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Subject: Preferred Partnership Freezes by N. Todd Angkatavanich & Edward A. Vergara

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Preferred Partnership Freezes

They come in different flavors; and provide a menu of creative planning solutions

By N. Todd Angkatavanich & Edward A. Vergara

Preferred partnerships (Pps) are very useful and versatile estate planning vehicles that have been around for decades, yet still appear to fly under the radar. From an economic perspective, a PP is often well-suited to act as a multi-generational family investment vehicle; older generations are typically seeking a steady income flow and protection of capital, while younger family members are often willing to forego current income and capital security for the prospect of capturing upside growth. Much as one balances an investment portfolio between fixed income and equities based upon the particular needs at a given stage of one's life, a PP can provide for such a division of economic interests within a private investment vehicle. From an estate planning perspective, these partnerships are sometimes referred to as “freeze partnerships,” because they provide a structure that enables one class of partnership interests, typically held by a senior generation family member, to be “frozen” or limited to a fixed rate of return, thereby enabling the future appreciation in excess of that fixed rate to inure to the benefit of the other class of partnership interests, typically held by younger generations or trusts for their benefit. As with many estate freeze techniques, such as grantor retained annuity trusts (GRATs) or sales to grantor trusts, the freeze partnership is an attractive estate planning technique because, if structured properly, it may be implemented with the use of little or no lifetime gift tax exemption.

Practitioners can augment the “vanilla” PP structure by using it in conjunction with other planning techniques, such as qualified terminable interest property (QTIP) trusts, GRATs and charitable lead annuity trusts (CLATs), in which the growth of assets in a tax-inefficient trust can be contained in favor of growth occurring in other more tax-efficient trusts. Additionally, a PP can be very useful in less traditional types of planning arrangements, such as planning with transfers of fund carried interests, planning to minimize the draconian “throwback rules” applicable for foreign non-grantor trusts and planning to minimize growth of assets in a C corporation.

A PP can provide a very useful planning solution, when it may be desirable to divide the economic interests of a particular investment or entity into cash flow and growth interests. Here's an overview of some planning options that practitioners might consider.

Pps in General

A PP is a statutorily blessed vehicle under Internal Revenue Code Section 2701 that, with the right assets, can provide one partner — typically the senior generation family member (the parent) — with fixed cash flow through the issuance of preferred interests, while at the same time shifting future growth in excess of the preferred coupon away from the parent's taxable estate through the issuance of common “growth” interests, in a transfer tax-efficient manner. Typically, a PP is created by a parent contributing[1] assets to an entity, such as a partnership or limited liability company, in exchange for preferred interests that pay a fixed, cumulative, annual preferred return.[2] A child (or, perhaps, a generation-skipping transfer (GST) tax-exempt trust for the child's benefit) would contribute assets to the partnership in exchange for common interests in the entity; the parent would typically also contribute additional assets in exchange for a modest common interest in the entity to ensure that the parent is considered a partner in the entity. Alternatively, the parent could initially own both the preferred and common interests and subsequently transfer common interests by gift or sale to the child or trust.

In a typical PP, the parent holding preferred interests would receive a fixed annual cumulative preferred interest payment but wouldn't receive any of the potential upside growth of PP assets in excess of the preferred coupon (other than any upside growth attributable to the common interests owned by the parent, if any). The parent would also receive a liquidation preference entitling the parent to a priority return of his capital contribution upon liquidation of the partnership. The child, or trust for the child's benefit, would receive the upside growth potential represented by the common interests above the amount needed to pay the preferred coupon and the liquidation preference to the parent. Over time, if the PP investments outperform the required coupon on the preferred interest, the common interest would appreciate in value, thereby enabling the growth in the entity in excess of the preferred coupon and liquidation preference to be shifted to or for the benefit of the younger generation. The parent's preferred interests, however, would be frozen for estate tax purposes at the amount of the preferred coupon, and the liquidation preference and the excess appreciation attributable to the common interests would pass gift and estate tax-free to the next generation(s).

Gift Tax Formation Issues

Practitioners must consider various issues in connection with the formation of a PP. Most notable is IRC Section 2701, which will generally result in a deemed gift upon a parent's contribution of assets[3] to the PP under a “subtraction method” of valuation unless very specific requirements are satisfied with respect to the parent's preferred interest.

To avoid a deemed gift upon contribution to the partnership, the parent's preferred interest in the PP typically will be structured as a “qualified payment right,” which requires that the parent receive a fixed percentage return on his capital contribution, payable at least annually and on a cumulative basis.[4] When a parent retains a preferred interest that satisfies the requirements of a qualified payment right, the parent's preferred interest won't be valued at zero for gift tax purposes, but rather, the parent's preferred interest will be valued under traditional valuation principles.

In structuring the rights associated with preferred interests in the PP, it's also imperative that the parent not retain any extraordinary payment rights under the Section 2701 regulations, which include puts, calls, conversion rights and rights to compel liquidation, the exercise or non-exercise of which affects the value of the transferred interest.[5] The restriction on "extraordinary payment rights" is meant to ensure that the preferred interest holder doesn't retain any discretionary rights that aren't retained by the common interest holders. Inadvertently retaining an extraordinary payment right in combination with a qualified payment right would also result in a deemed gift upon the parent's capital contribution under the so-called "lower of" rule.[6]

Even if the parent's preferred interest is properly structured in compliance with Section 2701, it's still critically important that the amount of the annual preferred coupon is properly determined to ensure that the parent won't be deemed to have made a partial gift upon contribution of assets into the partnership under traditional valuation principles. The parent should obtain a valuation appraisal from a qualified appraiser to determine the proper amount of the preferred coupon so that the preferred interest holder receives par value for his capital contribution. Revenue Ruling 83-120 provides guidance on the factors that the Internal Revenue Service considers the most relevant in determining the adequacy of the preferred coupon.[7] To determine the amount of the preferred coupon, an appraiser should analyze comparable preferred interest returns on high quality publicly traded securities and compare several factors, including the security of the preferred coupon, the size and stability of the partnership's earnings, asset and income coverage, management expertise, business and regulatory environment and any other relevant facts or features of the particular PP. Under the guidance set forth in Rev. Rul. 83-120, the partnership's coverage of the preferred coupon (that is, its ability to actually pay the required coupon) and its coverage of the liquidation preference (that is, its ability to pay the liquidation preference) will greatly influence how large the preferred coupon percentage will have to be. To the extent that a PP is created with a substantial percentage of the partnership interests consisting of preferred interests, there would be less common interests available to support the larger amount of preferred payments required to be paid annually, thus resulting in weaker coverage. Weaker coverage of a partnership translates to greater risk of the partnership failing to make the required payments and, consequently, a higher required coupon. Most Pps strive for a lower percentage coupon payable to the parent, so as to shift more asset growth to the common interests held by the younger generation. A prohibitively high preferred coupon, resulting from too high a proportion of preferred interests, is generally undesirable. In light of the recent increase of the lifetime gift tax exemption from $1 million to $5 million, it will be easier for a parent to fund a new trust using his lifetime gift tax exemption, so that the trust could initially own a larger common interest in a PP. Having the trust make a larger investment in common interests would provide stronger coverage that should help support a lower coupon. It should be noted that under a minimum value rule, the common interest should be at least 10 percent of the total value of the equity interests.[8]

Assuming that the parent receives an adequate coupon rate for his qualified payment right, and that the requirements of Section 2701 are satisfied, the parent should be deemed to have received full value for his contribution to the partnership at par value, and there should be no deemed gift by the parent. Determining an adequate preferred coupon is also important from the standpoint of ensuring that the "bona fide sale for an adequate and full consideration" exception to IRC Section 2036(a) applies, so that the parent's capital contribution isn't determined to constitute a "transfer" to the PP with a retained interest.

Income Tax Formation Issues

In addition to considering gift tax issues, practitioners must consider the partnership tax issues in connection with the formation of the partnership to ensure that no gain will be recognized as a result of the contribution of assets into the PP. Partnership assets consisting of securities should recognize no gain as a result of the capitalization of the partnership if no diversification occurs under IRC Section 721(b) as a result of a partner's capital contribution. Accordingly, if both partners already have diversified portfolios, as defined in the regulations, then the contributions of their portfolios into the PP shouldn't result in gain under the diversification rules. Alternatively, if at least 20 percent of the partnership assets consist of real estate or other non-security assets, this too would avoid recognition of gain as a result of the capitalization. Lastly, under the so-called "de minimis" exception, if one of the partners contributes assets that are de minimis in amount, the contribution of

those assets also wouldn't result in diversification. Although an example in the Treasury regulations indicates that a contribution of less than 1 percent would be de minimis, private letter rulings have concluded that up to a 5 percent contribution would be de minimis.[9]

Freezing a QTIP

Conventional estate planning wisdom is that, following the death of the first spouse to die and the funding of a QTIP trust under the deceased spouse's estate plan, the assets of a QTIP trust will eventually be subject to estate tax in the surviving spouse's estate under IRC Section 2044, based upon the value of the trust's assets at that time. In larger estates, in which the majority of the deceased spouse's assets may pass to a QTIP trust, the estate tax bill with respect to the QTIP trust could be substantial at the time of the surviving spouse's death.

There's an often overlooked estate planning opportunity that exists in the context of the administration of a QTIP trust that can have the effect of shifting potential appreciation away from a QTIP trust, perhaps into a credit shelter trust, or to children or trusts for their benefit, thereby removing that appreciation from the surviving spouse's taxable estate. A properly structured PP coupled with a QTIP trust may result in significant transfer tax savings in this manner.

The creation of a PP with a QTIP trust would involve the QTIP trust owning the preferred interests in the entity, with the children or trusts for their benefit owning the common interest.[10] The QTIP trust would receive its preferred fixed coupon return, which would be paid to it before any distributions with respect to common interest holders would be made. All of the appreciation of the assets of the partnership in excess of the amounts required to satisfy the coupon payments and liquidation preference would inure to the benefit of the common interest holders and, therefore, will pass outside of the QTIP trust free of estate tax at the surviving spouse's death.

This application could also be achieved with a qualified domestic trust so as to contain the growth of the trust assets that will eventually be subject to estate tax upon the death of a non-U.S. surviving spouse. What's more, payment of the preferred interest should constitute fiduciary accounting income, which can be paid to the non-citizen spouse and potentially avoid U.S. estate taxation as a distribution of income.

QTIP PP Gift Formation

In addition to the considerations discussed above with respect to the formation of a PP, it's critical to consider IRC Section 2519 when coupling a PP with a QTIP trust. Broadly speaking, Section 2519 provides that if the income interest holder of a QTIP trust transfers that income interest, then the income interest holder (that is, the surviving spouse) will be deemed to have made a taxable gift of the entire interest of the QTIP trust. In the context of a PP, the question is whether the creation of the partnership with the contribution by the QTIP trust of its assets into the partnership will be construed to be a disposition of the surviving spouse's income interest in the QTIP trust, thereby triggering a gift under Section 2519. There's authority suggesting that a properly structured partnership capitalization shouldn't be deemed a disposition of an income interest under Section 2519. Field Service Advice 199920016 considered this very issue in which a QTIP trust and various family members created a family limited partnership. The QTIP trust received limited partnership interests (the FSA involved a single class limited partnership, rather than a preferred limited partnership). The partnership made regular distributions of income to its partners. Based upon these facts, the IRS determined that no disposition would be made under Section 2519 of the surviving spouse's income interest in the QTIP trust. The IRS' conclusion under Section 2519 was based on the fact that the QTIP trust was receiving regular distributions of income from the partnership so that there was no disposition of an income interest. Additionally, the IRS noted that the surviving spouse had the right to compel the QTIP trustee to convert the trust's assets into income-producing property, which further supported the conclusion that no disposition of an income interest occurred as a result of the capital contribution. Under this logic, it would appear that in the case of a PP, no Section 2519 disposition should be deemed to occur upon formation, particularly in light of the fact that the QTIP trust would be entitled (rather than have a mere history and expectation of continued distributions, as was the case in the FSA above) to a preferred coupon

payable on an annual basis, cumulatively, and those distributions would need to be made before any distributions could be made to the common partnership interest holders.

PP GRAT

GRATs are generally considered to be conservative techniques for shifting wealth due to the fact that they're statutorily prescribed vehicles under IRC Section 2702. Of course, one of the shortcomings generally associated with GRATs is that GST tax exemption can't be effectively allocated to a GRAT during the GRAT trust term due to the application of the estate tax inclusion period (ETIP) rule.[11] Thus, GRATs are generally considered to only be effective for transferring wealth down to the next generation, but not on a multi-generational basis. In addition, the GRAT technique has inherent estate tax risks due to the risk of inclusion of some of the GRAT assets in the grantor's estate under IRC Section 2036(a)(1) if the grantor dies during the GRAT term. If the proposal to impose a minimum GRAT term of 10 years eventually becomes law, the mortality risk will be significantly heightened.

The creation of a PP GRAT, which involves the combination of a statutory GRAT with a statutory PP, may provide a way to obtain the statutory certainty of a GRAT while at the same time shifting appreciation into a GST tax-exempt trust and limiting the amount of potential estate tax inclusion if the grantor dies during the GRAT term.[12] This technique dovetails the planning advantages of the PP with those of a GRAT by combining these two statutorily prescribed techniques. Initially, the parent and a pre-existing GST tax-exempt trust would create a PP, with the parent owning preferred interests and the GST tax-exempt trust owning common “growth” interests. Thereafter, the parent would gift his preferred interest to a long-term (for example, 12 years to 15 years) zeroed-out GRAT, while the GST tax-exempt trust would continue to hold the common interests. The GRAT would be funded by the parent with the preferred interest in the PP and would be structured with a sufficiently long term so that the preferred coupon payments made annually to the GRAT would be large enough to allow the GRAT to make its required annuity payment to the grantor. The GST tax-exempt trust, as the common interest holder, would benefit from the potential upside growth above the amount attributable to the preferred interests in the PP. At the end of the GRAT term, if the parent is living, the GRAT remainder would be distributed to the intended beneficiaries or trusts for their benefit in a GST non-tax-exempt solution. In any event, however, appreciation in excess of the preferred payments will have passed into the GST tax-exempt trust and will be outside the parent's estate. The state tax exposure to the parent's estate should be limited to the preferred interests gifted to the GRAT (but not the common interest), as the parent never owned or transferred them.

Ideally, the preferred coupon payments made to the GRAT from the PP would be sufficient to allow the GRAT to satisfy the annual annuity payments due to the parent. By transferring his preferred interest to a GRAT, the parent is able to shift any spread between the appreciation in PP assets and the preferred coupon payment to the GST tax-exempt trust.

If the proposal to create a 10-year GRAT minimum term[13] becomes law, the PP GRAT may provide an interesting way to minimize the mortality risk associated with a longer term GRAT, while at the same time minimizing the GST allocation limitations associated with the longer ETIP.

“Rolling” PP GRAT

Of course, if the proposed 10-year GRAT minimum term becomes law, one of the obvious consequences will be the elimination of the so-called “rolling GRAT” technique, in which the annuity payment that the grantor receives each year is “recycled” into subsequent short-term GRATs as a way to continuously shift future appreciation gifts tax-free to the next generation. If the 10-year GRAT minimum becomes law, there still may be a way to obtain some of the “recycling” benefits of the rolling GRAT through the PP GRAT structure.

After establishing the PP GRAT, when the parent receives the annuity payment from the GRAT (that has been funded by the parent's gift of preferred interests), the parent could make a subsequent capital contribution into

the PP in exchange for newly issued preferred interests. The parent could thereafter gift those new preferred interests into a new long-term GRAT, and as a consequence, enable the upside growth in the newly contributed partnership assets to shift to the partnership's common interest holders (that is, the GST tax-exempt trust). While the new long-term GRAT would have a longer mortality period, only the newly gifted preferred interests in the new GRAT should be subject to potential estate tax inclusion. The upside growth potential in the assets will be shifted to the GST tax-exempt trust as the common interest holder, without the estate tax risk.

There are other complexities when the parent makes an additional capital contribution in exchange for a new preferred interest in the partnership, including determining whether making an additional capital contribution makes economic sense, obtaining a new appraisal to determine the appropriate preferred coupon for the newly issued preferred interests, analyzing the "diversification" issues under IRC Section 721(b) and potential issues under Section 2036(a), all of which would need to be very carefully considered.

PP CLAT Variation

Conceptually similar to the PP GRAT is the PP CLAT. Rather than the parent contributing his interests in the PP into a GRAT and personally retaining an annuity interest, the parent would contribute PP interests to a CLAT with the annuity payment stream payable to a charity. Assuming the CLAT is structured as a grantor CLAT, this would provide the parent with an upfront income tax deduction, subject to adjusted gross income limitations. As with the PP GRAT, a pre-existing GST tax-exempt trust would hold the common interest. By funding the CLAT with PP interests, the growth of the remainder interest in the CLAT that would generally not be GST tax-exempt will be contained, thereby allowing future growth to be shifted to the GST tax-exempt trust.

Reverse PP

A reverse PP is similar to a PP in that the parent may use the technique to transfer the appreciation of an asset out of his estate and into the hands of his children. However, instead of the parent holding the preferred interest, as with the standard vanilla PP, the parent retains the common "growth" interest and transfers the preferred interest to his children. The use of a reverse PP is attractive because it's not subject to Section 2701, allowing for greater flexibility in structuring the preferred payment. As with the PP, it's necessary to obtain an appraisal of the preferred interest. However, by structuring the ratio of preferred versus common interests so as to increase the entity's preferred payment obligations and consequently diminish the strength of the entity's coverage, it may be possible to structure the preferred interest to maximize the required coupon payment. Maximizing the preferred interest payment would increase the value transferred to younger generations and, consequently, would minimize the likelihood for growth in the value of the common interests held by the parent, thus effectuating a reverse PP.

PP Carried Interest Planning

Use of a statutory PP or possibly a reverse PP can provide a creative solution to some of the limitations of the so-called "vertical slice rule" that has presented challenges to trusts and estates lawyers in the carried interest transfer planning context.[14] While there are several methods of addressing this complex and thorny issue, "non-vertical" planning utilizing different forms of Pps may provide effective approaches to addressing the dreaded Section 2701 risks when planning for transfers of carried interests. These approaches may be particularly useful when planning for a fund principal who may have committed a substantial amount of capital into the fund as a limited partner, and, consequently, may be limited in the percentage of the carried interest that can be transferred without significant gift tax if planning using a more traditional vertical slice approach.

Non-vertical PP planning, broadly speaking, would involve a fund principal first contributing all of his fund general partner interests (containing the carried interest) and all of his fund limited partnership interests into a holding entity that would be structured as a PP or reverse PP. Thereafter, the fund principal would transfer some or all of the common growth interests in the holding entity to the children or trusts for their benefit while retaining the preferred interests in the partnership. As described above, because the preferred interest in the

holding entity that the parent would retain would be structured to be a qualified payment right, the zero valuation deemed gift rule wouldn't apply in valuing the transfer of the gifted common interest to the children.[15]

To achieve additional flexibility, each annual preferred payment due to the fund principal from the PP could be deferred for up to four years, plus an additional four years through the issuance of a promissory note, while shifting the upside growth potential, attributed in large part to appreciation in the carried interest, to the next generations.[16] This flexibility may be particularly helpful when representing principals of private equity funds, in which capital may be tied up in the investments for several years before realizing a return.

Throwback PP

Pps can also be very useful in the international trust-planning context. One example would be the use of a PP in connection with foreign trusts to limit the application of the so-called "throwback tax." A foreign non-grantor trust that fails to distribute all income and gains in a given taxable year may cause U.S. beneficiaries of the trust to be subject to an onerous penalty tax when previously accumulated earnings are distributed in a later year.[17] The application of the throwback tax depends on the presence of two factors: (1) the foreign trust has an accumulated income account; and (2) the trust makes a distribution in excess of current year distributable net income (DNI) and fiduciary accounting income (FAI). Importantly, the DNI of a foreign trust includes realized capital gains.

A throwback PP can be a useful tool for limiting the amount of income realized by a foreign non-grantor trust from year to year, which would, in turn, minimize the amount of income that may be subject to the throwback tax. If, for example, the foreign non-grantor trust held a common interest in a PP, the trust would receive income from the partnership only if and when the realized income and gains in the PP exceeded the cumulative value of the preferred coupon payments. Thus, the trust would participate in the growth of the value of the PP assets while minimizing the production of current income (and therefore minimizing the chances of creating or increasing the value of the trust's accumulated income account) from year to year. This planning could minimize or eliminate the bite of the throwback tax when a distribution is made in a later year.[18]

A throwback PP may also be useful in the context of foreign trusts when the foreign non-grantor trust already has significant accumulated income. Pursuant to IRC Section 655(b), an accumulation distribution occurs (and a throwback tax is potentially triggered) only if and when a trust distribution exceeds both current year DNI and current year FAI. Under the laws of most jurisdictions, the coupon payment received on a PP interest will qualify as income for FAI purposes.[19] Therefore, the coupon could act as something of a safe harbor for the foreign non-grantor trust in avoiding accumulation distributions — as long as the year's distribution didn't exceed the coupon payment, an accumulation distribution wouldn't incur. A PP structured with a high yield coupon, perhaps through a reverse PP, could provide a means for the foreign non-grantor trust to make significant distributions of value without causing an accumulation distribution and the imposition of a potential throwback tax.

C Corporation Planning

The PP technique (or reverse PP) may also be used to contain the growth of assets in a C corporation that would otherwise be subject to double taxation, without causing a liquidation of the corporation. This could be accomplished if a C corporation contributes its assets to a PP in exchange for preferred interests, while other individuals or trusts hold the common interests. By having the C corporation own the frozen interests, growth of the C corporation will be limited to its preferred coupon, while the upside growth in the PP's assets beyond the preferred coupon amount would be shifted over to the common interest holders, thus limiting the amount of appreciation that would otherwise be subject to double taxation upon the eventual liquidation of the C corporation.

— The authors would like to thank Chi-Yu Liang, an associate at Withers Bergman LLP in New York, for her valuable contributions to this article.

Endnotes

1. A preferred structure could also be created by a recapitalization of an existing single class entity. See Treasury Regulations Section 25.2701-1(b)(2).
2. Since a preferred structure can be implemented with a partnership or a limited liability company (LLC), for purposes of this article, when the term "partnership" is used, it shall also be intended that an LLC structure be included.
3. Internal Revenue Code Section 2701 is applicable not only to the initial capital contributions to a new entity, but also to recapitalizations and other events changing the capital structure of an existing entity.
4. IRC Section 2701 (c)(3).
5. Treas. Regs. Section 25.2701-1(a)(2)(i).
6. Treas. Regs. Section 25.2701-2(a)(3).
7. Revenue Ruling 83-120, 1983-2 C.B. 170.
8. IRC Section 2701(a)(4).
9. *See* Example (1) of Treas. Regs. Section 1.351-1(c)(7), Private Letter Ruling 9345047 (Aug. 17, 1993) and PLR 200006008 (Sept. 30, 2009).
10. Practitioners should be aware that the surviving spouse who's the beneficiary of a qualified terminable interest property trust generally would have the right to compel the trustees to make trust property income-producing to satisfy the requirements of Treas. Regs. Section 20.2056(b)-(5)(f)(1).
11. IRC Section 2642(f)(3); Treas. Regs. Section 26.2632-1(c)(1).
12. This technique was originally discussed at length in N. Todd Angkatavanich and Karen E. Yates, "The Preferred Partnership GRAT — A Way Around the ETIP Issue?" 35 *ACTEC Journal* 289 (2009).
13. *See* the Small Business and Infrastructure Jobs Act of 2010 (H.R. 4849), the Small Business Jobs Tax Relief Act of 2010 (H.R. 5486) and the Responsible Estate Tax Act (S. 3533 and H.R. 5764).
14. This technique was originally discussed in detail in N. Todd Angkatavanich and David A. Stein, "Going Non-Vertical With Fund Interests — Creative Carried Interest Transfer Planning: When the 'Vertical Slice' Won't Cut It," *Trusts & Estates* (November 2010) at p. 22.
15. Treas. Regs. Section 25.2701-2(b)(6).
16. Treas. Regs. Section 25.2701-5.
17. *See* IRC Section 665 et. seq.
18. The authors would like to acknowledge the contribution of their partners, James R. Brockway and Richard A. Cassell, in connection with this planning idea.
19. This would certainly be the case under most versions of the Uniform Principal and Income Act.

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