Preferred Equity Freeze Entity:
Transfer Tax Aspects
November 14, 2007

This summary reviews certain U.S. federal transfer 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 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 transfer 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 tax considerations. 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.

Overview

The proposed Freeze Entity contains a "freeze" feature that allows an investor to contribute assets to the Freeze Entity in exchange for preferred equity interests that expose the contributor to less economic risk, but limit the contributor's participation in the future income and appreciation of the Freeze Entity assets. The "freeze" label is misleading because the value of the contributed assets is not frozen, but rather the contributor's share in the growth of that value is capped at the fixed rate of return on the Preferred Units. Preferred equity freezes are attractive to senior generations who want to retain a substantial economic interest in the contributed assets, but want to transfer to younger generations or trusts for their benefit future income and appreciation at a low transfer tax cost, particularly if the Freeze Entity performs exceptionally well. Deferral of Freeze Entity distributions to descendants also often fits the parents' estate planning objectives. The significant transfer tax (estate, gift and generation-skipping transfer (GST) tax)) aspects of the Freeze Entity and each class of unit in the Freeze Entity are discussed below.

Structure of the Freeze Entity

The Freeze Entity accomplishes its transfer tax objectives through the issuance of three types of equity interests: Managing Units, Preferred Units and Residual Units. The Managing Units collectively represent an undivided 1% interest in the Freeze Entity's capital, income and loss. Although the Trustee makes all distribution, redemption and liquidation decisions, the holders of a majority of the Managing Units may exercise most other management rights. First, the majority may elect or remove the Investment Manager who, in turn, controls all investment decisions. Second, the majority may remove the Trustee with the consent of a majority of the holders in each other class of units. Finally, the majority also may fill any vacancy in the office

of Trustee, except that the new Trustee must be "independent" as to all holders of Managing Units if the vacancy results from removal of the prior Trustee.

Holders of Preferred and Residual Units collectively own the remaining 99% of the economic interests in the Freeze Entity. Preferred and Residual Units are limited to voting on certain extraordinary matters. Preferred Units, which correspond to preferred stock in a corporation, have a fixed value on liquidation and provide for annual payments at a fixed rate of return (the "Preferred Rate") based on that value. Residual Units, which correspond to common stock in a corporation, are entitled to 99% of the Freeze Entity's capital, income and appreciation not payable to the holders of Preferred Units in preferred payments or on liquidation. If the assets contributed for Preferred Units outperform the Preferred Rate, additional value is transferred without additional transfer tax to the holders of the Residual Units, usually to descendants or trusts for their benefit.

Chapter 14 of the Internal Revenue Code[1]

Due to perceived abuses of certain family business techniques, Congress added Chapter 14 to the Internal Revenue Code in 1990 to govern the transfer tax consequences of transfers of interests in certain family owned entities.

Section 2701 under Chapter 14 provides special valuation rules for transfers of junior interests in family-owned entities with preferred equity interests. Adverse transfer tax consequences result when valuable rights associated with the preferred interests fail to qualify for recognition under these special valuation rules. First, Section 2701 disregards for gift tax purposes certain "extraordinary payment rights" associated with preferred equity (such as put, call or conversion rights or rights to compel liquidation). Second, distribution rights (such as the annual payments on the preferred equity at a fixed rate) with respect to interests in certain family-owned entities also are disregarded for gift tax purposes. Under these rules, the Preferred Units in the Freeze Entity would be treated as having zero value. However, Section 2701 provides that distribution rights may be accorded value if the Preferred Unit holder accepts certain adverse estate or gift tax consequences if the preferred payments are not made "on time."

The regulations under Section 2701 prescribe a "subtractive method" of valuation for gift tax purposes when certain transfers of common interests are made in an entity with preferred equity interests. Let us consider the example of a proposed $10 million investment in the Freeze Entity. For that investment, the investor will receive 84,000 Preferred Units with a liquidation value of $100 per unit and 16,000 Residual Units. An additional $101,010 (1% of the total initial value of $10,101,000 of the Freeze Entity) will be invested for 1,000 Managing Units, which have a 1% economic interest in the Freeze Entity. Because the investor will receive all of the Preferred and Residual Units, no transfer subject to Section 2701 results from the creation of the Freeze Entity.

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

If the investor later transfers some or all of the Residual Units by gift (or by sale) to descendants or trusts for their benefit, Section 2701 will apply to determine the value of those Residual Units for gift tax purposes. Under the required "subtractive method" for valuation of the Preferred and Residual Units, the value of the Preferred Units as determined under the special rules of Section 2701 is subtracted from the value of 99% of the Freeze Entity to determine the federal gift tax value of the Residual Units. (The special valuation rules of Section 2701 do not apply to the Managing Units because they represent a proportional interest in each economic interest in the Freeze Entity. Accordingly, 1% of the Freeze Entity's value will be allocated to the 1% economic interest of the Managing Units.)

If the original investment has not appreciated in value, the remaining value of the Freeze Entity after allocating 1% to the Managing Units will be $10 million. Under Section 2701, the value of Preferred Units depends almost entirely on the adequacy of the Preferred Rate. If the Preferred Rate and Market Rate are both 6%, the value of each Preferred Unit for purposes of Section 2701 equals its liquidation value of $100. The Preferred Units will have a combined value of $8,400,000, leaving a subtractive value of $1,600,000 for the Residual Units or $100 per Unit. However, the Regulations recognize that the transferred Residual Units may have a lower fair market value due to discounts for minority interest and lack of marketability. Thus, assuming a combined discount of 25% (resulting in a total reduction in value of $400,000), each Residual Unit would have a gift tax value of $75 under Section 2701.

If the Preferred Rate is lower than the Market Rate, their gift tax value will decrease and the Preferred Unit holders may be treated as making a taxable gift by shifting value to the Residual Unit holders due to adjustments under Section 2701. If the Preferred Rate is 6% and the Market Rate is determined to be 8%, each Preferred Unit will have a gift tax value under Section 2701 of $75 (6%/8% X $100). The Preferred Units then will have a combined value of $6,300,000, leaving a subtractive value of $3,700,000 for the Residual Units before discounts. Although the Regulations recognize that a discount remains appropriate under this circumstance, they seem to limit the discount to the total discount calculated without applying Section 2701 or the $400,000 described above. If the Regulations are valid, the Residual Units will have a combined value of $3,300,000 ($3,700,000-$400,000) or $206.25 per Unit. The $2,100,000 increase in the total value of 16,000 Residual Units equals the "lost" Preferred Unit value allocated proportionately among the Residual Units. In contrast, if the Preferred Rate is higher than the Market Rate, Section 2701 provides that the value of each Preferred Unit cannot exceed its liquidation value under its "lower of" valuation rule.

Section 2701 also requires that Residual Units have a "minimum value" for gift tax purposes of at least 10% of the total entity's value. As a result, if the Residual Units represent only 10% of the entity's capital, discounts cannot further reduce the gift tax value of the Residual Units. The Regulations under Section 2701 seem to prohibit any discount in valuation of the Residual Units when they are issued on the creation of the entity or when capital is contributed in exchange for Preferred Units. In addition, Section 2701 is designed to assign a gift tax value to Residual Units higher than their fair market value. However, the value of the Residual Units for federal GST tax and income tax purposes remains their lower fair market value.

Gift Tax Reporting

Whenever a Residual Unit in the Freeze Entity is transferred, the transferor should file a federal gift tax return to make a timely election stating the presumed timing of the preferred payments on the Preferred Units and accepting the adverse transfer tax consequences for late preferred payments. Section 2701 does presume that preferred payments will be made when due on preferred equity interests that are the equivalent to cumulative preferred stock; however, Preferred Unit holders can never be sure whether Preferred Units in any entity other than a corporation will be treated as equivalent to cumulative preferred stock under Section 2701. If the holder of Preferred Units does not make this election on a timely filed gift tax return, the Preferred Units may have zero value for gift tax purposes regardless of their actual value or whether missed preferred payments will cumulate or even compound. If all of the rights associated with the Preferred Units are valued at zero, the liquidation value of the Preferred Units will be treated as transferred to the Residual Unit holders, potentially resulting in a taxable gift to the Residual Unit holders in that amount. Caution dictates that Preferred Unity holders should file the election to treat preferred payments as made on their respective due dates, instead of relying on the cumulation of missed preferred payments.

Setting the Market Rate by Appraisal

Preferred Units will have a gift tax value equal to their liquidation value when the preferred payment rate is a "Market Rate," meaning the rate of return paid on similar preferred equity interests determined while disregarding any extraordinary payment rights. The Code does not provide a safe harbor Preferred Rate; therefore, the rate generally is determined by an appraisal. Although an appraisal is not technically required, the Regulations contemplate that an appraisal will be used to satisfy the adequate disclosure requirements in the gift tax return. (If a freeze is not adequately disclosed in a federal gift tax return, the statute of limitations will not run and the IRS will have an unlimited time to assess a gift tax deficiency.) The failure to include an appraisal of the Units in the Freeze Entity that describes the sufficiency of the preferred payment rate is more likely to prompt an audit of the gift tax return, and diminish chances for successful defense in an audit.

An appraiser valuing units in the Freeze Entity must understand the valuation requirements of Section 2701, in particular how to determine the appropriate Market Rate to set the preferred payment rate. For example, if the appraisal recites that the Market Rate determination depended partially on the Preferred Unit holders' right to compel liquidation of the Freeze Entity – an extraordinary payment right that must be disregarded under Section 2701 – the IRS may argue that the Market Rate must be higher when that extraordinary right is properly disregarded. The appraiser may face difficulty in defending the reported valuation, and the taxpayer likely will need a second appraiser to substantiate the Market Rate, if possible. An appraiser will look at Preferred Rates on stock as a guide to determine the appropriate Market Rate, considering the terms of the preferred stock, such as whether the rate resets periodically or is fixed for the term, the coverage of the preferred payments and other factors not inconsistent with Section 2701.

If the rate on the Preferred Units is reset periodically in accordance with an objective guidepost, the Market Rate would be measured by short-term rates, which are usually less than long-term rates. However, the ability of the Preferred Unit holders to withdraw and force the redemption of their units at liquidation value might be considered a right to compel liquidation,

which Section 2701 would require be ignored for valuation purposes. Also, if the Market Rate is fixed, rather than floating, a risk would exist that the Preferred Unit holders would be considered as making a gift if Market Rates increased and they failed to withdraw. Fixing the Preferred Rate in the Freeze Entity agreement, therefore, necessitates denying the Preferred Unit holders the right to withdraw without the approval of the Trustee. Moreover, as a practical matter most families prefer the certainty of a fixed rate, even when that rate might not produce the maximum transfer tax savings.

Because the Freeze Entity agreement requires a fixed rate, the Market Rate would be measured by long term rates, rather than short term rates. Normally long term rates reflect that the investment may not be unilaterally terminated prior to its maturity date. If the Trustee could redeem the Preferred Units at any time, the Preferred Unit holders would have an investment that they could be stuck with indefinitely if rates go up, yet could be yanked from them if rates go down. This one sidedness would drive up the required Market Rate beyond the typical long term rate. Thus, the agreement reflects that neither the Trustee nor the Preferred Unit holder alone can force the redemption of the Preferred Units.

The appraiser should not only determine the Market Rate and the resulting gift tax value of the Residual Units, but also their potentially lower fair market value, which will apply for other federal tax purposes (i.e., income tax, estate tax, GST tax).

Timing of Preferred Payments

The most important consideration in operating the Freeze Entity is timely satisfaction of the preferred payments to avoid inclusion of a phantom amount in Preferred Unit holder's taxable gifts or taxable estate. Section 2701 provides a grace period of up to 4 years after the original due date to make a preferred payment. If a preferred payment is made after the grace period, Section 2701 computes a "phantom amount" determined as if the payment had been made to the Preferred Unit Holder when it was due (on its original payment date 4 years before) and then reinvested at the Market Rate, compounding annually. Moreover, making the late preferred payment will not stop annual increases in any outstanding phantom amount. Although the compounding on the past due preferred payment stops when the payment is actually made, the compounding of any outstanding phantom amount continues until the holder transfers the Preferred Units (the phantom amount is treated as a taxable gift) or dies owning the Preferred Units (the phantom amount is added to the taxable estate).

For example assume the Market Rate is 6% and that a $1000 preferred payment is due on December 31, 2007, but the payment is not made before the 4-year grace period expires on December 31, 2011. As a result, a phantom amount of the missed $1,000 payment with compounding at 6% per year is generated, or $1,262.48 as of January 1, 2012. A $1000 payment on January 1, 2012, reduces the phantom amount to $262.48, but this amount will continue to compound each year at 6%. The actual inclusion of the phantom amount in the Preferred Unit holder's taxable gifts or taxable estate will not occur until the occurrence of a relevant gift tax election, transfer of the Preferred Unit or the death of the Preferred Unit holder. As the cost for missing a preferred payment by even a day can be very high, it is crucial that payments be made within the grace period.

If the Freeze Entity lacks sufficient cash to make a preferred payment within the grace period, the Freeze Entity should make the payment by distributing property with the required fair market value or by borrowing. The Regulations, however, prohibit issuing a note or additional Freeze Entity equity to satisfy the payment. To facilitate satisfaction of preferred payments within the grace period and avoid potentially adverse transfer tax consequences, the Freeze Entity agreement grants the Preferred Unit holder a right to force distribution of a preferred payment if it is more than 3 years late and, as explained in the next section, to the extent tax profits are sufficient for the payment.

Interaction of the Gift and Income Taxes

The interaction of the gift tax rules under Section 2701 and the partnership income tax rules under Subchapter K of the Code complicates the determination of when, or even if, a preferred payment may be made. Section 2701 encourages timely payment of preferred payments to avoid adverse transfer tax consequences. Moreover, the Freeze Entity agreement provides for mandatory payment of the preferred payments if cash is generated, unless the Trustee has determined that the cash should be reinvested. The requirement that cash be used to pay the preferred priority amount also reduces the Market Rate. However, Subchapter K provides that if preferred payments may be made without regard to the Freeze Entity's "income," then the preferred payments are "guaranteed payments." The transfer of property other than cash to satisfy an obligation to make a "guaranteed payment" would constitute taxable sale of the asset by the Freeze Entity.

The plain text of Section 2701 seems to exclude guaranteed payments from its application for transfer tax purposes. However, the Regulations add another requirement to the exception: the guaranteed payments must be fixed in time and amount to escape Section 2701. For income tax purposes, the definition of guaranteed payment requires only that the payment be payable without regard to whether the partnership has income. As a result, the Regulations under Section 2701 actually deny the exception for most preferred payments that are guaranteed payments for income tax purposes. Thus, characterization of preferred payments as guaranteed payments only exposes Preferred Unit holders to potentially adverse income tax consequences without any transfer tax advantage. The Freeze Entity agreement avoids the creation of guaranteed payments by providing that a preferred payment should not be made unless the Freeze Entity has sufficient undistributed, realized tax profits to satisfy the payment. Although requiring payment of mandatory preferred payments from unrealized gains also would avoid creation of guaranteed payments, the holder would have taxable income both when the cash is distributed and later when the gains are realized if such cash amount exceeds the holder's basis in the Freeze Entity.

Due to the importance of making timely preferred payments, the Sample Freeze Agreement provides two discretionary ways to make a preferred payment despite the lack of sufficient realized tax profits, while avoiding treatment as guaranteed payments. First, the Trustee is authorized to "redeem" part or all of the "profits interest" of the Preferred Unit holders at any time. To "redeem" means that the Freeze Entity buys a holder's interest in the Freeze Entity, and the redemption proceeds can be cash or Freeze Entity assets valued at fair market value. "Profits interest" refers to the priority payments on the Preferred Units. At any time while unpaid preferred payments remain outstanding, the Trustee, in its sole discretion, can

distribute an amount to the Preferred Unit holders to satisfy those outstanding preferred payments without regard to the tax profits limitation. Thus, the Trustee can avoid characterization as guaranteed payments and any late payments overdue for more than 4 years. Because the preferred payment would be made at its "face" value, the Preferred Unit holder has no choice but to accept the payment.

In addition, if any preferred payment remains unpaid for more than three years, the Preferred Unit holder has a special power to compel its payment ("Timely Payment Power"). The Timely Payment Power allows the Preferred Unit holder to direct the Trustee to sell or otherwise dispose of Trust assets or take such other actions allowed under the Agreement as necessary to satisfy the preferred payment. Because the timeliness of preferred payments is a principal factor in determining the preferred payment rate of the Preferred Units, the Timely Payment Power helps reduce that rate. The Timely Payment Power serves another important purpose of justifying the Trustee's redemption of unpaid preferred payment amounts of Preferred Unit holders at face value. However, the Timely Payment Power, however, is subject to an important limitation that does not apply to a redemption of unpaid preferred payment amounts: the preferred payments cannot exceed cumulative undistributed net realized tax profits.

The 4 Year Dilemma

Section 2701 provides that the phantom amount resulting from a failure to make timely preferred payments cannot exceed the appreciation in the entity from the date of the freeze to the date when the phantom amount must be included in the Preferred Unit holder's taxable gifts or taxable estate. This transfer tax limitation on the phantom amount corresponds with the income tax limitation to avoid guaranteed payment treatment with one exception: unrealized gains are included in determining the transfer tax limitation but not in determining the income tax limitation. Therefore, the Sample Freeze Agreement is structured so that the Residual Unit holders' capital need not be used to make preferred payments, although it can be eroded to pay the Preferred Unit holders their capital value on liquidation (including payments upon exercise of the Timely Payment Power).

The limitation on the phantom amount applies when inclusion is triggered, rather than when its accrual begins. As a result, the Trustee will not know at the moment when the preferred payment is about to become 4 years late whether the Trustee should make that payment. As the possible transfer tax consequences of making a preferred payment more than 4 years late are irrevocable, the Trustee generally should make the payment. However, once the preferred profits interest is redeemed, the corresponding right to preferred payments can never be recovered (except perhaps by creditors), even if the Freeze Entity never appreciates in value. Thus, the Trustee and the holders face a dilemma at any time when a preferred payment is about to become more than 4 years late if the Freeze Entity assets have not appreciated as expected.

In the family context, the proper resolution of this dilemma is to liquidate the Freeze Entity. If liquidation would result in a loss of capital by the Residual Unit holders, the family's initial reaction will be to resist liquidation to avoid "wasting" a part of the original gift of Residual Units. However, if the holders contribute their property from liquidation of the original Freeze Entity to a new Freeze Entity, no additional gift would be needed to create the new entity.

Moreover, if the assets thereafter appreciate, none of that appreciation would be used to pay the first 4 years of outstanding preferred payments as would be required if the original Freeze Entity was not liquidated. In fact, the 4-year grace period should start anew as a technical matter. However, liquidating and reforming the Freeze Entity with the same owners would be treated as a continuation of the original entity for partnership income tax purposes. Although the income tax treatment should be meaningless for gift tax purposes, a court is likely to conclude that taxpayers cannot repeatedly re-start the 4-year grace period.

Valuation of the Preferred Units

Because the preferred payment rate is set by reference only to the Market Rate and other factors affecting the security of the preferred payments, the value of the Preferred Units is unlikely to be discounted for gift or estate tax purposes. Because the preferred payment rate is set without regard to the Preferred Units' lack of vote and their lack of marketability, it would be inappropriate to claim these discounts when valuing the Preferred Units even if Section 2701 does not apply to the transfer. Moreover, if the Preferred Units have rights that have been disregarded for purposes of Section 2701, then the Preferred Units will have a lower value under Section 2701 than their fair market value. (The Freeze Agreement avoids creating such additional rights for this reason).

Typically, Preferred Units are valued at liquidation value for transfer tax purposes other than under Section 2701, such as gift and estate tax purposes. However, the Preferred Units should fluctuate in value due to changes in prevailing Market Rates after the units are issued. If rates go down and the risk of nonpayment of the preferred amount remains unchanged, the Preferred Units should increase in value. Although the "lower of" rule discussed above prevents any increase in the value of the Preferred Units for purposes of Section 2701 as to transfers of Residual Units, that rule does not apply when Preferred Units are transferred. If rates go up and the risk of nonpayment remains unchanged, the Preferred Units should decrease in value. If a Freeze Entity succeeds and its assets appreciate over time, then the Freeze Entity assets will provide more coverage for the preferred payments. The increase in coverage would reduce the risk of failure to make the preferred payments, which arguably should reduce the preferred payment rate or increase the value of the Preferred Units. Accordingly, the Trustee and the Preferred Unit holders should consider the redemption of the Preferred Units, or the conversion of the Preferred Units to Residual Units, when the objectives of the freeze have been accomplished, particularly if the Preferred Units might be included in their holder's taxable estate at a value higher than liquidation value.

Inclusion of Freeze Entity Assets in the Investor's Estate under Section 2036

Courts following the decisions in *Strangi v. Commissioner* have held that investment assets contributed to a family limited partnership ("FLP") in exchange for partnership interests should be included in the contributor's estate under Section 2036. Even if Section 2036 applies beyond trusts to partnerships, the IRS may be less likely to challenge a Freeze Entity than a standard family limited partnership ("FLP") for several reasons. The IRS has challenged the validity of many FLPs under Section 2036(a)(1) 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 and they have

retained all of their original rights and interests in the property. 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 to the economic reality of the Freeze Entity, legal distinctions separate the Freeze Entity from standard FLPs. 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. In addition, 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. The *Strangi* court focused on powers over partnership distributions and applied Section 2036(a)(2) to conclude that the partnership assets should be included in the contributor's estate. However, Congress considered and addressed ownership interests in family-owned businesses in the enactment of Section 2701 and other Chapter 14 provisions. The Freeze Entity also provides that an independent Trustee makes all distribution decisions, thereby increasing the protection against a claim that Section 2036 should apply to the assets contributed by a Unit holder.