Tasty Freeze: Preferred Partnership Tax-Saving Recipe

For widowed taxpayers who will remarry, creating a preferred partnership can be a way to have their cake and eat DSUE.

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Section 2701 can leave a bitter taste in the mouth of any family enterprise owner. Families who seek to move beyond "plain vanilla" equity structures in their corporations or partnerships risk triggering Section 2701's special valuation rules, which can produce harsh transfer tax consequences. However, those same rules offer a sweet opportunity for a surviving spouse who has inherited his or her deceased spouse's unused estate tax exemption.

The problem with portability

"Portability" is a powerful tool that has become a permanent fixture on the estate planning scene. The concept is relatively straightforward: When a married individual dies without using all of his or her estate tax exclusion amount, the unused portion (the deceased spousal unused exclusion, or DSUE, amount) may be "ported" (transferred) to the decedent's surviving spouse.[1] Thereafter, the surviving spouse generally may use both that DSUE and his or her own gift/estate tax exclusion to shelter lifetime gifts or bequests at death from federal gift or estate tax.[2]

Portability, however, can become a "use-it-or-lose-it" benefit for a surviving spouse who remarries. The DSUE available for a surviving spouse is that of his or her "last deceased" spouse.[3] Thus, if a surviving wife inherits DSUE from her late husband and then remarries, she will lose the ability to use her first husband's DSUE if her second husband also predeceases her.[4]

Example. Al and Betty (both U.S. citizens) are married and own $7 million of assets jointly with rights of survivorship. Following Al's death in 2015, Betty becomes sole owner of the assets. She also inherits Al's unused exclusion of $5.43 million. Betty relies on the income stream from the assets for her support, so she does not want to transfer any portion of the assets to her children during her life.

In 2018, Betty marries Paul. Unfortunately for Betty (and especially for Paul), Paul dies later that year. Under Paul's will, his remaining estate tax exclusion amount (assume it is $5.78 million) passes to his children from a previous marriage. The balance of Paul's estate ($3 million) passes to a qualified terminable interest property (QTIP) trust for Betty's benefit, the assets of which will be included in Betty's taxable estate at her death.[5]

Betty dies in 2020. Assuming that her assets appreciate at a constant 8% annual rate (and she consumes all of the income without depleting any of the principal), she will die with a taxable estate of $13.5 million (consisting

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of $10 million of assets in her individual name and $3.5 million in the QTIP trust for her benefit). Betty has no DSUE to use. She lost Al's DSUE when Paul died and replaced Al as Betty's "last deceased spouse." Because Paul used his entire exemption, there remains no DSUE of his own that could be "ported" to Betty.[6] Assuming Betty's own indexed exclusion amount is $6 million, Betty's estate (and, ultimately, her children) will be left footing a federal estate tax bill of approximately $3 million.

If Betty had used the DSUE she inherited from Al by making lifetime gifts, the result at her death would be much different. Assume that, before marrying Paul, Betty gifts property worth $5 million to her children. Due to a special ordering rule, Betty is deemed to use the DSUE first, sheltering the gift from gift tax while preserving her own exemption.[7] The property's post-gift appreciation will escape inclusion in Betty's taxable estate at her death. On those assumptions, when Betty dies in 2020, she will have a taxable estate of $6.5 million (consisting of $3 million of assets in her individual name and $3.5 million in the QTIP trust) rather than $13.5 million. After applying Betty's exemption, which for purposes of this example is assumed to be $6 million, her estate will generate a federal estate tax of approximately $200,000. In sum, Betty's timely use of Al's DSUE can save her family $2.8 million of estate tax.

The goal of an estate freeze transaction is to shift wealth at current valuations, minimizing or eliminating gift taxes while removing future growth in asset value from the transferor's estate.

Thus, Betty faces a conundrum when she accepts Paul's marriage proposal. On one hand, she understands the substantial estate tax benefit afforded by the DSUE she has received from Al—and the possibility that her family will lose that benefit if she is widowed again. On the other hand, Betty depends on the income from her assets to support her lifestyle; she cannot afford the cash-flow implications of gifting the property during her lifetime.

In short, Betty is motivated to engage in the opposite of typical estate planning: she wants to make a substantial gift for tax purposes without shifting actual value. Luckily for Betty, Section 2701 allows her to achieve her objective.

Section 2701 and the preferred partnership

Enter Section 2701 and the preferred "freeze" partnership. Section 2701 imposes special valuation rules designed to combat abusive "estate freeze" transactions. The goal of an estate freeze transaction is to shift wealth (typically to junior generation members) at current valuations, minimizing or eliminating gift taxes while removing future growth in asset value from the transferor's estate. Some estate freeze vehicles, such as grantor retained annuity trusts (GRATs), are expressly permitted within specified parameters.

Section 2701 targets the following freeze technique: One or more family members create or recapitalize a business entity (typically a corporation or partnership) with two classes of equity: a senior (or preferred) interest and a subordinate (or common) interest. The senior equity interest is endowed with certain preferred rights, such as a priority return on capital and a liquidation preference, while the common interest is designed to capture the growth in value of the enterprise. This structure represents a "freeze" because the senior interest receives a fixed rate of return, while appreciation in excess of that fixed rate accretes to the common class.

After the entity is created or restructured, the junior generation members receive the common equity (via gift, sale, capital contribution, or some combination), effectively removing future growth in value of the enterprise from the taxable estate of one or more senior generation members. The family members adopt certain techniques to depress the gift tax value of the common interests while artificially increasing the value of the retained preferred interests. For example, certain rights, such as put or call options, are conferred upon the preferred equity; however, these rights may be illusory "bells and whistles" that the senior generation members never intend to exercise. Preferred equity holders also may retain noncumulative dividend rights, so that if dividends are not paid to senior family members in any given year, income may be shifted to holders of the common interests.

Section 2701 combats the specific valuation abuses of stock with

1 Section 2010(c)(2); Temp. Reg. 20.2010-1T(d)(2). The IRS issued temporary regulations that provide guidance on the requirements for electing portability and the rules for a surviving spouse's use of DSUE. See Temp. Regs. 20.2010-1T through -3T, and 25.2505-1T through -2T. The temporary regulations expire on or before 6/15/2015 (if final regulations are issued). Temp. Regs. 20.2010-1T(f), -2T(f), and -3T(g), and 25.2505-1T(f) and -2T(h). The IRS has issued proposed regulations that are identical to the temporary regulations. See Prop. Regs. 20.2010-1 through -3, and 25.2505-1 through -2.

2 Section 2010(c)(2); Temp. Reg. 20.2010-1T(d)(2).

3 Section 2010(c)(4)(B); Temp. Regs. 20.2010-3T(a)(1) and 25.2505-2T(a)(1).

4 See Temp. Reg. 20.2010-1T(d)(5).

5 See Section 2044.

6 See Temp. Reg. 20.2010-3T(a)(2).

7 See Temp. Reg. 25.2505-2T(b).

noncumulative payment rights and "bells and whistles," which exist only to inflate the (retained) preferred stock's transfer tax value. In practice, Section 2701 imposes a draconian rule with rigid, narrow exceptions, often ensnaring relatively standard, arm's-length business transactions. If Section 2701 applies to a transfer, it is possible that the transferor's retained preferred interest will be valued at zero even if that interest has real economic value, producing a taxable gift that may approximate the fair market value of the entire enterprise. This result is a bitter pill for anyone to swallow—anyone, that is, except for Betty.

In fact, Section 2701 provides Betty with a sweet opportunity: Betty can make a deemed gift to consume Al's entire DSUE before it disappears, even as she retains access to a portion of the assets and a significant income stream for the rest of her life. She can achieve this outcome by creating a preferred partnership, using the attributes of preferred and common equity to provide a steady economic return for herself while transferring only future growth to junior generation members.

Before we review that technique in further detail, we need to delve a bit further into Section 2701. While a comprehensive discussion of Section 2701's complex maze of rules and exceptions is beyond the scope of this article, here is an overview of its general principles.

Basics of Section 2701

Section 2701 determines whether a TRANSFER[8] of an equity interest to a MEMBER OF THE FAMILY of the transferor is a gift and the amount of the gift, if the transferor or an APPLICABLE FAMILY MEMBER retains an APPLICABLE RETAINED INTEREST immediately after the transfer.[9] Section 2701 incorporates the following defined terms:

TRANSFER: includes a gift, sale, or exchange for full and adequate consideration, a capital contribution to a new or existing entity, a change in capital structure (e.g., a redemption or recapitalization) involving the receipt (or increase in value) of an APPLICABLE RETAINED INTEREST or the surrender of a junior equity interest by the transferor or an APPLICABLE FAMILY MEMBER.[10] *Exceptions.* Certain transactions are not treated as transfers under Section 2701: (1) a change in capital structure in which the economic interests of the transferor, each APPLICABLE FAMILY MEMBER, and each MEMBER OF THE FAMILY remain substantially the same (e.g., a recapitalization into voting and nonvoting common stock that does not shift equity ownership) or (2) a shift resulting from a nontaxable exercise, release, or lapse of a limited (nongeneral) power of appointment.[11]

MEMBER OF THE FAMILY (the transferee): class that includes the transferor's spouse, lineal descendants of the transferor or the transferor's spouse, and any spouse of such a lineal descendant—i.e., relatives *junior to* (or, in the spouse's case, in the same generation as) the transferor.[12]

APPLICABLE FAMILY MEMBER (attributed to the transferor): class that includes the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and any spouse of such an ancestor—i.e., relatives *senior to* (or, in the spouse's case, in the same generation as) the transferor.[13]

APPLICABLE RETAINED INTEREST: an equity interest with respect to which there is either (1) an EXTRAORDINARY PAYMENT RIGHT or (2) a DISTRIBUTION RIGHT in a CONTROLLED corporation or partnership (or any entity treated as a corporation or partnership for tax purposes, such as an LLC).[14]

EXTRAORDINARY PAYMENT RIGHT: includes a put right, call right (e.g., a warrant), conversion right, or right to compel liquidation of the entity.[15]

DISTRIBUTION RIGHT: any right to receive distributions with respect to an equity interest (e.g., a dividend right).[16] *Exceptions.* Distribution rights do not include (1) 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, (2) any right to

8 Defined terms form the backbone of Section 2701 and are highlighted in capital letters in this portion of the article.

9 Section 2701(a)(1).

10 Section 2701(e)(5); Reg. 25.2701-1(b).

11 Reg. 25.2701-1(b)(3).

12 Section 2701(e)(1); Reg. 25.2701-1(d)(1).

13 Section 2701(e)(2); Reg. 25.2701-1(d)(2).

14 Section 2701(b); Reg. 25.2701-2(b)(1).

15 Reg. 25.2701-2(b)(2).

16 Section 2701(c)(1)(A); Reg. 25.2701-2(b)(3).

17 Regs. 25.2701-2(b)(3) and (4).

18 Section 2701(b)(2); Reg. 25.2701-2(b)(5). Presumably this reference includes whatever "general partner" means in the LLC context.

19 Reg. 25.2701-3(a).

20 Reg. 25.2701-3(a).

21 Section 2701(a)(3)(A); Regs. 25.2701-2(a)(1) and (2). If an APPLICABLE RETAINED INTEREST confers certain rights, such as a voting right or a right to share in liquidation proceeds, in addition to an EXTRAORDINARY PAYMENT RIGHT or a DISTRIBUTION RIGHT that is not a QUALIFIED PAYMENT RIGHT, those rights may have value notwithstanding Section 2701.

22 Sections 2701(a)(3)(A) and (C); Regs. 25.2701-2(a)(2) and (4). However, if an APPLICABLE RETAINED INTEREST confers both a QUALIFIED PAYMENT RIGHT and one or more EXTRAORDINARY PAYMENT RIGHTS, the value of all such rights is determined by assuming that each EXTRAORDINARY PAYMENT RIGHT is exercised in a manner that results in the lowest total value being determined for all the rights (the "lower of" valuation rule). Reg. 25.2701-2(a)(3).

23 Section 2701(c)(3)(A); Reg. 25.2701-2(b)(6)(i).

24 Section 2701(c)(3)(C)(ii); Reg. 25.2701-2(c)(2).

25 Section 2701(c)(3)(C)(i); Reg. 25.2701-2(c)(1).

26 Section 2701(e)(6); Reg. 25.2701-5(a).

receive a specific amount at a specific time (e.g., a redemption right or guaranteed payment), (3) the right to participate in a liquidating distribution, or (4) certain nonlapsing conversion rights.[17]

CONTROL (measured immediately before the transfer): in the case of a corporation, ownership, in aggregate, by the transferor and any lineal descendant of a parent of the transferor or the transferor's spouse (e.g., the transferor's descendants, siblings, and descendants of siblings) of at least 50% of the total voting power *or* the total fair market value of the equity interests; in the case of a partnership, ownership by the transferor and such family members (in aggregate) of (1) at least 50% of the capital interest, (2) at least 50% of the profits interest, or (3) *any* interest as a general partner.[18]

Effect of Section 2701. If there is a TRANSFER to which Section 2701 applies, then the "subtraction method" determines whether the transfer is a gift (and the amount of any such gift).[19] Under the subtraction method, the value of the transferor's gift is determined by subtracting the values of family-held senior equity interests (including all APPLICABLE RETAINED INTERESTS held by the transferor or APPLICABLE FAMILY MEMBERS) from the aggregate value of all family-held interests in an entity.[20] For these purposes, an EXTRAORDINARY PAYMENT RIGHT or a DISTRIBUTION RIGHT that is not a QUALIFIED PAYMENT RIGHT attributable to an APPLICABLE RETAINED INTEREST is valued at zero.[21] Consequently, most or all of the value of an interest actually retained by the transferor may be deemed gifted for gift tax purposes.

Exceptions. A full discussion of Section 2701's exceptions is beyond the scope of this article. The general concept is that the anti-abuse rules of Section 2701 are inapplicable where it is difficult to manipulate the value of rights attributable to retained preferred interests. One of most notable exceptions is that a DISTRIBUTION RIGHT that constitutes a QUALIFIED PAYMENT RIGHT is generally valued based on the ordinary gift tax principles of Chapter 12 rather than the special valuation rules of Section 2701.[22]

QUALIFIED PAYMENT RIGHT: any right to receive cumulative equity distributions payable on a periodic basis (at least annually), determined as a fixed rate or fixed amount.[23] The classic example of a QUALIFIED PAYMENT RIGHT is a fixed percentage dividend on cumulative preferred stock. A special rule permits a holder to elect QUALIFIED PAYMENT RIGHT status for nonconforming rights, if in fact payments are made in accordance with the election.[24] Additionally, a transferor may elect under Section 2701(c)(3)(C) to treat payments under any specified interest as nonqualified payments.[25]

Adjustment rules. If an APPLICABLE RETAINED INTEREST is actually transferred following a deemed Section 2701 TRANSFER, special rules provide for gift and/or estate tax adjustments to prevent double taxation for the individual who paid the increased gift tax on the initial transfer (called the "initial transferor").[26] When an individual subsequently transfers the APPLICABLE RETAINED INTEREST to someone other than the initial transferor or an APPLICABLE FAMILY MEMBER of the initial transferor, the initial transferor may reduce the amount on which his or her tentative gift or estate tax is computed by the lesser of (1) the increase in the initial transferor's taxable gifts caused by the application of the special valuation rules or (2) the amount by which the fair market value of the APPLICABLE RETAINED INTEREST on the date of the subsequent transfer exceeds the value of the interest on the date of the initial transfer (as determined under Section 2701).[27] Thus, if the value of the APPLICABLE RETAINED INTEREST decreases after the initial transfer, the initial transferor will not receive a full reduction for the increase in his or her taxable gifts caused by the application of Section 2701 to the initial transfer.

Preferred partnership technique

Recall Betty's objective: Before her wedding to Paul, she would like to "eat up" Al's $5 million DSUE—to use it before she loses it. However, Betty feels she cannot afford to make a "real" gift, since she depends on the income generated by her assets.

A preferred family limited partnership (LP) or limited liability company (LLC) can resolve Betty's conundrum. Betty can create an entity or recapitalize an existing entity, establishing two classes of equity interests: a preferred class and a common class. The preferred class would be endowed with certain rights, including the right to receive fixed annual payments, while the common class would represent the right to share in the residual growth of the entity. Betty could then gift or sell the common class to her children while retaining the preferred class.

As a holder of the preferred equity, Betty would be entitled to a flow of payments from the entity. However, even though Betty would retain a preferred interest with real economic value, she could elect under Section 2701(c)(3)(C) to trigger the special valuation rules of Section 2701 intentionally. As a result of the election, Betty's fixed payment right would be valued at zero. Thus, Betty would be treated as having made a much larger gift than the amount, if any, she would actually transfer gratuitously.

Betty can create an entity or recapitalize an existing entity, establishing two classes of equity interests: a preferred class and a common class.

Betty opts to proceed with this technique in 2018. She forms an LLC, contributing $5 million of capital in exchange for two classes of equity interests: a preferred Class A interest and a common Class B interest. As a Class A member, Betty is credited with a capital account of $4.5 million; the balance of her capital contribution is attributed to her Class B capital account. The Class A interest enjoys both a liquidation preference and a priority payment stream (annual priority distributions equal to 9% of Betty's aggregate capital contributions as a Class A member). The priority distributions are cumulative; if a distribution is not paid in any given year, the missed payment must be "made up" before any distribution can be made to Class B members. The LLC agreement allocates profits first to the Class A members to the extent of their cumulative priority distributions; any profits above the Class A members' fixed return are allocated to the Class B members.

Betty's priority distribution right generates $400,000 per year. Satisfied that this income stream (plus income from her other assets) is adequate to meet her annual living expenses, Betty gifts her class B interest to her children.

For Section 2701 purposes, Betty has made a TRANSFER (in this case, a gift) of an equity interest is an LLC to her children, who are each considered A MEMBER OF THE FAMILY. Further, she has retained an APPLICABLE RETAINED INTEREST immediately after the transfer: a DISTRIBUTION RIGHT in a CONTROLLED ENTITY. The entity is CONTROLLED because Betty and the lineal descendants of Betty's parents—i.e., Betty's children—own all of the LLC's capital and profits. However, Betty's DISTRIBUTION RIGHT is a QUALIFIED PAYMENT RIGHT because she is entitled to receive annual cumulative distributions at a fixed rate. Thus, Betty's QUALIFIED PAYMENT RIGHT attributable to her retained Class A interest will generally be valued under ordinary gift tax principles rather than the special valuation rules of Section 2701.[28]

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27 Regs. 25.2701-5(b) and (c).

28 If the retained Class A interest includes both a QUALIFIED PAYMENT RIGHT and an EXTRAORDINARY PAYMENT RIGHT (for example, if Betty has the right to compel the liquidation of the LLC), all rights will be valued under the "lower of" valuation rule of Section 2701 (i.e., the value will be determined assuming the EXTRAORDINARY PAYMENT RIGHT will be exercised (or not exercised) so as to minimize that value).

29 It is possible that one or more of the rights conferred by the Class A interest, such as the liquidation participation right, will have value notwithstanding Betty's election under Section 2701(c)(3)(C) to treat the QUALIFIED PAYMENT RIGHT as a nonqualified payment right. To account for this possibility, Betty may want to capitalize the LLC with more than $5 million at the outset; the excess capital should equal the value of those retained rights with real worth, thus ensuring that Betty's deemed gift will consume Al's entire $5 million DSUE. Betty should consult closely with an experienced valuation professional during the LLC's design phase—that is, while the LLC's economics are being structured.

30 See Temp. Reg. 25.2505-2T(b).

31 See Regs. 25.2701-5(b) and (c).

32 Section 671.

Later in 2018, Betty marries Paul. Betty's DSUE from Al is now at risk; thus, it would be advantageous for her to trigger the special valuation rules of Section 2701. Accordingly, on her 2017 gift tax return, Betty "opts in" to Section 2701—that is, she elects under Section 2701(c)(3)(C) to treat her Class A payment right as a nonqualified payment right. As a result of the election, Betty's right to receive fixed distributions is valued at zero, so she may be treated as having made a gift of $5 million (the entire fair market value of the LLC) to her children.[29]

Under the DSUE ordering rule, Betty will be deemed to use Al's $5 million DSUE, thus shielding the transfer from gift tax while leaving her own gift and estate tax exclusion intact.[30] By structuring the LLC with preferred and common interests and then gifting the common Class B interest to her children, Betty effectively "freezes" her preferred stake at $4.5 million. Meanwhile, she ensures that future appreciation in the LLC interests will pass to her children free of gift and estate tax. She also retains a guaranteed $400,000 annual distribution stream.

When Betty passes away, the value of the preferred Class A interest will be includable in her gross estate. However, special adjustment rules under Section 2701 will apply to prevent double taxation. Assuming that the Class A interest had a value of $4.5 million on the date of the initial transfer and did not decline in value, the amount on which Betty's tentative estate tax is computed is reduced by $4.5 million—i.e., the same amount by which Betty's taxable gifts were increased as a result of the application of Section 2701 to the initial transfer.[31] Thus, the value of both the preferred interest and common interest—including all appreciation that accreted to the common interest after the initial transfer—will escape taxation at Betty's death.

The annual distributions that Betty actually receives as a Class A member will potentially increase her taxable estate upon her death. However, because Betty retained those payments specifically to support her lifestyle, one expects that Betty will consume all or nearly all of the distributed cash during her lifetime, leaving little if any extra in her gross estate at death.

Thus, Section 2701 and the preferred partnership technique permits Betty to "have her cake"—receive a fixed payment stream for the rest of her life—"and eat DSUE"—make a deemed gift to use Al's DSUE before it vanishes. The icing on the cake: Because the value of the preferred Class A interest is includable in Betty's gross estate (subject to the mitigation rules), the Class A interest will receive a step-up in basis upon Betty's death under Section 1014. The LLC members then can make a Section 754 election to adjust the "inside" basis of the partnership's underlying assets to match the Class A interest holders' "outside" basis.

A tastier cake

Betty can choose from the following alternatives to enhance the preferred partnership technique.

Gift of common shares to grantor trust. Instead of transferring the Class B interest to her children outright, Betty can gift the common interest to one or more grantor trusts for her children's benefit. A grantor trust is a "passthrough" vehicle for income tax purposes. Thus, Betty, as grantor of the trusts, reports the trusts' income, gains, losses, and deductions on her own income tax return.[32] She may use the fixed annual payments from her Class A interest to pay the income tax liability.

Under the DSUE ordering rule, Betty will be deemed to use Al's $5 million DSUE, thus shielding the transfer from gift tax while leaving her own gift and estate tax exclusion intact.

Having Betty pay the trusts' income taxes provides several advantages. First, nongrantor trusts pay federal income taxes at the same top rate as individuals, and that top rate applies at a much lower threshold. Additionally, Betty's payment of the trusts' income taxes is not considered an additional gift to the trusts for gift tax purposes. Accordingly, the trusts' assets can grow in value, outside Betty's taxable estate, free of that income tax burden. Meanwhile, Betty's payments will reduce her own taxable estate.

Over time, having Betty pay the trusts' income tax liabilities can result in very significant tax savings to her family. If Betty ever wants to shift the income tax burden back to any of the trusts, she can "turn off" the trust's grantor trust status, although she should not seek to "toggle" the trust's grantor trust status on and off.

Noncumulative payment rights. Instead of retaining a fixed, cumulative payment right, Betty's payment stream attributable to her Class A interest could be noncumulative in nature. Thus, if the LLC members choose not to distribute her entire $400,000 payment in a given year, she will not receive "make-up" distributions in future years. In this scenario, Betty's noncumulative DISTRIBUTION RIGHT would not qualify as a QUALIFIED PAYMENT RIGHT; thus, Section 2701 would apply to value her payment right at zero without the need for an "opt in" election.

Structuring the distribution right to be noncumulative is advantageous because it enables the LLC members to permit some or all of Betty's distribution rights to lapse in years in which she does not need the income, thereby shifting value to the Class B interest holders. Especially in this circumstance, Betty should take care not to retain control over LLC distributions; otherwise, she may be deemed to retain the Class B interest for estate tax purposes. It may be beneficial for the junior family members to "kick in" consideration to receive the subordinated interest, either by buying the interest or making a capital contribution in exchange for it.

Wrapping it up

Section 2701 imposes complex gift tax valuation rules to intra-family transfers of equity interests in preferred partnerships, the operation of which can leave a bitter taste in anyone's mouth. If the special valuation rules apply to an individual's transfer of a subordinate equity interest in an entity to his or her children, the individual may be deemed to have made a gift of more than he or she actually transferred. This seemingly harsh consequence offers a sweet opportunity to a surviving spouse with inherited DSUE: He or she can make a deemed gift of assets to consume the DSUE amount before it disappears, while preserving access to a steady flow of income from the assets. That truly takes the cake. ■