

**Preferred Equity Freeze Equity:
Federal Income Tax Aspects
November 14, 2007**

This summary reviews certain U.S. federal income tax aspects of a freeze structure under current law, but keep in mind that tax law can always change (sometime with retroactive effect) such that different rules may apply. This summary is based on the sample Agreement of Trust ("Sample Freeze Agreement") for a Delaware Statutory Trust ("Freeze Entity") that reflects the basic principles of a freeze structure. Unless otherwise defined in this summary, all other capitalized terms shall have the meaning ascribed to them in the Sample Freeze Agreement.

This summary is not intended to address all U.S. federal tax considerations that may be relevant to an investment in a Freeze Entity, nor is it intended to serve as a private placement memorandum. In addition, the discussion below does not address state or local income tax considerations nor does it address taxes other than income taxes. The following discussion also does not address tax 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.

Base Case

The discussion below assumes that the Freeze Entity will be taxed as a partnership for federal income tax purposes. It further assumes that the Freeze Entity will have three types of economic units: (i) Managing Units, (ii) Preferred Units and (iii) Residual Units. Holders of Managing Units are assumed to have a 1% economic interest in the Freeze Entity. Of the remaining 99% economic interest, holders of Preferred Units are assumed to have a limited return equal to the annual preferred payment on the Preferred Units and a priority return of their capital contribution upon the liquidation of the Freeze Entity, while holders of Residual Units are assumed to share in all excess appreciation in the assets of the Freeze Entity after the accrued but unpaid preferred return for holders of Preferred Units is satisfied.

Contributions to Freeze Entity

General

Under Code Section¹ 721(a), tax gain or loss is generally not recognized if property is transferred to a partnership in exchange for an interest in the partnership. In that situation, the contributing partner's basis in the Units of the Freeze Entity received in the exchange should be equal to the amount of money and the adjusted basis of the property contributed by such person to the Freeze Entity. Similarly, the basis of the contributed property to the Freeze Entity should equal the adjusted basis of the property to the contributing partner at the time of the contribution.

¹ Unless otherwise noted, all "Section" references are to the Internal Revenue Code of 1986, as amended ("Code"), and the Treasury Regulations promulgated thereunder.

Example #1: B contributes \$1,000 in cash and Property Z with a fair market value of \$1,000 and an adjusted tax basis of \$500 to a Freeze Entity in exchange for Units in a tax-free transaction. B's basis in its Units should be \$1,500, and the Freeze Entity's basis in the contributed assets should be as follows: \$1,000 in cash and \$500 in Property Z.

Investment Company Exception

Under Code Section 721(b), tax gain (but not loss) is recognized if property is transferred to a partnership which, if incorporated, would qualify as an investment company within the meaning of Code Section 351.

As explained by Treasury Regulations under Code Section 351, a transfer is treated as made to an "investment company" if (1) the transfer results, directly or indirectly, in diversification of the transferors' interests, and (2) the transferee is, in relevant part, a corporation more than 80% of the value of whose assets (excluding cash and nonconvertible debt obligations) are held for investment and are "stocks and securities."

In determining whether the asset value threshold is met, all "stocks and securities," whether or not publicly traded, held by the Freeze Entity after the transfers are taken into account. For this purpose, the term "stock and securities" is broadly defined, but there are favorable look-through rules that may apply if the Freeze Entity holds a majority position in the stock of an issuer.

Even if more than 80% of the value of the Freeze Entity's asset are held for investment (which may often be the case), the transfer will only trigger taxable gain under Code Section 721(b) if the transfer results in "diversification" of the transferors' interests. Diversification generally occurs if two or more persons transfer nonidentical assets to the Freeze Entity in the exchange. For this purpose, if any transaction involves one or more transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, such transfers shall be disregarded in determining whether diversification has occurred. In the only example of this "de minimis" rule in the Treasury Regulations, A and B each transferred \$10,000 worth of Company X stock (which was publicly traded) to a newly formed entity ("Newco"), while C transferred \$200 worth of Company Y stock (also readily marketable) to Newco. In determining whether or not diversification occurred, C's participation in the transaction (C transferred less than 1% of total value to Newco) was ignored. Consequently, there was no diversification resulting from these transfers and no gain was recognized.

In addition to the "de minimis" rule, if there is only one transferor (or two or more transferors of identical assets) to a newly organized corporation, the transfer will generally be treated as not resulting in diversification. In the example above, A and B were not treated as diversifying their interests through their contribution to Newco since they transferred identical assets (Company X stock).

In addition, a transfer of stocks and securities is not treated as resulting in diversification if each transferor transfers a diversified portfolio of stocks and securities. For this purpose, a portfolio of stocks and securities is diversified if it satisfies the 25 and 50-percent tests set forth in the Code and Treasury Regulations. These tests are satisfied if not more than 25% of the value of a portfolio is invested in stocks and securities of a single issuer, and not more than 50% is invested in five or fewer issuers.

Example #2: B contributes a minority position in Stock Y with a fair market value of \$1,000 and an adjusted tax basis of \$500, and C contributes a minority position in Stock Z with a fair market value of \$1,000 and an adjusted basis of \$200. Stock Y and Stock Z are the only two assets held by the Freeze Entity. This contribution will trigger the entire tax gain to both B and C under the investment company rules because (1) more than 80% of the value of the Freeze Entity's assets are stocks and securities and (2) B and C contributed nonidentical assets (since each contributed a single asset, the exception for contributions of a diversified portfolio of stocks and securities does not apply).

Contribution of Property Subject to Liabilities

A person that contributes property subject to liabilities is deemed to receive a cash distribution equal to the amount of liabilities assumed by the Freeze Entity. Under detailed partnership tax rules governing the treatment of partnership liabilities, the contributing partner will generally be allocated some or all of liability for tax purposes, which is treated for tax purposes as a contribution of money made by the contributing partner to the Freeze Entity. If and to the extent this deemed cash distribution made to the contributing partner exceeds the deemed cash contribution made by the contributing partner (such excess the "Net Deemed Distribution"), the contributing partner will recognize tax gain as a result of the Freeze Entity's assumption of the liability on the contribution to the extent the Net Deemed Distribution exceeds the adjusted basis of the contributing partner's interest in the Freeze Entity immediately after the contribution.

Example #3: B contributes Property Z with a value of \$1,000 and a basis of \$500 to a Freeze Entity. Property Z is subject to a \$700 liability which the Freeze Entity assumes. If A's share of the liability held by the Freeze Entity is \$100, then A will be deemed to receive a Net Deemed Distribution of \$600 as a result of the liability shift, which will result in a \$100 tax gain to A.

Disguised Sale Presumption

If a member contributes property to the Freeze Entity and the Freeze Entity makes a distribution of money or other property to the contributing member within two years after the contribution, the Code presumes that the transaction constitutes a sale between the contributing member and the Freeze Entity unless an exception applies. The contributing member may take the position that this presumption is rebutted in the particular circumstances of the member's contribution, but the member must disclose this position to the Internal Revenue Service (the "IRS") on the member's tax return.

Similarly, if (i) a member transfers property to the Freeze Entity subject to a liability that was incurred within two years of the transfer, (ii) the Freeze Entity assumes or takes the property subject to the liability, and (iii) the amount of the liability transferred by the contributing member exceeds the contributing member's share of that liability as determined immediately after the transfer under relevant tax rules, the contributing member may, in certain instances, be presumed to have sold part of the property to the Freeze Entity. This presumption may also be rebutted so long as the application of the presumption and rebuttal are disclosed to the IRS.

Allocations

General

A Freeze Entity does not pay taxes except in limited cases such as state and local taxes in some jurisdictions. Instead, the income and losses² of the Freeze Entity pass through to, and are allocated to, the Unit holders, who must take into account those items in the current tax year, regardless of whether a distribution is made to the Unit holders by the Freeze Entity. Unit holders will normally be taxed on their allocable share of Freeze Entity tax items based on the original character of the tax items to the Freeze Entity (e.g., ordinary income or loss, capital gain or tax-exempt income).

The tax law has detailed rules governing allocations, including a safe harbor test. If the safe harbor test is not satisfied, allocations are respected if they are consistent with the partners' interests in the partnership. The safe harbor test is satisfied if income and losses are allocated to capital accounts and liquidating distributions are made in accordance with capital account balances, or are made in a way that produces an equivalent result regardless of the economic performance of the partnership. The Sample Freeze Agreement allocates income and losses to capital accounts, and provides that liquidating distributions are made pursuant to the distribution priority stated in the Sample Freeze Agreement. Allocations of Profits and Losses (as determined under the Sample Freeze Agreement) are made to provide (to the greatest extent possible) that a Unit holder's capital account balance is equal to the amount that person would receive assuming the Freeze Entity sold all of its properties for an amount of cash equal to a book value, satisfied its debt, and distributed the proceeds in liquidation of the Freeze Entity pursuant to the distribution priority.

The approach taken in the Freeze Agreement should produce an equivalent result to liquidating according to capital account balances or should be respected as in accord with the partners' interests in the partnership. While there is no guarantee that the IRS will respect these allocations, it is believed that liquidating according to the distribution priority stated in the Freeze Agreement is preferable to liquidating according to capital account balances because ensuring the correct economic deal (and avoiding the resulting gift tax cost if the preferred units are not the equivalent of preferred stock for purposes of Code Section 2701) outweighs the risk (and the resulting income tax cost) of the IRS reallocating tax items.

Example #4: Assume the Freeze Entity is formed with an initial capital contribution of \$10,000,000, of which 10% (or \$1,000,000) is attributable to the holders of residual units and 1% (or \$100,000) is attributable to the holders of managing units. Further assume that the annual preferred return for the preferred units is determined to be 8%.

Year 1: The Freeze Entity realizes a net book and tax loss of \$1,000,000. One percent (1%) of these tax losses (or \$10,000) should be allocated to the holders of managing units, while the remaining \$990,000 of losses should be allocated to the holders of residual units.

² The ability of a person to use a loss may be limited by application of certain tax rules (e.g., at-risk, passive activity) which are outside the scope of this summary.

Year 2: The Freeze Entity realizes a net book and tax gain of \$1,000,000. None of that gain should be allocated to the holders of preferred units because the Freeze Entity has not earned cumulative net profits since its inception (its two year cumulative net profit is \$0). As a result, 1% of the tax gain (or \$10,000) should be allocated to holders of managing units, and \$990,000 should be allocated to holders of the residual units. The prior year losses have been restored.

Year 3: The Freeze Entity realizes a net book and tax gain of \$2,500,000. The holder of managing units should be allocated 1% of this gain (or \$25,000). The remaining book and tax gain should be allocated 100% to the holder of preferred units until that holder has been allocated a cumulative amount equal to the unpaid preferred return. In this example, that holder should be allocated \$2,136,000 with respect to the preferred return, which amount is the capital contribution in exchange for preferred units (\$8,900,000) multiplied by the preferred return (8%) multiplied by 3 years. The remaining \$339,000 of taxable income in Year 3 should be allocated to the holders of residual units.

Special Rules for Allocating Losses Attributable to Freeze Entity Liabilities

If a loss or deduction should arise that is attributable to a nonrecourse liability of the Freeze Entity, the Sample Freeze Agreement provides that such “nonrecourse” loss or deduction shall be allocated to the holders of Preferred Units. A loss is considered attributable to a liability for this purpose only if prior losses and distributions have caused the members to have negative capital account balances, which is very unlikely to occur in a Freeze Entity. A “nonrecourse” liability is one that no member or related party has funded or guaranteed.

If a loss or deduction should arise that is attributable to a “partner nonrecourse” liability of the Freeze Entity (generally a nonrecourse loan made, or guaranteed, by a Unit holder or related party), such loss or deduction (referred to as a “partner nonrecourse” deduction or loss) shall be allocated to the Unit holders that bear the economic risk of loss as determined under the tax rules.

Under the Sample Freeze Agreement, any Unit holder that is allocated a nonrecourse deduction or loss or a partner nonrecourse deduction or loss from the Freeze Entity shall be specifically allocated income to offset (or “charge back” against) the loss or deduction.

The Taxation of Built-In Gains

There are special rules that handle the allocations of “built-in gains” or “built-in losses” -- that is, the difference between the fair market value and basis of property at the time contributed to the Freeze Entity. As mentioned above, the Freeze Entity generally takes the contributing partner’s basis in the property. If and when the Freeze Entity subsequently sells that property, the portion of the taxable gain attributable to the original “built-in gain” will be allocated and taxed to the contributing partner.

Example #5: B contributes stock worth \$4,000,000 with basis of \$1,000,000 to the Freeze Entity for Preferred Units. The built-in gain is the unrealized appreciation of \$3,000,000 at the time of contribution.

Assume that the Freeze Entity later sells that stock for \$6,000,000. B will be allocated and taxed on the first \$3,000,000 of gain, representing B's original \$3,000,000 of built-in gain. The remaining \$3,000,000 of gain on the sale is allocated in accordance with their partnership agreement.

Please note that holders of Residual Units also will bear built-in gain tax liability for their contributions of appreciated property, even though they cannot receive distributions from the Freeze Entity until the holders of Preferred Units have received all of the preferred payments. If the holders of Residual Units do not have or do not choose to use their other assets to pay this tax liability, the Freeze Entity must consider a partial liquidation to distribute cash or assets to all Unit holders or a pro-rata redemption of the Residual Units.

Distributions: General

Under the Sample Freeze Agreement, a holder of Managing Units receives 1% of all distributions made by the Freeze Entity. The remaining distributions are made to the holders of Preferred Units and Residual Units, respectively, as follows:

- ☐ If the distribution is made from Income Flow, which is defined as amounts that would be treated as income under trust accounting principles if received by the Unit holders directly, the holders of Preferred Units are entitled to first receive amounts equal to their accrued but unpaid preferred return. Any remaining amount is distributed to the holders of Residual Units.
- ☐ If the distribution is made from Capital Proceeds, which is defined as amounts that would be allocated to capital under trust accounting principles if received by the Unit holders directly, the holders of Preferred Units are entitled to first receive amounts equal to their accrued but unpaid preferred return. Next, the Freeze Entity can, at the Trustee's discretion, elect to make a tax distribution to the holders of Residual Units to cover their tax liability. Any remaining amount is distributed to the holders of Residual Units.

Distributions: Holders of Preferred Units

Guaranteed Payment

As discussed above, partners normally are taxed on their allocable shares of partnership income based on the original character of the income to the Freeze Entity (e.g., ordinary income, capital gain or tax exempt income). However, a holder of Preferred Units would be required to report its preferred payments as ordinary income if the Freeze Entity were required to make those payments regardless of whether it had income equal to the payments. Preferred payments required without regard to the income of the Freeze Entity are referred to as "guaranteed payments." The transfer of property other than cash by the Freeze Entity to satisfy an obligation to make a guaranteed payment would be viewed as a taxable sale by the Freeze Entity.

To avoid characterization as a guaranteed payment, the Sample Freeze Agreement provides that a holder of Preferred Units is only entitled to the preferred payment to the extent that the Freeze Entity has

generated cumulative tax profits (including tax-exempt income and nondeductible expenses but excluding any unrealized gains or loss in the assets) measured from its inception through the date of the distribution (after accounting for the 1% share of the holders of Managing Units). In that way, the Freeze Entity should not create income taxable to a holder of Preferred Units when none actually exists. If the Freeze Entity's share of cumulative tax profits is insufficient to provide the preferred payment in any year, the "shortfall" is carried forward and satisfied out of future tax profits.

If the Freeze Entity does not earn sufficient cumulative tax profits to make a preferred payment before end of the 4-year grace period under Chapter 14 (see "Transfer Tax Memorandum"), the Freeze Entity can distribute its assets or borrow cash to make the payment to avoid a deemed gift. (The Freeze Entity may distribute borrowed cash if its assets are appreciating sufficiently for the benefit of the holders of Residual Units.)

Assuming the distribution is not a guaranteed payment, the tax treatment of distributions will depend on the form of the payment.

Cash Distribution / Disguised Sale Presumption

The distribution of cash by the Freeze Entity in satisfaction of the preferred return will reduce the basis of the holder of Preferred Units, and will result in tax to the holder of the Preferred Units only to the extent the amount of cash distributed exceeds the adjusted basis of the person's Units in the Freeze Entity immediately before the distribution. Since preferred return distributions are limited to cumulative tax profits and profits are allocated first to the holders of Preferred Units, the distribution is unlikely to exceed the basis of the Units. Any resulting gain should be capital in nature. The disguised sale presumption discussed above could apply to this cash distribution depending on the time between contributions and distributions.

Example #6: Assume the Freeze Entity distributes \$100 to B in satisfaction of the preferred return. B would recognize gain to the extent B's adjusted basis in B's Freeze Entity Units was less than \$100 immediately before the distribution. Even if B's adjusted basis was greater than \$100 at the time of the distribution, if B contributed appreciated property to the Freeze Entity within two years of this distribution, the disguised sale presumption could apply and require disclosure if B will not treat the transactions as a sale for tax purposes.

In-Kind Distribution – Marketable Securities

The distribution of appreciated property ("In-Kind Distribution") in satisfaction of the preferred return should generally not be taxable. A taxable event could occur if (i) the distributed property is a "marketable security" (generally, certain assets that are actively traded) whose fair market value exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution and (ii) no exception applies (e.g., the distributed property is not property that was originally contributed by the holder to the Freeze Entity, the distributed property is appreciated as much as the Freeze Entity's securities generally or the Freeze Entity qualifies as an "investment partnership"). One of the exceptions usually applies, but this issue should be monitored when in-kind distributions are made.

Example #7: B contributed cash to the Freeze Entity in Year 1. In Year 3, the Freeze Entity distributes Property Z (a marketable security) to B and the fair market value of Property Z at the time of the distribution exceeds B's basis in B's Freeze Entity Units. B will be required to recognize gain to the extent of the excess of the value of the property over B's basis in B's Freeze Entity Units unless an exception applies (e.g., the Freeze Entity is an "investment partnership" and A is an "eligible partner").

In-Kind Distribution After Seven Years of In-Kind Contribution

An In-Kind Distribution in satisfaction of the preferred return made after seven years of any appreciated property contributed by the holder of Preferred Units to the Freeze Entity will generally not be taxable, subject to application of the marketable securities rule discussed above.

Example #8: B contributed Property X in Year 1 with \$1,000 of appreciation, and that is the only contribution made by B to the Freeze Entity. In Year 8, Freeze Entity distributes Property Z (an appreciated non-marketable security). This distribution should be tax free.

In-Kind Distribution Within Seven Years of In-Kind Contribution

An In-Kind Distribution in satisfaction of the preferred return made within seven years of any appreciated property contributed by the holder of Preferred Unit to the Freeze Entity will generally cause a taxable exchange unless the distributed property was originally contributed to the Freeze Entity by the holder of the Preferred Units. If the distributed property is an interest in another entity, the exception for distributions of previously contributed property does not apply to the extent that the value of such interest is attributable to property contributed to that entity after the interest in the entity was contributed to the Freeze Partnership.

Example #9: B contributed Property X in Year 1 with \$1,000 of appreciation. In Year 5, Freeze Entity distributes Property Y to B. B will recognize tax gain on this distribution.

Example #10: B contributed Property X in Year 1 with \$1,000 of appreciation. In Year 5, the Freeze Entity distributes Property X back to B. This should be tax-free. However, if Property X is an interest in another entity (e.g., an interest in Partnership W), and part of the value of Partnership W is attributable to property contributed to Partnership W after B contributed it to the Freeze Entity, B may be subject to tax related to the increase in value.

Basis Ramifications of Tax-Free In-Kind Property Distribution

The basis of distributed asset in the hands of the Unit holder will be equal to the lesser of (i) the Freeze Entity's basis in the asset at the time of the distribution and (ii) the Unit holder's adjusted basis in its Units before the distribution. The amount of the Freeze Entity's basis in the distributed asset also will reduce basis in the holder's Freeze Entity interest. Assuming the distribution was tax-free when made, the Unit holder will recognize gain only when it sells that distributed asset.

Distributions: Holders of Managing Units and Residual Units

The discussion above under “Distributions: Holders of Preferred Units” generally applies to distributions made to holders of Managing Units and holders of Residual Units.

Liquidation

The Freeze Entity will be deemed to “constructively” terminate (solely for tax purposes) if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in the capital and profits of the Freeze Entity. For tax purposes only, a terminated partnership is treated as transferring all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership. Immediately thereafter, the terminated partnership is treated as distributing partnership interests in the new partnership to the partners in liquidation of the terminated partnership.

For an investment vehicle like the Freeze Entity, the primary income tax effects of a constructive termination are that (1) the new partnership must make new tax elections and (2) the terminated partnership must file a short-year final tax return for the taxable year ending with the date of its termination.

The income tax implications of an actual liquidating distribution is the same as a non-liquidating distribution discussed above. For example, if a Unit holder’s basis in the Freeze Entity Units is \$100 and the Freeze Entity distributes \$1,000 of cash to that Unit holder in liquidation of the Unit holder’s interest, that person would recognize the \$900 gain in the year of the liquidation.

In contrast, a Unit holder can receive a tax-free distribution of appreciated assets upon termination of the Freeze Entity, even if the value of those assets exceeds the holders basis in the Units. For example, if a Unit holder’s basis in the Freeze Entity interest is \$100 and the Freeze Entity distributes securities worth \$1,000 to that Unit holder, that person would not recognize gain immediately. Instead, that person would take the securities with a basis of \$100 basis and defer the gain until those securities were sold. If the securities were held until the death of the Unit holder, the Unit holder would never recognize the gain under current law because the Unit holder’s estate would receive a step-up in basis.

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