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Living With "Freeze Partnerships" in the Real World: Formation Considerations and Practical Applications

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INTRODUCTION

For individuals who desire to receive income from an income-producing asset during their lives, traditional estate planning techniques such as gifts, grantor retained annuity trusts (GRATs) and installment sales to grantor trusts cannot provide for income payments that continue until death. The preferred partnership can provide lifetime income payments and shift the increase in the value of the income-producing assets to individuals or trusts that are not exposed to estate tax when the individual dies. Because the only asset exposed to the estate tax is a retained preferred partnership interest that does not participate in the increase in value of the partnership's assets, the amount exposed to estate tax is frozen at the value of the preferred partnership interest, hence the term "preferred partnership freeze."

The freeze partnership has two ownership interests, a preferred interest entitled annually to a fixed amount and a common interest that is allocated all partnership income and value of the partnership's assets in excess of the guaranteed preferred payments. Typically, the individual contributes the income-producing asset to a partnership in exchange for a preferred interest and a common interest. The individual then transfers the common interest by a gift or sells the common interest to a trust, typically a grantor trust, for a promissory note. Because the frozen preferred partnership interest is owned by the individual, the financial objective, the retention of guaranteed income payments during life, while dividing the economics of the partnership into fixed-income preferred and common growth equity interests is achieved. By disposing of the common interest that is allocated all appreciation in value, the estate planning objective is also achieved.

By including a frozen preferred partnership interest in the decedent's estate, the income tax-free step-up in

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basis that is not available with estate planning techniques that shift appreciated assets out of the decedent's estate included can be used. And, if the partnership's asset is encumbered real estate, the income tax basis for the preferred partnership interest includes the value of the preferred interest and the amount of the mortgage liability. The income tax advantage can eliminate the phantom gain that would be reported when the mortgage liability exceeds the income tax basis for the real estate. On the practical side, it is important to consider how one should draft a preferred partnership agreement so as to take into account considerations under §2036(a).[1] After the freeze partnership had been implemented, one needs to consider how to maintain its income tax and estate tax benefits if the partnership has years when the cash flow is not sufficient to make the annual payments for the preferred interest and other financial considerations that may occur such as the partnership's assets decline in value.

HISTORY OF THE ENTITY FREEZE

Pre-Chapter 14 "Abusive" Preferred Partnerships

Prior to the enactment of §2701 in 1990 as part of the Chapter 14 regime, entity freeze techniques were referred to as "capital freezes."[2] This term was a reflection of the fact that under the planning of that time, no capital needed to be transferred for the preferred partnership freeze to accomplish the intended objectives. Before enactment of §2701, in effect, one could retain the principal and shift the income from the principal without transferring any value under the gift tax, making it easier to "shift" income to the next generation. There was no need to freeze what could be shifted.

The pre-1990 capital freeze first involved the recapitalization of a business entity (whether a partnership or a corporation) into separate classes of ownership interests. After the recapitalization there would be a preferred interest and a common interest. The preferred interest would be entitled to a priority return on its capital and a liquidation preference so that the preferred interest 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 or preferred distributions that would actually be paid. The preferred dividends or the priority return could be noncumulative so that if not paid in one year (or for several years) the holder of the preferred interest would not be entitled to a make-up distribution in future years. The non-paid preferred dividend or priority return 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 "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 so appraisers would attribute all or almost all of the value to the preferred interest which would reduce or, more likely, negate a gift upon the gift of the common interest to a trust for the younger generations.

Within the family context, all income and all appreciation in value could be shifted to the holders of the junior equity interests since they would benefit from the nonpayment of dividends on the senior preferred interests, 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 typically 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 economic value. Outside of the family context the option value represented 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.

Preferred Partnerships Today — Post Chapter 14

Today, there are a number of provisions set forth in Chapter 14, mostly in §2701, specifically designed to preclude this type of planning. Section 2701 was enacted to preclude these perceived abuses involving en-

[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] *See* the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508.

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tity freezes that were upheld by case law.[3] These cases involved, inter alia, rights belonging to the senior preferred interest holders that lapsed upon death, but which were taken into account in determining the value of the preferred interest.[4] Section 2701 has reigned in many of these types of abuses. The §2701 rules outline what rights the preferred interest must have so that the gift of the common interest will have a statutorily minimum value for gift tax purposes. By setting for the requirements for the preferred equity interest, §2701 now provides a safe harbor set of rules that, if followed, significantly reduce the potential for uncertainty surrounding the preferred partnership freeze.

Section 1274 and Use of Applicable Federal Rate

Another development that indirectly impacted the use of the entity freeze is §1274 which requires the use of the Applicable Federal Rate (the ''AFR'') for all deferred payment sales. Section 1274 was enacted in 1984 to combat potential abuses involving low interest purchase money indebtedness used on property acquisitions (i.e. seller-provided financing) to either (i) inflate depreciation deductions and thus possibly increase the tax benefits resulting from the purchase of income producing properties or (ii) convert interest income taxable at ordinary income tax rates into capital gains Prior to the enactment of §1274, artificially low interest rates could be charged so that the same level payment could support a higher nominal purchase price for such property. The higher nominal purchase price could result in disguising interest as principal, thus converting ordinary income into capital gains and producing in some cases inflated depreciation deductions which could be made available to offset unrelated income.

Although §1274 was intended to govern income tax deferred payment sales, it had a positive impact on freeze techniques used for estate planning that was likely unintended. This impact has been amplified in the current exceptionally low interest rate environment. Since the AFR is determined by reference to the one-year Treasury bill rate, it is always a below market interest rate, even in high interest rate environments. For example, a father could sell a $1 million corporate bond paying 3.0% interest to a son, and take back the son's nine-year, interest only, under a promissory note paying only 1.0% in satisfaction of the entire selling price, thus allowing the son to keep the excess $20,000 each year without any gift tax.

Since §1274 only applies to deferred payment sales, the AFR is not used to determine the priority return that must be paid on a preferred equity interest. Instead, the preferred return that must be paid in the entity freeze is determined by market forces. Other freeze techniques may rely on the AFR which is typically a far lower rate. Thus, GRATs must use the §7520 rate (which is 120% of the mid-term AFR) in determining the annuity payments that must be made to the grantor. Installment sales to intentional grantor trusts must pay interest at not less than the AFR. The AFR will almost always be lower than the market rate of return payable on a preferred interest.[5]

The availability of low ''hurdle'' rates associated with other freeze techniques, such as GRATs and installment sales to grantor trusts, can make those techniques preferable in many, but not all, situations. The situations in which those techniques may not work as well as the entity freeze are explored below.

CHAPTER 14 COMPLIANT PREFERRED ''FREEZE'' PARTNERSHIPS

Introduction

A preferred ''freeze'' partnership (referred to in this article as a ''Freeze Partnership'')[6] provides one partner, typically a parent or other Senior Family Members (referred to generally in this outline as ''Senior Family Member''), with a fixed stream of cash flow in the form of a preferred interest, while providing another partner with the future growth in the form of common interests in a transfer-tax-efficient manner. The preferred interests do not, however, participate in the upside growth of the partnership in excess of the preferred coupon and liquidation preference, as all that additional future appreciation inures to the benefit of the common ''growth'' class of partnership interests, typically held by the younger generation or

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[3] *See Estate of Harrison v. Commissioner*, T.C. Memo 1987-8; *Estate of Watts v. Commissioner*, T.C. Memo 1985-595, *aff'd*, 823 F.2d 483 (11th Cir. 1987); *Estate of Boykin*, T.C. Memo 1987-134.

[4] *See* TAM 8510002 and TAM 8401006 (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 non-voting at his death).

[5] Rev. Rul. 83-120 provides guidance that a market-based approach must be used to determine the priority return for a preferred entity interest. It is typical that the yield on a preferred interest as of August 2021 can be in the 6% to 9% range when the long-term AFR for August 2021 is only 1.89%. Rev. Rul. 2021-14.

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

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

Moreover, the Freeze Partnership can, over time, transfer considerable ownership and value to the holders of the common ''growth'' junior equity interest in a tax efficient manner. Like other ''freeze'' techniques such as installment sales and GRATs, the holder of the preferred interest is ''frozen'' in value so that the holder of the junior interest receives the benefits of future growth of income and appreciation.

OVERVIEW OF ISSUES IN STRUCTURING PREFERRED "FREEZE" PARTNERSHIPS[7]

Gift Tax Formation Issues

A triggering event that can cause a deemed gift under §2701 is known as a ''transfer.'' A transfer includes not only traditional gift transfers, but also capital contributions, redemptions, recapitalizations, or other changes in the capital structure.[8] Clearly the most critical issue in structuring a Freeze Partnership is §2701 which generally can result in a deemed gift upon a Senior Family Member's ''transfer'' of a partnership interest in which he or she retains senior equity interests, unless very specific requirements are satisfied with respect to the Senior Family Member's preferred interest.

Structuring the Preferred Interest

Qualified Payment Right

A Senior Family Member's preferred partnership interest is typically structured as a ''qualified payment right'' under §2701. A ''qualified payment right'' allows the Senior Family Member's retained preferred interest to be valued under traditional valuation principles for gift tax purposes, and not under the unfavorable ''zero valuation rule'' of §2701. This requires that the Senior Family Member's preferred interest be structured as a fixed percentage return on capital, that is payable at least annually and on a cumulative basis.[9]

Liquidation Preference

In addition to being entitled to a preferred coupon payment, the preferred interest would provide a priority liquidation right, meaning that upon liquidation, the preferred holder will receive a return of his or her capital before the common interest holders. The preferred holder, however, will not receive any of the potential upside growth in the Freeze Partnership, which would benefit the common interest holder.[10]

Valuation of the Preferred Coupon

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

- Comparable preferred interest returns on high-grade publicly traded securities in the same industry;
- The Freeze Partnership's ''coverage'' of the preferred coupon, which is the ability to pay the required coupon when due, and its coverage of the liquidation preference, which is its ability to pay the liquidation preference upon liquidation of the Freeze Partnership, will impact the required coupon; and
- Other factors.

Valuation Discounts and Other Relevant Factors

Reg. §25.2701-3(b)(1) imposes an additional valuation structure. 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 assump-

[7] For excellent comprehensive discussions of preferred partnership planning, *see generally* Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle,* 35-3 Univ. of Miami Law Center on Est. Planning (Jan. 2001). *See also* Paul S. Lee & John W. Porter, *Family Investment Partnerships: Beyond the Valuation Discount* (Sept. 2009).

[8] Reg. §25.2701-1(b)(2)(i).

[9] §2701(c)(3)(A).

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

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tions.''[11] This assumption is apparently designed to preclude valuation discounts such as discounts for lack of control and lack of marketability from being applied. If the entity is family controlled and all family held interests are deemed held by one individual that individual would not be deemed to 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.

The regulations contain an exception to the family attribution rule for ''contributions to capital.'' The Treasury regulations permit the use of fair market value as an exception to the family attribution rule when determining the value of the entire family held interest. This exception seems routed in the fact that if a minority or nonmarketable interest were contributed to the partnership it would be contrary to established law to ignore the discounts. In fact, the family attribution rule in the §2701 regulations is probably a reflection of the IRS view on family attribution at the time they were adopted. Approximately one year after their adoption, after suffering a number of defeats in the courts on the question of intra family discounting, the IRS issued Rev. Rul. 93-12 which recognized discounting among family members. It is an open question as to whether the IRS would seek to enforce the ''as if held by one person'' family attribution rules in light of Rev. Rul. 93-12.[12]

PARTNERSHIP TAX FORMATION ISSUES

Selected Partnership Tax Issues

In drafting the provisions relevant to the preferred coupon, it is necessary to balance the following income tax and transfer tax concepts, which are not necessarily compatible and often require some ''retrofitting'' to address the combination of different tax requirements.

Diversification

In the case of partnership assets consisting of securities there should be no recognition of gain as a result of the capitalization of the partnership if no ''diversification'' occurs under §721(b) as a result of a partner's capital contribution.[13] For example, if both partners contribute diversified portfolios,[14] then the contribution by into the Freeze Partnership should not result in gain under the §721(b) under the so-called ''diversified portfolio'' exception.

Investment Company

If at least 20% of the partnership assets consist of real estate or other assets other than readily marketable securities, this too would avoid recognition of gain as a result of the capitalization.[15]

De Minimis Exception

Under the ''*de minimis* exception,'' if one of the partners contributes assets that are ''insignificant'' in amount as compared with the total assets of the partnership, the contribution of those assets does not result in diversification.[16] Although an example in the Treasury regulations indicates that a contribution of less than 1% would be insignificant, private letter rulings have determined that up to a 5% contribution could be considered insignificant.[17]

Disguised Sale Rules

Under §707, a presumption exists that a ''disguised sale'' occurs any time a member contributes appreciated property to a partnership and cash or other property is distributed to the contributing partner within two years of the contribution.[18] If a disguised sale occurs, the contributing member is deemed to have sold all or part of the built-in gain property contributed (measured by the cash received versus the total value of the property contributed by the member).

A disguised sale generally occurs if, based on all of the facts and circumstances (i) the distribution would not have been made but for the contribution of property to the partnership, and (ii) the distribution is not dependent on the entrepreneurial risks of the partner-

[11] Reg. §25.2701-3(b)(1)(i).

[12] Rev. Rul. 93-12.

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

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

[15] Reg. §1.351-1(c)(2), §1.351-1(c)(3), §1.351-1(c)(1)(ii).

[16] Reg. §1.351-1(c)(5).

[17] *See, e.g.*, PLR 9451035, PLR 200006008.

[18] Reg. §1.707-3(c)(1).

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ship.[19] The Treasury regulations, however, provide an exception to disguised sale treatment for preferred returns where payments to the contributing member are ''reasonable'' and the facts do not ''clearly establish'' that the distribution is part of a sale.[20] The Treasury regulations further provide a safe harbor, deeming a preferred payment ''reasonable'' if the preferred payment does not exceed (i) the member's unreturned capital in the partnership at the beginning of the year multiplied by (ii) 150% of the highest applicable federal rate.[21] This safe harbor notwithstanding, in light of the historically low interest rates and the valuation factors discussed above, it is highly likely that, in light of the factors set forth in Rev. Rul. 83-120, the valuation of the preferred coupon will exceed the regulatory safe harbor. As such, structuring a preferred partnership in which the contributing partners are different taxpayers requires reconciling these two seemingly incompatible sets of rules.

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

Safe Harbor Approach 1 — ''True up'' in year Three with Qualified Payment Right Election

One approach to reducing the risk of a disguised sale could be to structure the preferred coupon so as to restrict the payment of the preferred return for the first two years to not exceed 150% of the highest applicable federal rate, followed by a make-up payment in the third year in order to ''true up'' the preferred partner to the preferred coupon amount required for the first two years.[22] However, while such a provision addresses the disguised sale rules, it is in direct conflict with the transfer tax requirement that the coupon be payable annually from the Freeze Partnership to the preferred interest holder (assuming the preferred coupon will be structured as a Qualified Payment Right under §2701). To address this issue, one could structure the preferred coupon to fall within the reasonable payment safe harbor, but intentionally not satisfy the requirements of a Qualified Payment Right, and instead make an election to treat the preferred interest as if it were a Qualified Payment Right on a timely filed gift tax return.[23]

Safe Harbor Approach 2 — ''Coupon true up'' with Qualified Payment Right Election

A variation on the above Safe Harbor Approach 1 would be for the preferred payment to be restricted in the first two years as in Approach 1. However, in year three rather than having the shortfall of years one and two ''trued-up'' in year three, instead, in year three the full coupon payments would begin. The required coupon rate, however, would reflect the fact that in the first two years a lesser coupon is paid out, which presumably would result in a slightly higher coupon rate beginning in year three than would otherwise be determined. In other words, the coupon would be ''smoothed out.''

Safe Harbor Approach 3 — Operating Cash Flow Distributions

An alternative safe harbor to the reasonable payment is available for operating cash flow distributions, which are not presumed to be disguised sales unless the facts and circumstances clearly suggest otherwise.[24] An operating cash flow distribution is a transfer of money by a partnership to a partner that does not exceed the partnership's net cash flow from operations, multiplied by the lesser of (i) the partner's percentage interest in partnership profits for the tax year in question, or (ii) the partner's percentage interest in overall partnership profits for the life of the partnership.[25] This approach may permit practitioners to more readily structure the preferred coupon in a manner that avoids classification as a guaranteed payment, which could provide certain advantages from an income tax perspective.[26]

Care should be taken if adopting this approach to ensure the partnership complies with the technical re-

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

[20] Reg. §1.707-4(a)(2).

[21] Reg. §1.707-4(a)(3)(ii).

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

[23] §2701(c)(3)(C); Reg. §25.2701-2(c)(2).

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

[25] Reg. §1.707-4(b)(2).

[26] See Note 24, above, at 215.

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quirements of both the operating cash flow safe harbor and the Qualified Payment Right under §2701, including possibly making a protective Qualified Payment Right election.

Non-Safe Harbor Reasonable Payment Approach

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

Factors to Consider

A review of the relative risks will need to be done to determine whether taking on the risk of disguised sale treatment is preferable to bearing the risk of a deemed gift under §2701. This review will require a comparison between the income tax consequences of triggering a disguised sale, which would be offset (at least somewhat) by an accompanying basis increase), compared to the tax costs associated with failing to satisfy the valuation rules in §2701. For example, if the property to be contributed has significant appreciation it may be preferable to rely on the ''safe harbor'' approach paired with a Qualified Payment Right election to avoid potentially triggering the disguised sale rules, which could have a larger income tax impact. However, if the contributed assets have a relatively high basis, triggering the disguised sale rules might have a smaller income tax impact and the position that the preferred payment is a reasonable one (albeit outside of the safe harbor) might be an acceptable risk and this would avoid the need to make a Qualified Payment Right election.

FREEZE WITH REAL ESTATE

The following example is intended to illustrate how the Freeze Partnership shifts the future appreciation in real estate interests to future generations via trust with no gift or estate tax, while allowing the taxpayer to retain an interest in the real estate investment.

Facts

Oliver and Grace Warbucks[27] have made no prior gifts and each still have their entire lifetime gift tax and estate tax exemptions, currently $11.7 million in 2021. Oliver is age 86 and in good health and Grace is age 76 and in good health.

They currently own real estate interests worth approximately $250 million and are encumbered by an estimated $50 million of mortgages. Therefore, the equity in the real estate interests is $200 million. All real estate interests are interests in limited liability companies characterized as partnerships for federal income tax purposes. The real estate owned by each limited liability company is subject to a long-term triple net lease with well capitalized tenants. Neither Oliver nor Grace are actively involved in the operations of the leased properties.

Because these are long-term triple net leases, the rents for the lease term are locked in. Therefore, the potential for appreciation in value will be limited and we will assume that at the end of ten years the real estate will be worth $300 million.

We also assume that the principal payments on the mortgages over the next 10 years will fully amortize the remaining mortgage liabilities. Therefore, over this 10-year period, the equity in the real estate will increase by $50 million even if the value of the properties does not increase.

Because the rentals are based on the triple net leases, we assume that the $9 million of annual income generated by the real estate interests will not increase. The rate of return on the $200 million of equity is 4.5%.

Oliver and Grace are residents of New York State with an 9.65% state income tax rate. Their combined federal income tax rate is 40.8% (37% + 3.8%). As a result, their effective income tax rate is 50.45%.

Since the triple net leases are for up to 30-year terms with well capitalized tenants, the real estate interests are like 30-year bonds. Thus, if an appraiser were to value the interests in the real estate entities, for purposes of this analysis we assume the valuation discounts for lack of marketability and lack of control would be about 20%. Using the current $200 million of equity, the discounted value of the real estate interests would be $160 million (20% × $200 million = $40 million). We assume Oliver and Grace also have $100 million of cash and $125 million of Treasuries.

Status quo with no estate planning.

The following is a sample balance sheet for the real estate interests:

[27] This example is not based on any real-world individuals and is intended for discussion purposes only.

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Balance Sheet			
Assets	**Value**	**Liabilities**	
Real Estate	$250,000,000	Mortgage	$50,000,000
		Equity	$200,000,000
	$200,000,000		$250,000,000

- After the payment of all expenses and the payment of the principal and interest on the mortgages, the net cash generated by the real estate is $9 million (a 4.5% return on the $200 million of equity).
- Over the next 10 years, the remaining principal on the mortgage is paid off. The payment of principal increases the equity by $50 million even if the value of the real estate does not increase.
- By the end of ten years the estimated value of the real estate may be $300 million.

At the end of 10 years the balance sheet for the real estate will be:

Balance Sheet			
Assets	**Value**	**Liabilities**	*None*
Real Estate	$300,000,000		
		Equity	$300,000,000
	$300,000,000		$300,000,000

If Oliver died at the end of 10 years, and his real estate interests were exposed to the estate tax, the $300 million undiscounted value and the $45 million (rounded) of accumulated after-tax income, less the $6 million estate tax exemption that will be available after 2025, would be exposed to a 50% combined federal and NYS estate tax rate,[28] with an estate tax liability of $169.5 million (50% × $339 million). The entire $50 million of appreciation in the value of Oliver's real estate, the $50 million increase in equity resulting from amortization of mortgage principal and the accumulated after-tax earnings of $4.5 million or 10 years (or $45 million) would be exposed to the estate tax if he does not do planning.

Given that Grace is 10 years younger than Oliver, and she is expected to survive Oliver, there will not be an estate tax when Oliver dies because of the marital deduction. If the real estate passes to Grace using the marital deduction, the real estate will be exposed to the estate tax when she passes. If she lives another 10 years after Oliver passes, it is assumed that in 20 years the real estate will be valued at $500 million so that the estate tax exposure will be even greater.

For illustrative purposes, we will assume that the real estate will be subject to the estate tax at the end of 10 years.

Estate Planning Objectives

The estate planning objectives of the parties in the above example are:

1. Transfer all $50 million appreciation in the value of the real estate and the $50 million increase in the equity to a trust for the benefit of Oliver's children and grandchildren so that $100 million of value is not exposed to estate taxes.

2. Transfer as much as possible of the $9 million of income from the real estate to the family trust so that it is not exposed to the estate tax. The portion distributed to the family trust has no gift tax or estate tax exposure.

3. Determine the discounted value of the family limited partnership interests in the real estate investments. Because Oliver will contribute nonvoting, non-marketable interests in the real estate entities to the Freeze Partnership, conservative valuation discounts can be taken.

Proposal Using the Discounted Values for The Interests in the Real Estate Entities

Phase 1: Oliver contributes the interests in the nonvoting non-marketable separate interests in the real estate limited liability companies, collectively valued at $160 million[29] to a family limited partnership for a $160 million capital contribution. In exchange for the capital contribution Oliver will receive two ownership interests, a preferred interest, and a common interest. The $160 million capital contribution will be bifurcated into a $80 miliion preferred interest and a $80 million common interest. The preferred interest will have a 5.5% priority allocation of partnership profits. The priority return is low because of the coverage provided by the common interest that represents 50% of the capital in the partnership. Using a 5.5% priority allocation, the prior-

[28] As a New York State resident there would also be a New York State inheritance tax of 16%, which is deductible against federal estate tax, thus resulting in an overall effective tax rate of 49.6%.

[29] The value of your interests in each limited liability company can be discounted for lack of control and lack of marketability. In this example we assume a conservative overall valuation discount of 20%. Therefore, the collective value for your limited liability company 99% interests to be contributed to the freeze partnership would be is $158,400,000 (rounded to $160,000,000).

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ity allocation will be an amount equal to 5.5% of the $80 million preferred capital account = $4.4 million. A priority allocation of profits means that the first $4.4 million of partnership income must be allocated to and distributed to the preferred interest. Only partnership income that exceeds the $4.4 million priority allocation can be allocated to the common interest. With partnership income of $9 million the entire $4.6 million excess will be allocated to the common interest. Even if partnership income increases in the future, the preferred priority allocation is frozen at $4.4 million annually.

The recapitalized balance sheet will appear as follows:

Balance Sheet				
Assets	**Value**	**Liabilities**		
Real Estate[30]	$210,000,000	Mortgage		$50,000,000
		Equity Capital Accounts	Preferred $80,000,000	
			Common $80,000,000	$160,000,000
	$210,000,000			$210,000,000

With the preferred partnership, all appreciation in value is allocated to the common interest. And all income over the preferred priority allocation is allocated to the common interest.

Phase 2: Oliver will then dispose of the common interest by a transfer to the family trust:

a. The value of the common partnership interest will be less than its $80 million capital account because of lack of control and lack of marketability. Because of the guaranteed nature under the triple net leases, a 20% valuation discount is appropriate. Therefore, the discounted value for the common interest in the partnership should be $64 million.

b. Using a portion of the available $11.7 million gift tax exemptions for Oliver and Grace individually, Oliver will make a taxable gift of $20 million to the family trust, using the split gift election. There will not be any gift taxes on the two $10 million taxable gifts because Oliver and Grace will each use $10 million of their available gift tax exemptions.

c. After gifting $20 million of the $64 million discounted value for the common interest, Oliver will sell the remaining $44 million to the family trust for an interest only promissory note at 1.0% annual interest (the assumed mid-term AFR) and all note principal is due at the end of 9 years in a balloon payment. The annual interest payment will be $440,000.

d. Because the trust is a grantor trust for federal income tax purposes, the interest income and the interest expense on the note will not be reported. Instead, Oliver will have to report on his individual income tax return the grantor trust's taxable income and pay the income taxes on the trust's income.

Phase 3: If Oliver were to die after 10 years, the following is exposed to the estate tax:

Asset	Value
Preferred partnership interest	$80,000,000
Accumulated preferred return for 10 years	$44,000,000
Accumulated interest on note for 10 years	$4,400,000
Note from sale of common interest	$44,000,000
Less: Income taxes on $9,000,000 for 10 years	<$45,000,000>
Value exposed to the estate tax	$127,400,000
Estate tax at 50%	$63,700,000

The estate taxes on the real estate interests plus the earnings from the real estate interest will only be $63.7 million. When compared to $169.5 million with no planning, the estate taxes saved are $105.8 million.

Assets	Value	Liabilities	
Real Estate	$300,000,000[31]	Mortgage	none
		Equity (capital account)	Preferred $80,000,000
			Common $220,000,000
	$300,000,000		$300,000,000

As a result, the preferred partnership does more than shift future appreciation in value. When the common interest is transferred to the family trust, a substantial portion of the future income from the real estate is shifted to the family trust. And there is also the benefit of the grantor having to pay the income taxes on the income received by the family trust.

The two other factors that result in further estate tax savings:

[30] Discounted for lack of marketability and lack of control.

[31] This number assumes the real estate is liquidated at that time.

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1. ***Shifting income to the family trust***: Without the estate plan, each year Oliver would have received $9 million of taxable income and have accumulated $90 million over a 10-year period. If the Freeze Partnership is put in place, with the guaranteed preferred priority allocation of $4,400,000 and the $440,000 of annual interest on the promissory note, Oliver would then be receiving only $4,840,000 annually. Consequently, each year $4,160,000 of the $9 million of annual income would be shifted to the family trust (free from income and estate taxes) as the owner of the entire common interest, acquired in part as a gift and in part by purchase.

2. ***Payment of the income taxes on the entire $9,000,000 of income***: Oliver will still have to pay the state and Federal income taxes on the entire $9 million of income because the income shifted to the grantor trust is still reported by him. At the 40.8% federal rate and the 9.65% New York State rate, the combined state and federal income tax rate is 50.45% (rounded to 50%). Assuming all the income is ordinary income, the combined income taxes on $9 million will be $4.5 million. Each year Oliver will receive $4,840,000 (the guaranteed preferred priority allocation of $4.4 million and the $440,000 of annual interest on the promissory note) and pay $4.5 million annual income taxes, netting $340,000.

Results

After 10 years the preferred Freeze Partnership should save Oliver $**105.8 million** of estate taxes on the investment real estate and the earnings therefrom. The savings would be even greater if Oliver were to take advantage of the marital deduction and defer the payment of estate taxes for a longer period until the survivor of he or Grace passes.

FORWARD FREEZE WITH FUNDED TRUSTS

Consider the situation in which a parent has previously created an irrevocable grantor trust for the benefit of his or her children. Perhaps over time the parent has leveraged the growth of the trust by way of loan and/or sale transactions with assets that have appreciated significantly over time. Further, by virtue of the parent's grantor trust status he or she has paid the income tax liability of such trust over the course of several years, which has had the dual effect of allowing the trust to grow without reduction by the income tax liability and the parent's assets have been whittled down over time. Further the parent has not benefited by any upside appreciation in the assets as those have been transferred into the grantor trust.

One application would be for the parent and the grantor trust to enter into a forward preferred Freeze Partnership. In the forward application, the parent would contribute assets in exchange for a §2701 compliant preferred interest and the grantor trust would receive back the common interests. The adequacy of the coupon would be determined based upon the Rev. Rul. 83-120 factors. If, however, the parent's preferred interest constitutes a large percentage of the capitalization, this would result in weaker coverage for the partnership and thus a higher coupon may be required to be paid to the parent.

While beyond the scope of this article, whenever structuring a Freeze Partnership in which preferred and/or common interests will be held by trusts and, perhaps by way of entities, it is critical that any §2701 analysis be conducted — paying attention to entity and trust attribution rules set forth under Reg. §25.2701-6 (indirect holding of interests).[32]

FREEZE FOR NEGATIVE BASIS GENERALLY

The primary objective of a successful estate planning technique is to transfer an asset with potential appreciation in value out of the estate and at the same time freeze the amount subject to the estate tax at the asset's current value at the time the technique is implemented. The income tax drawback of these commonly used freeze techniques is that the asset is no longer in the decedent's gross estate at death. As a result, the asset cannot obtain an income tax-free basis step-up at death.

A more efficient approach for a highly appreciated asset is to use a technique that can obtain the income tax-free step-up in basis at death for the gain inherent in the frozen value. And, where the appreciated asset is subject to a liability, one should use a technique that retains that portion of the asset subject to the liability in the individual's gross estate as the amount exposed to the estate tax is the gross value of the asset less the liability encumbering the asset (i.e. the equity in the asset).

The often overlooked preferred partnership freeze is designed to accomplish this objective. And, in §2701 Congress provided a safe-harbor roadmap for

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[32] *See generally* Angkatavanich, *Warming Up To Preferred Partnership Freezes: Multiple Planning Applications with this Versatile Vehicle*, 51st Annual Heckerling Institute on Estate Planning (2017).

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structuring the preferred partnership freeze (the ''preferred partnership freeze'' or the ''entity freeze''). In effect, this entity freeze can shift future appreciation without the income tax cost that comes with carryover basis. To increase the estate tax savings, the entity freeze should be considered in situations involving assets encumbered by liabilities. As will be explained below, in the appropriate circumstances the entity freeze technique can be extremely compelling because it can avoid the income tax deficiencies of the other freeze techniques.

Perhaps the most compelling fact pattern where the entity freeze is advantageous is a highly leveraged asset with a low adjusted income tax basis, typically existing in real estate held in a partnership or in a limited liability company which is characterized as a partnership for federal income tax purposes. For leveraged real estate, the entity freeze is typically the only method that can eliminate the negative capital account or phantom gain potential with little or no estate tax exposure.

When the liabilities encumbering real estate exceed the income tax basis for the assets, the real estate is commonly referred to as *negative basis property*.[33] If the real estate with liabilities that exceed basis is sold, the amount of the gain on the sale is determined by treating both the cash proceeds and all of the liabilities as part of the sale price, thus giving rise to what is commonly referred to as *phantom gain*.[34] Since the phantom gain can be eliminated if the negative basis asset is included in the gross estate upon the death of the owner,[35] the estate planner needs to take this into account when considering an estate planning technique designed to shift this asset out of the individual's gross estate.

FREEZE FOR LIABILITIES IN EXCESS OF BASIS ILLUSTRATED

The following example is designed to illustrate that in situations in which the amount of liabilities in excess of basis is significant, the income tax savings can far exceed the estate tax cost of including the asset in the individual's gross estate and paying the estate tax.

Example

''Senior'' owns a commercial office building held for rental that was purchased in 1984 for $20 million; $16 million of the purchase price was allocated to the building. Senior was able to depreciate the entire amount allocated to the building over 18 years using an accelerated method of depreciation.[36] Moreover, over the years, Senior was able to take substantial funds out of the building tax-free by means of periodic mortgage refinancing. At present, the gross value, mortgage liability and adjusted tax basis for the building are:

Gross Value	$54,000,000
Adjusted basis	4,000,000
Mortgage	44,000,000
Equity	10,000,000[37]

If Senior died in 2021, when the maximum estate tax rate is 40%, and assuming Senior's domicile at death was a state with no estate tax (and assuming no available credit against the estate tax under §2010), the estate taxes (40% × $10 million equity) would be $4 million. And, the estate's income tax basis in the commercial office building would be stepped up, income tax-free, to $54 million. If the value of the land is $14 million, then the estate, or other successor in interest, can depreciate the $40 million allocated to the depreciable building over 27.5 (for residential rental buildings) or 39 years (for commercial buildings) (and quicker if a cost segregation study were used).[38]

Instead, Senior is alive and decides to sell the property in 2021. Since the property is located in New York City, the combined state and city income tax rate is 14.776%. If Senior sells the real estate for $54 million (after all selling expenses are taken into account), the $50 million gain realized on the sale will be taxed as follows:

Gain	*Combined income tax rate*	*Federal and state income taxes*
$16,000,000 ordinary income	55.576%	$8,892,160
$34,000,000 capital gain	38.576%	$13,115,840

[33] Liabilities in excess of adjusted tax basis can occur where the property is fully depreciated, especially when a cost segregation study has been implemented, the present property is the successor in a line of like-kind exchanges under §1031 or the owner has financially realized upon the appreciation in value by a series of income tax-free refinancing as loan proceeds are not taxable gain. *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952).

[34] *See Commissioner v. Tufts*, 461 U.S. 300 (1983), and *Crane v. Commissioner*, 331 U.S. 1 (1947).

[35] *Crane v. Commissioner*, 331 U.S. 1 (1947).

[36] Since an accelerated method of depreciation was used, all of the $16,000,000 of depreciation on the building is recaptured as §1245 ordinary income. See §1245(a)(5), as in effect before the Tax Reform Act of 1986, which treated all buildings using an accelerated method and an 18-year recovery period as §1245 recovery property. Pub. L. No. 97-34, §204(c). Section 1245(a)(5) is still applicable for property placed in service between 1981 and 1986 but is no longer in the Code. Pub. L. No. 99-514, §201(d)(11)(D).

[37] The $10 equity is determined by offsetting the $54,000,000 gross value by the $44,000,000 mortgage liability.

[38] §168(c).

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Gain	Combined income tax rate	Federal and state income taxes
Total income taxes		**$22,008,000**

The advantage of being subject to the federal estate tax is the complete elimination of the $50 million of gain, including the $40 million of phantom gain (excess of liabilities over adjusted tax basis) without exposing any of the phantom gain to the estate tax. So, at an estate tax cost of only $4 million applying the federal estate tax eliminates $22,008,000 of income taxes if the property is to be sold and no like-kind exchange is used.

As is readily apparent, selling the building is not financially advisable. The $10 million of net sale proceeds after the payment of the mortgage would be far less than the $22,008,000 of income taxes on the gain. Thus, there are many properties where the owners are reluctant to sell because the income taxes on the phantom gain can result in a negative cash position. The owners of negative basis real estate are inclined to hold the property until they die to eliminate not only the phantom gain, but all of the built-in gain and are willing to pay the estate tax on the real estate in order to obtain the income-tax-free basis step-up at death.

Even if the property is not sold by Senior's estate, and continues to be operated as a rental property, the step-up in basis at Senior's death creates an additional $50 million of basis that can be taken as depreciation deductions over 39 years (and over 27.5 years if the depreciable building is a residential rental property and more rapidly for a portion if a cost segregation study is used). Since the depreciation deductions are ordinary deductions, those deductions will save an additional amount in taxes over the depreciable recovery period. If $40 million is allocated the depreciable building, and the combined effective income tax rate is 55.576%, the income tax saved by $40 million of depreciation deductions is $22,230,400.

Even for buildings placed in service after 1986, the gain attributable to the straight line depreciation on the building is taxable at a federal rate of 25% as "unrecaptured §1250 gain."[39]

The estate tax disadvantage of holding the real estate until death is that not only is the current value included in the gross estate, but all future appreciation in value is also exposed to the estate tax.

So, the question is how to include the current $10 million of equity in the gross estate, obtain an income-tax-free basis step-up for the value offset by the $44 million and shift all future appreciation in value out of the gross estate? The answer is the preferred partnership freeze described in the next section.

[39] §1(h)(1)(E)(i).

USE OF THE PREFERRED PARTNERSHIP FREEZE WITH DEBT

Although the above example assumed that Senior owned the real estate as an individual, today a significant amount of real estate is generally owned in partnership form, either as a limited partnership or as a limited liability company. Using the same example as above, assume for illustrative purposes that the real estate is owned by a partnership and for simplicity purposes assume that the partnership is a limited partnership with Senior as the sole limited partner and that the general partner is a management company that receives a guaranteed payment in return for services. Thus, the partnership balance sheet is as follows:

Partnership Balance Sheet				
Asset	Basis	Value	Liabilities	Value
Real Estate	$4,000,000	$54,000,000	Mortgage	$44,000,000
			Capital	
			Limited partner	$10,000,000
			General partner	Zero
Totals		**$54,000,000**		**$54,000,000**

During 2016, when the real estate was worth $64 million the partnership refinanced the real estate for the current $44 million mortgage loan, using $32 million of the refinancing to pay off the old mortgage and distributing the remaining $12 million as an income-tax-free distribution to Senior.

Senior intends to hold the real estate (actually the partnership interest) until his death so as to receive an income-tax-free set up in basis, thereby eliminating all of the $50 million gain, including the $40 million of phantom gain (the so-called negative basis). In addition, Senior expects the value of the building to rebound to its prior level, especially since the building is 100% occupied and is located in an area where commercial rentals are expected to increase in the long-term. Because of Senior's concern with the phantom gain, Senior has done no estate planning for this partnership interest and intends to hold the real estate (actually the partnership interest in the partnership that owns the property) until his death. The disadvantage of this approach is that all subsequent appreciation will be included in Senior's estate at death.

Using a preferred Freeze Partnership under §2701, Senior can shift all future appreciation in value without any gift or estate taxes and still obtain an income tax-free step-up in basis at death for all or 90% of the phantom gain as well as the remainder of the built-in gain.

Pursuant to §2701, Senior will recapitalize the partnership into preferred and common limited partner-

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ship interests. The tax benefits of the preferred partnership structure are two-fold. First, all subsequent appreciation in excess of the current $54 million of value must be allocated to the common interest and the common interest can be shifted out of Senior's estate without any estate tax on that future appreciation. Second, by Senior retaining a preferred partnership interest until death, 90% of the phantom gain, and up to 90% of the ''equity'' gain, can receive an income-tax-free step-up in basis at death.

Alternative Solution #1: Convert the $10 million of partnership capital held by the limited partner into a preferred capital account representing 70% of the capital and a common capital account representing 30% of the capital.

Partnership Capital Accounts					
Partner	Tax Basis[40]	Gross Value	Liability[41]	Phantom Gain	Capital Account
Preferred (70%)	$2,800,000	$37,800,000	$30,800,000	$28,000,000	$7,000,000
Common (30%)[42]	$1,200,000	$16,200,000	$13,200,000	$12,000,000	$3,000,000
Totals	**$4,000,000**	**$54,000,000**	**$44,000,000**	**$40,000,000**	**$10,000,000**

Senior retains ownership of the preferred interest and disposes of the common interest by a transfer of the common interest to a grantor trust[43] for the benefit of junior family members. By making a gift to a grantor trust, there is no gift for income tax purposes and therefore no income tax liability shift.[44] Alternatively, the disposition of the common interest can be by an installment sale to the grantor trust. Under the partnership agreement, all subsequent appreciation in the value of the real estate is allocated to the common interest.

When Senior dies, the preferred limited partnership interest is an asset included in Senior's gross estate. Since the preferred interest is a limited partnership interest, it is eligible for a valuation discount. But, for now, assume that the preferred limited partnership interest is valued in Senior's gross estate at $7 million no valuation discounts are taken) when Senior dies. That preferred partnership interest has the following characteristics:

Partner	Tax Basis	Gross Value	Liability	Phantom Gain	Capital Account
Preferred (70%)	$2,800,000	$37,800,000	$30,800,000	$28,000,000	$7,000,000

The total potential gain in the preferred interest is $35 million (of which $28 million is phantom gain).

Using the $7 million value (no valuation discounts are taken) for the preferred partnership interest included in the gross estate, the estate's income tax basis in the preferred partnership interest will be $37.8 million (includes the $30.8 million of liabilities allocated to the preferred interest). Since the estate's $37.8 million basis (outside basis) in its partnership interest exceeds the $2.8 million share of the partnership's basis (inside basis) in the real estate, the §743(b) special basis adjustment is $35 million, thus eliminating 90% of the phantom gain, and 90% of the remaining gain, at a very modest estate tax cost. And, all of the future appreciation has been shifted to the common interest.

Using a 40% estate tax rate, the estate taxes on $7 million are $2.8 million. This estate tax cost is far less than the income taxes on the $35 million of income tax gain eliminated by including the preferred interest in the gross estate.

If there was a gift of the common interest to a grantor trust, the common interest is not included in the gross estate and the $13.2 million of gain inherent in the common interest at the time Senior transfers it by gift remains exposed to the income tax.[45] That common partnership interest has the following characteristics:

Partner	Tax Basis	Gross Value	Liability	Phantom Gain	Capital Account
Common (10%)	$1,200,000	$16,200,000	$13,200,000	$12,000,000	$3,000,000

Alternatively, Senior can sell the common interest to a grantor trust for a $3 million installment note (again, assuming no valuation discounts). If Senior dies while the grantor trust's entire $3 million note obligation is outstanding, upon Senior's death, the trust becomes a non-grantor trust for federal income

[40] §704(c). The Treasury regulations require that all of the built-in gain must be allocated to the partners who were partners at the time the built-in gain occurred, commonly referred to as a ''reverse §704(c) allocation.'' Reg. §1.704-1(b)(4)(i), §1.704-3(a)(6)(i).

[41] Reg. §1.752-3. Likewise, the partnership liability allocation regulations require that the liabilities creating the reverse §704(c) allocation also be allocated to the same partner who was allocated the reverse §704(c) gain. Reg. §1.752-3(a)(2).

[42] Section 2701(a)(4) requires a minimum valuation for the junior or common interest to be at least 10% of the values for all of the capital accounts.

[43] If the gift is to Junior directly, or to a non-grantor trust, then there would be a liability shift for income tax purposes, and gain would be realized and recognized to the extent the liability exceeded the basis in the gifted asset. *See* §1001 and §1015. In other words, this would be a part-sale, part-gift, causing the realization and recognition of $12 million of gain ($13.2 million of liability in excess of $1.2 million of basis for the common interest). Thereafter, the donee's basis in the common interest would be $4.4 million. *See, e.g., Guest v. Commissioner*, 77 T.C. 9 (1981); *Ebben v. Commissioner*, 783 F.2d 906 (9th Cir. 1986), *Diedrich v. Commissioner*, 457 U.S. 191 (1982). *See also* Rev. Rul. 81-163.

[44] *Cf.* Rev. Rul. 81-98 (gift of installment note to a grantor trust is not an early disposition under §453B); Rev. Rul. 85-13; and PLR 200434012 (followed Rev. Rul. 85-13, holding that there was no income tax realization event for income tax purposes upon the sale of an appreciated asset to a grantor trust).

[45] §671–§677.

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tax purposes. Upon the conversion of the trust, which occurs simultaneously with the grantor's death, Senior is treated for income tax purposes as transferring the encumbered common partnership interest by reason of death. Since a transfer of property subject to a liability by death is not an income tax realization event, none of the $12 million built-in gain inherent in the common interest is reported, and the trust, which is now a non-grantor trust, takes a $16.2 million income tax basis in the common interest, creating another $15 million §743(b) special basis adjustment.[46]

If the preferred limited partnership interest is discounted, the discount does not change the amount of phantom gain that can be eliminated by inclusion of the preferred interest in the gross estate. Since the discount only reduces the value of the preferred limited partnership interest included in the gross estate, the discount only reduces the income tax step-up in basis for the value of the $7 million of equity in the preferred interest.[47] For example, if the preferred interest was valued in the gross estate at a discounted value of $5 million, the estate's income tax basis would be $35 million ($5 million + $30.8 million) and the §743(b) special basis adjustment would be $33 million. So, the $800,000 reduction in estate tax resulting from the $2 million valuation discount (40% × $2 million = $800,000) must be compared to the $2 million additional income tax gain that may be eventually reported.

DISPROPORTIONATE DEBT ALLOCATIONS

When appreciated property is contributed to a freeze partnership with liabilities in excess of basis, the impact of the step-up in basis upon death can be amplified by allocating the liabilities to the preferred interest (owned by G1). The foregoing example assumes that the liabilities will be allocated proportionate to contributed capital. Thus, if 70% of the capital is contributed for the preferred interest, the example assumes 70% of the debt will be allocated to the holder of the preferred. That means 30% of the liabilities are allocated to the common — which in a typical Freeze Partnership will get a stepped up basis because it will be held by a grantor trust.[48]

If the Freeze Partnership is between the grantor and a grantor trust, it may be a disregarded entity for income tax purposes. As such, it would not be subject to the rules under §704(c) (allocation of built-in gain on the contribution of appreciated property) and §752 (allocation of debt among the partners).

It should be possible to further optimize the structure by allocating disproportionate debt to the holders of the preferred, which increase the amount of the basis step-up under §1014 upon the death of the holder.[49] This can be accomplished by treating the entity as a partnership for income tax purposes, rather than a disregarded entity, from its inception. To accomplish this, create a non-disregarded entity to be an initial partner, who will acquire the junior equity in-

[46] When the grantor dies with the promissory note outstanding, the promissory note is an asset included in the grantor's gross estate at its fair market value. The contentious issue is whether there is a taxable transfer at the time of death for income tax purposes by the grantor to the family trust of the property originally ''sold'' to it, because it is transferred subject to the obligation of the promissory note. The better view is that the transfer at death should not result in recognition any more than a transfer of property to the estate subject to an obligation owed to a third party secured by a mortgage in an amount in excess of the decedent's basis in the property results in gain recognition. Death is simply not a realization event. Thus, because the termination is at death, the decedent does not realize taxable gain on any excess of the balance of the tax amount of the note over the basis of the property transferred. Similarly, there is no income in respect of a decedent (IRD) under §691 because there was no gross income prior to death. IRD is defined as income realized while the decedent was alive but not reported while alive because of the decedent's method of accounting. Since the initial ''sale'' to the family grantor trust was not a realization event for income tax purposes, it cannot satisfy the terms of §691(a). Several commentators agree that the termination of grantor trust status as a result of the grantor's death while the promissory note is outstanding does not result in the realization of the gain inherent in the assets initially transferred to the grantor trust. *See* Gans and Blattmachr, *No Gain At Death*, 149 Trusts & Estates 34 (Feb. 2010); Aucutt, *Installment Sales to Grantor Trusts*, 4 Business Entities 28 (Mar./May 2002); Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. of Tax'n 149 (Sept. 2002), and Hesch and Manning, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Ests., Gifts & Trs. J. No. 1, 21–26 (Jan. 14, 1999). Other commentators have reached a different conclusion without addressing the application of the principle developed by the Supreme Court in *Crane v. Commissioner*, 331 U.S. 1 (1947), that death is not an income tax realization event when an encumbered asset is transferred by reason of death. *See* Cantrell, *Gain Is Realized At Death*, 149 Trusts & Estates 20 (Feb. 2010); Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95 J. of Tax'n 49 (July 2001); Peebles, *Death of an IDIT Noteholder*, 144 Trusts & Estates 28, 32–33 (Aug. 2005); Joy Hodge, *On the Death of Dr. Jekyll — The Dispostion of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at the Grantor's Death*, 29 Tax Mgmt. Ests., Gifts & Trs. J. No. 6, 275, 283–284 (Nov. 11, 2004). An unofficial administrative position taken by the IRS appears to support the position that there is no gain at death. *See* CCA 200923024.

[47] §1014(a).

[48] Some commentators have argued that even assets in the grantor trust will get a stepped-up basis. See generally Note 50, below.

[49] *See generally* Breitstone, *Estate Planning for Negative Capital*, Trusts & Estates (May 2012) at 26, and Breitstone, *Estate Planning for Investment Real Estate: Don't Forget the Income Tax Side*, NYU, 71st Institute on Federal Tax'n (2012).

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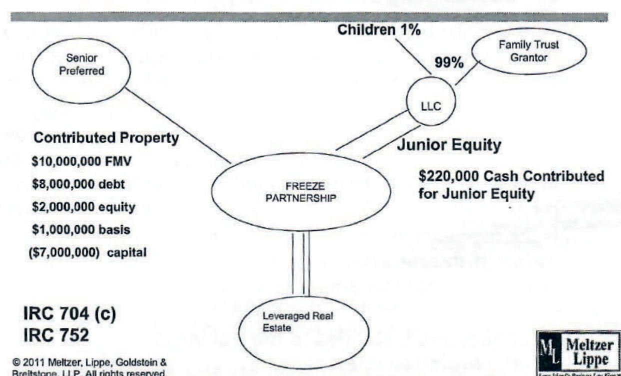
terest. An example of a non-disregarded entity is an LLC with the grantor and one other member — even one with a small interest. It's important to note that the low basis leveraged property should be contributed in exchange for the senior preferred ownership interest. Different property, presumably unencumbered property or cash, should be contributed to the non-disregarded entity formed to hold the junior equity interest. The non-disregarded 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 the grantor contributes it, the grantor would receive, in exchange, an ownership interest in the non-disregarded entity. The grantor could then gift or sell that interest to a grantor trust. All of the income tax items (except for the small percentage owned by others) would flow through to the grantor either directly as the holder of the senior preferred interest, or indirectly from the non-disregarded 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 purposes. One partner would be the grantor. By operation of the second-tier rule for non-recourse liabilities under §752, all of the liabilities the contributed property was subject to 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 grantor's death, which should result in a basis step-up for the entire negative capital under §1014.

The following diagram illustrates this technique:



WHAT HAPPENS WHEN THE FREEZE IS UNDERWATER

There can be significant adverse tax consequences if the Freeze Partnership does not generate sufficient income to cover the qualified payments. For estate tax purposes, §2701(d) provides that the gross estate of a transferor for estate tax purposes is increased by the amount of dividends due and payable at the time of the death of the transferor. The amount included in the estate of the transferor is the amount of dividends that should have been received if all payments had been made on time plus the interest the payments would have been earned if they had been distributed. Payments made within four years of their due date are treated as having been paid in a timely fashion. For gift tax purposes, §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.

When operating cash flows are insufficient to make the qualified payment to the senior equity interest, and the freeze does not anticipate an increase in future cash flows, the freeze may consider recapitalizing the membership interests. This may be especially useful when the underlying assets have appreciated substantially but cash flow has not yet grown commensurately. One option would be to recapitalize the preferred and common interests into a single class of common interests. Another option is to recapitalize some of the preferred interests into common interests, such that the senior equity interest would be comprised of a mix of preferred and common interests and the junior equity interest would include solely common interests.

The first option may be illustrated by the following example, which shows how a freeze partnership can be recapitalized in order to alleviate the problem of an anticipated long-term deficiency in cash flow. An example of this is below:

Example

Starting Balance Sheet:

Asset (FMV)	$5,000,000
Adjusted Basis	$1,000,000
Mortgage	$4,000,000
Net Equity	$1,000,000
Senior	$900,000
Junior	$100,000

Qualified payment @ 8% = $900,000 × 0.08 = $72,000

Cash flow to common = $0

Assume that the asset appreciates to $6 million. But the primary tenant leaves. Assume further that the LP is unable to fill the vacancy, and the LPs available

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cash flow is reduced to $50,000. The coverage is only equal to 5.55% of the preferred capital. If the LP remains unable to fill the vacancy, and cash flow remains at a low level for several years, the future viability of the freeze becomes an issue.

One solution is to recapitalize the preferred and common interests into solely common interests. After the LP does a revaluation under Reg. §1.704-1(b)(2)(iv)(f) (which would allocate the unrealized appreciation to the member holding junior equity interest) and recapitalizes the interests solely into common, the balance sheet is as follows:

Revalued and Recapitalized Balance Sheet:

Asset (FMV)	$6,000,000
Adjusted Basis	$1,000,000
Mortgage	$4,000,000
Net Equity	$2,000,000
Senior (common)	$900,000
Junior (common)	$1,100,000
Total cash flow =	$50,000
Residual to senior =	$50,000 × (9/20) = $22,500
Residual to junior =	$50,000 × (11/20) = $27,500

This example also illustrates the efficacy of the freeze which has, in effect, transferred more than 50% of the equity value, and thus the ownership, to the holders of the junior equity interest without any transfer taxes being imposed.

By recapitalizing the mix of preferred and common interests into a single class of common interests, the LP is able to alleviate the cash flow deficiency created by the freeze. If market conditions change, the LP may desire to recapitalize back into a mix of preferred and common interests. Any future recapitalizations should head the guidance of this outline and fresh valuation should be obtained to assess the Senior Generations capital interest.

Alternative Balance Sheet:

In the alternative, the LP may consider recapitalizing some but not all of the senior equity's preferred interests into common interests. The balance sheet might look like this:

Asset (FMV)	$6,000,000
Adjusted Basis	$1,000,000
Mortgage	$4,000,000
Net Equity	$2,000,000
Senior (preferred)	$450,000
Senior (common)	$450,000
Junior (common)	$1,100,000
Total cash flow =	$50,000
Qualified payment to senior =	$450,000 × 0.08 = $36,000
Residual to senior =	$24,000 × (40.9%) = $9,816
Residual to junior =	$24,000 × (59.1%) = $14,184

The LP would be able to meet the qualified payment, but not all of the future growth and appreciation would be shifted to the junior generation. Note that the 8% preferred return would need to be evaluated to ensure that it still equals the market rate and could fluctuate in either direction.

Leveraging the Partnership to Reduce Qualified Payments

A Freeze Partnership's failure to pay the qualified payment on a timely basis may result in an increase in the holder's taxable gifts if he or she transfers a qualified payment right during life or in the holder's taxable estate if the right is held at death. The increase will generally be an amount equal to the unpaid distribution amount times the compounded interest rate which is equal to the discount rate assumed in initially valuing the cumulative return for purposes of the initial gift tax return. As the following example shows, a Freeze Partnership can reduce its qualified payment obligations by leveraging out:

Example

Real Estate contributed to Freeze LP

Asset (FMV)	$10,000,000.00
Adjusted Basis	$1,000,000.00
Mortgage	$8,000,000.00
Net Equity	$2,000,000.00

Balance Sheet	
Asset (FMV)	$10,000,000.
Mortgage	– (8,000,000.)
Equity	$2,000,000.
Capital Accounts	
	Senior $1,800,000.
	Junior + 200,000.
	$2,000,000.

Preferred return @ 8%= 1,800,000 × .08=$144,000

The Freeze Partnership then borrows against a separate stock portfolio:

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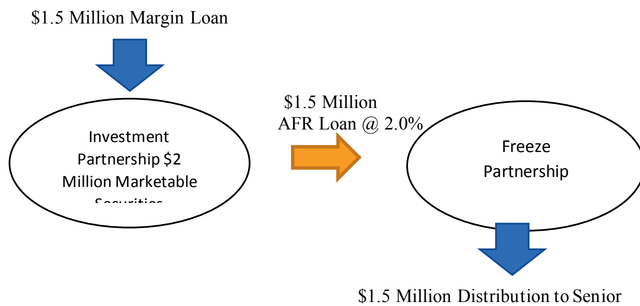

New Balance Sheet	
Asset (FMV)	$10,000,000.
Liability (Mortgage)	$8,000,000.
Liability (AFR Loan)	$1,500,000
Equity	$500,000
Capital Accounts	
Senior	$300,000
Junior	$200,000
Preferred return @ 9%= $300,000 × .09 =	$27,000
Interest on AFR Loan @ 2% =	$30,000
Total payments on capital =	$57,000
Compare Unleveraged Return	$144,000
Compare Installment Sale	$128,000

Reduction from Unleveraged Freeze = $144,000 – $57,000 = $87,000.[50]

REVERSE FREEZE PARTNERSHIP

General

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

In the reverse scenario, parent would receive the common and the grantor trust would receive the preferred. In such case §2701 would not be applicable since parent would receive back the subordinate interest. If the capitalization was such that the coverage was very strong such would provide for a relatively lower coupon paid to the grantor trust with the parent enjoying the upside growth.

The reverse freeze is best suited for low yielding assets that could not support the "qualified payment" obligation of a forward Freeze Partnership. There are concerns, however, if there is no chance that the junior equity interest will ever profit from the endeavor. If the reverse freeze is merely a method to siphon wealth from the senior generation that holds the junior equity interest where there is no reasonable prospect for the senior generation to profit from the arrangement, there is risk that the arrangement could be recharacterized as a disguised gift. Moreover, the prospect for the senior generation to profit significantly from the junior equity interest, the entire arrangement could backfire from an estate planning perspective by enriching the senior generation significantly. The planner must monitor the lifecycle of the underlying investment assets. Where the prospect for a significant increase in the value of the underlying assets starts to appear on the horizon, it may be prudent to consider recapitalizing the reverse freeze into a forward freeze before that valuation increase occurs.

Section 2701 Not Applicable

The use of a Reverse Freeze Partnership is attractive because, unlike a forward Freeze Partnership, it is generally not subject to §2701, which allows for greater flexibility in structuring the preferred payment. This is because in a Reverse Freeze Partnership, the Senior Family Member holds a "subordinate interest" in the form of the common interest, which excepts the Senior Family Member's interest from being a "distribution right" subject to the zero valuation rule under §2701.[51] In such case, however, it is critical to ensure that the Senior Family Member does not hold any "extraordinary payment rights." In order for §2701 to apply, the transferor or an applicable family member must, immediately after the transfer, hold an applicable retained interest. Reg. 25.2701-2(b)(1) provides that an applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either an extraordinary payment right or a distribution right. Under the §2701 regulations, an extraordinary payment right is 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. If the Senior Family Member holds "extraordinary payment rights," such rights could still be valued at zero

[50] Example assumes the qualified payment rate will be 9% in the leveraged example because leverage increases risk and reduces coverage.

[51] Reg. §25.2701-2(b)(3)(i).

under §2701, even in the case of a Reverse Freeze Partnership.[52]

Valuation Considerations

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

The risk with the Reverse Freeze Partnership is that the assets may begin to substantially appreciate. When the holder of the preferred interest anticipate that the property will appreciate, they should either convert their preferred interest in the Reverse Freeze Partnership to a common interest, or the Reverse Freeze Partnership should redeem their preferred interest in exchange for an interest in the asset. A risk in this planning is that the conversion or redemption may be a gift to the partnership, since the preferred interest holders receive their preferred return. It is important that the senior member receives adequate consideration in the exchange, and that the interest in the asset is properly valued prior to the exchange. It is also important that the conversion or exchange occur while the appreciation potential is still speculative. An example of this scenario is below.

Example

A grantor trust for the benefit of children and grandchildren (the ''Juniors'') owns the preferred interest in a Reverse Freeze Partnership and a senior owns the common interests. The Reverse Freeze Partnership's asset is a hotel with a value of $200 Million at contribution. The preferred interest and the common interest are each valued at $100 Million. The rate of the preferred return is 7%. Thus, the grantor trust is entitled to receive a return of $7 million a year. The hotel generates net cash flow of approximately $3 million per year so $4 million per year in preferred returns are not being paid on a current basis but are accruing.

After five years the hotel has not appreciated in value but the owners believe that if they install new management the hotel will double in value over time. The Juniors are owed $20 million in unpaid but accrued preferred return (ignoring any compounding). The senior who owns a preferred interest, therefore, wants to convert their preferred interest to common. If they convert their preferred interest into a common interest, they are giving up a right to receive $7 million per year. Therefore, adequate consideration must be given in exchange for the preferred interest, or the conversion will subject the Partnership to gift tax. At this point, assume the balance sheet of the partnership is as follows:

Assets	
Hotel	$200,000,000
Liabilities	$0
Equity	
Junior Preferred	$120,000,000
Senior Common	$80,000,000

Assume the partnership is recapitalized so that the Junior receive common interests and Senior receives preferred interests. After five years (assuming the hotel has doubled in value and has paid its preferred distributions on a current basis) the balance sheet would be as follows:

Assets		
Hotel	$400,000,000	
Liabilities	$0	
Equity		
Senior Preferred	$80,000,000	
Junior Common		$320,000,000

When the value of the hotel increases, the value of the common interest will increase while the value of the preferred interest will remain stagnant. Therefore, it is essential that the senior accomplish this conversion while the possibility that the property will increase in value is still speculative.

CONCLUSION

The preferred partnership technique is often overlooked despite its many benefits. Unlike other main-

[52] Reg. §25.2701-2(b)(2).

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stream planning techniques, it affords a steady income stream for the life of the creator, it maximizes the basis step-up upon death (especially where there are liabilities in excess of basis or ''negative capital''), and in terms of its economics, is competitive with other techniques such as installment sales and GRATs which look for their hurdle rate of return to the applicable federal rate or the §7520 rate. This article explained above how, through proper structuring and use of leverage, the hurdle rate (the preferred rate of return) can be minimized to avoid the concerns about a ''leaky freeze.'' This article discussed above the ways to structure the freeze and restructure the freeze when circumstances change to meet the moment. Taking into consideration the need to maximize the basis step-up for appreciated assets, especially encumbered real estate, this technique can be advantageous to the alternative techniques.

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