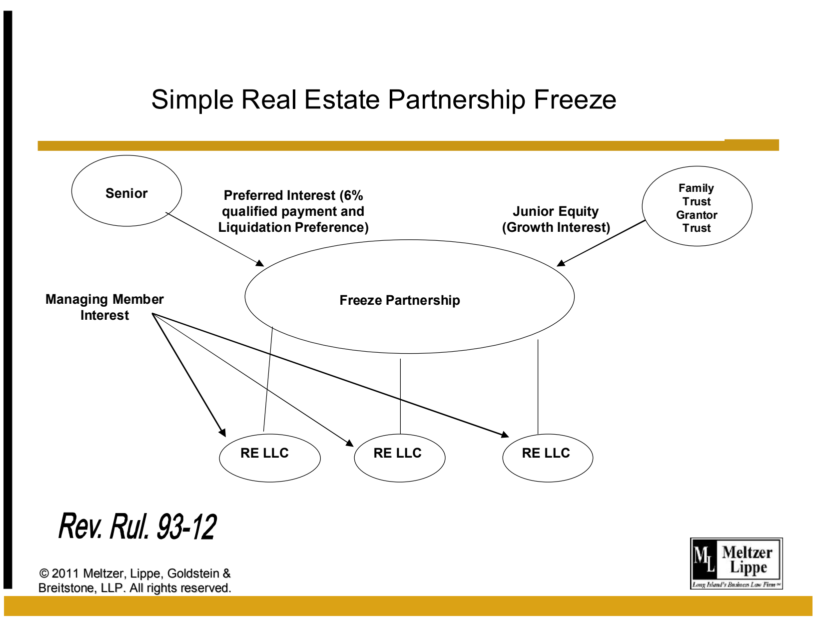
[99] 79 T.C.M. (CCH) 1507 (2000).

If the partnership is largely asset based and not actively managed so that its value is more directly tied to the fair market value of its assets than the particular management structure in place then the net asset value may be considered a more appropriate valuation method.[100]

Transactional Structures

Armed with the guiding principles, some of the key transactional structures of the freeze partnership will now be addressed. In the pages that follow, there will be a description of (i) the simple real estate partnership freeze structure; (ii) a structure designed to force liabilities to be allocated to the senior generation to maximize the basis step-up upon death; (iii) the leveraged freeze structure designed to allow some of the payments to the senior generation to accrue at the AFR; and (iv) the reverse freeze.

The following is illustrative of the simple real estate freeze partnership structure:



[100] *See*, *e.g.*, *Estate of Curry v. Comm'r*, 706 F.2d 1424, 1430-31 (7th Cir. 1983); *Harwood v. Comm'r*, 82 T.C. 235, 265 (1984); *Estate of Watts v. Comm'r*, 823 F.2d 483, 486 (11th Cir. 1987).

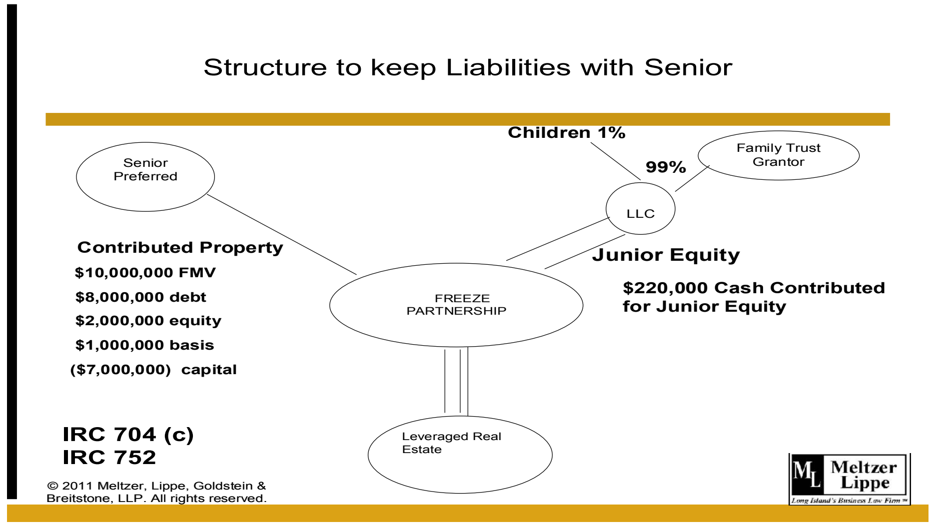
In this structure, the senior generation ("Senior") contributes low basis leveraged real estate to a limited partnership (or limited liability company) in exchange for a frozen preferred interest that accrues a "qualified" payment or distribution equal to six (6%) percent of the value of Senior's capital contribution. The six (6%) percent return must be determined by appraisal. The appraisal determines the market rate of return that would have to be paid on the preferred interest so that it would be worth no less than 90% of the value of the family controlled interests in the partnership. The 90% value requirement is a function of section 2701's requirement that at least ten (10%) of the partnership equity is attributable to the junior equity interest.[101] Note that since in this example Senior has contributed noncontrolling interests in lower tier real estate partnerships or limited liability companies. Therefore, Senior's contribution, and thus his preferred interest, should be valued at a discount to reflect lack of marketability and control. However, under the section 2701 regulations, there is a rule that all family controlled interest should be valued as if held by a single individual. If that rule were applicable, no such discounts would apply. However, there may be a question as to whether that rule is applicable on these facts since Senior is making "capital contributions" of these interests. The regulations "fair market valuation rule" for capital contributions seems to apply to these facts. Some practitioners are concerned that if the lower tier entities were created principally for the purpose of creating discounts, the discounts may not be recognized by the government. Others are concerned that whether or not created for this purpose, unless the lower tiered entities have nonfamily members as partners, the discounts would not be recognized.

Another concern with this structure is that since the partnership is essentially between the grantor and a grantor trust it will not be a partnership for income tax purposes. It will become a partnership for income tax purposes only at the time the trust ceases to be a grantor trust – likely not until the death of the grantor. At that point it will become a partnership between the grantor's estate and the former grantor trust. As discussed above, there will be significant uncertainty as to the treatment of the termination event. It will also be unclear as to whether there will be a basis step-up to the estate for the entire share of liabilities in excess of basis of the contributed property that would have been treated as if transferred from the grantor. There may also be a question as to whether gain would be recognized at that point – although

[101] IRC § 2701(a)(4)(A).

this author believes the better view is that no such gain is recognized.

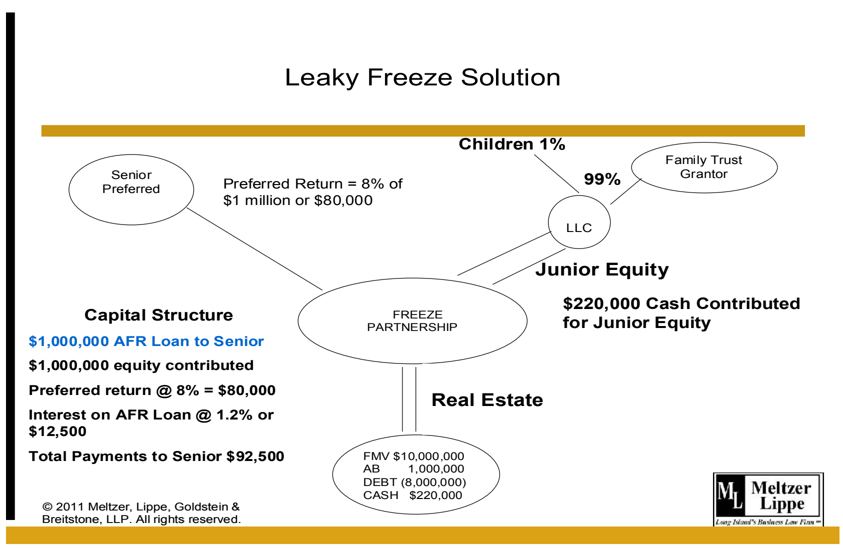
This uncertainty can be avoided with some structuring at the time the freeze partnership is created. The following is an example of a structure that should be able to avoid these uncertainties:



In this example, the partnership will not be a disregarded entity. It is structured so that it will be treated as a partnership for income tax purposes from its inception. This is accomplished by creating a nondisregarded entity to be the initial partner who will acquire the junior equity interest. There are a number of ways to accomplish this goal. However, it is important to note that only the low basis leveraged property should be contributed in exchange for the senior preferred ownership interest. Different property, presumably unencumbered property or cash, should be contributed to the nondisregarded entity formed to hold the junior equity interest. The nondisregarded entity would, in turn, contribute this property to the partnership in exchange for the junior equity interest. This other property can be contributed either by the grantor or by other family members. If it is contributed by the grantor, the grantor would receive, in exchange, an ownership interest in the nondisregarded entity. In the example, that is a 99% interest – although there is no magic to that percentage. The grantor could then either gift or sell that interest to the grantor trust. All of the income tax items (except for the 1% owned by others) would flow through to the grantor either directly as the holder of the senior preferred interest, or indirectly from the nondisregarded junior equity interest holder through the grantor trust as grantor. The separate existence of the junior equity interest holder should be sufficient to treat the partnership as a freeze partnership with two partners for income tax purpose. One partner would be the grantor. By operation of the second tier rule for nonrecourse liabilities under section 752, all of the liabilities to which the contributed property was subject at the time of contribution would be allocated to the grantor's senior preferred interest. This interest would be included in the grantor's estate for estate tax purposes upon the death of the grantor which should result in a basis step-up for the entire liability share under section 1014. 54

As discussed above, the freeze partnership requires a higher return to be paid on the frozen interest than other freeze techniques such as GRATs or IDGTs. In some instances paying this higher return to the senior generation would not be a disadvantage but rather welcomed since the senior generation may wish to retain the income stream but transfer the growth in underlying capital assists. However, that is not always the case.

It may be the case that the freeze partnership is the planning vehicle of choice because the GRAT and IDGT do not work well for low basis leveraged assets with liabilities in excess of basis. The higher returns that must be paid on the senior preferred interest may be a real impediment to effectuating a viable freeze. For this reason, the freeze partnership has sometimes been referred to as a "leaky freeze." It is leaky because too much must be paid back to the senior generation which cuts against the estate planning objectives. Accordingly, it may be desirable to seek methods to minimize the return that must be payable to the senior generation. One possible structure to accomplish this objective is as follows:



Under the above example, a portion of the equity that would otherwise be allocated to the senior preferred interest is reduced by introducing a note owed to the senior generation that bears interest at the AFR. Assuming that note represents bona fide indebtedness, it should effectively reduce the equity that must accrue the higher rate of return that must be paid on the senior preferred interest. Section 2701 clearly contemplates that there may be indebtedness owed to the senior generation within the capital structure of a freeze partnership. Section 2701 does this by measuring the ten (10%) percent minimum value that must be attributed to the junior equity against the total equity plus indebtedness owed to the senior generation.[102] Note that if the equity is too thin this note might be reclassified as equity for tax purposes which would likely defeat this strategy. In addition, it is likely that if the entity were leveraged in this manner a somewhat higher return would be warranted on the remaining equity. However, this should not be sufficient to negate the benefits of interposing leverage to the transferor into the structure.

Lastly, the freeze partnership may not work particularly well for low yielding assets which would not generate sufficient return to pay the required return on the senior preferred interest. In those situations, the "reverse freeze" may be a viable alternative. In the reverse freeze, instead of giving the junior equity to the children, the transferor retains the junior equity and the preferred stock is gifted to the junior generation. Alternatively, the junior generation contributes assets to the freeze partnership in exchange for preferred interest. In either case, the higher yields that must be paid on the preferred interest will accrue to the benefit of the junior generation. Over time, this return may be more valuable than the growth and appreciation that would be earned by the junior equity interest held by the senior generation. Note that in this scenario the imposition of family attribution upon the valuation of the preferred interest contemplated in the section 2701 regulations may actually benefit the junior holders of the preferred interest holders. This is because equity that accrues will not be discounted and the higher rate of return that will be required on the preferred.

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[102] IRC § 2701(a)(4)(A) provides:

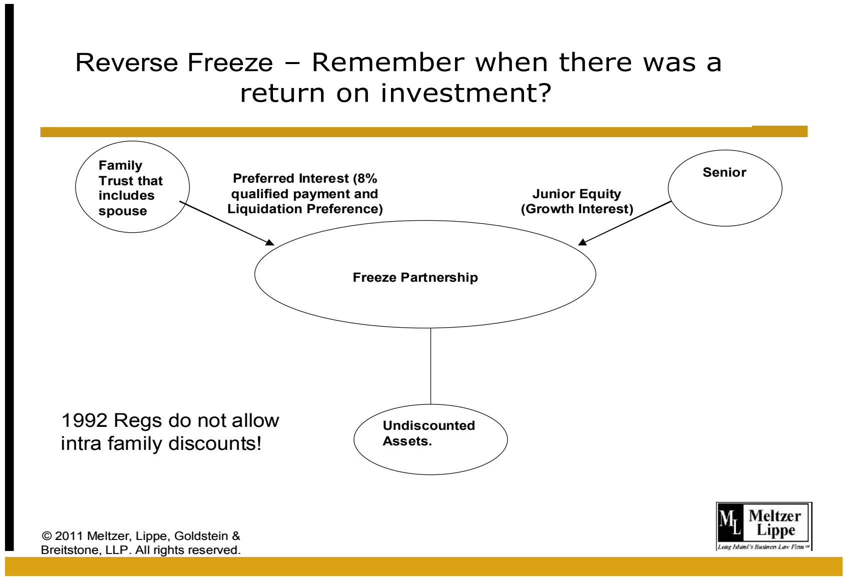
(4) Minimum valuation of junior equity

(A) In general - In the case of a transfer described in paragraph (1) of a junior equity interest in a corporation or partnership, such interest shall in no event be valued at an amount less than the value which would be determined if the total value of all of the junior equity interests in the entity were equal to 10 percent of the sum of—

(i) the total value of all of the equity interests in such entity, plus

(ii) *the total amount of indebtedness of such entity to the transferor* (or an applicable family member). *(emphasis added).*

The reverse freeze structure is illustrated as follows:



Conclusion

A great deal of income tax as well as estate planning sophistication is required to properly design and effectuate a freeze partnership. To be competitive with other freeze techniques such as installment sales to intentionally defective grantor trusts and grantor retained annuity trusts, entity freezes governed by section 2701 present a number of significant hurdles. However, neither the GRAT nor the IDGT offers a key advantage offered by the partnership freeze. Only with the partnership freeze will there be certainty as to the ability to obtain a basis step-up upon death for low basis leveraged assets which tend to have liabilities in excess of basis or negative capital. Moreover, other techniques may actually trigger this built-in gain which can result in a tax that consumes a substantial portion, and perhaps the entire equity value of these low basis leveraged assets. Unfortunately, the partnership freeze technique is often overlooked because it presents significant complexities. Also, since the return that must be paid on the frozen ownership interest cannot be tied to the AFR, the economics of the freeze partnership can be a challenge to the planner. However, by employing the ideas and techniques set forth in this article, many of these challenges can be overcome.

<u>About the Author</u>

Stephen M. Breitstone, Esq., heads Meltzer Lippe's internationally acclaimed tax group representing clients in Europe, Israel, South America, Australia and elsewhere. Mr. Breitstone primarily practices sophisticated tax and estate planning for several large New York real estate families, Wall Street investment bankers, hedge fund managers, corporate executives, and others.

He has pioneered many novel and sophisticated tax planning techniques, many of which have come into widespread use.

Steve, his wife Jill, who is also a lawyer, and their children Jason and Lauren live in Melville, Long Island. Steve enjoys sailing, woodworking, politics and charitable work. He is an active member of the American Israel Public Affairs Committee ("AIPAC").

Picture Attached:

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