WHAT IS IT?

In the most fundamental sense, an estate freeze is any planning device where the owner of property attempts to freeze the present value of his estate and shift the future growth to successors, generally the next generation. It may also involve the retention of some form of income stream or cash flow from the property.

This definition of an estate freeze is so broad it includes a variety of techniques, including installment sales of property (see Chapter 35), private annuities (see Chapter 36), a variety of gift planning techniques (see Chapter 22), and buy-sell agreements (see Chapter 40). The term’s general use, however, has been more limited to cover the structuring of family businesses and investments in such a way that the original owners retain much of the present value and control, and some source of revenue, while the growth is shifted. The usual vehicle is the family limited partnership (see Chapter 43), or limited liability company (see Chapter 44), or corporation (see Chapters 46 and 47).

In the case of the family corporation, the senior generation typically retains control through the use of voting preferred stock that has a fixed liquidation value, usually par value. Either by forming a new corporation or recapitalizing an existing one, one or more classes of common stock are created, which may be nonvoting or at least have limited voting rights. All or part of this common stock is sold or given to the next generation.

The counterpart in the case of the partnership is the formation or restructuring of an existing partnership in such a way that the senior family members retain partnership interests that control the management of the business or investments, from which they receive preferred profit distributions, but which have a fixed liquidation value. Thus, the retained partnership interests resemble preferred stock in a corporation. The remaining partnership interests may then, like the common stock in the case of a corporation, be sold or given to the next generation.

WHEN IS THE USE OF SUCH A DEVICE INDICATED?

Where a family business is involved, the freeze has been an important planning tool to assure retention of the enterprise in the family at minimum tax cost. The same may apply to family investments, particularly real estate. It will only be used where there is a desire to perpetuate the business or investment within the family.

WHAT ARE THE REQUIREMENTS?

As discussed above, a business entity, either a corporation or a partnership, must be created or altered to structure this form of a freeze. The retained stock or partnership interests of the senior generation must have a limited liquidation value, since that is what makes it impossible for the value of those interests to grow. The retention of preferred dividends or profit distributions is not essential, but adds to the value of the retained interest, which in turn reduces the value of the interests transferred to the next generation. Since the transfer of interests may, and probably will, have gift tax implications, the value of the retained interests is very important.

HOW IT IS DONE – AN EXAMPLE

Client owns 100 percent of the common stock in Acme Corporation, a manufacturing concern. It has been valued at $1,000,000. He wants to bring his two children into the business, give them an incentive to work there by giving them an equity stake in the enterprise, and minimize his own gift and estate taxes.

Client recapitalizes the corporation with $1,000,000 par value preferred stock with an 8 percent cumulative preferred dividend and common stock. The preferred stock is voting, and in the event of corporate liquidation, the preferred shareholders can receive only par value for it. The common stock is then transferred by gift or sale to the children.

WHAT ARE THE TAX IMPLICATIONS?

1. IRC Section 2701, titled “Special valuation rules in case of transfers of certain interests in corporations or partnerships” (applicable to transactions entered into after October 8, 1990), focuses on the valuation of retained senior interests in such entities...
in determining the extent of taxable gifts of other junior interests in the same entity. It also deals with the transfer tax treatment of the retained interests, and how those retained interests will be valued for subsequent transfers during life or at death.

2. Also to be considered in this area is IRC Section 2704, providing, in general, that most lapsing restrictions on transferred interests in businesses created after October 8, 1990 will be ignored in valuing the interest for transfer tax purposes, or the lapse itself will trigger a transfer tax. This involves situations in which restrictions are imposed on the value of retained stock or partnership interests, which depress the value of those interests. After the owner dies, these restrictions either lapse or can be readily removed by family members.

Section 2701

How Retained Interests Are Valued for Gift Tax Purposes

For the purposes of determining whether or not the transfer of interests in partnerships or corporations to family members are gifts, and the value of the gifts, any retained interest in the partnership or corporation must be valued under IRC Section 2701, unless it falls within an exception.

The assumption under the statute is that the value of the residual interests transferred to “family members,” in this case corporate stock or partnership interests, will be valued by subtracting from the total value of the entire corporation or partnership the value of any retained interests that have preferred rights, adjusted to reflect the proportionate interest of the transferor in the business entity.

For purposes of Section 2701, “family members” are the transferor’s spouse, lineal descendant of the transferor or spouse, and the spouse of any descendant.

Covered transfers include contributions to capital, redemptions, and other changes in capital structure, as well as any transfer that increases the property owned by the entity or the value of the applicable retained interest (defined below) of the transferor or applicable family members, including transfers to a start up entity. A sale is covered by these valuation rules if there is an applicable retained interest (e.g., the sale of common stock in the entity for its full fair market value where the transferor retains preferred stock).

Example: Transferor owns 100% of the common stock of a corporation worth $1,000,000. He recapitalizes, taking voting preferred stock with a par value of $1,000,000 and paying a cumulative preferred dividend of 8%, and made a gift of the nonvoting common stock to his children. The gift is valued at $1,000,000 less the value of the preferred stock.

According to Section 2701(b), what is valued under the statute is an “applicable retained interest,” which is:

1. A “distribution right,” if immediately after the transfer the transferor and “applicable family members” control the entity; or

2. Liquidation, put, call, or conversion rights.

A distribution right is defined as a right to distributions from a corporation with respect to its stock or a partnership with respect to a partnership interest, except:

1. Rights in connection with “junior equity interests,” defined as common stock or partnership interests under which rights to income and capital are junior to all other equity interests.

2. “Liquidation, put, call, or conversion rights,” defined as any such right, or similar right, that affects the value of the transferred interest. However, the term does not include any right that must be exercised at a specific time at a specific amount.

3. Rights to guaranteed payments from a partnership defined in IRC Section 707(c), which are certain payments determined without regard to partnership income.

“Control” means at least a 50 percent interest in a corporation by vote or value of the corporate stock, or at least 50 percent of the capital or profits in a partnership, or the holding of any partnership interest as a general partner. Control includes interests held by “applicable family members.” It also includes attribution through entities and interests held by brothers or sisters or lineal descendants of an individual.

An “applicable family member” means the transferor’s spouse, ancestor of the transferor or transferor’s spouse, or the spouse of an ancestor.
According to the regulations, applicable retained interests include extraordinary payment rights and distribution rights in a controlled entity.9 As noted, guaranteed payments from a partnership covered by IRC Section 707(c), and possibly other rights to distributions under IRC Section 707, are excluded from Section 2701. Also excluded from this definition are any rights to distributions of the same class as the transferred interests.

Extraordinary payment rights are retained put, call, conversion rights, and rights to compel liquidation, or similar rights.10 A right falls within this definition only if it affects the value of the transferred interest.

Certain rights, such as the right to mandatory payments fixed as to time and amount are neither extraordinary payment rights nor distribution rights.11 Thus, mandatory redemption rights (e.g., a requirement that preferred stock be redeemed at a fixed price at a time certain) are not covered. A right to participate in a liquidation is not covered unless the transferor, family members, and applicable family members can compel liquidation.

Nonlapsing conversion rights in a corporation (i.e., the right to convert an equity interest into a fixed percentage of shares of the transferred interest except for nonlapsing differences in voting rights) are not covered. Similar rights in a partnership are also not covered (e.g., where all rights in partnership interests are the same except for nonlapsing differences in management rights and limitation of liability).

If the transferor retains both a qualified payment right and an extraordinary right, the value of all rights is determined by assuming the extraordinary right is exercised in such a way as to produce the lowest possible valuation.12 The special valuation rules do not apply to the transfer of any interest for which market quotations are readily available on the date of transfer from an established securities market,14 and the following retained interests are specifically excluded from these special valuation rules:

1. An interest that can be valued on an established securities market.
2. An interest that is of the same class as the transferred interest.
3. An interest that is proportionately the same as the transferred interest, except for nonlapsing differences in voting rights or, in the case of a partnership, nonlapping differences in management and limitations on liability unless the transferor or applicable family member can alter the liability of the transferee.

The valuation of the applicable retained interest is zero, except to the extent it consists of the right to receive a “qualified payment.”15 Qualified payments are any periodic dividend on cumulative preferred stock, any comparable payment from a partnership interest, or any other payment where an irrevocable election is made to treat other payments, such as noncumulative preferred dividends, as qualified payments. Further, an irrevocable election can be made out of qualified payment status, in which case the distribution right will apparently be valued at zero. The right to a qualified payment is to be valued at fair market value (i.e., what a willing buyer would pay a willing seller for it).

The rules of Section 2701 are complex. Possibly the following summary of how the section works will be helpful:

Section 2701 applies to an interest in a corporation or partnership transferred to a family member where the transferor or “applicable family member” retains a certain interest in the enterprise classified as an “applicable retained interest.” If the section applies, the gift resulting from the transfer is determined by subtracting from the value of the entire entity the value of any interests senior to those transferred.

The applicable retained interest consists of the following:

1. An “extraordinary payment right” (i.e., a discretionary liquidation, put, call, conversion, or similar right, valued at zero).
2. A distribution right, also valued at zero unless it is a “qualified payment” right.
3. A qualified payment right, generally a fixed-rate cumulative payment, or a payment which the transferor elects to treat as such a payment, valued as if the rights valued at zero do not exist, but otherwise without regard to Section 2701.

If an extraordinary payment right is held in conjunction with a qualified payment right, the rights are valued on the assumption they will be exercised in such a way as to produce the lowest possible value.
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The Minimum Value Rule

Since the value of the gift under the above rules is determined by subtracting the value of the retained qualified payment from the value of the entire entity, it is possible the result could be a small amount where the value of the qualified payment is large. However, regardless of the results of the subtraction method, the minimum value that can be assigned to the transfer of a junior equity interest is 10 percent of the total value of all equity interests in the partnership or corporation, plus the total indebtedness of the entity to the transferor, or applicable family member.16

Transfer Taxation of Cumulative Unpaid Distributions

If the corporation or partnership fails to make the required cumulative distributions, or noncumulative distributions the transferor has elected to treat as cumulative distributions, then upon the occurrence of a “taxable event,” the taxable gifts or estate of the transferor will be increased by the value of such unpaid distributions. This value will be determined on the assumption all payments are made when due, then compounded as if reinvested at the same discount rate used in valuing the retained interest, less actual distributions paid, based on the date actually paid, but with a 4 year grace period for late payment.

The total amount subject to tax cannot exceed the transferor’s proportionate interest in the excess value of all junior interests in the entity at the applicable date of the taxable event over the value of all such transfers at the original date of transfer. In other words, the additional amount subject to federal transfer tax is limited to the actual growth in the enterprise that was shifted.

A taxable event is the death of the transferor if the applicable retained interest is included in his or her estate, or the transfer of such applicable retained interest. Also, the transferor can elect to treat late payment as a taxable event.17

Where the transfer is to a spouse and is not taxable because of the marital deduction or because the transfer was for full and adequate consideration, the above rules will not apply, but the spouse will inherit the tax consequences on a subsequent taxable event.18 Applicable family members other than the transferor are subject to the same taxable event rule with respect to their retained interests, and if the applicable retained interest is transferred to an applicable family member, such applicable family member is subject to the same rules as to distributions accumulating after the transfer.19

Qualified payments can be made in the form of debt instruments if they are for not more than 4 years and compound interest at a rate no less than the appropriate discount rate is payable from the due date of the payment.20

It is important to note that the value of the unpaid distribution is added to the taxable estate or taxable gifts of the transferor along with the value of the retained corporate stock or partnership interest. According to the regulations, the amount subject to transfer tax will be reduced by any amount subject to transfer tax with respect to the same rights to prevent double taxation.

Value of the Retained Frozen Interests for Purposes of Subsequent Transfers

Section 2701 only deals with the value of the retained interest for purposes of valuation of a transferred interest at the time of the transfer of the transferred interest. Apparently, the retained preferred stock or partnership interests would be valued under normal rules for purposes of any subsequent transfers. This means any retained put, call, conversion, or liquidation rights valued at zero under Section 2701 will subsequently be valued when the retained interest is transferred. The result is clearly double taxation, since an interest that was valued at zero when retained is subsequently valued at fair market value when the transferor dies or transfers the retained interest.

To avoid this result, there is an adjustment to the decedent’s adjusted taxable gifts by reducing them to reflect the amount by which decedent’s taxable gifts were increased due to Section 2701 over the increase in the estate or adjusted taxable gifts attributable to inclusion of the applicable retained interest in the estate. The adjustment may also be available to the transferor’s spouse.21

Is the Freeze a Viable Planning Alternative?

Although a corporate or partnership freeze through the use of common and preferred stock or partnership interests is now available, many commentators believe it has less utility than in the past. In order to avoid a zero valuation for retained interests, it will be necessary to make distributions with respect to the retained interests. The income tax will be paid now, while the estate tax is deferred, often until the death of a surviving spouse. Note that the use of the freeze eliminates qualification for the S election, since preferred stock is involved. However, if the entity is a partnership, particularly one with a good
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cash flow, the freeze may make a great deal more sense – the maximum individual federal income tax rate has been decreased to 35%.

If the qualified payments are not made, the resulting inclusion of accumulated distributions in the transferor’s taxable gifts or estate could easily exceed the value of the retained interest for federal gift tax purposes.

Example: Assume the applicable discount rate is 10%, and the retained dividend is 8%. Based on the assumption that the present value of the annual dividend is its fair market value, as required by the regulations, the value of the retained interest is 80% of the value of the transferred property. Thus, if the business is valued at $1,000,000, the retained interest is valued at $800,000, the gift at $200,000.

However, if the dividends are not paid for 10 years, and the grace period does not apply, the amount of the cumulative unpaid distributions subject to federal gift or estate tax under Section 2701(d)(1) would be approximately $1,275,000.

Note: The amount included in the taxable transfers of the transferor cannot exceed the actual growth in the business.

If a freeze is contemplated, can the amount of the taxable transfer be reduced by discounts? The Congressional Committee Reports acknowledge that all existing discounts are preserved, which means it is possible to argue that the value of the transferred interest for federal gift tax purposes must be reduced to reflect discounts for minority interests, lack of marketability, etc.

The regulations under Section 2701 recognize the existence of such discounts, and set forth a four step method to value the taxable gift, taking into account such discounts, as follows:

1. Determine the fair market value of all family-held interests in the entity.
2. Subtract all senior equity interests held by the family other than applicable retained interests held by the transferor or applicable family members, with a pro-rata adjustment for any control premium, followed by the subtraction of the value of all applicable retained interests held by the transferor and applicable family members.
3. Allocate the remaining value among the transferred interests and any other family-held junior (or subordinate) interests.
4. Reduce value for consideration received, and for any minority or similar discounts (presumably including a discount for lack of marketability), determined by subtracting the fair market value of the family-held interests (determined as if voting rights were held by one person who had no other interest in the entity other than the family-held interests of the same class) from the value of the transferred interest determined without regard to Section 2701.

Note that if the transfer is to a grantor retained interest trust (i.e., a GRAT or GRUT, see Chapter 26), any reduction in the value of the transfer under IRC Section 2702 will also be subtracted to determine the net taxable gift.

Alternatives to the Freeze

If the transferor retains common stock or partnership interests, and transfers the preferred interests, Section 2701 does not apply. This is sometimes called a “reverse” freeze. When the transferor dies, the value of the common stock will reflect growth, but should be substantially discounted in value because of the burden of the preferred stock with its prior claim to dividends and liquidation proceeds.

Consider the use of a variety of other techniques to freeze growth. This includes installment sales of business interests to family members (see Chapter 35), use of the private annuity (see Chapter 36), and premortem stock redemptions or partnership liquidations of interests of senior family members, giving senior family members a cash flow and transferring the growth in the value of the enterprise to the next generation. Under some circumstances, if the transferor receives a debt instrument issued by a family partnership or corporation, the IRS may seek to treat it as retained preferred stock. See Example 1, Senate Committee Report (OBRA ’90), referring to “convertible debt” and treating it as retained preferred stock.

Section 2704

IRC Section 2704 deals with the transfer tax consequences of lapsing rights, and provides that property, in general, will be valued without regard to lapsing restrictions. As a result, the lapse of a voting or liquida-
Example: If parent and child control a corporation, and parent’s stock has a voting right that lapses at parent’s death, parent’s stock is valued for federal estate tax purposes as if that right were nonlapsing.22

Section 2704 applies if the individual holding such right and members of the family control the corporation, as control is defined in Section 2701(b)(2). However, in this case, “family member” includes the spouse of the individual, ancestors and lineal descendants of the individual or spouse, brothers and sisters of the individual, and spouses of any of them.23

Under the regulations, the taxable transfer is measured by the reduction in value of all interests in the entity owned by the holder immediately before the lapse unless attributable to other causes. The lapse of the right is deemed to be a transfer subject to transfer tax, at date of lapse, based on the difference between the values of all interests in the entity held by the individual before the lapse and after the lapse.24 This provision is so broad that any shift of equity or growth could be deemed a lapse, and any contingency that results in lapse of payment, voting, or other rights could have transfer tax consequences.

A voting right is defined as the right to vote on any matter, and in the case of a partnership, includes the rights of management held by general partners.25 A liquidation right is the right to compel the entity to acquire all or a portion of the holder’s interest, including a right arising solely by reason of the fact the holder owns sufficient voting rights to compel liquidation.26

A lapse occurs whenever a presently exercisable right is restricted or eliminated. However, a transfer with respect to a liquidation right is not a lapse of a liquidation right unless the transfer eliminates the right of that individual to compel liquidation of an interest other than the interest conferring the power.27

Example: D, who owns 84% of the voting common stock of corporation, gives 14% each to three children. Even though this reduces D’s voting rights to 42%, and D loses control, this is not a lapse covered by the statute because the voting rights have only been transferred, not eliminated.

Example: Assume D is both the general and a limited partner in a family partnership. As general partner, D can compel liquidation. If D transfers her general partnership interest, she can no longer compel liquidation, but since the successor general partner has the same voting rights, there is no lapse as to D’s rights as a general partner. However, there is a lapse as to D’s rights as a limited partner, since D has lost the power to compel liquidation of the limited partnership interest, which was an interest other than the interest conferring the power.28

A lapse of rights in a retained interest valued under Section 2701 is not subject to Section 2704.29 Nor is the inability of the family to liquidate after the transfer where the holder could have liquidated before the transfer.30 If the lapsed right may be restored upon the occurrence of a future event not within the control of the family, there is no lapse so long as the right could be restored.31

A voting or liquidation right may arise by state law, corporate charter or bylaws, an agreement, or in any other manner. Similarly, a lapse may occur by reason of state law, corporate charter or by-laws, agreement, or any other means. However, if the lapse is caused only by a change in state law, it is not subject to Section 2704.32

In addition, an “applicable restriction,” which is any restriction that effectively limits the ability of the corporation or partnership to liquidate, is to be disregarded if the transferor and family members control the entity, and the restriction either lapses after the transfer or can be removed by the transferor or family members, individually or collectively.33 However, the term does not include a commercially reasonable restriction imposed in connection with financing if furnished as either a debt or equity contribution by an unrelated person (as defined by IRC Section 267(b), excluding banks as defined by IRC Section 581) for trade or business operations.34

An “applicable restriction” is a limitation on liquidation of an entity that is more restrictive than state law. It is only a restriction if it will either lapse or can be removed by the transferor, transferor’s estate, or members of the family. Any buy-sell agreement, option, or restriction covered by IRC Section 2703 (see Chapter 40), is not subject to Section 2704.35

Example: D owns all of the preferred stock of corporation, and can compel liquidation after 10 years. All common stock is owned by
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D’s children. If D transfers the preferred stock to the children, it is valued without regard to the restriction on liquidation (i.e., as if the right to compel liquidation was immediately exercisable).

The IRS has applied Section 2704(b) to disregard liquidation restrictions imposed by a family limited partnership agreement when valuating a partnership interest held by a decedent. The partnership was created on the decedent’s deathbed and the partnership agreement’s liquidation provisions were more restrictive than state law. However, the courts have held that restrictions imposed by state law in a partnership are not applicable restrictions.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

In a community property state, the business or investment assets may be co-owned by both husband and wife as community property. If so, both must participate in the transaction, and the preferred stock or partnership interests will be held by them as community property. If the common stock or partnership interests are transferred to the children by gift, they may be separate property of the children, depending on state law. However, it is possible that the spouses of the children will obtain a community interest in the transferred property; particularly, if they purchase the stock, its status as community or separate property will depend on what assets they use to pay for it. Thus, the use of trusts to acquire the stock may minimize or eliminate this potential problem.

QUESTIONS AND ANSWERS

Question — Client owns 100% of the common stock of X Corporation, which has been valued at $1,000,000. It has been suggested that he recapitalize the corporation to create voting preferred stock with a par and liquidation value of $1,000,000, and a noncumulative preferred dividend of 8% per annum, and nonvoting nonpar common stock. He would then transfer the common stock to his children. What are the gift tax consequences?

Answer — Under Section 2701, unless an election is made, the gift will be $1,000,000. The transaction falls within Section 2701, assuming none of the interests involved have a readily ascertainable market value. The common stock is being transferred to “family members,” children of the transferor. The transferor has an “applicable retained interest,” the preferred stock. It consists of a “distribution right,” i.e., the right to the preferred dividend, and a “liquidation right.” Under Section 2701, the liquidation right is valued at zero. The distribution right is also valued at zero unless it is a “qualified payment.” Since a qualified payment is the right to a fixed cumulative preferred dividend, this dividend is not a qualified payment. As a result, under the “subtraction” method required by Section 2701, the gift is the entire value of the enterprise, $1,000,000, less the value of the applicable retained interest, zero.

However, the transferor could elect to treat the noncumulative dividend as if it were cumulative. If so, it is a qualified payment and can be valued and subtracted from the value of the enterprise to determine the taxable gift. The regulations indicate the qualified payment is to be valued under general valuation principals, that is, at fair market value.

Question — In 1991, parent transferred undivided interests in the family farm, which was worth $1,000,000, to her children, and simultaneously, parent and children formed a family partnership into which they transferred their respective interests in the property. Parent, who was the general partner, received a capital interest of $1,000,000, and is entitled to an annual distribution of partnership profits of up to $80,000 before any profits are distributed to children. This right to distributions is cumulative, and if not made in one year, carries over to the next. If the partnership liquidates, the parent will receive the first $1,000,000 in liquidation proceeds, and any additional proceeds will be distributed to the children. The children receive limited partnership interests and are entitled to share in any partnership profits and liquidation proceeds not distributed to the parent.

Ten years later, parent dies. No partnership distributions were ever made to parent. Under the terms of the decedent’s will, her partnership interest, and all rights to distributions, passes to her surviving spouse outright. The farm was worth $1,500,000 at date of death. What are the estate tax consequences?

Answer — The initial formation of the partnership was covered by Section 2701, and the gift tax on the transfers of interests in the farm to the children would be computed by subtracting from the value of the farm in 1991 the value of the right to partnership distributions, which would be “qualified payments.”
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However, since the qualified payments were never made, they constitute “cumulative unpaid distributions” under the statute. When a “taxable event” occurs, in this case the death of the parent, the value of those unpaid distributions is subject to the applicable federal transfer tax, in this case the federal estate tax. However, since the right to the payments passes to the surviving spouse, the tax will be deferred until the surviving spouse either dies or otherwise transfers the interest.

Note several other points. The maximum amount that could have been taxed in the estate would have been the total growth of the enterprise, $500,000. Also, since there is a four year grace period during which qualified payments can be made to avoid the transfer tax at death, the full unpaid amount may not be subject to tax. When the partnership was formed, parent could have elected to value the qualified payment at zero and pay gift tax on the full value of the farm, $1,000,000. If she had done so, there would be no additional tax on the cumulative unpaid amounts.

Also note that the decedent’s estate would in any case include the value of her capital interest in the partnership, arguably worth at least $1,000,000, and her right to unpaid distributions, since those are valuable property rights owned by her estate. The regulations indicate there will be no double tax on the unpaid distributions.

Question – A family corporation is owned equally by two shareholders, parent and child. In 1991, the corporation is recapitalized, with parent and child each receiving voting preferred stock with a fixed liquidation value and a cumulative preferred dividend, and the child also receiving nonvoting common stock. The child then makes a gift of the nonvoting common stock to grandchild. Assume the preferred stock issued to the parent was equal to the full value of his interest in the corporation. What are the potential transfer tax consequences, if any, to the parent?

Answer – The parent did not make a taxable transfer when the corporation was recapitalized, since the parent received full value for his interest in the business and made no gift to the grandchild. However, since the parent is an “applicable family member,” the parent or his estate may be vulnerable to a later transfer tax.

In computing the taxable gift to grandchild under the subtraction method, the child may subtract from the value of the corporation the right to all “qualified payments,” in this case, the right to cumulative preferred dividends held by both the parent and child. If this is done, the parent is subject to the rules for transfer tax on cumulative unpaid distributions, i.e., if the corporation does not pay the dividends, there will be a gift or estate tax to the parent on a lifetime or deathtime transfer of the parent’s preferred stock. As a result, even though the parent was not even a party to the taxable gift, the parent or his estate can incur a substantial transfer tax liability.

Note that the parent can avoid this result if the parent elects not to have his right to the preferred dividend treated as a qualified payment. If the parent does so, the child cannot subtract its value for gift tax purposes, and there would be no later transfer tax to the parent under the cumulative unpaid distribution rules.

Question – Client proposes to form a family partnership to operate a business enterprise. Client will retain a general partnership interest and a limited partnership interest, and sell limited partnership interests to his children for their full value. All partners will participate proportionately in partnership profits and the proceeds of liquidation. Will either Section 2701 or 2704 apply to client?

Answer – Since the facts indicate all partners will share proportionately in both profits and growth, the gift tax consequences of these transactions are not subject to the provisions of Section 2701. As a result, since client sold interests to his children for their full value, there are no gift tax consequences. Note that limitations affecting liability and management do not bring the transaction under Section 2701, unless there is a provision for lapse of voting rights and management rights, or the transferor or applicable family member can alter the liability of the transferee partners. Such was not the case here.

However, if client dies or transfers his general partnership interest, client loses the power to compel liquidation of the partnership. Under Section 2704, this would be treated as a lapse of the client’s power to compel liquidation of his limited partnership interest, subject to gift tax if the client makes a lifetime transfer of his general partnership interest, or estate tax on his death.

ASRS: Sec. 51, ¶200; Sec. 55, ¶58.
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CHAPTER ENDNOTES

1. IRC Sec. 2701(e)(1).
4. IRC Sec. 2701(a)(4)(B)(i).
5. IRC Sec. 2701(c)(2).
6. IRC Sec. 2701(c)(1)(B).
7. IRC Secs. 2701(b)(2), 2701(e)(3).
8. IRC Sec. 2701(e)(2).
11. IRC Sec. 2701(c)(2)(C).
13. IRC Sec. 2701(a)(1).
15. IRC Sec. 2701(a)(4).
16. IRC Sec. 2701(b).
17. IRC Sec. 2701(d).
18. IRC Sec. 2701(d)(3)(B).
19. IRC Sec. 2701(d)(4).
23. IRC Sec. 2704(c).
30. IRC Secs. 2704-1(c)(2)(i)(B); 25.2704-1(c)(2)(iii).
31. IRC Sec. 2704(b).
34. TAMs 9723009, 9725002, 973003, 9735003.