Telephone
(805) 497-0888

Facsimile
(805) 497-0848

Carl R. Waldman
A Law Corporation
*Founding Member, WealthCounsel*

2801 Townsgate Road
Suite 203
Westlake Village
CA 91361
crw@waldmanlaw.com

# Preferred Family Limited Partnerships in Multi-Generational Estate Planning

Prior to the enactment of Internal Revenue Code (IRC) §2701, estate planners often designed entity structures that effectively freezed the value of their clients' estates for purposes of transferring assets between members of the same family. A typical example of an "estate freeze" worked like this: a father owns a business valued at ten million dollars and wants his daughter, who has been working for him, to take over the company as he steps away from day-to-day management of the business operations. If the business continues to grow in value under his daughter's management, the increased value would become part of the father's estate and would be subject to estate taxes at the time of his death.

An estate freeze avoided this outcome by transferring the future growth of the company's value to the daughter, either directly or in trust. A typical estate freeze involved a recapitalization of corporate stock, such that the father would be issued a preferred stock interest equal to the current value of the company, with the daughter being issued common stock which had no current value. By setting the value of the preferred stock at an amount equal to the current value of the company, the family avoided paying gift taxes on the transfer of the common stock to the daughter, since the common stock had no immediate value. Accordingly, the preferred stock would be paid a rate of return sufficient to prevent any part of the ten million dollar value of the company being treated as a gift. For example, if a ten percent rate of return would have been considered appropriate under the circumstances for the preferred shares, the preferred shares would be entitled to annual dividend payments of one million dollars.[1] However, taxpayers often structured estate freezes with no intention of actually paying the preferred dividend or exercising various rights, such as liquidation rights, that gave value to the preferred shares.

In order to combat this perceived abuse, Congress enacted IRC §2701. Section 2701 sets forth the guidelines for determining the value of retained preferred interests in corporations and

[1] The appropriate return for the preferred shareholder would need to be determined on a case-by-case basis taking into consideration business income, cash-flow and assets that may be available to pay the preferred dividend.

partnerships when the common interest in the entity is transferred to a family member. Accordingly, a properly structured preferred family limited partnership (PFLP) must adhere to the requirements of §2701 in order to effectuate a legally sanctioned estate freeze.

**Basic Mechanics of §2701**[2]

Rather than ban the estate freeze planning technique outright, Congress sought to curb the perceived abuse by taxpayers of the preferred interest equity structure. Prior to the enactment of §2701, the preferred interest in an equity freeze recapitalization was given various liquidation and distribution rights that were designed to eliminate any gift tax liability with respect to the transfer of the common interest. However, these rights were never intended to be exercised by the holder of the preferred interest. As a result, the value of the preferred interest was set artificially high based on rights that were never intended to be exercised.

Section 2701 addresses the preferred interest valuation problem by imposing the following requirements on families seeking to accomplish an estate freeze using a PFLP:

1. The value of the retained preferred interest is deemed to be zero except to the extent it is entitled to receive a cumulative distribution right that is a "qualified payment." A qualified payment is defined in §2701 as a payment payable on a periodic basis to the extent the payment is determined at a fixed rate.[3] Variable rates are allowed to the extent they are determined in reference to a specified market interest rate.

2. At least ten percent of the equity of the partnership is attributable to the common interest (also known as the junior equity interest).[4]

3. Liquidation, put, call and conversion rights granted with respect to the preferred interest are generally valued at zero.[5]

4. Cumulative but unpaid distributions are deemed to be reinvested in the PFLP at an interest rate equal to the preferred rate of return, subject to a four-year payment grace period.[6]

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[2] For purposes of this discussion, we are assuming the taxpayer is creating a PFLP, although the same analysis under §2701 would apply to the use of a corporation or limited liability company ("LLC") to accomplish an estate freeze.
[3] §2701(c)(3)(A)
[4] §2701(a)(4)(A)
[5] §2701(a)(3)(A)
[6] §2701(d)

These provisions have very specific consequences to the structuring of a PFLP. First, the only value of the PFLP attributable to the preferred interest for purposes of determining the gift tax consequences to the recipient of the common interest is the value of the qualified payment. Second, the recipient of the common interest is deemed to have received at least ten percent of the equity interest in the partnership. As a result, the recipient of the common interest must contribute at least ten percent of the equity of the PFLP or will be deemed to have received a gift equal to ten percent of the value of the total equity interests in the PFLP.

Accordingly, properly setting the fixed rate of return for the preferred distribution is vital to reducing the value of the common interest for gift tax purposes. If the rate of return on the preferred interest is set too low based on current market conditions and the risks inherent in the activities conducted by the partnership, in comparison with comparable entities and equity interests, the preferred interest will be valued lower than the value of the assets contributed to the PFLP resulting in a "gift" to the recipient of the common interest. In many instances, the best means to assure the payment of the preferred return will be through the use of a new generation of permanent life insurance products, insuring the life or lives of the younger generation family members. Such policies typically provide for more robust accruals of cash surrender values than older products and certain of these policies are keyed to one or more equity indices that present the opportunity for substantial growth in cash value and in the policy death benefit over an extended term of years. This type of policy death benefit growth is extremely useful in making certain that the preferred distribution payable to the senior generation family member (or to that person's successors in interest) will in fact be paid as required under Section 2701. Furthermore, in some instances the fact that the death benefit is likely to grow at a relatively predictable rate may be a significant factor in being able to employ third party financing in connection with the acquisition of the life insurance policy or policies.

In addition, the preferred interest holder must receive the periodic payments required under the PFLP agreement and, to the extent those payments are not received, they are includable in the estate of the preferred interest holder with interest as provided in §2701. *Accordingly, the "estate freeze" only works if the partnership's rate of return exceeds the rate of return paid to the preferred interest holder pursuant to the PFLP agreement.*

**Who Can Benefit From A Preferred Family Limited Partnership?**

These rules beg the question: when is it advisable to use the PFLP as an estate planning tool? The short answer is that the PFLP can be a very effective device when it is reasonably anticipated the assets contributed to the PFLP will grow in value in excess of the rate of return

paid to the preferred interest holder. Whether the PFLP is capitalized with real estate, an operating business, permanent life insurance tied to an equity index, or any other type of asset, the key to its success is being able to grow in value at a rate which exceeds the payment to the preferred interest holder.

As mentioned above, §2701 requires interest to be charged on any unpaid qualified payment to the preferred interest holder. However, any payment made within four years of the date the payment is due is deemed to have been made on the due date.[7] Accordingly, the PFLP is provided some flexibility in the timing of the preferred distributions which may help alleviate cash flow concerns. In addition, delaying the initial distribution to the preferred interest holder will allow for the compounded growth of PFLP assets during the first four years of partnership operations.

**Structuring Capital Contributions to the PFLP**

In the event that only the senior generation creates and funds the PFLP, there may be adverse gift tax consequences to the issuance of the common interests to the younger generation family members. Those gift tax concerns may be addressed by making certain that each partner contributes an appropriate amount of capital to the PFLP. In this regard, the determination of the appropriate capital contributions to be made by the partners may best be determined by a qualified independent appraiser. Such an appraisal must take into account the relative economic benefits to be conferred on the preferred and common interest holders, and will typically take into account the fact that the preferred interest holders will not receive current distributions from the PFLP, that the preferred interest holders will have a liquidation preference if the PFLP is liquidated during their lifetimes, and that the cumulative preferred return may be payable long in the future with such payment assured by a life insurance death benefit payable upon the death(s) of one or more common interest holders. If the appraiser uses a discounted cash flow approach in valuing the preferred and common interests, the respective capital contributions required by each class of partnership interest in the PFLP may be determined with a consistent methodology and may result in a determination that 80% to 90% of the total capital to be contributed to the PFLP must be contributed by the preferred interest holder. Again, if the capital contributions are made in the proportions determined by appraisal, there should be no gift on formation or recapitalization of the PFLP.

[7] §2701(d)(2)(C)

**Multi-Generational Planning Opportunities**

After creating a PFLP, further planning opportunities are available to leverage the benefits of the PFLP structure. The basic PFLP involves parents and children receiving preferred and common interests in the PFLP. Parents and children can then use their respective interests in the PFLP to effectuate more sophisticated estate planning goals.

For example, the children who receive the common interest could place the interest in a generation skipping trust for the benefit of their own children and grandchildren. By using the generation skipping tax credit of the common interest holder, some or all of the future growth in the value of the common PFLP interest could pass through multiple generations of the family without incurring further estate and gift tax liabilities.

In addition, the senior generation may consider selling their preferred PFLP interest to an intentionally defective grantor trust (IDGT). To the extent the income received by the IDGT from the preferred PFLP interest exceeds the applicable federal rate, the IDGT will have excess income that can be used to purchase life insurance or otherwise help meet the family's overall estate planning goals. When use of a PFLP is appropriate to meet a client's estate planning goals, the opportunity to use the PFLP structure in conjunction with other estate planning techniques needs to be considered by the estate planner.

**Risks of the Strategy**

The primary risk of using a PFLP is the partnership's failure to achieve a growth rate in excess of the rate of return paid to the holder of the preferred interest. Pursuant to §2701, at least ten percent of the equity interest in the partnership must be funded by the common interest holder. If the growth in the value of the PFLP does not exceed the preferred rate of return, then the reduction in the capital of the PFLP required to pay the preferred rate of return will effectively transfer part of the common interest holder's equity in the partnership to the preferred interest holder. As a result, the value of the preferred interest holder's estate would actually grow at the expense of the common interest holder's estate.

In addition, various potential pitfalls need to be considered with respect to the structuring of a PFLP. First, depending on the assets used to capitalize the PFLP, IRC investment company rules may need to be considered if marketable securities comprise more than 80% of partnership capital. Also, the same structural requirements applicable to family limited partnerships apply to PFLPs. For instance, the PFLP must have a legitimate business purpose other than estate and

gift tax avoidance, so consideration should be given to transferring real estate or other business interests to the PFLP.

**Conclusion**

Despite the potential pitfalls, under the appropriate circumstances the PFLP can be a powerful tool for transferring wealth to younger generations of family members. The PFLP accomplishes this goal by effectively freezing the value of the estate in the hands of the older generation and transferring the future growth in the value of PFLP assets to younger generations free of estate and gift taxes. Furthermore, the PFLP's preferred and common interests lend themselves to being used effectively with other estate planning techniques to maximize the efficient transfer wealth to younger generations.

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