

RECAPITALIZATION OF L.L.C. INTERESTS AND ISSUANCE OF PROFIT INTERESTS HELD TO BE GIFTS IN ESTATE FREEZE

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Code §2701 is a provision which renders the transfer of a partnership or membership interest to a family member a gift. The tax typically applies in an “estate freeze” scenario, where one generation attempts to transfer assets which appreciate in value to another generation, thereby removing it from their estate for estate tax purposes. In its latest Chief Counsel Advice (“C.C.A.”), the I.R.S. held that a recapitalization of a limited liability company (“L.L.C.”) triggers a gift under Code §2701 in a case where a mother retained a right of distribution but transferred the gain or loss attributable to the L.L.C.’s assets to her sons. The I.R.S. held that the interest retained by the transferor (a distribution right on the existing capital account balance) was a senior interest, whereas the transferred interest held by the sons (the right to future gain of the L.L.C.’s assets) was found to be a subordinate interest. What is notable and most troubling here is that the interests transferred to the sons are so-called “profits interests,” issued for future services to be rendered to the L.L.C.

IN GENERAL

Code §2701 imposes special gift tax valuation rules when partnership or membership interests are transferred to family members.²³ Family members covered under Code §2701 include the spouse of the transferor, any lineal descendant of the transferor or the transferor’s spouse, and the spouse of any such descendant.²⁴ In general, Code §2701 devalues interests of senior family members in order to increase the value of interests transferred to junior family members. Code §2701 generally applies to situations where the transferor retains a senior interest and transfers a subordinate interest to the transferee – such as when a parent keeps preferred shares and transfers common shares to family members.

Code §2701 will assign a value of zero to certain interests retained by the transferor or by “applicable family members,” thereby increasing the value of the

²³ Code §2701(a).
²⁴ Code §2701(e)

interests that have been transferred.²⁵ This rule effectively loads value onto the transferred interests and thereby defeats some traditional freeze arrangements.

A gift exists where there is a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership, if the taxpayer or applicable family member receives a retained interest of the entity pursuant to the transaction.²⁶ Furthermore, a transfer will take place where the transferor holding an applicable retained interest before the transaction surrenders an equity interest that is junior to the applicable retained interest and receives property other than an applicable retained interest.²⁷ An applicable retained interest is an equity interest in a controlled corporation where there is a distribution right.²⁸ A senior interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.²⁹



C.C.A. 201442053

In C.C.A. 2014402053, a mother and her sons formed an L.L.C. which was effective as of Date 1. The L.L.C. had a 20-year term that, if not wound up sooner, was to terminate on Date 4. The mother's capital contribution consisted of real property. She was the only member to make a capital contribution. Subsequently, she made gifts of the membership interests in the L.L.C. to her sons and their children.

Under the L.L.C.'s operating agreement, each member's capital account is credited with the amount of his or her capital contribution. Profits and losses are then allocated to a member's capital account *pro rata*, based on his or her ownership interest. A member's ownership interest is the proportion that his or her capital account bears to the aggregate positive capital accounts of all members. Distributions are made based on a member's ownership interest. No member has priority over any other member as to participation in profits, losses, and distributions or the return of capital contributions. No member has the right to withdraw a capital contribution.

The L.L.C. was recapitalized on Date 3, when the mother held an X% ownership interest, each son held a Y% ownership interest, and the grandchildren held the remaining Z% ownership interest. The operating agreement was amended to provide that going forward, all profit and loss, including all gain or loss attributable to the L.L.C.'s assets, would be allocated equally to the sons in exchange for their management of the L.L.C. After the recapitalization, the sole remaining equity interest of the mother and the grandchildren was the right to distributions based on their capital account balances as they existed immediately before the recapitalization.

²⁵ Code §2701(a)(1)(B).

²⁶ Code §2701(e)(5).

²⁷ Treas. Regs. §25.2701-1(b)(2)(B)(2).

²⁸ Treas. Regs. §25.2701-2(b)(1)(ii).

²⁹ Treas. Regs. §25.2701-3(a)(2)(ii).

The I.R.S. noted that the mother and her family controlled the L.L.C. at all times. On Date 3, the L.L.C. was recapitalized and the mother surrendered her right to participate in future profit and loss, including future gain or loss attributable to the L.L.C.'s assets. However, both before and after the recapitalization, the mother held an equity interest in the company coupled with a distribution right, which the I.R.S. indicated was a retained interest. The mother held a distribution right based on the existing capital account balance, as opposed to the sons, who held a right to *future* profit and gain. Thus, the I.R.S. determined that the mother held a preferred interest because she maintained a right to the existing capital account balance as opposed to the right to potential future profit and gain held by the sons. Additionally, the mother received "property" in the form of the sons' agreement to manage the real property.

Consequently, different classes of interest existed, and since the mother received a "senior" interest in exchange for "property," part of the recapitalization was considered a gift under Code §2701.

In determining the amount of the gift, as stipulated under Code §2701, the value of any family-held retained interests and other non-transferred equity assets is subtracted from the aggregate value of the family-held interest. Any distribution right in a controlled entity is generally valued at zero when determining the value of any applicable retained interest.

CONSEQUENCES

Practitioners should always be aware that the issuance of a carried interest (profits interest) in a family L.L.C. partnership setting can invoke the harsh application of Code §2701. Many commentators have suggested that the issuance of a carried interest (profits interest) for services should not necessarily create different classes of interest. The facts presented in C.C.A. 201442053 are somewhat unusual. Nonetheless, the granting of a profits interest should be carefully analyzed in the family partnership/L.L.C. context.

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