

PREFERRED EQUITY FREEZE ENTITY: FREQUENTLY ASKED QUESTIONS
November 14, 2007

This summary answers common questions about the creation and tax considerations of preferred freeze partnerships. Attached is a sample agreement (“Sample Freeze Agreement”) creating a freeze partnership in the form of a Delaware statutory trust (“Freeze Entity”). Unless otherwise defined, all other capitalized terms shall have the meaning defined in the Sample Freeze Agreement.

For more detailed discussion of the issues below, please see the summaries titled “Preferred Equity Freeze Entity: Federal Income Tax Aspects” (referred to below as “Income Tax Summary”) and “Preferred Equity Freeze Entity: Transfer Tax Aspects.” This summary is not intended to address all tax considerations that may be relevant to an investment in a Freeze Entity. In addition, the discussion below does not address state or local tax considerations or considerations that may be relevant under the laws of jurisdictions other than the United States. IN VIEW OF THE SUMMARY NATURE OF THIS DISCUSSION, EACH PERSON IS URGED TO CONSULT HIS, HER OR ITS OWN TAX ADVISOR REGARDING THE SPECIFIC TAX CONSEQUENCES TO SUCH PERSON OF AN INVESTMENT IN A FREEZE ENTITY.

1. What is the purpose of the Freeze Entity?

The purpose of a Freeze Entity is to “freeze” the rate of appreciation in assets that will be included in the senior generation’s estate for transfer tax (gift, estate and GST tax) purposes and shift the excess appreciation to the junior generation(s) without additional transfer tax.

2. What is the structure of the Freeze Entity?

A Freeze Entity generally has 3 classes of Units:

(i) Managing Units: provide general management control over the Freeze Entity and holders typically have a collective 1% economic interest.

(ii) Preferred Units and Residual Units: provide limited management rights and holders typically have a collective 99% economic interest.

(a) Preferred Units: provide a “frozen” return equal to the annual preferred payment on the Preferred Units and a fixed value on liquidation. The Preferred Units provide greater security but limit participation in appreciation of the Freeze Entity assets.

(b) Residual Units: provide excess appreciation in the Freeze Entity assets after satisfying the Managing Unit holders’ 1% interest, and the Preferred Unit holders’ preferred return. The Residual Units provide less security but accrue the capital, income and appreciation beyond the “frozen;” return to Preferred Unit holders.

3. How will the Freeze Entity be classified for federal income tax purposes?

For federal income tax purposes, the; Freeze Entity typically is taxed as a partnership.

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4. **How is the preferred payment rate on Preferred Units set?**

The preferred payment is set to reflect prevailing market rates and to result in a value of each Preferred Unit equal to its value on liquidation. For example, relevant factors may include the dividend rates of publicly traded preferred stocks, the credit worthiness of the partnership, the types of assets within the partnership and the proportion of Preferred Units to other Units. An appraisal by a professional valuation expert is often used to determine and to document the appropriate preferred payment rate.

5. **Can a person contribute appreciated assets upon the initial formation of the Freeze Entity on an income tax-free basis?**

Generally yes, subject to exceptions further described in the Income Tax Summary. One of the most important exceptions is a set of rules (the "Investment Company Rule") that results in recognition of gain if the holder's contribution results in diversification, subject to a number of exceptions.

6. **Can an existing or new holder of Units make an additional contribution to an existing Freeze Entity on an income tax-free basis?**

Generally yes, subject to exceptions further described in the Income Tax Summary.

7. **Will an additional contribution to a Freeze Entity be grouped together with a prior contribution in applying the Investment Company Rules?**

No, unless a subsequent transfer is part of an overall plan from the beginning to diversify assets without recognition of gain. For example, if a plan contemplates from the beginning that a later transfer to an investment company will occur in a purportedly tax-free transaction, then the Investment Company Rules will be applied after the subsequent transfer, regardless of the delay.

8. **What is the Freeze Entity's basis in assets contributed to the Freeze Entity for income tax purposes?**

The basis of property contributed to the Freeze Entity equals the contributor's adjusted basis of the property at the time of the contribution, increased by the amount (if any) of gain recognized on the transfer.

9. **Can the Freeze Entity own S corporation stock?**

The Freeze Entity typically should not hold S corporation stock because the Freeze Entity usually is taxed as a partnership. A partnership is not a permissible S corporation shareholder and so the S corporation status would terminate if the Freeze Entity owned its stock.

10. **How long can I defer the first preferred payment? How long can I defer the preferred payment in any subsequent year?**

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A 4-year grace period applies for any preferred payment, whether it is the first or subsequent preferred payment. For example, if a preferred payment is initially due on December 31, 2007, that payment may be deferred for the 4-year grace period until December 31, 2011.

11. **What are the consequences if a preferred payment is paid after the end of the 4-year grace period?**

If a preferred payment is not fully paid before the end of the 4-year grace period, then a phantom amount to the extent of the shortfall will be added to owner's taxable gifts or taxable estate when the preferred units are later transferred during life (taxable gift) or at death (taxable estate). The phantom amount will be the unpaid preferred payment plus "interest" compounding at the preferred payment rate from the original due date of the payment. The penalty for late preferred payments can be extremely high, so all preferred payments should be made before the end of the 4-year grace period. The manager of the Freeze Entity can use in-kind assets or obtain a loan to make payments.

Example: Assume that a holder owns Preferred Units with a 6% preferred rate, and that a \$100,000 preferred payment is due on December 31, 2007. The holder does not receive this preferred payment within the 4-year grace period ending on December 31, 2011. As of 1 day later, on January 1, 2012, the phantom amount to be added to the holder's taxable gifts or taxable estate is \$126,248, which is the value of the \$100,000 preferred payment compounded at 6% for 4 years. If the holder receives \$100,000 on January 1, 2012, the remaining phantom amount of \$26,248 continues to compound at 6% per year.

12. **Do preferred payments have to be satisfied with cash, or can they be satisfied with in-kind assets?**

Distributions to satisfy the preferred payments generally can be made in cash or other property valued at fair market value.

13. **Can a contributor who originally funded the Freeze Entity loan funds to the Freeze Entity to make preferred payments to Preferred Unit holders?**

While the Trustee can borrow funds to make preferred payments, the Preferred Unit holder should not loan funds to the Freeze Entity to make preferred payments, as the preferred payments may just return the loaned funds back to that holder. To avoid any dispute regarding the economic substance of the transfers or whether the Trustee has impermissibly satisfied the preferred payment with a note in violation of applicable tax rules, the Trustee should seek loans from sources other than the Preferred Unit holder.

14. **How will taxable income of the Freeze Entity be allocated to the holders of Units? Will taxable income be allocated to a holder regardless of whether the holder receives any distribution from the Freeze Entity?**

Income realized in a tax year first is allocated to the holders to whom losses were previously allocated. Once all prior losses have been restored, 1% of all realized income and gain in a tax year is allocated among the holders of Managing Units, and 99% of the taxable

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income should be allocated among the Preferred Unit holders until the outstanding amounts of their unpaid preferred payments are satisfied and then to Residual Unit holders. The tax character of the income allocated to a holder is the same as the tax character when owned by the Freeze Entity. Taxable income of the Freeze Entity may be allocated to a holder in the Freeze Entity even if no distributions are made to that holder.

An example of the income tax allocations is contained in the Income Tax Summary.

15. What are the income tax consequences of preferred payments to the Preferred Unit holder?

As noted in the preceding Question, an amount of taxable income equal to the annual preferred payment generally will be allocated to the partner each year whether or not the payment actually is made. The preferred payment, itself, generally does not have further income tax consequences, subject to rare exceptions described in the Income Tax Summary.

16. Can a holder of any Units withdraw? If so, what are the tax consequences to exercise or non-exercise of the right to withdraw?

A holder can withdraw as to any one or more Units if the following persons approve the withdrawal:

- (a) Managing Unit: Trustee.
- (b) Preferred Unit: Trustee and holders of a majority of Preferred Units.
- (c) Residual Unit: Trustee and holders of a majority of each class of Units.

No gift tax consequence should result from the failure to withdraw Units if market rates rise above the preferred rate because an independent Trustee's approval is required and a holder cannot withdraw Preferred Units freely.

No gift tax consequences should result from withdrawal of Units because they must be redeemed at full value. A taxable gift between the holder of the withdrawn Units and the other Unit holders could result if the Units are not properly valued for purposes of redemption.

The income tax consequences of withdrawal depend on whether or not the holder withdraws completely as to all of the holder's Units in the Freeze Entity. If a holder withdraws completely from the Freeze Entity for cash, the holder will recognize gain equal to the excess of the cash amount over the tax basis of the holder's Units. (For example, such basis may be less than the cash amount if the Preferred Units originally were issued in exchange for appreciated property.) If a holder withdraws completely from the Freeze Entity in exchange for a distribution of securities from the Freeze Entity, the withdrawal may be tax-free or taxable depending on factors discussed in the Income Tax Summary. If a holder withdraws with respect to some, but not all, of the holder's Units, the holder generally will recognize gain only to the extent that the cash amount received exceeds the holder's aggregate tax basis for all of the holder's Units.

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17. **What are the tax consequences of the death of a holder of Preferred Units?**

A holder's Preferred Units will be assets included in the holder's taxable estate and they are not valued with any discount. In addition, if any preferred payments were not timely paid within the 4-year grace period after the original due date and remain outstanding at death, then a phantom amount also will be added to the taxable estate. See Question #11 above.

For income tax purposes, the deceased holder's adjusted tax basis in any Units in the Freeze Entity owned at death is increased (or decreased) to equal the fair market value of those Units for federal estate tax purposes. The Freeze Entity should file a Section 754 election with its tax return for the year in which the death occurred (assuming the Freeze Entity has not previously made a Section 754 election) to adjust the tax basis of its assets to reflect the adjustment to the tax basis of the Units resulting from the death.

18. **Can my private foundation hold Units?**

Yes, your private foundation (and any other charitable organization to which transfers qualify for income, gift and estate tax charitable deductions) can hold Units. However, rules that prohibit private foundations from investments that jeopardize the execution of its tax-exempt function will affect whether Units are an appropriate investment for a particular private foundation.

19. **Can the senior generation retain investment control of the Freeze Entity?**

Yes, the senior generation can retain investment control by holding Managing Units. Managing Unit holders can appoint and remove Investment Managers to direct the Trustee as to the investment of any assets. A member of the senior generation also can act as an Investment Manager. Under current law, such retention of control over investments should not cause the assets to be included in the Managing Unit holder's estate because of each Investment Manager's fiduciary duties.

20. **Will a Freeze Entity be subject to the IRS's ongoing challenges to family limited partnerships ("FLPs") under Section 2036?**

The IRS may be less likely to challenge a Freeze Entity than a standard FLP for several reasons. The IRS has challenged the validity of many FLPs where the original contributor continues to treat the FLP as his/her personal assets and actually has not surrendered any rights or interests in those assets. In those cases, participants are not actually operating a true partnership. In contrast, the Preferred Units provide genuine liquidity to holders who need not undermine the partnership by relying on partnership assets for their ongoing living expenses. The Preferred Units also are not valued with a discount for transfer tax purposes, eliminating the primary reason why the IRS challenges FLPs. In addition, the Freeze Entity has a substantial non-tax purpose of allowing Unit holders to vary their shares of management control, liquidity and investment risk through the disproportionate issuance of Managing, Preferred and Residual Units. Finally, the repeal of former Section 2036 and substitution of special valuation rules like Section 2701 (which governs Freeze Entities) would be meaningless if Section 2036 applies to include the Freeze Entity assets in Unit holders' taxable estates.

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21. Can separate series with separate accounts in the DST be created for subsequent contributions to the DST? How do they operate? What are the tax consequences?

Yes, separate series could be created in the DST for subsequent contributions. Each separate series is like a separate subsidiary within the Freeze Entity. Each can have different and separate Unit holders, Investment Managers, assets, liabilities, governance provisions and relative rights, powers and duties. The separate series are typically created primarily for accounting purposes since liability is not an issue.

The issuance of new Units in a series due to an additional contribution must maintain the 1% proportion of Managing Units. The remaining 99% of new Units could be issued in any ratio between Preferred and Residual Units (subject to the minimum 10% Residual Units floor).

22. How do valuation discounts applicable to in-kind contributions to the Freeze Entity affect capital accounts and the preferred payment rate?

Any valuation discount applicable to a holder's contribution will reduce the holder's capital account and the annual preferred payment amount to the holder, as both are based on the value of the contribution.

23. What factors support the position that the Preferred Units should be considered equity rather than debt for income tax purposes?

The determination of whether a person's interest in a partnership should be treated as debt or equity for federal income tax purposes is primarily a factual analysis. Generally, an equity holder intends to make an investment and take the risks of the venture. Thus, an equity holder obtains an ownership interest in the enterprise and his/her fortune is tied to the profitability of the enterprise. In contrast, the creditor seeks a definite obligation, payable in any event. Debt is ordinarily defined as an unqualified obligation to pay a sum certain at a reasonably fixed maturity date, along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof.

The Freeze Entity is not absolutely obligated to pay to the Preferred Unit holders a sum certain at a reasonably fixed maturity date regardless of the Freeze Entity's income. Instead, preferred payments are permitted only to the extent the Freeze Entity has generated cumulative net profits since the formation of the Freeze Entity. Thus, Preferred Unit holders assume the risk that the Freeze Entity will not generate sufficient profits to satisfy the preferred payments. Other factors supporting equity treatment are that the Preferred Units do not have a maturity date and the holders cannot exercise creditors' remedies.

24. What occurrences would cause the Trustee to elect to revalue the Freeze Entity assets? How does revaluation affect the Unit holders' capital accounts for income tax purposes?

The most likely occurrence requiring revaluation of the Freeze entity assets would be the addition of a new Unit holder. In that case, revaluation avoids unfair allocation of existing tax gains to the incoming holder who did not benefit from that gain.

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Generally, a Unit holder's capital account is increased by the fair market value of property that the holder contributed to the Freeze Entity, and decreased by the fair market value of property distributed to the Unit holder from the Freeze Entity, regardless of the adjusted basis in the property contributed or distributed. The term "Carrying Value" as used in the Sample Trust Agreement refers to the value of property held by the Freeze Entity as reflected in the Unit holders' capital accounts.

The Treasury Regulations provide that the Freeze Entity may elect to revalue all Freeze Entity property, and increase or decrease the Unit holders' capital accounts to reflect such revaluation, upon the occurrence of any of the following events:

- (i) A non-de minimis, non-pro rata contribution of money or other property to the Freeze Entity by a new or existing Unit holder as consideration for a Unit;
- (ii) A non-de minimis, non-pro rata distribution of money or other property by the Freeze Entity to a retiring or continuing partner as consideration for a Unit; or
- (iii) The grant of Units representing a non-de minimis interest in the Freeze Entity as consideration for providing services to or for the benefit of the Freeze Entity by an existing or new Unit holder.

If the Trustee elects to revalue the assets of the Freeze Entity, each Unit holder's capital account will be increased or decreased by its share of the unrealized appreciation (or loss) in each Freeze Entity asset (measured by the capital account value of the asset immediately prior to the revaluation) based on its share of ownership in the Freeze Entity. A revaluation of the Freeze Entity's assets upon the occurrence of one of these events is not a taxable event for income tax purposes. Accordingly, it should only affect tax allocations and should not otherwise affect the economic interests of Unit holders.

25. Are there involuntary events which terminate the Freeze Entity? If so, can the Freeze Entity be reconstituted without any adverse tax consequences?

The Freeze Entity will be deemed to "constructively" terminate (solely for income tax purposes) if there is a sale or exchange of 50 percent or more of the total interest in the capital and profits of the Freeze Entity within a 12-month period. For an investment vehicle like the Freeze Entity, the primary income tax effects of a constructive termination are that (1) the new Freeze Entity must make new tax elections and (2) the terminated Freeze Entity must file a short-year final tax return for the taxable year ending with the date of its termination.

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