Multigenerational Estate Planning In Times of Anticipated Change

BY MARK B. RUBIN AND MICHAEL P. HEDDEN

The estate planning community has benefited from low interest rates, initially coupled with low asset values, for nearly a decade. During this period, many families took advantage of tax incentives to transfer both wealth and ultimate control of those assets to younger generations, while ensuring that the older generation still enjoyed sufficient income.

The economic and tax factors that encouraged families and non-family groups to engage in this type of planning still exist, and so do various techniques that accomplish a broad range of tax, financial, and family objectives.

One popular option is a freeze partnership, which enables a senior generation to “freeze” the value of its economic interests in the business assets, with future appreciation and risks of ownership typically held in trust for the next generation, so that substantially all future capital appreciation of those assets will be exempt from estate tax.

Classes of Interest

Parties to a freeze partnership typically have one of two classes of interest: preferred and common. In a traditional freeze partnership, the senior generation will contribute its ownership interest as a preferred interest. A professional appraiser determines the preferred interest value, along with a rate of return that will pay fixed, cumulative, annual returns, and a liquidation preference. The remaining common membership interest—the younger generation—is entitled to any future capital appreciation in the value of the business, as well as profits above and beyond the preferred rate of return on the preferred interest that the senior generation holds.

Let’s take for example an existing partnership with assets worth $1,000, that generates $60 annually in cash flow. The owner, Margaret, recapitalizes the partnership by creating $900 of preferred interests and $100 of common interests. She then transfers the $100 of common
interests to her children, through sale or gift, either directly, or in trust. Margaret effectively has fixed her interest in the asset at $900. Her children will enjoy all the appreciation. However, Margaret must follow the applicable tax rules under IRC §2701, or she will be deemed to have given the equivalent of $1,000 to her children. (Section 2701 of the IRC provides regulations, guidelines, and restrictions related to preferred corporate stock and partnership interests related to intra-family transfers.)

First, she must determine the appropriate coupon, or fixed, cumulative annual return on her preferred interest, so that it will have a legal value of $900. To do this, she will engage a valuation expert who will consider the:

• nature of the assets
• amount of income produced by the property
• risk profile of the property
• current market yields
• general economic factors

The valuation expert will then recommend an appropriate preferred coupon. If the coupon is 5 percent, Margaret will receive $45 annually. Her children will receive the balance. If the income decreases, Margaret still will be entitled to the first $45, and her children will receive less. The role of the valuation expert is crucial, and the expert should have the experience and credentials required to meet a possible IRS challenge.

A freeze partnership can also be beneficial in a “negative capital account” situation, where Margaret owns the property in an existing partnership, and the debt exceeds the tax basis of the property. Take for example a property that is subject to $600 of debt, but has a tax basis of $300. If Margaret were to transfer her partnership interest to her children, she could have $300 or more of taxable gain. But suppose that the children (perhaps using funds provided by Margaret) make a capital contribution equal to 10 percent of the value of the equity of the partnership. Margaret can then recapitalize her interest, so that it’s substantially all preferred interest. The tax rules will permit the partnership to allocate debt to Margaret so that she does not trigger her negative capital account and avoid triggering the $300 of taxable gain. When she dies, under current rules, her basis will be stepped up to fair market value and the negative capital account will be eliminated.

Accordingly, when properly structured, a freeze partnership avoids capital gains tax, even where the current owners have negative capital accounts. At their death, the senior generation will receive a step up in basis, wiping out their negative capital accounts. Meanwhile, the preferred interest owned by the senior generation will provide a reliable source of fixed income.

The freeze partnership is ideally suited to high-net-worth individuals not reliant on capital appreciation from future dispositions of real estate or businesses. The freeze works best with assets that currently generate a consistent stream of cash flow that equals, or exceeds, the preferred interest coupon of the senior generation. Any cash flow in excess of this fixed coupon will flow through to the younger generation. A freeze partnership is especially appropriate for a property asset that combines both current cash flow and the opportunity for appreciation.

Control of the freeze partnership must also be addressed. If working in the business, including members of the younger generation would make sense. The allocation of business interest among family members can be used to reward those members involved in operations. In addition, the management operations often have a value itself which can be captured and factored into the overall plan. Many families work with consultants who can guide the family through this process and set up governance that will

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**Valuation**

Revenue Ruling 83-120 by the Internal Revenue Service gives basic guidelines for determining the value of a closely held business’s preferred stock. The ruling states that the valuation should include analysis of the stated dividend rate and the risk associated with this payment. It should identify cumulative and non-cumulative dividends, and assess the company’s ability to pay the preferred stock’s liquidation preference at liquidation. Voting rights and redemption privileges should also be considered. The preferred stock’s value would equal the present value of anticipated future cash flows. The rate of return on the preferred stock, and its value, relate to its perceived risk.

How to determine the value of the preferred and common interests amounts to more than basic number-crunching. It can be complex and tricky, and should be entrusted to trained professionals—as should the entire implementation of the estate freeze transaction. Today, partnership interests often are able to be valued at a discount, reflecting lack of marketability and control. The Internal Revenue Service (IRS) has proposed regulations that would eliminate these discounts for family partnerships, although the Trump Administration has asked the Treasury Department to review the proposals. The process involves extensive planning, involving valuation analysts from the beginning. Professional wealth management advisors, tax professionals, and certified appraisers can:

- determine an adequate reasonable rate of return on the preferred interest
- appraise the real estate
- determine valuation discounts
- navigate IRC §2701 surrounding the particular method of freezing asset values
- structure the freeze while paying attention to the liquidity of a business
- determine the potential market for sale of the business interests
- establish the value of the business for future disposition
- come up with structural variations to provide even greater benefits.

**Questions to Consider**

The freeze partnership is just one of several alternatives available to families and other privately held business owners planning their estates and arranging their retirement. Before deciding on the best technique for an asset/management transfer, a family should address the following questions:

- Is the family transferring the future appreciation in assets, or a current interest in the assets, to the younger generation?
- Who will remain in control of the assets, and who will operate the business?
- Should the new structure reward members of the younger generation who are working in the business with a larger share of future profits? How will this impact relations among the siblings or cousins?
- Should the new structure provide the senior generation with a guaranteed fixed income?
- Do certain stable assets offer less upside than others that involve more risk? Should the stable assets be placed in separate pools? Do some assets require substantially more work? If so, how should this effort be compensated?
- Is the transfer intended to avoid future estate tax liability? What if the transfer creates additional income tax liability for the next generation?
- What is the current tax basis of the assets? Is the debt on the assets substantially more than its tax basis? Do the current owners have negative capital accounts?

While considering these questions, families must consider the tax, economic and emotional consequences, including current and potential tax rates, current and proposed regulatory environments, and current and potential asset values.