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TITLE: Introduction to Preferred Partnerships

AUTHOR: Salti, Rana H.

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AMERICAN BAR ASSOCIATION
REAL PROPERTY, PROBATE AND TRUST LAW SECTION
CLOSELY HELD BUSINESSES (TAX)/BUSINESS PLANNING GROUP
2006 JOINT FALL CONTINUING LEGAL EDUCATION MEETING

INTRODUCTION TO PREFERRED PARTNERSHIPS

RANA H. SALTI
WINSTON & STRAWN LLP
35 WEST WACKER DRIVE
CHICAGO, ILLINOIS 60601
TELEPHONE (312) 558-7537
FACSIMILE (312) 558-5700
RSALTI@WINSTON.COM

1. **Basic Structure of Preferred Partnership Recapitalization.**

   (a) In a typical preferred partnership recapitalization, a senior family member exchanges partnership interests for preferred partnership interests of an equal value.

   (b) The senior family member's preferred interests may provide preferential rights with respect to cash flow and dissolution.

   (c) The junior family member receives non-preferred interests, which are subordinate to the rights of the preferred interest holders.

2. **Primary Objectives of Preferred Partnership.**

   (a) A primary objective of a preferred partnership is to shift future appreciation of partnership assets to younger family members.

   (b) In addition, a preferred partnership recapitalization has the effect of "freezing" the value of the interests held by the senior family member.

   (c) Also, the preferred interests held by the senior family member can ensure more stable cash flow and greater certainty of distributions at dissolution.

3. **Characteristics of Preferred Interests.**

   (a) The holder of the preferred interests may be entitled to preferential rights with respect to the net cash flow of the partnership, or qualified payments.

(b) A qualified payment is any dividend payable on a periodic basis under any cumulative preferred stock or a comparable payment under any partnership interest to the extent that the dividend or comparable payment is determined at a fixed rate. IRC Section 2701(c)(3)(A)[1]

(1) *Fixed rate.* A payment based upon a variable rate is treated as based upon a fixed rate if the payment is determined at a rate bearing a fixed relationship to a specified market interest rate. Section 2701(c)(3)(B)

(2) *Payable.* The payment must be payable but does not necessarily need to be paid in a given period.

(3) *Cumulative.* To the extent that the payments are not made in a given year, the balance will be carried forward to the following year.

(A) Any payment of a distribution during a four-year grace period is treated as having been made on the due date. Section 2701(d)(2)(C)

(B) However, the four-year grace period does not extend beyond a taxable event, i.e., a transfer during life or at death. Reg. § 25.2701-4(b)(1)

(C) Any payment of an unpaid qualified payment is applied in satisfaction of the earliest unpaid qualified payment. Reg. § 25.2701-4(c)(4)

(c) At the dissolution of the partnership, the preferred interest holders receive the dissolution preference stated in the partnership agreement before any distributions are made to the nonpreferred interest holders.

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[1] References to "Code" refer to the Internal Revenue Code of 1986, 26 U.S.C. §1 et seq., and references to "Section" without further modification refer to Sections of the Code.

4. Characteristics of Nonpreferred Interests.

(a) The nonpreferred interest holders are entitled to the income generated in excess of the income required to be distributed to the preferred interest holders.

(b) The nonpreferred interest holders receive liquidating distributions after the stated dissolution preference is paid to the preferred interest holders.

(c) Accordingly, the nonpreferred interest holders bear a greater risk of any partnership losses but have a higher upside potential.

5. Valuation of Preferred Interests.

(a) Section 2701 provides a mechanical test for the valuation for gift tax purposes when an individual transfers an equity interest in a corporation or partnership to a member of the individual's family.

(b) For Section 2701 to apply:

(1) the transferred asset must be an interest in a corporation or partnership;

(2) more than one class of equity interest must exist, as described in Reg. § 25.2701-1(c)(3);

(3) market quotations must not be readily available for the transferred asset;

(4) the transferred asset must be transferred to or for the benefit of a member of the transferor's family; and

(5) after the transfer, the transferor or an applicable family member must hold an applicable retained interest in the controlled entity, under Section 2701 (b)(2) and Reg. § 25.2701-2(b)(5).

(c) An applicable family member is:

(A) the transferor's spouse;

(B) any ancestor of the transferor or the transferor's spouse; or

(C) the spouse of any such ancestor.

(2) An applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either:

(A) An extraordinary payment right [i.e., any put, call, or conversion right, any right to compel liquidation, or any similar rights, the exercise of which or nonexercise of which affects the value of the transferred interest, as described in Reg. § 25.2701-2(b)(2)]; or

(B) In the case of a controlled entity, a distribution right, which is the right to receive distributions with respect to an equity interest, except for the following:

(i) Any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest;

(ii) Any extraordinary payment right; or

(iii) Mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under § 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.

(d) In addition, the value of the nonpreferred interests must equal or exceed ten percent of the sum of the total value of all equity interests in the entity, plus the total amount of debt owed by the partnership to the transferor or an applicable family member. Section 2701(a)(4)(A)

(e) In addition to the mechanical rules of Section 2701, Revenue Ruling 83-120 provides guidance regarding the valuation of preferred and common stock of a closely held corporation.

(1) The ruling explains that the most important factors to be considered in determining the value of preferred stock are its yield, dividend coverage and the protection of its liquidation preference.

(A) *Yield.*

(i) The yield of the preferred stock is evaluated in part based upon the adequacy of the dividend rate.

(ii) The divided rate should be compared to the dividend rate of high-grade publicly traded preferred stock.

(iii) Whether the preferred stock has a fixed dividend rate and is non-participating influences the value of the preferred stock.

(B) *Dividend Coverage.*

(i) There is always the risk that an issuing corporation will be unable to pay its stated dividends in a timely manner.

(ii) This risk can be measured by the coverage of the stated dividends by the issuing corporation's earnings.

(iii) Coverage is measured by the ratio of:

(I) the sum of pre-tax and pre-interest earnings to

(II) the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends.

(iv) In evaluating a corporation's coverage, the ratio of the preferred stock should be compared with the ratios for high quality preferred stock.

(v) The earnings history of the corporation should be evaluated.

(vi) Inadequate coverage indicates that the value of preferred stock is lower than its par value.

(C) *Liquidation Preference.*

(i) In evaluating whether the issuing corporation will be able to pay the full liquidation preference at dissolution, the corporation's net assets should be considered.

(ii) The protection afforded by the corporation's net assets can be measured by:

(I) the ratio of the excess of current market value of the corporation's assets over its liabilities to

(II) the aggregate liquidation preference.

(iii) Like a corporation's yield and dividend coverage, the protection ratio should be compared with the ratios for high quality preferred stock to determine the adequacy of coverage of the liquidation preference.

(iv) If an unforeseen business reverse would threaten the corporation's ability to pay the liquidation preference, then the corporation's net assets are insufficient.

(D) *Voting Rights.* Voting rights and voting control also affect the valuation of the preferred stock.

(E) *Unusual Covenants or Provisions.* If a provision limits the marketability of the stock or the stockholder's ability to enforce dividend or liquidation rights, the provision would reduce the value of the preferred stock as compared to the value of preferred stock without such limits.

(F) *Redemption Privilege.*

(i) The value of preferred stock is also affected by whether the stock includes a redemption privilege.

(ii) The value of a redemption privilege triggered by the death of the preferred privilege will not exceed the present value of the redemption premium payable at the preferred shareholder's death.

(iii) The redemption privilege should be evaluated to ensure that the corporation possesses sufficient assets to redeem its preferred stock at the redemption price.

(2) Revenue Ruling 83-120 also addresses the valuation of common stock.

(A) *Right to Appreciation.*

(i) If the preferred stock has a fixed dividend rate and is nonparticipating, then the common stock has the exclusive right to any upside in the value of the corporation.

(ii) In evaluating this right, consideration is given to the corporation's past growth experience, the economic condition of the corporation's industry, and general economic conditions.

(iii) In addition, the value of the common stock will be increased by after-tax earnings of the corporation at the time the preferred stock is issued in excess of the stated dividends on the preferred stock.

(iv) The reinvestment of corporate earnings also will increase the value of the common stock.

(B) *Voting Rights of Preferred Stock.*

(i) The value of the common stock is also affected by the voting rights of the preferred stock.

(ii) In particular, if the preferred stock has voting control, the value of the preferred stock could be increased and the value of the common stock could be reduced.

(iii) This factor may be less important in jurisdictions which protect the rights of common stockholders as a class from actions by another class of stockholders.

6. Subtraction Method.

(a) If Section 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined by a subtraction method of valuation, as described in Reg. § 25.2701-3.

(b) In determining the value of any applicable retained interest held by the transferor or an applicable family member:

(1) Any put, call, conversion right, any right to compel liquidation, or any similar right is valued at zero if the right is an extraordinary payment right;

(2) Any distribution right in a controlled entity (i.e., a right to receive dividends) is valued at zero unless the right is a qualified payment right; and

(3) Any other right (including a qualified payment right) is valued as if any right valued at zero did not exist but otherwise without regard to Section 2701.

(c) Generally, under the subtraction method, the amount of the transfer is determined by subtracting the value of all family-held senior equity interests from the fair market value of all family-held interests in the entity determined immediately before the transfer.

(d) The value of the senior equity interests held by the transferor and applicable family members are determined under Section 2701, while other family-held senior equity interests are valued at their fair market value.

(e) The balance is then allocated among the transferred interests and other family-held subordinate equity interests, and certain discounts are permitted.

(f) Specifically, the following valuation methodology is used to determine the amount of the gift when Section 2701 applies:

(1) ***Step 1:*** Determine the fair market value of all family-held equity interests in the entity immediately after the transfer. In the case of a capital contribution, determine the fair market value of the contribution.

(2) ***Step 2:*** Unless the value in Step 1 is determined under the special rule for contributions to capital (in which case, subtract the value of any applicable

retained interest received in exchange for the contribution to capital), subtract the following amounts from the value obtained in Step 1:

(A) an amount equal to the sum of the fair market value of all family-held senior equity interests (other than applicable retained interests held by the transferor or applicable family members) and the fair market value of any family-held equity interests of the same class or a subordinate class to the transferred interests held by persons other than the transferor, members of the transferor's family, and applicable family members of the transferor; and

(B) the value of all applicable retained interests held by the transferor or applicable family members (other than an interest received as consideration for the transfer) determined under Reg. § 25.2701-2, taking into account an adjustment to the extent that the percentage of any class of applicable family members exceeds the family interest percentage [as defined in Reg. § 25.2701-3(b)(5)].

(3) ***Step 3***: Allocate the remaining value among the transferred interests and other subordinate equity interests held by the transferor, applicable family members, and members of the transferor's family.

(4) ***Step 4:*** The amount for the transferred interests determined in Step 3 is decreased by the following:

(A) Reductions for minority or other similar discounts, as provided in Reg. § 25.2701-3(b)(4)(ii);

(B) Reductions for the amount of consideration received by the transferor, but not in excess of the amount of the gift.

7. *Practical Considerations.*

(a) While the application of Section 2701 is fairly mechanical, there are several traps for the unwary.

(b) By example, while the creation or restructure of a partnership is typically a tax-free transaction, sale or exchange treatment may result if a partner is deemed to receive debt, rather than a capital interest.

(c) A preferred interest holder may be deemed to have made a gift to the extent that the cumulative net cash flow preference, its coverage, and the dissolution preference are deemed insufficient for the value of the property contributed by the preferred interest holder.

(d) In addition, although the transfer of appreciated property to a partnership generally does not result in gain recognition, the investment company rules of Section 351 must be considered.

(e) Of course, attention must be paid to avoid inclusion of partnership interests in the decedent's estate and to address all other arguments used by the IRS in its attacks on partnerships.

RPPT Illustrations:
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Illustration of Preferred Partnership

Rana H. Salti
Winston & Strawn LLP
(312) 558-7537

Agenda

- Operating assets of an S Corp. transferred to a preferred/common partnership in exchange for preferred interests
- Grantor trust transfers cash to preferred/common partnership in exchange for common interests

Assumptions

- Grantor's estate (such that is transferable) is comprised of a $2.7M family business operating as an S Corporation and $300,000 in cash
- Grantor has $300,000 of lifetime gift tax exemption remaining
- Grantor would like to retain existing equity and some return, but then shift excess return to the next generation
- Preferred/common recapitalization not available for an S Corporation
- Only Federal taxes are considered; income and capital gains taxes are based on current (2006) schedules; transfer taxes at 45%
- Any self-employment tax issues are ignored for purposes of illustration
- Yield of S Corporation is considered ordinary income
- Grantor has reasons for not choosing other freeze alternatives

Economic Flows of Preferred Partnership

Example					
Initial transfers to Preferred Partnership	Value	Basis	Growth rate of operating assets contributed by S Corporation		12.0000%
Operating assets, for preferred units	$ 2,700,000	$ -	Growth rate of reinvested cash contributed by Grantor Trust		6.0000%
Grantor Trust, for common units	$ 300,000	$ 300,000			
Gift tax exemption available before funding of grantor trust		$ 300,000	Stated Value of Class A Preferred Units	$	2,700,000
Discount rate for calculating NPV / §7520 Rate		6.0000%	... as a percentage of Total Undiscounted NAV		90.0000%
Years to measure		24	Preferred rate of return on Class A Preferred Units		8.0000%
Income tax rate		33.0000%	Percentage of preferred paid currently		100.0000%
Transfer tax rate for calculating savings		45.0000%	Amount of annual preferred return when paid currently	$	216,000

Coverage Test	*Passed*
Annual Stated Return on Preferred Units	$ 216,000
Above as a Percentage of Total NAV	7.2000%
Weighted Average Total Rate of Return	6.0000%

Distribution Assumptions re Common	
Distributions to Class B Common begin year	15
Distributions as a % of NAV net of Pfd Value	5.0000%
Distributions to Class A as % of Accrued	100.0000%

Ledger Illustrating Economic Flows of Preferred Partnership

Year	Beginning Value	Growth	Accrual of Class A Preferred Return	Contributions or (Distributions)	Ending Value	Cumulative Unpaid Class A Preferred Return	Preferred Class A Distributions	Residual Value to Preferred Class A Interest	Class B Common Distributions	Residual Value to Subordinate Class B Interest
0				$ 3,000,000	$ 3,000,000			$ 2,700,000		$ 300,000
1	$ 3,000,000	$ 342,000	$ 216,000	$ (216,000)	$ 3,126,000	$ -	$ 216,000	$ 2,700,000	$ -	$ 426,000
2	$ 3,126,000	$ 357,120	$ 216,000	$ (216,000)	$ 3,267,120	$ -	$ 216,000	$ 2,700,000	$ -	$ 567,120
3	$ 3,267,120	$ 374,054	$ 216,000	$ (216,000)	$ 3,425,174	$ -	$ 216,000	$ 2,700,000	$ -	$ 725,174
4	$ 3,425,174	$ 393,021	$ 216,000	$ (216,000)	$ 3,602,195	$ -	$ 216,000	$ 2,700,000	$ -	$ 902,195
5	$ 3,602,195	$ 414,263	$ 216,000	$ (216,000)	$ 3,800,459	$ -	$ 216,000	$ 2,700,000	$ -	$ 1,100,459
6	$ 3,800,459	$ 438,055	$ 216,000	$ (216,000)	$ 4,022,514	$ -	$ 216,000	$ 2,700,000	$ -	$ 1,322,514
7	$ 4,022,514	$ 464,702	$ 216,000	$ (216,000)	$ 4,271,215	$ -	$ 216,000	$ 2,700,000	$ -	$ 1,571,215
8	$ 4,271,215	$ 494,546	$ 216,000	$ (216,000)	$ 4,549,761	$ -	$ 216,000	$ 2,700,000	$ -	$ 1,849,761
9	$ 4,549,761	$ 527,971	$ 216,000	$ (216,000)	$ 4,861,733	$ -	$ 216,000	$ 2,700,000	$ -	$ 2,161,733
10	$ 4,861,733	$ 565,408	$ 216,000	$ (216,000)	$ 5,211,141	$ -	$ 216,000	$ 2,700,000	$ -	$ 2,511,141
11	$ 5,211,141	$ 607,337	$ 216,000	$ (216,000)	$ 5,602,477	$ -	$ 216,000	$ 2,700,000	$ -	$ 2,902,477
12	$ 5,602,477	$ 654,297	$ 216,000	$ (216,000)	$ 6,040,775	$ -	$ 216,000	$ 2,700,000	$ -	$ 3,340,775
13	$ 6,040,775	$ 706,893	$ 216,000	$ (216,000)	$ 6,531,668	$ -	$ 216,000	$ 2,700,000	$ -	$ 3,831,668
14	$ 6,531,668	$ 765,800	$ 216,000	$ (216,000)	$ 7,081,468	$ -	$ 216,000	$ 2,700,000	$ -	$ 4,381,468
15	$ 7,081,468	$ 831,776	$ 216,000	$ (465,862)	$ 7,447,382	$ -	$ 216,000	$ 2,700,000	$ 249,862	$ 4,497,520
16	$ 7,447,382	$ 875,686	$ 216,000	$ (473,860)	$ 7,849,207	$ -	$ 216,000	$ 2,700,000	$ 257,860	$ 4,891,347
17	$ 7,849,207	$ 923,905	$ 216,000	$ (495,963)	$ 8,277,150	$ -	$ 216,000	$ 2,700,000	$ 279,963	$ 5,297,187
18	$ 8,277,150	$ 975,258	$ 216,000	$ (518,822)	$ 8,733,585	$ -	$ 216,000	$ 2,700,000	$ 302,822	$ 5,730,763
19	$ 8,733,585	$ 1,030,030	$ 216,000	$ (543,240)	$ 9,220,376	$ -	$ 216,000	$ 2,700,000	$ 327,240	$ 6,193,136
20	$ 9,220,376	$ 1,088,445	$ 216,000	$ (569,279)	$ 9,739,542	$ -	$ 216,000	$ 2,700,000	$ 353,279	$ 6,686,263
21	$ 9,739,542	$ 1,150,745	$ 216,000	$ (597,050)	$ 10,293,237	$ -	$ 216,000	$ 2,700,000	$ 381,050	$ 7,212,186
22	$ 10,293,237	$ 1,217,188	$ 216,000	$ (626,669)	$ 10,883,756	$ -	$ 216,000	$ 2,700,000	$ 410,669	$ 7,773,088
23	$ 10,883,756	$ 1,288,051	$ 216,000	$ (658,257)	$ 11,513,550	$ -	$ 216,000	$ 2,700,000	$ 442,257	$ 8,371,293
24	$ 11,513,550	$ 1,363,626	$ 216,000	$ (691,946)	$ 12,185,230	$ -	$ 216,000	$ 2,700,000	$ 475,946	$ 9,009,284

Total Class A Distributions:	$ 5,184,000
Total Class B Distributions:	$ 3,480,948
Total Distributions:	$ 8,664,948
Present Value of Distributions:	$3,804,394
at 6% discount rate	
PV of Ending Value	$ 3,107,532
Total PV	$6,911,926

Snapshots of After-Tax Benefits of Preferred Partnership

		Baseline Scenario			Action Scenario		
		Status Quo, Simple Gift to Grantor Trust			Use Preferred Partnership		
Year		Grantor	Grantor Trust	Subtotal	Grantor	Grantor Trust	Subtotal
0	Assets held/gifted/transferred	$ 2,700,000	$ 300,000	$ 3,000,000	$ 2,700,000	$ 300,000	$ 3,000,000
	Gift tax incurred at transfer	$ -		$ -	$ -		$ -
2	Value of holdings (includes distributions)	$ 3,352,320	$ 337,080	$ 3,689,400	$ 3,132,000	$ 567,120	$ 3,699,120
	Income tax paid by grantor (33.00%)	$ 215,266	$ 12,236	$ 227,502	$ 142,560	$ 88,150	$ 230,710
	Estate tax if death occurred that year	$ (1,508,544)		$ (1,508,544)	$ (1,409,400)		$ (1,409,400)
	Net wealth to beneficiaries	$ 1,843,776	$ 337,080	$ 2,180,856	$ 1,722,600	$ 567,120	$ 2,289,720
	Advantage of using preferred partnership						**$ 108,864**
9	Value of holdings (includes distributions)	$ 5,786,942	$ 506,844	$ 6,293,786	$ 4,644,000	$ 2,161,733	$ 6,805,733
	Income tax paid by grantor (33.00%)	$ 1,018,691	$ 68,258	$ 1,086,949	$ 641,520	$ 614,372	$ 1,255,892
	Estate tax if death occurred that year	$ (2,604,124)		$ (2,604,124)	$ (2,089,800)		$ (2,089,800)
	Net wealth to beneficiaries	$ 3,182,818	$ 506,844	$ 3,689,662	$ 2,554,200	$ 2,161,733	$ 4,715,933
	Advantage of using preferred partnership						**$ 1,026,271**
15	Value of holdings (includes distributions)	$ 8,102,547	$ 718,967	$ 8,821,515	$ 5,940,000	$ 4,747,382	$ 10,687,382
	Income tax paid by grantor (33.00%)	$ 1,782,841	$ 138,259	$ 1,921,100	$ 1,069,200	$ 1,467,636	$ 2,536,836
	Estate tax if death occurred that year	$ (3,646,146)		$ (3,646,146)	$ (2,673,000)		$ (2,673,000)
	Net wealth to beneficiaries	$ 4,456,401	$ 718,967	$ 5,175,369	$ 3,267,000	$ 4,747,382	$ 8,014,382
	Advantage of using preferred partnership						**$ 2,839,013**