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Profits Interests Gifts Under Section 2701: 'I Am Not a Monster'

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Section 2701 provides special gift tax valuation rules for transfers of a partnership or corporate interest when the entity has multiple classes of equity. Congress enacted section 2701 to deal with potential valuation abuses it identified in the preferred stock recapitalization. Section 2701 was enacted to replace section 2036(c) that Congress believed unnecessarily restricted the flexibility of family business owners to arrange their affairs. Ironically the complexity of section 2701 has led estate planners to urge their clients to impose similar restrictions on family entities to avoid imagined disastrous gift tax costs. This concern has particularly impacted planning for a gift of a profits interest in a hedge or venture capital fund where its complex character clearly runs afoul of section 2701.

As families began to use simpler proportional profits interests in partnerships to shift investment risks among family members, estate planners have begun to reevaluate whether section 2701 even applies to partnerships with only this simplified profits interest. This report represents the author's year long struggle to apply section 2701 in this context, despite having been involved with its drafting almost 20 years ago. The author concludes that these simplified profits interests are outside section 2701, subject perhaps to a few tweaks. Moreover, a careful analysis of section 2701 reveals that it will produce a value which differs little from the fair market value analysis of a profits interest under the tax provisions of chapter 12 when a complex hedge or venture capital profits interest is given away. In fact using the subtraction method under section 2701 to value those "bucket" profits interests may be preferable to other valuation approaches.

Whether you are a corporate lawyer with little knowledge of section 2701 or an experienced estate planner, this report *will* surprise you. But remember, section 2701 — unlike section 2036(c) that it replaced — is not a Monster, so be not afraid.

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I. Chapter 14 Is the Anti-Section 2036(c)

Why the title "I Am Not a Monster"? Practitioners and commentators discussing the possible application of Section 2701 to gifts of profit interests have reminded me of my warnings about its predecessor, section 2036(c). Those warnings were captured by the title of my 1988 article "Section 2036(c): The Monster That Ate Estate Planning, and Installment Notes, Buy-Sells, Options, Employment Contracts and Leases."[1] It explored how section 2036(c), enacted the prior year, was fundamentally flawed in using the estate tax to address gift tax valuation "abuses" — one man's abuses being another man's business arrangements. It dismissed the effectiveness of the 1988 technical corrections that tried to limit the broad scope of section 2036(c) by providing safe harbors that would allow family businesses to operate without adverse estate tax consequences if they stayed within narrow exceptions. Congress heard the criticisms and agreed to replace section 2036(c) with chapter 14 — the anti-section 2036(c).[2] Section 2036(c) was a monster; by congressional design, section 2701 is not.

Yet nearly 20 years later we still struggle to embrace that history. My article "Time Traveling to Strangle *Strangi* (And Kill the Monster Again), Part 1,"[3] which

[1]Richard L. Dees, 66 *Taxes* 876 (1988).

[2]S. Stacy Eastland, "I.R.C. Section 2036 Defenses for the Family Limited Partnership Technique," State Bar of Texas, 31st Annual Advanced Estate Planning and Probate Planning, Chapter 18 (June 2007) (collecting the relevant legislative history).

[3]*Tax Notes*, Aug. 13, 2007, p. 563, *Doc 2007-16741, 2007 TNT 157-32*.

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appeared in 2007, also reminded its readers that chapter 14 is not section 2036(c). In particular, it argued that Congress's intent in enacting chapter 14 precluded the use of section 2036(a) to include family limited partnership (FLP) interests in a partner's estate. Chapter 14, whose purpose is to provide a specific set of valuation rules where Congress has identified abuses, has a flip side that practitioners, the IRS (in recent years), and the courts have mostly ignored. If Congress has not provided specific valuation rules, the equity interests of families who invest together are to be valued for transfer tax purposes like the equity interests of strangers who invest together. This flip side is just as important as the special valuation rules.

The intent of chapter 14 can be seen in the differences between the valuation rules under section 2702 for trusts and the valuation rules under the other sections of chapter 14 for partnerships and corporations.[4] Because the creation of a trust is voluntary and admittedly done for estate planning reasons, Congress is comfortable treating a retained income interest as having zero value, unless it is in the form of an annuity or unitrust interest. The retained trust income interest has economic value, but it was the trust's creator who chose to retain an interest she knew had no value for gift tax purposes.

On the other hand, section 2701 provides special valuation rules for equity interests retained in a family corporation or partnership (rather than a trust) in which the nature of those equity interests usually is shaped by factors other than estate planning. Congress therefore built into section 2701 rules designed to mitigate the negative effect of its special valuation rules. For example, section 2701 targets specific valuation abuses of noncumulative preferred stock. Congress saw valuation abuses in retaining noncumulative preferred stock in a family business as comparable to retaining an income interest in a trust. However, Congress permitted noncumulative preferred stock to be valued at its face value, rather than at zero, if the holder of the stock elected to accept adverse[5] transfer tax consequences in the event the noncumulative dividends were not timely paid. Congress provided no similar relief to a trust creator who retains an income interest in a trust under section 2702.

Without repeating the discussion in "Time Traveling," the other provisions of chapter 14 are replete with evidence that Congress intended to treat family equity interests like nonfamily equity interests when it has not provided special valuation rules. Although section 2703 has a broad rule disregarding the valuation effect of transfer restrictions and options, it also contains a broad exception for those options and restrictions that are comparable to arm's-length agreements. Although the literal language of section 2704(b) has no exception for liquidation restrictions in a family entity that are comparable to restrictions in a nonfamily entity, the regulations under section 2704 provide an exception if the liquidation restrictions are comparable to those provided under state law in the absence of an agreement.

Congress crafted those valuation rules to treat family entities like nonfamily entities if interests in those entities avoided the abuses identified in section 2701. This history should guide any attempt to apply the chapter 14 valuation rules to an equity interest in a family partnership or corporation. Commentators, on the other hand, largely have interpreted section 2701 as if it precluded the creation of family entities with classes of equity interests that differ by more than voting and management rights, unless those equity interests carried distribution rights similar to cumulative preferred dividends. But that interpretation resurrects the much-criticized safe harbors of section 2036(c) that straitjacketed family business transactions.[6]

If the IRS were pushing this interpretation of section 2701, commentators would be justified in warning of the possible draconian and irrational gift tax results when family businesses veer outside this straitjacket. But in nearly 20 years, not a single such case has been reported. Rather, Treasury has respected this history and, as we will see below, has drafted the section 2701 regulations with that history in mind.[7] Because corporations have relatively well-defined classes of stock, the concern that section 2701 hinders equity structures in family business and investment entities has most affected the drafting of agreements for a partnership or limited liability company and the transfer of interests in those entities, particularly the gift of a profits interest in a venture capital or private equity fund.

A profits interest is an interest in the profits of a partnership; it conveys no interest in the capital of the partnership. Profits include any gains from investments of the original partnership capital, so the capital interest is limited to the original capital contributed to the partnership. In the fund context, the general partner (GP) who manages the fund usually receives a profits interest as compensation, typically 20 percent of the fund's profits, and an annual management fee of 2 percent of invested capital, which is independent of any profits. However, that description oversimplifies the equity interests in these funds, which have evolved into a complex waterfall of interests, meaning economic rights swing

[4]The first legislative language of the replacement to section 2036(c) provided a single set of valuation rules for trusts, partnerships, and corporations. *See* the discussion draft in House Ways and Means Committee Press Release No. 28 (Mar. 22, 1990).

[5]Section 2701(c)(3)(C)(ii).

[6]In my testimony at the first congressional hearing concerning section 2036(c), I described those safe harbors as follows:

> This approach to narrowing the application of 2036(c) is the equivalent of me telling someone how to get to my house by describing everywhere in America that I do not live. No matter how well traveled I am, I am bound to miss something in that description, and the people who write these safe harbors are not well traveled in the business world.

U.S. Senate, Comm. of Finance, S. Hearing 101-380 (May 10, 1989) at p. 35.

[7]"Time Traveling," *supra* note 3, at p. 573 details the IRS's reluctance to apply section 2036(a) to FLPs and the other evidence of the Service's respect for the significance of chapter 14's legislative history.

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back and forth between the GP managers and the limited partner (LP) investors. Although that complexity has confounded those who have tried to apply section 2701 to gifts of either a profits interest or a capital interest in one of these entities, this report shows how to do so.

Recently, a simpler profits interest has evolved in the context of family investment partnerships as a way to divide risks and rewards among different family members. This profits interest usually involves a straight 80/20 or 90/10 division of profits between the LP investors and GP manager. Unlike the typical fund, which charges the investors a 2 percent annual management fee to offset the GP's administrative expenses, the GP pays those expenses out of the profits interest, reducing the risk borne by the investors.

I first consider whether section 2701 could produce harsh gift tax results on the creation of a family investment partnership with a simplified profits interest or on the transfer of its equity interests. This report should disperse that fear. The creation or existence of a simple profits interest in a partnership should not present any section 2701 valuation issues. Moreover, the careful analysis of the regulations required to understand how section 2701 applies to a simple profits interest also reveals that Treasury drafted the regulations to mitigate any possible draconian and irrational results had the regulations followed the statute's literal language.

This close analysis demonstrates that even the gifts of complex profits interests that are subject to the special valuation rules under section 2701, such as profit interests in a hedge or venture capital fund, may not produce severe gift tax results. Rather, the report concludes that the gift under chapter 14 should not be much different — at least with a few tweaks — from the gift under the ordinary gift tax valuation principles of chapter 12.

II. Chapter 12 Gift Tax Analysis

A. Profits Interest Basics in the Farm Context

A partnership in which one partner contributes capital, the other contributes services, and they split the profits predates the federal income tax. It probably even predates the legal existence of partnerships. Yet hedge and venture capital funds are so exotic that an understanding of the profits interest in one of those funds is daunting. Transplanting the profits interest concept to the farming context might ease one's understanding.

A common type of farm partnership involves one partner contributing the land, the other contributing services and farm equipment, and the two then splitting the profits. When the partnership is over, the partners receive back their respective capital contributions. The profit split in the farm partnership is similar to a simplified profits interest in an investment partnership. The difference between the two is that the profits interest in the investment partnership includes the gain from reinvesting the original capital contributed by the partner with assets. Because the GP manager's expertise includes investing the original capital for gain, sharing that gain is appropriate in an investment partnership. In the farm partnership, however, the farming services do not necessarily add to the value of the land, and the equipment may depreciate in value. Thus, each partner typically takes back the original property contribution on termination of the farm partnership without sharing appreciation or depreciation.

When a parent and child create a partnership, a gift can result whether the partnership has a profits interest or not. If a parent and child enter into a farming partnership, with the parent providing the land and the child providing labor and equipment, a gift would result — without resort to the special valuation rules under section 2701 — if their respective partnership interests do not reflect the value of their respective contributions. Because the substance of this farm partnership is similar to a crop share lease arrangement, one should expect to see the partners share profits in a similar 50/50 manner.[8] If the parent receives only a 10 percent profits interest, a gift should result under the ordinary gift tax principles of chapter 12.

If the capital contributed by the parent was 90 percent of the value of the partnership capital, the parent's share of the profits would not have to be 90 percent to avoid a gift. The gift tax value of the child's services as a farmer would be recognized as part of the fair market value of the child's contribution. The gift tax does not require that those services be ignored for gift tax purposes. Although unlikely, the IRS might well investigate whether the child was making a gift to the parent by taking less than her economic share of the profits. Because the partners retain the right to receive their respective capital contributions at the termination of the partnership, a gift of capital cannot result under chapter 12. Rather, chapter 12 asks whether the annual use of the parent's land is adequately compensated by the child's services.

B. Profits Interest Basics in the Investment Context

1. Simplified profits interest example. We will consider the creation of a family investment partnership with a simplified profits interest structure similar to the splitting of profits in a farm partnership:

> Daughter is an investment banker who has agreed to leave Wall Street and act as GP for her parents' newly created investment partnership (Eli LP). Mom and Dad have decided to adopt a more aggressive investment policy using liquid investments. They agree that Daughter should have seven years to prove her investment strategies. Parents offer a very generous hourly rate, but Daughter responds, "If I have learned anything on Wall Street, it is that only suckers work by the hour."
>
> After intense negotiations, they shake hands on a modified 80/20 deal. Unlike the traditional venture capital arrangement, Daughter would receive no fixed administrative fee. She could choose investments and advisers, but has to pay all investment expenses. Parents and Daughter would form Eli LP with $50 million in investments. Parents would

[8]The passive loss regulations treat a crop share lease as a joint venture, like a partnership. Temp. reg. section 1.469-1T(e)(3)(viii), Example 8.

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invest 99 percent of the capital equally in exchange for all the LP units. Daughter would invest 1 percent of the capital, agree to provide investment management services, and pay all investment expenses in exchange for all the GP units. The GP units would share ratably in all original capital distributions. The GP units also would carry a right to 20 percent of the profits of Eli LP, while the remaining 80 percent would go to holders of the LP units, in proportion to their invested capital. Eli LP will liquidate at the end of seven years, unless Daughter terminates it earlier.

2. Chapter 12 analysis. Under ordinary gift tax principles, the excess of the FMV of the profits interest transferred to Daughter over the FMV of the services contributed by Daughter (including the value of her agreement to pay investment expenses) would be the value of the gift under chapter 12. As we saw in the farming context, Parents' retention of their right to their original contribution means any such gift would result from the services provided by Daughter having less value than the right to use the capital, rather than from a gift of the capital itself.

III. Section 2701 Gift Tax Analysis

Does chapter 14 dramatically change the gift tax analysis so that the gift under chapter 14 includes a deemed gift of the capital? Some commentators argue in the investment context that granting the child a percentage profits interest for managing the partnership that is greater than her percentage of contributed capital would result in a gift of that portion of the underlying capital. In other words, because Parents contributed 90 percent of the capital, in the farm context those commentators would apparently believe that section 2701 treats Parents as giving away 40 percent of the value of the farmland simply by taking back the appropriate 50 percent profits interest. Presumably those commentators also would conclude that when the partnership unwinds and Parents take back the farmland, any future transfer of the same 40 percent, during life or at death, would again be subject to transfer tax, except as limited by mitigation provisions under section 2701. However, I know of no instance in which the IRS has argued for that irrational and harsh result in the context of either a farming or investment partnership.

We now will consider whether section 2701 applies to the creation of the profits interest in an investment partnership. Whatever we conclude, the transfer tax consequences should be the same whether the partnership is engaged in farming or investing.

A. The Corporate Analogy

We have already seen that the profits interest is easier to understand in the farm context than in the hedge or venture capital fund context. Before delving into the complexities of applying section 2701 in the partnership context, let us consider how it applies in the corporate context.[9] Of course, the partnership profits interest has no exact corporate counterpart. However, the following corporate structure duplicates the economics of a partnership profits interest:

> Parents and Daughter contribute $50 million, 1 percent from Daughter and 99 percent from Parents, to a new corporation (Eli Corp.). Eli Corp. has two types of equity interests: preferred stock and common stock. The preferred stock provides for no preferred dividends and no vote, but for a payment of $50 million whenever Eli Corp. is liquidated. The common stock, of course, carries the rights to all other economic interests. Parents and Daughter divide both classes of stock in proportion to their capital contributions. For example, if Eli Corp. had 50,000 shares of preferred with each share having a liquidation value of $1,000 and 100 common shares, Daughter would receive 50 preferred shares and 1 common share.
>
> Assume that Parents transfer 19 more shares of common stock to Daughter in exchange for her management contract so that she then has 20 shares of common stock. Because the liquidation value of the preferred at the time of the gift equals the value of the corporation, or its original capital, the common stock has zero value on a subtractive basis. Thus, the common stock effectively is an interest only in the ''profits'' of the corporation with Parents receiving 80 percent and Daughter 20 percent.

The subtractive value of the common stock, zero, would not be its FMV under chapter 12. Rather, the FMV of the common stock should reflect its ability to use the capital until the corporation liquidates, which Parents do not control. One's immediate reaction is that section 2701 would apply to this preferred stock. After all, section 2701 clearly applies if the preferred stock carries a right to noncumulative dividends. However, the regulations under section 2701, surprisingly perhaps, exclude this capital structure from the application of section 2701. Only a careful analysis of the section 2701 regulations allows one to see this conclusion.

1. Requirements for the application of section 2701.

a. Equity interest. The regulations under section 2701 of chapter 14 apply special gift tax valuation rules to the transfers of some equity interests in a partnership or corporation. The statute[10] refers only to ''interests'' and not specifically to ''equity,'' but the addition of the word

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[9]A subcommittee of the American College of Trust and Estate Counsel studying section 2701 issued a report on the simple profits interest dated Feb. 8, 2009 (ACTEC Report). Although I disagree with the conclusions in the ACTEC Report, I am grateful for footnote 1, which offers a corporate structure equivalent to a partnership profits interest. Earlier drafts of this report had said that the profit interest has no corporate counterpart. Analyzing a corporate ''profits interest'' under section 2701 is much easier, because the regulations were drafted on a corporate paradigm. I also appreciate the group's many suggestions and challenges to my earlier drafts, which have improved this report.

[10]Section 2701(a)(1).

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''equity'' in the regulations reflects legislative history prohibiting the application of section 2701 to borrowings, leases, and compensation arrangements. Clearly, the common stock in Eli Corp. is an equity interest.

b. Applicable retained interest. Section 2701 does not apply to transfers of all equity interests. To trigger section 2701, the transferor or an applicable family member must own an applicable retained interest in the entity after the relevant transfer. The regulations[11] define an applicable family member as the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and the spouse of any ancestor. (This definition prevents the application of section 2701 when the younger generation owns the preferred stock and transfers common stock to the senior generation.)

The regulations[12] further define an applicable retained interest as:

> an equity interest in a partnership or corporation with respect to which there is either —
>
> (i) An extraordinary payment right, . . .
>
> (ii) In the case of a controlled entity, . . . a distribution right.

Let us consider the application of each of these definitions.

i. Extraordinary payment right.

a. Liquidation, put, call, or conversion right under the statute. The regulatory ''extraordinary payment right'' began life as the statutory ''liquidation, put, call or conversion right'' (LPCC right), meaning any LPCC right ''or any similar right, the exercise or nonexercise of which affects the value of the transferred interest.''[13] LPCC rights are always valued at zero, while distribution rights are valued at zero only if the family controls the entity. Further, section 2701(a)(3)(B) limits the value of an equity interest conveying both a qualified payment right and an LPCC right to the lower of the value of the interest's qualified payment right and liquidation value.

b. Extraordinary payment right under the regulations. The regulations[14] replace the LPCC right with the extraordinary payment right, defined as a ''put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest.''[15] The statute refers[16] just to a ''liquidation right,'' but the regulations[17] separate this term into a ''right to compel liquidation'' and a ''liquidation participation right,'' meaning a right to participate in liquidating distributions. The right to compel liquidation is an extraordinary payment right; the liquidation participation right is not.[18]

1. Definition of liquidation. The regulations under section 2701 do not define liquidation or a liquidating distribution. However, the regulations under section 2704 (also a part of chapter 14) do:

> Liquidation right means a right to compel the entity to acquire all or a portion of the holder's equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity.[19]

Under this definition, a liquidation right includes a right to compel the liquidation of an equity interest, and not just the right to compel the liquidation of the entity. Accordingly, the right to compel liquidation should include any right to require the entity to purchase the equity interest (which overlaps with a simple put right). A liquidating distribution thus includes any distribution an entity makes to reacquire an equity interest from an owner as well as any distribution made to the owners when the entity liquidates. Both types of distributions extinguish or retire an equity interest in the entity, rather than being paid with respect to (and without diminishment of) the equity interest, which is the definition of a distribution right.

2. Splitting the liquidation right. As discussed above, the code refers only to a ''liquidation right'' and further provides that liquidation rights are to be valued at zero. If it took the code literally, Treasury could have treated a right to participate in a liquidation distribution as a liquidation right, having zero value, despite actually having substantial economic value. Instead, Treasury drafted its regulations by focusing on the abuse Congress was targeting when it included a liquidation right within the scope of section 2701.[20]

Congress enacted section 2701 to prevent the use of bells and whistles to increase the value of preferred stock. Before section 2701, taxpayers would set the face value of the preferred stock nearly equal to the value of the entire corporation. The preferred stock would carry a put right, or the holder would control the entity, giving the preferred holder the right to liquidate. The preferred stock would be valued at face, although its value in an ongoing business would be much less. The taxpayer would subtract this face value from the company's value, leaving only negligible value in the common stock, which the preferred holder then gave away. The preferred shareholder's right to immediately liquidate the preferred stock and receive its face value was the key to valuing the common stock at nearly zero. Because the arm's-length definition of FMV assumes that the owner will maximize value, any abuse of the fair market valuation rules

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[11]Reg. section 25.2701-1(d)(2).

[12]Reg. section 25.2701-2(b)(1).

[13]Section 2701(c)(2)(A).

[14]Reg. section 25.2701-2(b)(2).

[15]We will adopt the convention that an LPCC right is a potential extraordinary payment right but becomes an extraordinary payment right only if the equity interest to which it is attached is an applicable retained interest. Like the regulations, we will assume the ''L'' in LPCC henceforth stands for a right to compel liquidation, rather than just a liquidation right.

[16]Section 2701(b)(1)(B).

[17]Reg. section 25.2701-2(b)(2).

[18]Reg. section 25.2701-2(b)(4)(ii).

[19]Reg. section 25.2704-1(a)(2)(v).

[20]We will see below that the proposed regulations came close to this treatment, but the final regulations adopted a different treatment.

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depended on the common stockholder not being able to block the liquidation of the company or the redemption of the preferred stock.

The regulations respond to this history in two ways. First, they create a right to compel liquidation, to join the put, call, and conversion rights as rights with zero value. Second, the regulations create a liquidation participation right that, unlike the liquidation right or the right to compel liquidation, will not have zero value. Rather than simply value the preferred shareholder's right to receive liquidating distributions at zero, the regulations prevent the manipulation of the right to liquidate. When the family can control the liquidation of an equity interest, the regulations value this liquidation participation right at market value as if the right to compel liquidation ''did not exist, or . . . if the lower of rule applies, is exercised in a manner that is consistent with that rule.''[21]

Thus, the regulations value any liquidation participation right without regard to the right of the family to compel liquidation. In contrast, the regulations value extraordinary payment rights (a put or conversion right) at zero,[22] thereby eliminating any value to those rights. By drawing a distinction not in the statute, the regulations narrow its scope, allowing the right to share in a liquidating distribution to retain its market value, without increasing that value for a retained family right to compel that liquidation. In other words, the right of the preferred stock in Eli Corp. to participate in liquidation on termination retains its market value under section 2701, but that value cannot be increased by any family held right to compel liquidation earlier.

The regulations already disregard rights valued at zero under section 2701 in valuing at FMV any economic interest not subject to the special valuation rules. The overlap can be seen in the italicized language in the regulation below:

> Any other right (including a qualified payment right not subject to the prior paragraph) is valued as if *any right valued at zero does not exist and as if any right valued under the lower of rule is exercised in a manner consistent with the assumptions of that rule* but otherwise without regard to section 2701. Thus, if an applicable retained interest carries no rights that are valued at zero or under the lower of rule, the value of the interest for purposes of section 2701 is its fair market value. [Emphasis added.][23]

The difference is that this regulation disregards only individually held rights valued at zero, including the right to compel liquidation, while the earlier regulation disregards a family-held right to compel liquidation.

c. Whose (extraordinary payment) right is it anyway?

1. Mandatory rights are not extraordinary payment rights. The regulations exclude mandatory payment rights from section 2701.[24] The definition of mandatory payment rights and liquidation participation rights overlap when the preferred stock has a fixed redemption date or the entity liquidates at a fixed date. Fixed liquidation payments are not extraordinary payment rights, nor are they distribution rights; therefore, fixed liquidation payments have value under section 2701 without being classified as liquidation participation rights. Accordingly, the concept of giving liquidation participation rights value under section 2701 is needed only when the timing of their exercise is uncertain.

Neither the regulations nor the statute refer to LPCC rights or extraordinary payment rights as ''discretionary'' rights. Because the regulation exclude all fixed rights from the definition of extraordinary payment rights, only discretionary rights remain. However, neither the statute nor the regulations answer the question: whose discretion?

2. Whose discretion? The question of who needs to hold the discretionary exercise of an LPCC right to turn it into an extraordinary payment right has four possible answers: (1) the family, acting together, can exercise the LPCC right; (2) the holders of the applicable retained interest carrying the LPCC right, acting together, can exercise the right; (3) the applicable family members owning the applicable retained interest carrying the LPCC right, acting together, can exercise the right; or (4) the holder of the applicable retained interest carrying the LPCC right can exercise the right in any capacity. Before examining those four possibilities, let us dismiss a fifth possibility, that all the owners, not necessarily just family owners, can exercise the right. The statute requires a distribution right to be in a controlled entity before it is valued at zero, but it imposes no similar requirement for an LPCC right to be an extraordinary payment right. However, Congress cannot have intended to treat every LPCC right exercisable by its owners, acting together, to be an extraordinary payment right, because all of the owners can liquidate any corporation or partnership and, under that definition, every entity and every equity interest would have an extraordinary payment right.

First, defining an extraordinary payment right by reference to its exercise by the family as a group seems the least likely interpretation. The statute and regulations are careful to identify the family members who must hold a right to trigger a particular statutory provision. If Congress or Treasury intended to define an extraordinary payment right in terms of family control, they simply could have required that the LPCC right be in a controlled entity, as is the case with a distribution right. Moreover, as already seen, before the enactment of chapter 14, if the common stock owner was one of the family group whose approval was needed, a fair market valuation of the common stock was not abusive.

Second, despite defining an applicable retained interest as a separate class of stock, defining an extraordinary payment right by reference to its joint exercise by the owners of the preferred stock seems unlikely. Section 2701 applies when control of the entity gives the applicable family member the right to liquidate her preferred stock, even if the preferred stock carries no right to convert, put, or otherwise force the liquidation of the preferred stock. Thus, whether an LPCC right is an extraordinary payment right appears not to turn on

[21]Reg. section 25.2701-2(b)(4)(ii).
[22]Reg. section 25.2701-2(a)(1).
[23]Reg. section 25.2701-2(a)(4).
[24]Reg. section 25.2701-2(b)(4)(i).

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whether the preferred stockholder exercises the LPCC right in that capacity. Because the entity, not the stockholder, has the discretion to exercise any call right, it seems inappropriate to label a call option a call "right." Rather, the applicable family member holding the discretion to exercise an LPCC right in a capacity other than as a preferred shareholder will still hold an extraordinary payment right.

Third, a narrower test defining an extraordinary payment right by reference to its exercise by the applicable family members owning applicable retained interests as a group also lacks statutory or regulatory support. As seen above, an applicable family member who can exercise an LPCC right through the ownership of another class of equity would still be considered to have an extraordinary right concerning the applicable retained interest. Thus, tying discretion to a particular class of equity ownership appears inappropriate. Moreover, neither the statute nor the regulations refer to this specific family group as holding an extraordinary payment right.

Finally, the most likely definition of an extraordinary payment right would tie the discretion to the holder being able to exercise the LPCC right in any capacity. Put and conversion rights are associated specifically with an equity interest, so the existence of an extraordinary right should turn on whether the discretionary right is held by the owner. The right to call an equity interest or the right to compel the liquidation of an entity generally is held by the entity, not the equity holder. If the transferor holds either right concerning any applicable retained interest subject to special valuation, the right should be an extraordinary right even if another applicable family member owns the preferred interest and even if the transferor owns no preferred stock. Congress was concerned that a parent might avoid section 2701 by owning only common stock and giving it away while a spouse or grandparent held the preferred stock. This concern also mandates that the definition of extraordinary right include a call right or a right to compel liquidation held by an applicable family member who owns a preferred equity interest, even if the LPCC right is exercisable because of ownership of another equity class.

However, nothing in the statute or regulations authorizes the transferor or applicable family member to be considered as holding an extraordinary payment right if she can exercise the right only as a member of a group. The regulations apply a special rule to group control over a liquidation participation right, so Treasury did know how to provide for a rule governing the exercise of a right as a group. In that regulation the group is "the transferor, members of the transferor's family or applicable family members" who, if they "have the ability to compel liquidation," will result in the liquidation participation right being valued as if it did not exist, or will be exercised consistently with the lower-of rule.[25]

Examples 3 and 4 in the regulations[26] further confuse whose discretion is important in determining whether an LPCC right is an extraordinary payment right. Example 3 says "P's right to *participate in liquidation* is an extraordinary payment right." (Emphasis added.) Example 4 says "P's right to *participate in liquidation* is not an extraordinary payment right under paragraph (b)(2) of this section, because P and P's family cannot compel liquidation" of the corporation. (Emphasis added.) Those examples suggest that an extraordinary payment right exists when the family, as a group, holds the right to compel liquidation.

The flaw in that analysis is that under the final regulations, a right to participate in liquidation, which is obviously a liquidation participation right, is *never* an extraordinary payment right. A look at reg. section 25.2701-2(b)(4), as originally proposed, explains the confusion:

> A liquidation participation right is a right to participate in a liquidating distribution. A liquidation participation right does not include the right to participate in a liquidating distribution if the transferor, members of the transferor's family, and applicable family members have the ability to compel liquidation.

Under the proposed regulations, a liquidation participation right was an extraordinary payment right when the family controlled the liquidation of the entity. Under the final regulations a liquidation participation right is never an extraordinary payment right. Thus, those examples do not address the question of who has to hold the discretionary right for an LPCC to be an extraordinary payment right.

Treasury intentionally changed the final regulations to treat family-held liquidation rights more favorably than the proposed regulations. If that change had not been made, the determination of whether a liquidation right is subject to section 2701 valuation would turn on the family's ability to control either the liquidation of the entity or the liquidation of the equity interest. That change would be meaningless if a family-held LPCC right is always an extraordinary payment right.

3. The resort to technical corrections. After Treasury drafted the chapter 14 regulations, it went back to Congress for technical corrections to chapter 14 that would support some of the positions taken in the regulations. Technical corrections to chapter 14 were eventually enacted as part of the Small Business Job Protection Act of 1996.[27] Despite lacking any corresponding statutory language, House Ways and Means Committee Report No. 586 (1996) provides:

> It is understood that Treasury regulations could provide, in appropriate circumstances, that the right to receive *amounts on the liquidation* of the corporation or partnership constitutes a liquidation right within the meaning of section 2701 if the transferor, *alone or with others*, has the right to cause liquidation. [Emphasis added.]

Treasury appeared concerned that without congressional support a court would not uphold the regulatory rule requiring a liquidation participation right to be

[25]Reg. section 25.2701-2(b)(4)(ii).

[26]Reg. section 25.2701-2(d).

[27]*See also* ACTEC Report, *supra* note 9, at note 18.

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valued as if the family could not force the liquidation. Moreover, the same regulation applies the lower-of rule to the valuation of a liquidation participation right when the statute applied that rule only to the valuation of a qualified payment right.[28] By including nonfamily members, the 1996 legislative authority went beyond a family-held right to compel liquidation, but Treasury has not exercised its discretion to go that far.

Treasury asked only for Congress to approve the unity rule regarding the ''right to receive amounts on the liquidation of the corporation or partnership'' or liquidation participation right. It could have asked for similar authority to treat jointly held LPCC rights as extraordinary payment rights. Its failure to do so supports my position that the decision whether an LPCC right is an extraordinary payment right turns on an individual exercise of the right, rather than on a group exercise.

d. Conclusion: Eli Corp. preferred stock has no extraordinary payment right. If the regulations excluded only a liquidation participation right from being an extraordinary payment right, it still would have zero value as a distribution right in a controlled entity. The regulatory definition of a distribution right also excludes a liquidation participation right. Under the regulations, a liquidation participation right is neither an extraordinary payment right nor a distribution right.[29] The regulatory treatment of a liquidation participation right in the typical preferred stock context is dramatically different than under the statute. That difference is underappreciated.

We conclude above that whether an LPCC right is an extraordinary payment right turns on the transferor or an applicable family member having the discretion to exercise that right. Because the exercise of the LPCC right has to affect the value of a transferred interest, the extraordinary payment right has to be associated with a senior equity interest. If that extraordinary payment right exists, the senior equity interest is an applicable retained interest and, subject to section 2701 valuation, if owned by the transferor or an applicable family member.

Our partnership example assumes that any right to withdraw depends on the approval of Daughter as GP. For the Eli Corp. example to mimic the partnership's structure, the preferred stock should have no put, call, or conversion right, and any decision to liquidate the corporation would need to be Daughter's decision alone. One could duplicate this in the corporate context by having both voting and nonvoting stock, with Daughter's one share of common stock being the only voting stock.

That structure would create its own set of chapter 12 valuation issues. The example assumes that the original issuance of common stock was based on proportional capital contributions. A chapter 12 gift would likely result from the failure of Parents to take back a pro rata share of the voting common stock. After the gift, Parents would no longer control liquidation and would therefore lack the requisite applicable retained interest.[30] Finally, in addition to ignoring the chapter 12 gift complexities, the subsequent discussion assumes that both voting common stock and nonvoting common stock are of the same class for section 2701 purposes.[31]

The corporate example does not state whether Eli Corp. will liquidate in seven years like Eli LP or will have perpetual life. That factor is irrelevant, however, to a determination of whether the preferred stock is an applicable retained interest. A fixed liquidation date would enhance the value of the preferred stock because the longer redemption or liquidation is deferred, the less the current value of the preferred stock (because of present values discounting).

However, no preferred shareholder in the example has the right to either liquidate Eli Corp. or to cash in preferred stock before the liquidation of the corporation. Thus, the preferred stock in the example carries no extraordinary payment right.

ii. Distribution right. Although the preferred stock in Eli Corp. confers no extraordinary payment right, the preferred stock would still be an applicable retained interest if it carries a distribution right. Because Eli Corp. is wholly family owned, it is a controlled entity.

The regulations define a distribution right as ''the right to receive distributions with respect to an equity interest.''[32] However, the regulations also exclude some distribution rights from their definition of distribution right. The only payment right of the preferred stock in Eli Corp. is the right to receive back the amount of original capital when Eli Corp. liquidates. A return of original capital is certainly a liquidating distribution. As previously discussed, this is a liquidating participation right that is neither a distribution right nor an extraordinary payment right.

2. Significance of section 2701 not applying to the corporate equivalent of a profits interest. Because the preferred stock in Eli Corp. has neither an extraordinary payment right nor a distribution right, the preferred stock is not an applicable retained interest. If a company has no applicable retained interest, section 2701 will not apply to a transfer of its common stock. Although the existence of this type of preferred stock without any dividends might seem unlikely outside the family context, the first instance in which I applied the final regulations under section 2701 involved a preferred stock, created in a bankruptcy reorganization, that paid no dividends. One family had a significant interest in the corporation, perhaps effective control, and the company's lawyers were concerned that chapter 14 might prevent the reorganization.

Does not section 2701 apply to all attempts to create equity interests with disproportionate appreciation rights? Is this not a gaping loophole in section 2701? The answer to both questions is no. There is simply no abuse of the type regulated by section 2701.

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[28]Section 2701(a)(3)(B)(ii).

[29]Reg. section 25.2701-2(b)(4)(ii).

[30]The transfer would not be a lapse of a liquidation right under reg. section 25.2704-1(c).

[31]Reg. section 25.2701-1(c)(3).

[32]Reg. section 25.2701-2(b)(2).

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a. Disproportionate appreciation. When practitioners consider how to apply section 2701, they often ignore how Congress designed it to be the anti-section 2036(c). It was noted above that the interpretation some practitioners would place on section 2701 would have the same effect in straitjacketing the equity interests in family businesses as did the safe harbors under section 2036(c). One of the problems with section 2036(c) is that Treasury could never decide, disproportionate to what?[33] Accordingly, section 2701 does not require that it apply to every entity with equity interests carrying disproportionate rights to appreciation.[34]

b. Liquidation participation rights reflect Treasury's intent to treat family and nonfamily entities alike under chapter 14. The decision by the drafters of the section 2701 regulations to treat a liquidation participation right as neither an extraordinary payment right nor a distribution right is simply another example of Treasury writing the regulations to treat family businesses fairly (like nonfamily businesses) under the transfer tax. Treasury did so despite the opportunity under the literal language of the code to write harsher regulations, thus providing further evidence of the understanding between Congress and the White House as to chapter 14's significance. As we will see below, not a single example in the legislative history or the regulations applies section 2701 to an equity structure in which profits are shared proportionately.

B. Simplified Profits Interests

If the corporate equivalent of a profits interest is not caught by section 2701, neither should the simple partnership profits interest. Applying section 2701 differently to the same economic interests in a partnership and corporation would be contrary to the statute's intent. (It would be just as wrong as coming to two different conclusions regarding the transfer tax consequences of profits interests in partnerships engaged in farming or investing.) Thus, we should interpret the regulations under section 2701 to provide comparable treatment in either type of entity. Because section 2701 and its regulations were drafted with the corporate paradigm in mind, we will see that it is harder to apply those rules to partnerships.

The chapter 12 gift is the starting point for determining any chapter 14 gift.[35] If the FMV of the GP units Daughter receives exceeds the FMV of her contributed property and services (including the value of her agreement to pay all investment expenses), under that simple structure Parents would make a chapter 12 gift of the excess. If these values are equal, do Parents nonetheless make a chapter 14 gift under section 2701?

1. Requirements for application of section 2701.

a. Equity interest. Section 2701 applies to equity interests in partnerships such as Eli LP. Equity is synonymous with ownership. Although a partnership may issue GP units in exchange for services as well as property, the "service" GP units comprise an equity interest for income tax purposes. A GP owning only a profits interest is a partner for federal income tax purposes, although, as in our case, the GP often also owns a 1 percent capital interest in the partnership. Thus, for tax purposes, the transfer of a profits interest in a partnership, including the grant of a profits interest in exchange for services, is likely to be a transfer of an equity interest for purposes of section 2701.

Because the paradigm for section 2701 and its regulations is the preferred stock freeze, analyzing the gift tax effect of a transfer of a profits interest is difficult under both the statute and regulations. Our partnership example involves GP and LP units that staple the profits interest to a proportionate 1 percent interest in partnership capital, unlike the corporate example in which the capital and profits interest are represented by two different classes of stock.

b. Applicable retained interest. For section 2701 to apply, the transferor or an applicable family member must own an applicable retained interest in the entity after the relevant transfer. An applicable retained interest is an equity interest that carries either an extraordinary payment right or a distribution right. Because the preferred stock had neither, Eli Corp. lacked the requisite applicable retained interest.

i. Extraordinary payment right.

a. Fixed liquidation date. In our example, Parents' LP units have no put, call, or conversion right, nor any right to compel the partnership's liquidation. Only Daughter, as the holder of the GP units, can compel Eli LP to liquidate before expiration of the seven-year term. Moreover, the requirement that Eli LP liquidate at the end of the seven years is not a right to compel liquidation but rather a mandatory payment right.

b. Alternative withdrawal rights. Daughter wants to operate Eli LP for at least seven years so she can recoup her costs and earn a profit, which otherwise might be jeopardized by short-term market setbacks. Remember that the right of the LP units to receive liquidating distributions when Eli LP terminates at the end of seven years is a liquidation participation right and therefore not an extraordinary payment right. However, it is less clear whether Parents and Daughter can arrange their affairs in other ways to achieve the same business objective without creating an extraordinary payment right. For example, if Parents could withdraw at any time after seven years and Eli LP would not liquidate until Parents withdrew, the economic effect would be the same as having a seven-year term because Parents and Daughter could always agree to extend their partnership beyond the seven years. Both approaches should produce the same gift tax result.

Although the chapter 14 regulations refer to "lapsing rights" many times, they never refer to "springing" rights, such as the right to withdraw after a fixed time period. No authorities have ever addressed whether a delay makes any difference in determining if a right is a

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[33]Disproportionality always seemed to turn on the FMV of the equity interests when Congress enacted section 2036(c) due to the inadequacy of FMV valuation.

[34]Despite the code lacking the concept of disproportionality in determining whether section 2701 applies, as discussed below, a proportionate transfer is exempted from section 2701 under the code and under the regulations.

[35]Reg. section 25.2701-2(a).

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put right or a right to compel liquidation. A right to liquidate after a fixed period does not present the same valuation abuse as an immediate right to withdraw or liquidate. Thus, an extraordinary payment right should exist only if it is exercisable at the time of the transfer.

Some investment partnerships permit investors to immediately withdraw, subject to monetary penalties based on the timing of the withdrawal. Those penalties provide more certainty and flexibility for investors while still protecting the GP. As the partnership term nears the end of its seven years, the penalties are phased out. Economically, those penalties should have the same effect as either allowing an LP to withdraw after seven years or to compel the partnership to liquidate at the end of seven years. However, unlike a springing withdrawal right, section 2701 is likely to treat the immediate right to withdraw as a right to compel liquidation or as a put right, despite being subject to a monetary penalty to deter withdrawal. Another problem with having the immediate right to withdraw subject to penalties is that the lower-of rule limits the value of the LP units to their least possible value on liquidation.

c. Liquidation value includes unpaid distributions.

1. The meaning of present value. The value of a right to receive a fixed amount in redemption of a preferred interest is a mandatory payment right and not a distribution right. A mandatory payment right is valued at FMV without regard to section 2701. FMV would be the present value of the amount to be received on liquidation, discounted by the appropriate market rate of return. Rather than stop there, let us look at what this means mathematically. The formula for compound interest is: $P \times (1 + r)^n = F$, in which P = present value, r = the rate of investment for a period, n = the number of periods of compounding, and F = the future value after n periods. The formula is derived by starting with the amount to invest (P) and then computing the amount you have at the end of the year if you invest at an annual rate of r. At the end of one year, you would have your original amount invested plus the interest earned, or $F = P + P \times r$. At the beginning of the next year you have the principal and the first year's interest to invest, or $P + P \times r$, so at the end of the year you have your original amount, interest for two years on that amount, and interest for one year on the first year's interest, or $F = P + P \times r + (P \times r) \times r$. The same applies every year for n years, resulting in a series: $F = P + P \times r + P \times r \times r + P \times r \times r \times r \ldots$ n times. The shorthand way to express $r \times r$ is r^2. If you know that any number raised to a zero power equals 1 and any number raised to the first power is that number, the formula for future value can be expressed as $F = P \times r^0 + P \times r^1 + P \times r^2 + \ldots + P \times r^n$ repeated n times. This series can be simplified to the formula: $F = P \times (1 + r)^n$. When you discount a number, you start from the future value (F) but want to solve for the original amount invested (P), so you solve this equation for P by dividing both sides: $F/(1 + r)^n = P$.

The present value of the right to receive $1,000 in the future when the preferred stock is redeemed at the end of five years discounted at a market rate of 12 percent (stated as a decimal fraction) is therefore $\$1{,}000/(1 + 0.12)^5 = \$567.43$. In other words, if you invest $567.43 today at 12 percent, in five years you will have $1,000. The higher the interest rate, the less you need to invest today; the longer you have to invest, the less you need to invest today.

2. Present value and compounding permeate section 2701. We know that section 2701 was designed so that a preferred stock with a face value of $1,000 would have the same gift tax value (present value) when the preferred dividends are payable at the same rate as the market rate and those dividends are a qualified payment right. Being a qualified payment right allows the dividends to be deemed timely paid for purposes of section 2701. The market rate is the rate at which an investment maintains its value over time. Section 2701 therefore assumes that the timely made payments also are reinvested at the market rate. Otherwise, the amount the preferred stockholder would have at the end of the term would not equal the compounded amount.

However, a preferred stock need not provide for any preferred payments if the redemption amount equals an amount that includes not only the face value of the preferred stock, but also an additional amount equal to the forgone compounded interest payments. If the redemption date is fixed, the redemption amount is a mandatory payment right explicitly allowed to be valued at FMV (determined by discounting). When the redemption date is uncertain, the redemption amount is not a mandatory payment amount, but the redemption amount is a liquidation participation right that also is valued at FMV. A zero coupon bond acts in this fashion.

If the redemption date is uncertain, no single fixed amount can have a present value equal to face value. If the redemption amount is tied to a formula, however, and that formula amount is based on compounding a market rate applied to face value, for any possible redemption date the present value of the redemption amount would equal the original face value. If the amount paid on redemption is the equivalent of a compounded market rate of return, the special rule for valuing a family-held liquidation participation right, preventing an increase in the value of the right by assuming an early exercise, will not affect its present value.

On the other hand, if the rate of return does not compound and the family controls the liquidation date, the special rule will cause the present value to go to zero because the redemption date is postponed in perpetuity. If the stock is noncumulative, the preferred stock's only liquidation participation right is the right to the face value of the preferred stock sometime in the future. If the liquidation of the noncumulative preferred stock has no fixed date, today's liquidation value reduces to zero the longer liquidation is postponed. Cumulative preferred stock, however, would include in its liquidation value the amount of all unpaid dividends in addition to the preferred stock's face value. However, without compounding, the present value of the unpaid cumulative dividends will reduce to zero at a much slower rate, but nonetheless, if redemption is deferred indefinitely, will go to zero.

In enacting section 2701, Congress expressed its concern that preferred stock was being valued as if the preferred payments would be made annually when, in

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fact, they were never being paid. Valuing the right to preferred dividends at zero in a family controlled company could result in an unfair gift if the dividends were in fact paid. Thus, Congress provided an agreed quid pro quo: If the transferor and applicable family members agreed to adverse transfer tax consequences in the event a payment was not made within four years of its scheduled date, the transferor would be able to assume that the dividends would be paid on time.

If the dividend payments are at market rate and made on time, the preferred stock could be valued at its face value. We saw that this result assumed that the timely paid dividends were reinvested by the shareholder at the market rate. If the dividend payments are made on time, it is irrelevant whether passed dividends cumulate. However, section 2701 automatically treats cumulative preferred dividends retained by the transferor as a qualified payment right — the type of distribution right subject to section 2701's adverse tax consequences — while a right to noncumulative preferred dividends requires the transferor to elect qualified payment treatment.

Congress designed the adverse transfer tax consequences triggered when a qualified payment right dividend is late to mimic the transfer tax consequences that would result from timely payment. The applicable family member receives the phantom dividend and reinvests the phantom dividend. We saw above that section 2701 assumes that timely paid dividends are reinvested at the market rate. Every year, therefore, the phantom amount compounds at the market rate. If the late dividend is eventually paid, it reduces the phantom amount by the amount of the dividend, but the phantom amount resulting from an assumed reinvestment will continue to compound. Moreover, once a payment passes its four-year grace period, the missed dividend is assumed to have been paid on its original due date and annually reinvested.

Unless an exception applies, the transfer of the preferred stock triggers the phantom amount. If the preferred stock is given away during life, the phantom amount is added to the gift tax base. If the preferred stock is given away at death, the phantom amount is added to the tax base for computing the estate tax. Because the phantom amount represents the amount the preferred stockholder would have if the dividends were paid on time and reinvested at the market rate, the value of any cumulative dividends, which already are included in the preferred stock's value, will reduce the phantom amount to prevent double taxation.

We saw that basing the redemption amount on the compounded market rate would permit the face value of the preferred stock to equal its section 2701 value. It is more common for the preferred stock to provide that any unpaid dividends would compound in value. If this compounded rate is the market rate and the dividends are not paid, the value of the preferred stock would include the compounded unpaid dividends at redemption, the same as if the redemption amount were based on compounding, as above. Because the compound dividends cumulate as well as compound, they would be a qualified payment right and therefore be assumed to be timely paid. However, if the owner elects out of qualified payment treatment, section 2701 requires that the dividends be assumed not to be paid. Under that assumption, when the preferred stock is redeemed, its redemption value includes the compounded unpaid dividends. If the redemption date is fixed, the present value of the redemption amount, including the compounded unpaid dividends, would be the value of the mandatory payment right. If the redemption date is uncertain, the present value of the liquidation participation right of the preferred stock should also include the compounded unpaid dividends.

Because the phantom amount is computed in precisely the same way as the compounded unpaid dividends, the same amount ends up in the transfer tax base. Of course, a dividend might be paid earlier and not reinvested at the market rate, but that would be true with all of the timely paid dividends under a qualified payment right.

3. The regulatory assumption. This result is consistent with the above-quoted language of reg. section 25.2701-2(a)(4) that provides that the value of any right is determined "as if any right valued at zero does not exist." A distribution right is valued at zero if it is not a qualified payment right. Thus, the regulations assume that a right to distributions does not exist when valuing the liquidation participation right. We followed that directive when we valued the preferred stock as if none of the dividends were paid. Under the terms of that preferred stock the unpaid dividends would compound.

It makes no sense to interpret this regulation as meaning that disregarding the right to have dividends distributed also requires disregarding the treatment of the unpaid dividends on the preferred stock. At least four reasons can be advanced to counter this interpretation.

First, a liquidation participation right is not a distribution right; therefore, treating the distribution right as if it does not exist has no effect on the liquidation participation right. Second, assuming that no distribution right exists for the preferred stock is consistent with assuming that no dividends are paid and that the unpaid dividends cumulate (or not) and compound (or not) in accordance with the terms of the preferred stock as part of its value on liquidation. Third, ignoring the value of passed dividends in determining liquidation value would, under section 2701, treat a preferred stock with a redemption amount computed at a compounded market rate (like a zero coupon bond) differently from the same redemption amount determined by compounding unpaid dividends. Section 2701 should treat the same economic interests identically, not impose radically different valuations. Finally, Congress imposed the qualified payment regime to ensure that preferred dividends would be timely paid. It would be ironic, not to mention contradictory, to interpret section 2701 as denying value to an unpaid dividend solely because the dividend might be paid *before* liquidation.

I am unaware of any argument to support the opposite conclusion: that the liquidation value of the preferred stock cannot include unpaid preferred dividends because they might have been paid before liquidation. Unfortunately, commentators too often dissect the individual parts of the section 2701 regulations to find an irrational and severe tax result, rather than look at the regulations as a whole, in light of the purposes of section 2701, to find a regime that best fits its individual parts.

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ii. Distribution right. Although the LP units carry no extraordinary payment rights, they would be applicable retained interests if Eli LP is a controlled entity and the units carry a distribution right. Because Eli LP is wholly family owned, it is a controlled entity. A distribution right is the right to receive distributions regarding an equity interest. The LP units share in 80 percent of any profits distribution; therefore, they have a distribution right, unless that right fits within one of the exceptions.

a. Excluded distribution rights. As we saw above, the regulatory definition of a distribution right excludes extraordinary payment rights, mandatory payment rights, liquidation participation rights, and, in the case of a partnership, guaranteed payments. Because the profit distributions of the LP units in Eli LP are not payable at any fixed time and certainly not in any fixed amount, they are neither mandatory payment rights nor guaranteed payments.[36] (For a partnership distribution to be a guaranteed payment under the statute it needs to meet only the section 707(c) definition.[37] Section 707(c) requires only that guaranteed payments be payable without regard to profits. The regulations, on the other hand, require that the payments be fixed in time and amount.[38] Whether these additional requirements in the regulations are valid is an open issue.) The right of the LP units to participate in liquidating distributions is a liquidation participation right and, as we have seen, it is neither an extraordinary payment right nor a distribution right. However, none of these exclusions apply to the right to share in 80 percent of the profit distributions from Eli LP.

b. Senior or subordinate? The definition of distribution rights also excludes rights regarding an equity interest of ''the same class as, or a class that is subordinate to, the transferred interest.''[39] This regulation thus assumes that the various classes of equity interests can be sorted into senior interests, subordinate interests, and interests of the same class. Section 2701 requires senior and subordinate interests. The disregard of any bells and whistles attached to the preferred stock or senior equity interest decreases its value, resulting in an increase in the value of the transferred common stock or subordinate equity interest when the subtractive value method is used. The resulting increase in the subordinate equity interest's value is the added gift under chapter 14. Therefore, without senior and subordinate equity classes, section 2701 cannot function properly.

The preamble to the final regulations captures the importance of senior and subordinate interests:

> Some commentators argue that section 2701 does not require use of a subtraction method. They argue, contrary to the conference report reference to ''present law principles,'' that there are no such present law principles. Other commentators suggest that section 2701 should apply only if (and to the extent) a subtraction method would be appropriate under present law.
>
> These and similar comments are based on the premise that section 2701 operates within the general framework of section 2512 of the Internal Revenue Code, i.e., that the special valuation rules are to be used to determine the value of the transferred property which, in turn, measures the amount of the gift. They ignore the operative language of section 2701 that the amount of the gift is to be determined by valuing certain retained rights under the special rules in section 2701. *If use of the subtraction method is not required by section 2701, valuation of retained rights would have no bearing on the amount of the gift.* That interpretation would cause section 2701 to be a nullity in that the valuation of retained rights cannot affect the amount of the gift other than by subtraction from a pretransfer aggregate value.
>
> The Treasury Department and the Service do not believe that section 2701 was intended to be a nullity or merely an appendix to section 2512, but rather that chapter l4 provides an independent set of rules intended to ensure more accurate gift tax valuation. [Emphasis added.][40]

Treasury could not be clearer on the necessity of senior and subordinate interests.

The concepts of senior and subordinate are explicit in the definition of distribution rights. The definition of extraordinary payment rights implicitly contains the same concept: ''An extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which *affects the value of the transferred interest.*'' (Emphasis added.)[41] An extraordinary payment right would have to be attached to an interest senior to the transferred interest for the right to affect the transferred interest's value.

For Parents' LP units to be characterized as an applicable retained interest, the LP units must be a senior or preferred interest as to Daughter's GP units. Because Eli LP provides that Daughter (who holds GP units) can receive distributions of her share of the profits more frequently than Parents (who hold LP units) to ensure Daughter has sufficient liquidity to pay investment expenses, the GP units are arguably senior to the LP units. Under that reasoning, if any class of interest in Eli LP is subordinate, it would be the LP units, thus preventing the application of section 2701.[42]

More likely, neither the GP units nor the LP units are senior or subordinate interests. They are not the same

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[36]Reg. section 25.2701-2(b)(4)(iii).
[37]Section 2701(c)(1)(B)(iii).
[38]Reg. section 25.2701-2(b)(4)(iii).
[39]Reg. section 25.2701-2(b)(3)(i).

[40]T.D. 8395 (Feb. 4, 1992).
[41]Reg. section 25.2701-2(b)(2).
[42]This analysis could cause a problem if Parents hold the GP units and transfer the LP units to Daughter. Because Parents know the GP units carry rights to appreciation disproportionate to their capital investment, no one believes this is a concern. If one simply applies the literal words of the regulations without regard to their purpose or without making them meaningful, either the GP or LP units could be senior equity interests. In fact, the more likely application of the words of the regulation would seem to point to the GP units as applicable retained interests, rather than the LP units.

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class of units either. So what are they? How do we decide whether section 2701 applies and, if it does, which units are the applicable retained interests? Do we assume that section 2701 does apply and that the IRS can simply argue that either class of units is the senior interest depending on which one results in the worst possible gift tax consequences? If so, why would Treasury and the IRS go to great lengths in the regulations to avoid the harsh results that the statute could have produced, only to reinstate those results by stretching the regulations beyond their apparent meaning? Delving into the interstices of the regulations seems unlikely to help us apply section 2701 to our partnership equity interests.[43]

c. Class or right? Let us return to the corporate analogy in which we were able to avoid section 2701 without resolving the senior versus subordinate question. Because its preferred stock carries neither an extraordinary payment right nor a distribution right, section 2701 did not apply to Eli Corp. All we need to do to avoid section 2701, therefore, is to have Eli LP issue partnership units that are equivalent to the preferred and common stock in Eli Corp., rather than issue LP and GP units.

Each class of corporate stock carries a bundle of rights developed by tradition and statute over a long period. Before check-the-box, partnerships typically did not have classes of equity interests to avoid inadvertent corporate tax status. Instead, partnerships typically granted a series of different economic and management rights to various partners. Because the regulations do not define class, they are unclear as to what comprises a class of partnership equity. Class could have any of three meanings in the partnership context.

First, the bundle of economic rights identified in the partnership agreement as comprising a unit in the partnership could also comprise the class. That meaning of class would allow the drafters of the Eli LP agreement to avoid section 2701 by simply providing preferred and residual units with terms comparable to the classes of stock in Eli Corp. If the drafter of the partnership agreement is able to manipulate the chapter 14 value by the construction of partnership units, section 2701 would seem to simply be a trap for the unwary. The gift tax consequences of the same economic interests should turn on neither the choice of entity nor the drafting of a partnership agreement. Either result would be contrary to chapter 14, which was intended to provide flexibility to business owners to operate in an arm's-length manner without triggering adverse transfer tax consequences.

Second, each partner's bundle of economic rights in the partnership could comprise the class. The GP and LP units in Eli LP are already structured in this manner. Disregarding a partnership's described classes of units is the policy of the federal income tax in which each partner is considered to have only one capital account no matter how many classes of equity the partner might hold.[44]

Finally, each separate economic right in the partnership could comprise a separate class. Considering each equity interest in the partnership as a separate class would cast a new light on the meaning of reg. section 25.2701-7, which allows the secretary to prescribe guidance (or a taxpayer may seek guidance) under which an applicable retained interest can be treated as two or more separate interests under section 2701. As discussed below, the legislative history specifically contemplates that an appreciation right attached to preferred stock would be an example of a separate interest. Practitioners have found themselves wanting to rely on this regulation in the partnership context without the requisite Treasury guidance. Treating a partnership differently from a corporation by looking at each economic interest as a separate class of equity will reduce the need to rely on this regulation or to seek Treasury guidance.

Neither of the first two possible meanings of class makes the choice of entity and the drafting of the partnership agreement irrelevant. Although adopting the bundling approach satisfies the requirement that each class of stock be treated as a separate class, it also means that the results under section 2701 will turn on the drafting of the partnership agreement. Looking at each economic interest as a separate class avoids these problems, but it lacks any statutory or regulatory support. Neither aggregating nor separating a partner's economic rights should produce different results under section 2701.

d. Separate interests. Treating the distribution right as a separate class of equity from the return of capital right does, however, provide equivalent treatment to Eli Corp. and Eli LP. Fortunately, we have a code provision, section 2701(e)(7), that says:

> The Secretary may by regulation provide that an applicable retained interest shall be treated as 2 or more separate interests for purposes of this section.

The regulations expand on this provision:

> The Secretary may, by regulation, revenue ruling, notice or other document of general application, prescribe rules under which an applicable retained interest is treated as two or more separate interests for purposes of section 2701. In addition, the Commissioner may, by ruling issued to a taxpayer upon request, treat any applicable retained interest as two or more separate interests as may be necessary and appropriate to carry out the purposes of section 2701.[45]

The preamble to the proposed regulations explains this approach as follows:

> The proposed regulations exercise the regulatory authority granted by section 2701 to treat interests as separate interests in appropriate cases. However, because the situations in which it may be appropriate to treat interests as separate interests are likely to be dependent on the particular facts and circumstances, this authority is exercised by permitting taxpayers to request private letter rulings from the Internal Revenue Service.

[43]*See* ACTEC Report, *supra* note 9, at p. 4.

[44]Reg. section 1.704-1(b)(2)(iv)(b).

[45]Reg. section 25.2701-7.

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The legislative history of section 2701(e)(7) details the circumstances under which the exercise of discretion is appropriate:

> The conference agreement also grants the Secretary of the Treasury regulatory authority to treat a retained interest as two or more separate interests under the provision. Such treatment would allow value to be accorded to the participating feature of a participating preferred interest pursuant to the exception for retained interests that are of the same class as the transferred interest.[46]

The conference report also gives two examples of the application of the rule:[47]

> **Example 3.** Mother owns all the stock in a corporation. One class is entitled to the first $100 in dividends each year plus half the dividends paid in excess of $100 that year; the second class is entitled to one half of the dividends paid above $100. The preferred right under the first class is cumulative. Mother retains the first class and gives the second class to Child. Under the conference agreement, Treasury regulations may treat an instrument of the first class as two instruments under the provision; one, an instrument bearing a preferred right to dividends of $100; the other, an instrument bearing the right to half the annual dividends in excess of $100, which would fall within the exception for retained interests of the same class as the transferred interest.
>
> **Example 4.** Father and Daughter enter into a partnership agreement under which Father is to receive the first $1 million in net cash receipts and is thereafter to share equally in distributions with Daughter. Under the conference agreement, Treasury regulations may treat Father's retained interests as consisting of two interests: (1) a distribution right to $1 million and (2) a 50 percent partnership interest. Father could elect to treat the first interest as a right to receive qualified payments at specified amounts and times; the second interest would fall within the exception for retained interests of the same class as the transferred interest.

The legislative history is quite specific as to when an economic right associated with an applicable retained interest should be treated as a separate class. The examples explicitly provide that a participating feature of a preferred interest should be split from the preferred. The legislative history goes further and treats the participating feature as the same class as the common interests. It reaches this result without any facts showing that the rights were exactly the same. For example, the common stock in example 3 is likely to have a capital value while the participating right is not. At best, the interests are proportionally the same because, under my definition, they share profits and capital in different proportions, if at all.

Treasury has ducked the responsibility of providing general regulations. Asking for a private letter ruling can be quite costly. However, applicable authorities permit taxpayers to apply the splitting rule described in the conference agreement without the issuance of regulations.

1. Phantom regulations. Whether taxpayers can obtain the benefit of a statutory provision authorizing Treasury to issue regulations without the actual issuance of those regulations is common enough to be known as the "phantom regulations" question.[48] One of the first cases to deal with this issue was *International Multifoods Corp. v. Commissioner*.[49] The statute directed: "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations . . . relating to the treatment of losses from the sales of personal property."[50] The court noted:

> When Congress directs that regulations be promulgated to carry out a statutory purpose, the fact that those regulations are not forthcoming cannot be a basis for thwarting the legislative objective. It is well established that the absence of regulations is not an acceptable basis for refusing to apply the substantive [code] provisions.[51]

The court believed it could derive the substance of the regulations that Congress intended from the legislative history and the General Explanation of the Tax Reform Act of 1986 (the Blue Book), prepared by the Joint Committee on Taxation. The court relied on that clear intent in allowing the taxpayer to have the intended benefit. The court held that Treasury cannot sidetrack that congressional intent by refusing to issue regulations. On the other hand, the court seemed to put little weight on the use of "shall" in the directive to Treasury.

One author characterized the Tax Court's decisions on phantom regulations as follows:

> The Tax Court has frequently found mandatory, taxpayer friendly delegations self-executing, concluding that treating such delegations otherwise would inequitably deprive taxpayers of legislatively intended benefits.[52]

The IRS, as one might expect when a taxpayer-friendly benefit is at stake, takes a narrower view. However, under its analysis, taxpayers should be able to rely on the separate interest test. TAM 200447037, *Doc 2004-22217*, *2004 TNT 225-24*, states:

> It is the position of the IRS that a statute is not self-executing with respect to a reference to regulations unless the statute itself or the legislative history gives some specific guidance as to what the content of the regulations should be.

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[46]Conference Committee Report, H.R. 5835 (Oct. 29, 1990) at act sections 11601-11602.

[47]*Id*.

[48]*See generally* Amandeep S. Grewal, "Substance Over Form? Phantom Regulations and the Internal Revenue Club," VII *Houston Bus. & Tax J*. 42 (2006).

[49]108 T.C. 579 (1997), *Doc 97-18003, 97 TNT 118-31.*

[50]Section 865(j)(1).

[51]*International Multifoods,* 108 T.C. at 587.

[52]*Supra* note 48 at p. 53.

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Under that test, the separate treatment in the statute should be self-executing because the legislative intent for the substance of the regulations is clear. In TAM 200447037 the IRS denied the taxpayer's request to apportion a loss using the closing of the books method, rather than apportioning the loss on a daily basis. The Service had authorized the use of the closing of the books method in several private rulings. However, it believed the taxpayer's attempt to use the closing of the books method in hindsight, after an audit commenced, lacked timeliness.

The taxpayer's reliance on the statutory provision seems misplaced. The statute provided: ''Except as provided in regulations, the net operating loss shall . . . be allocated ratably to each day of the year.''[53] The taxpayer took the dubious position that congressional intent was sufficiently clear to allow it to rely on the phantom regulations to use a type of accounting contrary to expressed congressional intent because the IRS had permitted its use in private letter rulings.

Because the legislative history of section 2701(e)(7) is so specific about the rule Congress intends for Treasury to issue, the courts are likely to find the provision self-executing. A contrary argument would rely on the statute's use of a discretionary ''may,'' rather than a mandatory ''shall,'' in its direction to Treasury. However, this is not a case in which Congress has provided a taxpayer benefit ''*only* to the extent prescribed in regulations.'' (Emphasis added.)

2. 'Stripping rule.' Section 2701 should be applied to the GP and LP units in Eli LP, with the understanding that any subordinate or proportional economic rights attached to a senior equity interest would be treated as separate classes of equity. If the stripped economic interest is the same, or proportionately the same, as another class of equity, the two interests should be treated as a single class of equity — the single class of common stock in Eli LP. This approach is consistent with the examples in the legislative history of section 2701(e)(7).

iii. Effect of a right to withdraw. We concluded that starting from the stated rights associated with the preferred stock or partnership unit in question then applying the stripping rule is the proper way to determine the classes of equity interests for section 2701. If we analyze the LP units in our example under section 2701, we would strip the profits interest from the capital interest attached to the LP units. That profits interest is the same as the GP's profits interest. The GP's capital interest is of the same class as the LP's capital interest, making them also the same class. Because the capital interest is no longer associated with the profits interest, it lacks the requisite distribution right for section 2701 to apply. The stripping rule, therefore, produces comparable treatment for the comparable equity interests in Eli LP and Eli Corp.

If we alter the facts slightly and permit an investor in Eli LP to withdraw at any time (the same as allowing a preferred holder to put the preferred stock to the company at any time), the capital interest then will have the requisite extraordinary payment right for section 2701 to apply. If we had not stripped the profits interest from the capital interest, we could argue that the 80 percent profits, which accumulate if not distributed, support the LP unit's liquidation value. Profit distributions are not qualified payments and, as distribution rights, have no value without a qualified payment election. But undistributed profits should increase the liquidation value of the LP units.

When unpaid dividends compound at the market rate, the liquidation value of the preferred stock will be the same as its face value. Unpaid profit distributions should similarly increase liquidation value: If profits are not distributed they will be reinvested, and the profits from that reinvestment also will be split 80/20. In both cases the timing of the payments is irrelevant, and section 2701 is designed to enforce valuation assumptions based on timely payments.

In the case of a profits interest, however, we need to establish the equivalent of a market rate. Obviously, that rate is not a particular fixed percentage rate. Rather, the share of the profits an investor would be willing to give up to obtain the services of the GP manager should be the measure of whether the undistributed profits adequately compensate the investors. If an unrelated party is willing to invest capital for an 80 percent share of the profits, that share must be the right amount to support the stated liquidation value of the capital right. We saw that sharing farming profits equally, which was consistent with arm's-length terms, should avoid a gift under chapter 12.[54] If we tie the capital and profits interest together, the chapter 12 and chapter 14 gift analyses become the same.

By valuing a liquidation right not at zero, but at its true liquidation value, the regulations minimize the risk of a substantial gift. The regulations prevent abuse by requiring that the liquidation value be determined as if the family does not hold any right to accelerate the liquidation of the applicable retained interest or the payment of distributions. Because fixed payment rights already have value, the regulations intentionally give liquidation participation rights value to minimize the gift tax risk when the applicable retained interest has no fixed liquidation date. The regulations, however, treat the profits interest as a separate class of equity apart from the applicable retained interest so that the profits interest no longer supports the value of the applicable retained interest. Did the regulation writers force an irreconcilable conflict between these two regulatory positions?

This conflict, I believe, results from the uniqueness of the contribution of services in exchange for equity, rather than a flaw in the regulations. If the arrangement is economically sound, the value of the manager's services enhances the return on the 80 percent of profits allocable to the investors by an amount equal to the forgone return the investor would have earned on the 20 percent capital.

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[53]Section 384(c)(3).

[54]*Cf.* ACTEC report, *supra* note 9, at 5. The report's analysis fails to take into account that the undistributed profits interests would be reinvested, presumably diminishing the impact of the passage of time on the present value analysis, just as compounding the dividends would do.

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Every year the partnership is in existence, the manager's 20 percent of profits compensates for the services provided to the partnership that, in turn, result in an enhanced return on the investors' 80 percent of profits. Because the manager's services compensate the investors each year, an indefinite term does not diminish the value of the investors' capital. A freeze limits the return on capital; only the common holder benefits from any enhanced return. In our case, however, any enhanced return benefits the investor parent four times more than the manager child. A profits interest is more an antifreeze than a freeze.

2. Proportionality exception. Because the preferred stock in Eli Corp. has no extraordinary payment right, the corporate equivalent of the Eli LP profits interest is outside section 2701. However, we arrived at two dead ends trying to reach the same conclusion for Eli LP. Although we wanted the failure to identify senior and subordinate interests in the partnership to mean that the partnership profits interest was outside section 2701, naysayers argue that the IRS can simply assign the equity interests to either category as it chooses. We decided that the conclusion should not depend on how class is defined in the partnership context. However, we did see, if section 2701(e)(7) is self-executing, how we could strip off the profits interest from the capital senior equity interest and treat the capital and profits interests of Eli LP as two separate interests comparable to the preferred and common stock in Eli Corp. We concluded that if the preferred stock cannot be liquidated without Daughter's approval, the senior capital interests lack an extraordinary payment right and therefore are not applicable retained interests. Conversely, if a Parent could liquidate his or her preferred interest, we would conclude that section 2701 applies. However, we would argue that tying the profits interest together with the capital interest should mitigate any potential gift. Our analysis has degenerated into a cat chasing its tail.

If the section 2701 valuation for the same economic interest differs when we split or tie economic interests together, our analysis must be flawed. I believe that a different reason explains why the simplified profits interest is not subject to section 2701: Eli LP and Eli Corp. have only proportional equity interests. We cannot identify the senior and subordinate equity interests in the partnership context because we only *appear* to have done so in the corporate context. Because preferred stock is always the senior equity interest and the common stock is always the subordinate equity interest, we assumed that was also true in this case. However, the two equity interests relate to completely different economic interests in the corporation. The preferred stock grants economic interests only in the corporation's original capital, and the common stock grants economic interests only in the corporation's profits. In that sense the ownership interests in Eli Corp. and Eli LP are identical. The owners share in different proportions in the different types of economic interests: Daughter has 1 percent of the original capital and 20 percent of the profits, with Mom and Dad sharing the balance in each equally. Because these economic interests do not overlap, technically the preferred and common stock are not senior and subordinate equity interests under section 2701, despite their names.

This proportionate sharing in each separate economic interest in the entity must be the reason that the simple profits interest structure is exempt from section 2701. Section 2701 should not apply to either a farm or an investment partnership because the capital partner can withdraw when that withdrawal also forfeits the continuing benefit of the service partner's services. Proportionality is the common link between both the corporate and partnership entities and both the farming and investment contexts. How does proportionality and the lack of overlap of economic interests fit within an exception to section 2701?

a. Statutory and regulatory definition. If we agree to treat the LP units or their attached rights as applicable retained interests, as the naysayers require, section 2701 would apply unless one of the three exceptions in subsection (a)(2) is satisfied. First, section 2701(a)(2)(A) requires that market quotations be available for the applicable retained interest, which will not apply in a family entity. Second, section 2701(a)(2)(B) requires that all the retained and transferred interests be of the same class, which does not appear to be our case. Finally, section 2701(a)(2)(C) requires that the applicable retained interest be "*proportionally the same* as the transferred interest, without regard to nonlapsing differences in voting power (or, for a partnership, nonlapsing differences in management and limitations on liability)." (Emphasis added.) We will refer to that test as the proportionality test.

The proportionality test under both the statute and the regulations[55] is the same, but the regulations — unlike the statute — go further and lump together interests of the same class with interests that are proportionally the same. One always should pay close attention when the regulations under section 2701 deviate from the statute. We have seen this deviation before in the important distinction between liquidation rights under the statute and liquidation participation rights under the regulations. We will see later why the regulations treat classes that are proportionally the same as if the classes are, in fact, the same class of equity.

"Proportionally the same" must mean something other than the "same" or "identical," otherwise section 2701 would not contain separate exceptions for classes that are the same without regard to management and voting rights and those classes that are proportionally the same. Proportionality must mean something other than a percentage "vertical slice" of every right in the partnership. The regulations add to the other three statutory exceptions a transfer of a vertical slice of every interest separate from the proportionality test section.[56] A separate exception in the regulations would not be needed if proportional meant the same proportion in each economic interest.

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[55]Reg. section 25.2701-1(c)(3).

[56]Reg. section 25.2701-1(c)(4). The preamble to the final regulations states that this exception was added in the final regulations in response to a commentator's request, suggesting that the IRS perhaps understood the proportionality test differently than the commentator.

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The regulations again deviate from the statute, which has no such test, by deriving a proportionate interest exception from the statute's proportionality test. The regulations appear to offer this vertical slice exception because it contemplates transfers of admittedly separate multiple classes of equity interests that, when taken together, result in a proportionate transfer of *all* economic interests held by the transferor and applicable family members. By contrast, the proportionality test treats two or more different classes of equity that are proportionately the same as a single class under section 2701.

If separate tests address when two classes of interests are the same and when a transfer of multiple classes results in the transfer of a proportion of each equity interest, ''proportionally the same'' must mean that each of the rights associated with the applicable retained interests must be proportional to those same rights attached to the transferred interests. It does not say, nor can it mean, that the proportion in each right must be identical.

In our simple example, the GP and LP units share capital and profits proportionately, but in different proportions. The LP units carry a right to 80 percent of profits and 99 percent of capital while the GP carry a right to 20 percent profit and 1 percent of capital. The preferred and common stocks in Eli Corp. also share capital and profits proportionately, but in different proportions. If sharing in *all* of the different economic interests in the entity in different proportions satisfies the proportionality test, the meaning of class and the definition of senior and subordinate interests becomes irrelevant. No matter how the interests are grouped together in corporate shares or partnership units, the underlying economic interests are all shared, resulting in the classes being proportionate to each other. No other interpretation of the proportionality test seems to make as much sense.

Nor should it matter whether the owners share in *each* economic interest. If Daughter holds only a profits interest and has no interest in capital, section 2701 should not apply. Otherwise, the application of the proportionality test under section 2701 would differ dramatically depending on whether an owner shared in none of a particular economic interest or shared in only 0.001 percent of that right.

b. A working definition of proportionality. The proper test of whether two classes of equity are proportional, therefore, is whether the owners share each economic interest in the entity fractionally, if at all. In our case, profits are shared fractionally and capital is shared fractionally, just not in the same fraction. Just as an estate planning formula must be either fractional or pecuniary, the ownership of an economic interest can be fractional or pecuniary. A pecuniary division of an economic interest means that one owner would receive a fixed amount, and another owner would receive the balance. A pecuniary division of any economic interest, therefore, creates two different classes of equity with the pecuniary interest senior to the subordinate residual interest. A fractional division, on the other hand, does not create two classes of equity interest; it lacks a priority interest or a preference, as would be necessary to have senior and subordinate equity interests.

A preferred or senior equity interest under section 2701, therefore, means only an ownership interest that comes ahead of another ownership interest, not an ownership interest that is larger, prettier, more popular, or any other of the more casual meanings of ''preferred.'' None of those other meanings creates the requisite retained senior interests and transferred subordinate interests that are crucial to the operation of the subtractive valuation method under the regulations.

Try to apply the subtractive valuation method while treating fractional economic interests as two separate equity classes. It cannot be done. Because fractional rights do not create the requisite senior and subordinate equity interests, the regulations[57] are correct to treat the two fractions as a part of the same class. Let us see whether my proposed definition of proportionality is consistent with the known purposes of section 2701 and existing guidance.

c. Testing our definition of proportionality.

i. The classic preferred stock freeze. Congress designed section 2701 on the paradigm of a corporation with preferred and common stock. For my interpretation of the proportionality test to be valid, it must not treat preferred and common stock as proportionately the same. Preferred stock shares in economic rights with the common stock in a pecuniary manner, rather than fractionally or proportionately. Preferred stock is entitled to the first $X of the dividends payable by the corporation and the first $X of capital on liquidation. The common stock receives the residual dividends and the residual capital after paying the preferred stock. The preferred stock is clearly senior to the common stock regarding each economic right the two classes share.

Compare this structure to Eli Corp. when the preferred stock disposes of all of the corporation's original capital. Although the liquidation value of the preferred stock is a pecuniary amount, it is 100 percent of the original capital, leaving no economic interest in the original capital to constitute a subordinate interest. Unlike typical preferred stock that shares in profits to a fixed amount of preferred dividends, leaving the balance of corporate profits to the common stock, the preferred stock in Eli Corp. carries no rights to any profits.

ii. Compliance with Treasury rulings. One of the problems with understanding how section 2701 applies to a profits interest is that commentators (including me) have too often spoken in concepts, rather than analyzing and applying the technical provisions of the regulations. We can take some comfort that the IRS is guilty of the same laxity. TAM 199933002, *Doc 1999-27412, 1999 TNT 162-14,* is the only Service guidance on the question of how to apply section 2701 to a partnership profits interest. Rather than apply its own regulations or the statute, the IRS based its holding on a Senate committee report,[58] which explained the proportionality test as:

> an exception in situations where the rights in the retained interests in the business are proportionally

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[57]Reg. section 25.2701-1(c)(3).

[58]Senate Finance Committee Report, S. 3209 (Oct. 18, 1990) at act sections 11601-11602.

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> the same as all of the rights in the transferred interests in the business, other than voting rights. This exception would apply, for instance, if the retained and transferred interests consisted of two classes of common stock, which shared in all distributions, liquidation and other rights in a two for one ratio.

Of course, if the two classes of common stock shared in every economic right in the same proportion, the classes would differ only by the number of shares in each class. Nor does the language require the proportion in every economic right to be the same because it says this is only one instance of proportional rights.

The TAM, however, cites the conference agreement, which concurs with the Senate report but adds:

> It would not apply to a partnership with both a general and limited partner if one partner had a preference with respect to distributions.

The TAM concludes that any difference in economic rights between the general and limited partnership interests that was a preference would cause section 2701 to apply.

The TAM first discusses the disproportionate right to profit distributions, 35 percent to the GP and 65 percent to the LP, without treating this disproportionality as a preference. Rather, it identifies the requisite preference as the LPs' right to receive back all of their capital contributions before the GP receives any. (Because the GP contributed only 1 percent of the capital, it would make little practical difference to allocate each capital distribution 99 percent to the LPs and 1 percent to the GPs. That change should avoid the application of section 2701.) The ruling supports the conclusion that "preference" is used synonymously with "priority" or "coming before."

The conference agreement offers no explanation for the additional sentence or its focus on general and limited partners. The sentence likely was meant to be helpful to taxpayers by excluding from the application of section 2701 a typical FLP in which the only difference between the general and limited partnership interests are different management rights and liability. After all, if under our definition an economic preference exists between two classes of equity, creating senior and subordinate equity interests, section 2701 would apply whatever the difference in liability. The ruling can only be viewed as concluding that the priority distribution of capital caused the partnership to fail to meet the exception for straight-up FLPs.

The proposed proportionality test is consistent with current guidance and, moreover, exempts a common bank holding company equity structure from section 2701. While section 2701 was being drafted, the author proffered that structure as a reason for the statute to define applicable retained interests by reference to the definition of preferred stock for corporate income tax purposes — in other words, a stock with a limited right to participate in corporate growth. Although chapter 14 adopts corporate and partnership income tax rules in other contexts, it did not do so in defining what constitutes an applicable retained interest. Thus, section 2701 could apply to some equity interests that are not frozen, such as a right to receive the first specified number of barrels of oil or other commodities in which the price can fluctuate, despite no family member being able to manipulate the interest to increase the value of the subordinate or residual interest.

When I offered this example to the drafters, the draft statute contained no proportionality test; it was later added to section 2701. The example follows:

> Bank Co. has two classes of common. Class A has one vote per share. Class B has ten votes per share, but is paid a dividend of 90 percent of the dividend declared on a Class A share. In all other respects, the two classes are equivalent.

In the example, the voting advantage of Class A is offset by the 10 percent dividend advantage of Class B. Because the voting rights no longer offer any advantage once the bank liquidates, both classes of common stock share proportionately in liquidating distributions. Unless the proportionality test permits different proportions in different rights, the capital structure in the example, which I believe prompted the proportionality exception, would be subject to section 2701. Without the proposed definition of proportionality, section 2701 would apply to a corporation with two different classes of common stock and no preferred stock, despite the lack of a single word anywhere suggesting that treatment is appropriate.

iii. Consistent with contemporaneous legislative history. The conference committee report that accompanied the enactment of chapter 14 contains four examples of the type of equity structures that are subject to section 2701. In each example, the applicable retained interest is identified as an interest stated as a pecuniary amount. Let us consider the first two examples.

> **Example 1.** Father retains cumulative preferred stock in a transaction to which the provision applies. The cumulative dividend is $100 per year and the stock may be redeemed at any time after two years for $1,000. Under the conference agreement, the value of the cumulative preferred stock is the lesser of (1) the present value of two years of $100 dividends and the present value of the redemption for $1,000 in year two, or (2) the present value of $100 paid every year in perpetuity.

The example is intended to illustrate the operation of the lower-of rule, but it contains two rights subject to special valuation: a fixed dividend of $100 per year and a fixed redemption value of $1,000. Both rights are pecuniary and under my proposed proportionality test are subject to valuation under section 2701.

Example 2 similarly supports my conclusion that section 2701 requires a pecuniary right to trigger its application:

> **Example 2.** Father and Daughter are partners in a partnership to which Father contributes an existing business. Father is entitled to 80 percent of the net cash receipts of the partnership until he receives $1 million, after which time he and Daughter both receive 50 percent of the partnership's cash flow. Father's liquidation preference equals $1 million. Under the conference agreement, the retained right to $1 million is valued at zero, unless Father elects to treat it as a right to receive qualified payments in

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> the amounts, and at the times, specified in the election. If Father elects that treatment, amounts not paid at the times specified in the election become subject to the compounding rules.

Because Father held a $1 million liquidation preference, the example concludes section 2701 applies, consistent with my test. The preference also is payable out of the net cash receipts, without regard to profits, making it a guaranteed payment under section 707(c). By implication, therefore, this example supports the regulation that provides that a guaranteed payment must also have fixed payment dates and amounts to qualify as a guaranteed payment exempt from section 2701. The example also describes only the $1 million preference as a distribution right subject to an election to treat the distribution as a qualified payment right. However, the example does not state that the profits interest, originally 80 percent, then 50 percent, is valued at zero or subject to the qualified payment election. The explanation may be that the profits interest was stripped from the pecuniary payment right and treated as the same interest as Daughter's interest. If so, this would further support the treatment of the separate interest rule as being self-executing. Either reason would prevent an adverse gift tax consequence from the gift of a proportionate profits interest.

We saw above that examples 3 and 4 apply the separate interest rule to applicable retained interests, but let us consider their meaning in this context.

> **Example 3.** Mother owns all the stock in a corporation. One class is entitled to the first $100 in dividends each year plus half the dividends paid in excess of $100 that year; the second class is entitled to one half of the dividends paid above $100. The preferred right under the first class is cumulative. Mother retains the first class and gives the second class to Child. Under the conference agreement, Treasury regulations may treat an instrument of the first class as two instruments under the provision; one, an instrument bearing a preferred right to dividends of $100; the other, an instrument bearing the right to half the annual dividends in excess of $100, which would fall within the exception for retained interests of the same class as the transferred interest.

Again, the example treats a fixed dividend right to $100 as a qualified payment right subject to section 2701, which is consistent with my proportionality test. The fourth example, however, is like Example 2, another profits interest example.

> **Example 4.** Father and Daughter enter into a partnership agreement under which Father is to receive the first $1 million in net cash receipts and is thereafter to share equally in distributions with Daughter. Under the conference agreement, Treasury regulations may treat Father's retained interests as consisting of two interests: (1) a distribution right to $1 million and (2) a 50 percent partnership interest. Father could elect to treat the first interest as a right to receive qualified payments at specified amounts and times; the second interest would fall within the exception for retained interests of the same class as the transferred interest.

The example does not explain whether the $1 million payable to Father is a right to return of his original capital contribution. If it is, the regulations may have affected this example by treating the $1 million distribution right as a liquidation participation right. Whether the right is a distribution right or a liquidation participation right, its value cannot be increased by the family's power to accelerate its payment. Similarly, if the family controls the entity, the right to receive original capital back before profits are distributed is unlikely to increase its value under section 2701.

Although the regulations contain no example of a profits interest, the legislative history contains two. In neither example does the conference agreement imply that the profits interest might be a distribution right valued at zero or a distribution right eligible for a qualified payment election.

iv. The proportionality test in sum. My proportionality test, which turns on whether any interest is pecuniary, is consistent with the known guidance under section 2701 and the examples provided in its legislative history. Moreover, one cannot properly apply the subtractive valuation method under the regulations without identifying senior and subordinate interests. By adopting the proposed proportionality test, one need apply section 2701 only when the requisite senior and subordinate interests are present.

Adopting my proportionality test would mean that the application of section 2701 to Eli LP or Eli Corp. will not turn on the form of the implementation of a seven-year investment minimum. If a springing or restricted withdrawal right associated with the capital interest is an extraordinary payment right, the proportionality test would still prevent the application of section 2701. The proposed proportionality test avoids divergent gift tax treatment for two entities with similar economic terms and avoids a calamitous gift tax result from the creation of a typical farm partnership.

My definition of proportionality considers each separate economic interest to see whether each interest has only fractional ownership. This dissection is only for the purpose of seeing whether an entity has any senior and subordinate economic interests. If not, the inquiry ends and section 2701 will not apply. This analysis under the proportionality test should not contradict the requirement that each class of stock with all of its associated rights be treated as a separate class under section 2701. For all the reasons offered above, I believe that a partnership in which the investors have the right to a return of their original capital and they split the profits in any proportion with the service partner is outside section 2701.

C. 'Bucket' Profits Interests

However, we saw that, if section 2701 does apply to Eli LP, the chapter 14 gift should be little different from the chapter 12 gift. This conclusion will surprise many practitioners who consider the creation or transfer of a profits interest subject to section 2701 as ill-advised and risky. We will explore these number questions further with a profits interest that is clearly subject to section 2701 and closer to that of a venture capital fund. The waterfall interests in these funds create preferences because they

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create pecuniary rather than fractional or proportional equity interests. A pecuniary interest is better represented by a bucket filling with water and then overflowing into the next bucket than by a waterfall whose spray jumps from rock to rock on its inevitable downward flow.

A fund agreement might provide first for the payment of the 2 percent management fee that would be structured as a guaranteed payment because it is earned without regard to profits. After paying the fee, the fund might provide that any distributable cash would first go to the LPs in an amount equal to their invested capital. Distributable cash could consist of profits, borrowings, or a return of original capital. Once the cash fills that bucket, distributable cash would next go to the GPs to the extent of their invested capital. Once an amount equal to all of the original capital has been paid from distributable cash, profits could be distributed. Most fund agreements would require that distributable cash next go to the LPs to give them a pecuniary amount equal to an 8 percent compounded return on their invested capital. Once that bucket is filled, the residual profits might be divided 80/20 among the LPs and the GP.

> Daughter and Parents want to create a new limited partnership, Samuel LP, to replace Eli LP. Because of the need to fund the investment expenses from profit distributions to the GP, however, the terms of Samuel LP must differ from the standard fund agreement in which the management fee finances the GP's expenses.
>
> Parents are unhappy with Daughter's boyfriend, who wants to join in the management of Eli LP. The seven-year original term of Eli LP has expired, and Parents are worried that Daughter and her boyfriend might just park the money in the bank and live off the profits interest without doing any real investing. Because Daughter is not receiving a management fee, she needs her share of the profit distributions to pay investment expenses, so she cannot agree to give Parents their capital back first. She does agree that on liquidation Parents would get their entire capital investment back first. She also agrees to pay a 4 percent annual return on Parents' invested capital (4 percent payments) before dividing the remaining profits 80/20. Any missed 4 percent payments would cumulate and be paid at liquidation. Of course, because Daughter expects to make a substantially higher return on investments, the 4 percent payments will generally be paid annually. These new terms are incorporated in a new partnership agreement for Samuel LP, along with the retention of a new seven-year life.

1. Application of the three principles. We have identified three principles for applying section 2701 to any entity:

- analyze the economic interests in the entity to see if it has any pecuniary interests that create the requisite senior and subordinate equity interests;
- apply a stripping rule, like that contemplated by section 2701(e)(7), that will treat any proportional right associated with the senior equity interests as a separate class of equity; and
- those equity interests that are not pecuniary are proportional, and proportional economic interests are to be treated as the same class.

a. Principle One: Determine pecuniary and fractional interests. Because Parents are to receive their 4 percent payments before distributing profits 80/20 and because they are to receive all of their invested capital back on liquidation before Daughter gets any of hers back, section 2701 applies to the valuation of any transferred subordinate equity interest. The 4 percent payments resemble the dividends payable on preferred stock. As under TAM 199933002, Parents' priority right to the return of their original capital is the type of preference that is subject to section 2701, unlike Eli LP, which returned capital proportionately.

In addition to the traditional analysis, our proportionality test would conclude that Samuel LP is subject to section 2701. Both the 4 percent payments and the right to a priority return of capital are pecuniary rights. Thus, under the proportionality test the requisite senior and subordinate interests are created, meaning that section 2701 will apply to any transfer of a subordinate equity interest in Samuel LP.

Both pecuniary economic interests attach to Parents' LP units so those units can be considered a single class of equity that is senior to the GP units to which both residual economic rights attach. Section 2701, therefore, will apply to the issuance of the GP units with the attached 20 percent profits interest.

b. Principle Two: Apply the stripping rule to the senior equity interests in the entity. The LP units carry three economic rights: the 4 percent payment right, the priority right to a return of capital in a fixed amount, and an 80 percent interest in the residual profits. The 4 percent payment right and the priority right to a return of original capital are both senior (pecuniary) interests. The 80 percent residual profits interest is subordinate to the 4 percent payment right and it shares proportionately in residual profits with the GP units. Under principle two, this right to residual profits should be treated as a separate class of equity.

The GP units carry two economic rights: a subordinate right to a return of capital and a 20 percent interest in residual profits. Because the Samuel LP agreement requires the return of all invested capital on liquidation, the return of capital has a higher priority than profit distributions. Daughter's capital interest, therefore, must be senior to the residual profits rights, although junior to Parents' capital right. Because the right to capital is pecuniary, it is a senior interest. Applying principle two, the GP's residual profits right also should be stripped from the GP capital right.

c. Principle Three: Treat proportional economic interests as the same class. After application of the above principles, Samuel LP's equity structure consists of four classes. The first class is the LP units with their 4 percent payment right and the right to the priority return of original capital on termination. The second class is the GP units' subordinate capital right. Because this right is subordinate to the LP units' capital right, it represents a separate class of equity subordinate to the LP units but senior to the GP units' residual profits interests. The third

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class is the 80 percent residual profits interest stripped from the LP units. The fourth class is the 20 percent profits interest stripped from the GP units.

The third and fourth classes are obviously fractional interests in the same residual profits interest. The third and fourth classes, therefore, are treated as one class of equity that we will refer to as the residual profits interest. Thus, we see why the regulations, unlike the statute, consider proportional interests as if they were in the same class.

Those three classes of Samuel LP equity also correspond to their corporate equivalents. First, the LP units are the equivalent of preferred stock, carrying cumulative dividends and a liquidation priority in a fixed amount. Second, the GP units' capital interest is the equivalent of a second class of preferred stock, carrying the equivalent of a fixed liquidation right but no dividends — an unusual preferred stock, but consistent with the preferred stock in Eli Corp. above. Finally, the residual profits interest is the equivalent of common stock, carrying a right to profits but not a right to capital, because the preferred stock absorbs all of the original value of the company.

2. Definitional issues. Having applied our three principles, the economic structure of Samuel LP consists of LP units, the GP unit capital interest, and the residual profits interest. Before applying the subtractive method, however, an understanding of two definitional concepts is crucial: types of family members and types of equity interests. We then will be ready to determine whether the transfer of a bucket profits interest results in a chapter 14 gift that is substantially more than the chapter 12 gift.

a. Types of family members. Three types of family relationships are important under the regulations. First, the broadest definition of family and the one tied to the definition of family held includes the transferor, the transferor's applicable family members, descendants of the transferor's parents, and descendants of the transferor's spouse's parents.[59] Second, applicable family members are defined as the transferor's spouse, any ancestor of the transferor or of the transferor's spouse, and the spouse of any such ancestor.[60] Finally, a member of the family is the transferor's spouse, any descendant of the transferor or of the transferor's spouse, and the spouse of any such descendant.[61] Relations who fall into none of these three categories we will call "collaterals."

b. Types of equity interests. The regulations sort family-held equity interests into four categories. Reg. section 25.2701-3(b)(2)(A) defines three:

> [1] family-held senior equity interests (other than applicable retained interests held by the transferor or applicable family members) and . . . [2] family-held equity interests of the same class or [3] 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.

The fourth category of equity interests consists of those equity interests that are proportionally the same, a topic we have discussed at length. In our example, the residual profits interest of the LP units and of the GP units are treated as the same class: the residual profits interest.

The regulations define a senior equity interest as an "equity interest in the entity that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest."[62] The regulations further define a subordinate equity interest as an "equity interest in an entity as to which an applicable retained interest is a senior interest."[63] Senior equity interests have preferred (first, not larger) rights to the transferred interest, so they would include the class of the applicable retained interest and any senior class of equity. Subordinate equity interests include the transferred interest and any interest junior to the transferred interest. The regulations contain a possible flaw: A preferred interest that is junior to the applicable retained interest but senior to the transferred interest is both a senior equity interest and a subordinate equity interest (if it is not held by the transferor or an applicable family member because it would then be an applicable retained interest). The GP units' capital interest falls into this category.

In the regulatory parlance, the senior equity interest is the LP units without the residual profits interest, and the subordinate equity interests are the GP units' capital interest — while a senior interest to the residual profits interest — and the residual profits interest.

3. Putting it all together. We are now equipped to apply the subtraction method to the equity interests in Samuel LP. Our three principles have filled the regulatory gaps. Changing any one of these three principles opens gaps in the regulations that cause the application of the subtractive method to fail. When different possible interpretations of a regulation are available, the proper interpretation should be the one that avoids creating gaps in the regulations, not one frustrating their intended operation.

a. Valuation of applicable retained interests under section 2701. Section 2701 applies only to a transfer of a subordinate equity interest by a senior generation to a younger generation when, after the transfer, the transferor or an applicable family member holds an applicable retained interest in the entity. In Samuel LP the 4 percent payments and the priority return of original capital are both senior interests associated with the LP units. Because the LP units are held by Parents, they are applicable retained interests. The only other economic interest associated with the LP units is the right to share in 80 percent of the profits remaining after the 4 percent payments. This economic interest, therefore, is a separate class of equity to be combined with the profits interest of the transferred GP units as a single class, creating the residual profits interest class.

When an equity interest is an applicable retained interest, section 2701 provides special rules for valuing

[59] Reg. section 25.2701-2(b)(5)(i).

[60] Reg. section 25.2701-1(d)(2).

[61] Reg. section 25.2701-1(d)(1).

[62] Reg. section 25.2701-3(a)(2)(ii).

[63] Reg. section 25.2701-3(a)(2)(iii).

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that interest to determine the value of the transferred interest. Because the application of the special valuation rules to nonvoting, noncumulative preferred stock without a redemption date generally results in a value of zero for the preferred stock, many practitioners expect an equity interest to have zero value under section 2701 unless that interest has distribution rights equivalent to cumulative dividends.

However, as with many aspects of chapter 14, the reality often differs greatly from the perception. The starting point for valuing the applicable retained interest is its FMV under chapter 12.[64] The following subsections in reg. section 25.2701-2(a) then modify this valuation. Subsection (1) provides that any extraordinary payment rights are valued at zero. Subsection (2) values a distribution right in a controlled entity at zero, unless it is a qualified payment right. Subsection (3) supplies the lower-of rule, which prevents the use of a high dividend rate to increase the value of an applicable retained interest beyond its liquidation value. Subsection (4) values any other right (including a qualified payment right) at FMV, as under chapter 12.

i. Liquidation participation right. Voting rights, mandatory payment rights, and liquidation participation rights (which are neither distribution rights nor extraordinary payment rights) are among the rights of the applicable retained interest whose chapter 14 value will be the same as their chapter 12 value. As we saw above, when the family can control the liquidation of an equity interest, the regulations[65] value the liquidation participation rights as if the right to compel liquidation did not exist.[66] Thus, the regulations value any liquidation participation rights associated with Parents' retained LP units as if neither Parents nor Daughter has the right to compel liquidation of Eli LP, despite Daughter actually having that right. In the case of Samuel LP, the right to a priority return of original capital is a liquidation participation right.

ii. Mandatory payment right. The statute also excludes mandatory payment rights from section 2701. The definition of mandatory payment rights and liquidation participation rights overlap when the preferred interest has a fixed redemption date or the entity liquidates at a fixed date. The priority return of original capital at the end of the seven-year term of Samuel LP, therefore, is also a mandatory payment right.

iii. Qualified payment right.

a. No qualified payment election necessary for 4 percent payment right. If the 4 percent payment right is a qualified payment right, the regulations under section 2701 value that right at its market value. The regulations define a qualified payment right in a partnership as ''any other cumulative distribution right payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount.''[67]

Although a similar right in most venture capital funds would not be a qualified payment right, the 4 percent payment right in Eli LP is a qualified payment right without any election. Section 2701 presumes that the payments will be made annually as provided in the partnership agreement. The appraiser will determine the appropriate market rate reflecting the risk associated with nonpayment of the 4 percent amount. This triggers the other aspect of section 2701: An enforcement mechanism to impose a phantom inclusion amount if a payment is not timely made (within four years after its due date). The phantom inclusion amount compensates for the lost earnings from any delay in payment beyond this grace period. This amount will be added to taxable gifts if the applicable retained interest is disposed of during life or to the taxable estate if disposed of at death. (Because the preferred payments cumulate, they also will add to the liquidation value of the LP units at the end of seven years, if the transferor elects out of qualified payment treatment.)

b. Electing qualified payment treatment for the profits interest. If Parents do not rely on the stripping rule to treat the 80 percent profits interest as proportionately the same class as the 20 percent profits interest, they should be able to elect qualified payment treatment for the 80 percent profits interest. The statute provides:

> A transferor or applicable family member holding any distribution right which (without regard to this subparagraph) is not a qualified payment may elect to treat such right as a qualified payment, to be paid in the amounts and at the time specified in such election. The preceding sentence shall apply only to the extent that the amounts and times so specified are not inconsistent with the underlying legal instrument giving rise to such right.[68]

The regulations expand the requirements for the election:

> Any individual may elect to treat a distribution right held by that individual in a controlled entity as a qualified payment right. . . . The election is effective only to the extent —
> - Specified in the election, and
> - That the payments elected are permissible under the legal instrument giving rise to the right and are consistent with the legal right of the entity.[69]

The statute and regulations use different language to define the qualified payment election. Above, we emphasized the importance of differences in language between the statute and regulations. Here, not so much.

The statute's choice of the double negative ''not inconsistent'' rather than just ''consistent'' reveals Congress's intent that the election be liberally construed. It implies that Congress intends to put the burden on the IRS to

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[64]Reg. section 25.2701-2(a).

[65]Reg. section 25.2701-2(b)(4)(ii).

[66]If the lower-of rule applies, the value of the liquidation participation rights is determined as if the right to liquidate is exercised in a manner that is consistent with that rule.

[67]Reg. section 25.2701-2(b)(6).

[68]Section 2701(c)(3)(ii).

[69]Reg. section 25.2701-2(c)(2).

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show that an election is inconsistent with the instrument, rather than on the taxpayer to show that the election is consistent. The regulation's choice of ''permissible'' conveys the same liberality. Although the regulations add that the payments must be consistent with ''the legal right of the entity'' — presumably to make the scheduled payments — this is implied by the statute because every legal instrument must be construed consistently with applicable state law. However, perhaps Treasury chose ''consistent,'' rather than ''not inconsistent,'' to resist the congressional attempt to shift the burden of proof.

The qualified payment election was intended as a safety valve. A knowledgeable tax return preparer would have a last chance to fix a gift tax problem created by corporate types who did not understand the operation of section 2701. Congress perceived the disregard of the value of LPCC rights as having little risk of creating an unintentional tax problem. It was wrong, of course, but the regulations filled the gap by changing ''liquidation right'' to ''right to compel liquidation'' and respecting the FMV of a liquidation participation right while ignoring any increased value that might be attributable to a family's manipulation.

Distribution rights, on the other hand, were essential to nearly any equity interest, and Congress worried that valuing the right to distributions at zero could have unintended tax consequences. The abuse with distribution rights, in Congress's view, was that an appraisal would assume payments would be made when, in fact, they were not. Specifically, an appraiser would assume that noncumulative dividends would be timely paid because the preferred stockholder controlled the entity, a perfectly reasonable assumption between unrelated owners. But the preferred stockholder then would act as a parent and not require the dividends to be paid.

Congress, therefore, created the section 2701 regime: Unless the distribution right was a qualified payment right, distributions in family-controlled entities could not be valued as if they would be paid. A qualified payment right could be valued as if its distributions would be made as scheduled, but adverse transfer tax consequences would result if the payments were made after the grace period. Congress designed those consequences to mimic the transfer tax consequences that would result if the payments had been timely made. A late payment would become a phantom amount. That phantom amount would increase as if the phantom payment had been reinvested at the same rate as the market rate for the preferred interest. Later paying the missed payment will not stop the growth of the phantom amount. The late payment will reduce the phantom amount, but the amounts resulting from the assumed reinvestment will continue to compound. The phantom amount will be added to the preferred holder's transfer tax base when the preferred stock is transferred (if transferred at death, to the estate tax base, or if transferred during life, to the gift tax base).

Because the enforcement mechanism prevents abuse, Congress allowed a liberal qualified payment election. I have been unable to find a single authority limiting the taxpayer in electing qualified payment treatment for any type of distribution right or for any payment schedule. The only authority suggesting any limit is in the preamble to the proposed regulations:

> Section 2701 provides that an individual may elect to treat a payment that is not a qualified payment as a qualified payment. . . . The proposed regulations allow taxpayers to make ''partial'' elections with respect to otherwise nonqualifying distribution rights. The portion of the qualified payment right that is valued under a partial election must *meet all the requirements of a qualified payment (e.g., amounts must be payable periodically and no less frequently than annually)*. For example, if corporate stock provides a 10-percent annual non-cumulative dividend, a taxpayer may elect to treat that dividend right as a qualified payment right with respect to a 5-percent annual cumulative dividend.[70] [Emphasis added.]

The qualification mentioned in the parenthetical appears nowhere else, including the proposed regulations. Even here, the qualification applies only to a partial election that, absent in the statute, could be considered a matter of regulatory grace subject to any restrictions the IRS might require.

Thus, Parents should be able to elect to treat the 80 percent profits interest as a qualified payment right, payable on any schedule consistent with its terms.[71] Unlike a cumulative preferred dividend, the scheduled payments should not have to be annual or at a fixed rate or amount. For example, if the election were applied to noncumulative preferred dividends, nothing restricts the election from contemplating that no dividends will be paid for the first five years but will then begin to be paid annually. Nor should Parents be limited in scheduling their profits interest payments to match their expected payment dates and amounts. The purpose of section 2701 is to ensure that the valuation assumptions about distributions match reality by adding an enforcement regime.

If Parents elect qualified payment treatment for their 80 percent profits interest, the scheduled date of each payment then becomes the due date of the payment for purposes of computing the phantom inclusion amount. Section 2701 then would value the scheduled payments as a qualified payment right, and its enforcement mechanism would apply to those payments. Because of the uncertain timing of any profit distributions, however, this election is seldom if ever made in the fund context. If the election is made for a profits interest that otherwise would be stripped from the applicable retained interest, the profits interest payments should remain a part of the value of the applicable retained interest just as if they would be if there was a true qualified payment. We assume that neither Mom nor Dad elect qualified payment treatment for their share of the 80 percent residual profits interest in the Samuel LP example.

iv. Valuation impact of a term. We saw in the Eli LP context that Daughter's agreement to provide services annually could be compensation offsetting the annual decline in the LP units' liquidation value. Investors prove

[70] 56 *Fed. Reg.* 14,321 (Apr. 9, 1991).

[71] Reg. section 25.2701-2(c)(2).

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this point every time they invest in a venture capital fund that grants profits interest to the managers. Landlords prove this point when they enter into a crop share lease to split profits equally. However, this concept is subtle. Rather than relying on the ability to explain this subtlety to the Service, if section 2701 might apply to a partnership with any type of profits interest, give the entity a fixed liquidation date so that the liquidation value of the applicable retained interest can be quantified.

b. Valuation under the section 2701 regulations.

i. Four-step subtraction method. Having established the two pecuniary economic interests comprising the value of the applicable retained interest, we will apply the four-step subtraction method of valuation in the regulations[72] to determine any potential chapter 14 gift.

Step 1 determines the FMV of all family-held equity interests in Samuel LP after the transfer, assuming that they were held by one person. Step 1, therefore, results in a value equal to the entire initial capital of Samuel LP, or $50 million.[73]

Step 2 has a Part A and a Part B. Part A requires determining the FMV of (1) all senior equity interests other than applicable retained interests and (2) all subordinate equity interests held by collaterals. Here there are no such interests, so the value in Part A is zero.

Part B requires determining the value of all applicable retained interests using the special valuation rules. In our example, Parents' 4 percent payment right and their priority right to the return of capital are applicable retained interests. Absent a qualified payment election, parents' retained 80 percent profits interest, however, is not part of their applicable retained interest.

We must apply the special valuation rules to each applicable retained interest. Because the 4 percent payment right is a qualified payment, it retains its FMV.[74] However, a 4 percent return on invested capital is not a sufficient rate of return given the risk involved in this investment. For purposes of our computations we will assume that the LPs would demand a 12 percent rate of return.

For comparison purposes, the Samuel LP would have to earn a 14 percent return on its capital for the LPs' 80 percent share to return 12 percent. Also, an investor who earned only an 8 percent return would have to invest approximately $84 million to obtain the same return from $49.5 million invested at 12 percent, about 1.7 times as much.

The market rate of 12 percent then becomes the discount rate to use when determining the present value of any economic right. If the seven annual payments are discounted at an assumed market rate of 12 percent, the 4 percent payments would have a present value equal to $9,036,238.

Section 2701 also recognizes the market value of the liquidation participation rights associated with the retained capital interest. As discussed above, a liquidation participation right is not an extraordinary payment right and is valued at market value assuming the family's right to compel liquidation did not exist.[75] Any capital distribution to Parents on the termination date would be both a liquidation participation right and mandatory payment right, both of which are valued at fair market value. Because Samuel LP liquidates in year seven, the market value of the liquidation participation right on Parents' returned capital, discounted at the assumed 12 percent market rate for the seven-year period, is $22,391,286. The total value of those two rights, $31,427,524, is the value of Part B. Most commentators fail to consider the value of the liquidation participation rights. They instead improperly jump to the conclusion that the capital interest has zero value because preferred stock with an indefinite life and no right to benefit from passed dividends has zero value.

The zero value in Part A is added to the value in Part B, and this total is then subtracted from the value in Step 1, resulting in a residual value of $18,572,476 ($50 million minus $31,427,524).

Step 3 allocates this remaining $18,572,476 among the transferred and other subordinate interests,[76] beginning with the most senior interest, to fairly approximate their values using the assumptions under section 2701. The GP units' capital interest is the most senior of the subordinated equity. Because the GP units are held by Daughter, it is neither an applicable retained interest nor a collaterally held equity interest. Therefore, this equity interest is valued at market: The right to the return of $500,000 in seven years discounted at 12 percent is $226,175.[77]

Step 3 would allocate the residual amount of $18,346,301 ($18,572,476 - $226,175) between the transferred 20 percent profits interest and the retained 80 percent profits interest. Because the interests are treated as the same class, Step 3 allocates 20 percent of this amount ($3,669,260) to the transferred profits interest.

Step 4 further reduces the value of the transferred profits in Step 3 by allowing additional value reductions for minority interest, for transfers with a retained interest under section 2702, and for consideration paid. Because the GP units control Samuel LP, no minority discount is appropriate. Nor does section 2702 apply. However, Daughter did give consideration for her GP units, and reg. section 25.2701-3(iv) provides for a reduction equal to ''the amount of consideration in money or money's

[72]Reg. section 25.2701-3.

[73]If the family does not own the entire company, discounts may be applied to arrive at the value of the family's equity interests for Step 1. When the family owns the entire company, most discounts from the underlying value of the company will not apply. If the company is a C corporation, however, a discount for the tax on built-in gains could apply.

[74]Reg. section 25.2701-2(a)(4).

[75]Reg. section 25.2701-2(b)(4)(ii).

[76]Subordinate to the applicable retained interests.

[77]One could argue the subordinate nature of the interest should cause it to be discounted at a higher rate. However, the chances seem rather remote that the 99 percent LP capital interest would be repaid and not the 1 percent GP capital interest.

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worth received by the transferor.'' This chapter 14 consideration offset is nearly the same as the chapter 12 consideration offset in section 2512(b).[78]

Obviously the $500,000 that Daughter contributes to Samuel LP is a reduction, but the value of the services she contributes should also be a reduction. The value of services is ''consideration in money or money's worth.'' Otherwise, paying a family member employee would be a gift by the owners of the company. Thus, the value of the gift is the excess (if any) of $3,169,260 ($3,669,260 less Daughter's $500,000 capital contribution) over the value of the services and other benefits she provides as GP.

Does the value of the services Daughter provides exceed the value of the profits interest she receives (here computed to be $3,169,260)? If both family and nonfamily members invest in the LP units, the nonfamily member investments would be evidence that the value of Daughter's services equaled or exceeded the value of her profits interest. Lacking that evidence, one must resort to other means to determine the value of her services.

The subtractive valuation method under chapter 14 quantifies the value of the profits interest by determining the present value of the partners' rights to the return of their capital and qualified payments. That value depends on the market rate the LPs demand for their invested capital. The value of the profits is the excess of the capital contributed over the present value of those contributions. The value of Daughter's 20 percent profits interest is 20 percent of this excess. Conceptually, the gift under chapter 14, therefore, does not differ from the gift under chapter 12. In both cases, the gift is the excess of the value of the profits interest Daughter receives over the value of the services and other benefits she provides.

ii. Effect of the 10 percent minimum gift rule. Congress limited the use of the subtraction method to depress the value of the common stock by providing a minimum value for the common stock. This minimum value approximates the option value of the common stock or ''junior equity interest,'' which must be at least 10 percent of the value of the entity, plus the value of any debt of the entity held by the transferor or applicable family member (ancestor debt). The calculation of the minimum gift includes ancestor debt as part of entity value to prevent the family from further leveraging the entity, which would further enhance the option value of the common stock.

The regulations define junior equity interest as:

> common stock or, in the case of a partnership, any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests. Common stock means the class or classes of stock that, under the facts and circumstances are entitled to share in the reasonably anticipated residual growth in the entity.[79]

If more than one class of stock shares in most of the corporation's appreciation, the last sentence treats all of those classes of common as the junior equity interest. If multiple partnership interests share in the partnership's appreciation, however, the regulation and the statute each limit the definition of junior equity interest to the partnership's most junior interest. In this case the residual profits interest is the equivalent of common stock. The GP units' capital interest is not the most junior and does not share in the partnership's appreciation.

In the above example, the most junior equity interest is the residual profits interest, which is shared 80/20 by Parents and Daughter. Because they share the economic interest proportionately or fractionally, the interests are of the same class under my interpretation of the regulations. Thus, the value of that class must be at least 10 percent of the value of the entity ($50 million x 10 percent = $5 million). The subtraction method values the junior equity interest at $18,346,301, more than three times the minimum gift value.

The minimum value rule offers additional evidence that Parents' 80 percent interest in the profits and Daughter's 20 percent profits interest are of the same class under section 2701. Any profits from the investment of capital are divided 80/20. The option value is the benefit the holder enjoys to participate in any increase in the profits without placing any capital at risk for that benefit. Daughter enjoys that benefit only to the extent her share of the profits exceeds her share of the invested capital. Unless chapter 14 treats the partners as sharing proportionately in the same class of equity as I propose, the minimum gift rule would fail to correspond with the economics of Samuel LP.

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[78]ACTEC report, *supra* note 9, at 8 implies, without explanation, that the test might be different. Perhaps the implication comes from reg. section 25.2701-3(a)(4)(iv), which states: ''The amount of the transfer (determined under section 2701) is reduced by the amount of the consideration in money or money's worth received by the transferor, *but not in excess of the amount of the gift (determined without regard to section 2701)*.'' (Emphasis added.) The italicized language is one example of Treasury displaying a faulty position that runs throughout the section 2701 regulations: Section 2701 is not really a valuation section, but a phantom gift provision that adds any increase in the value of a gift to the donor's gift tax base. This concept is found throughout the section 2701 regulations, but is flatly inconsistent with section 2701(a)(1), which provides: ''Solely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family *is a gift (and the value of such transfer)*.'' (Emphasis added.) Section 2704, in contrast, does treat a lapse as an addition to the tax base. *See* section 2704(a)(1), flush language. Although many worry that the section 2701 regulations operate in an uncertain and irrational manner, I wish Treasury was less clear in its apparent attempt to transplant a section 2704 concept into section 2701 to adversely affect the annual exclusion, the marital and charitable deductions, and the value of the consideration paid (which is preposterous because the value of the consideration paid adds to the donor's assets whether or not the amount was more than needed to avoid a gift). I am unaware of any attempt by the IRS to apply the regulations in this aggressive manner.

[79]Reg. section 25.2701-3(c)(2).

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Because the 10 percent minimum gift rule only approximates the option value of the profits interest, chapter 14 theoretically[80] could produce a higher or lower value than chapter 12, which should include the option value in the FMV of the profits interest. The minimum gift rule will apply under chapter 14 when the value of the profits held by both Parents and Daughter (because they are of the same class) is less than 10 percent of the entity's value. Under the subtraction method, the value of the profits interest is the excess of the value of the entity over the present value of the right to the return of capital. Thus, the value of the profits interest depends on two variables: the discount rate and the term of the partnership.

If the discount rate goes up, the present value of the right to the return of capital goes down. If the investment return (discount rate) is greater, one needs to invest less today (present value) to receive $50 million in the future. If the present value of the return of capital right is less, the subtractive value method correspondingly increases the value of the right to profits, which is the junior equity interest. The minimum gift rule ensures a minimum value for the profits interest so it will apply only if the value of the profits decreases. Thus, the minimum gift rule will apply only when the discount rate goes low enough to produce a present value for the capital that exceeds 90 percent of the value of the entity.

If the term of the partnership is lengthened, the present value of the right to capital is decreased because one has a longer time to invest that present value to receive $50 million in the future, and the discount rate at which the present value of the return of capital right exceeds 90 percent of the value of the entity will be lower. The discount rate that will result in the return of capital right having a present value of more than 90 percent of the entity value turns out to be extremely low for all of the likely partnership terms. The following table shows the minimum discount rate for various terms of years that would cause the present value of the right to the return of capital to equal exactly 90 percent and, therefore, the value of the profits to equal 10 percent of the entity's value.

Partnership Term	Discount Rate
5 years	2.13%
6 years	1.77%
7 years	1.52%
8 years	1.33%
9 years	1.18%
10 years	1.06%

Because the discount rate is the rate that causes the partnership profits to have a value equal to 10 percent of the entity's value, the chapter 14 minimum value will apply only if the value of the profits decreases. For the value of the profits to decrease, the value of the right to the return of capital must increase, which will occur only if the discount rate is further lowered. These discount rates are already so low, it is unlikely that the 10 percent minimum value rule will ever increase the chapter 14 value of the profits interest.

Because the minimum gift rule is so unlikely to apply, following the chapter 14 subtractive method might result in a lower value for the profits (and the 20 percent profits interest) than a market value appraisal. Because part of the consideration that Daughter provides is the payment of administrative expenses, she is at risk if her profits interest is inadequate to fund those expenses. Because the GP in a venture capital fund is usually paid a 2 percent fee to cover administration expenses, the option value of the GP's profits interest in a typical venture capital fund should be greater than the one in Samuel LP, reflecting that a fund's profits interest only has upside value, and not any downside risk below the 2 percent annual fee.

IV. Lessons for Gifts of Profits Interests

A. Simplified Profits Interest

A traditional FLP with a simplified profits interest should satisfy the proportionality test. Any other conclusion would produce contradictory results for the same economic interests. If my proportionality argument is correct, the terms of withdrawal from the partnership will not have any section 2701 significance and the partners can structure their rights according to their economic deal. Under my analysis, a simple profits interest avoids the need for a section 2701 appraisal or the need to comply with the special election and gift tax reporting requirements under that section.

If a planner nonetheless remains concerned with the risk that section 2701 might apply to a simplified profits interest, the agreement should prohibit the withdrawal of the investors for a significant period, preventing them from holding an extraordinary payment right. (Also, please send me your card so you can explain to the farmers here in Illinois why their common family partnership agreements result in a substantial gift of the farmland, even while retaining the right to get it all back.) My understanding is that all planners agree that the lack of an extraordinary payment right prevents section 2701 from applying. However, if the services provided by the managers proved to be inadequate, locking the investors in for a long period might increase the chapter 12 gift.

B. Bucket Profits Interests

Avoiding the application of section 2701 to a transfer of a typical profits interest in a venture capital or private equity fund will be almost impossible. However, the value of the profits interest in a typical fund will not be much different under chapters 12 and 14, despite having different terms from those discussed above, assuming the fund has a fixed liquidation date.

The GP's 2 percent management fee is not subject to section 2701 either because it is not an equity interest, or if it is, it's a guaranteed payment. The fund documents are likely to provide for the return of the investors' capital and a fixed compounded rate of return on that capital before distributing the profits 80/20. If the fund provides that the return of capital is to be made from

[80]Not literally, because the chapter 14 value is an upward adjustment to the chapter 12 value.

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distributions of profits, the invested capital amount becomes just another fixed value or pecuniary amount.

Because the capital in the fund is repaid before the 8 percent payments are made, the payments likely are not the partnership equivalent of cumulative preferred dividends. Thus, the payments will be distribution rights without value under section 2701 unless an election is made to treat those payments as qualified payments, which in turn requires a commitment to the timing of the payments.

Although the return of capital and 8 percent payments will not have any value as distribution rights, the value of those compounded payments on liquidation or redemption on a fixed date should have value as liquidation participation rights. Again, caution dictates using a fixed liquidation date if section 2701 applies so that one can quantify the value of the liquidation participation rights. As we saw before, if passed distributions on the senior interest compound at the market rate, the holder of the senior interests benefits from passed distributions, rather than the holder of the subordinate interests.

By compounding the return, the timing of the payments becomes irrelevant. Thus, if 8 percent were the appropriate market rate on the investment, the value of the liquidation participation right of those payments would equal the invested capital. However, the 8 percent payments are unlikely to be the requisite market rate, as the investors demanded 80 percent of the profits in addition to the compounded 8 percent return. Accordingly, the FMV of the liquidation participation rights in a venture capital or private equity fund is likely to be a fraction of the invested capital, unless one can show that the fund has an outside date for liquidating or redeeming the investors' interests.

If the fund does have a fixed liquidation date or term, section 2701 would value the liquidation participation rights as of the termination date by discounting that amount using an appropriate market rate. The regulations would value the profits interests of both the GP and LPs at the excess of invested capital over this discounted value. The regulations would then allocate this residual value 80 percent to the LPs and 20 percent to the GP. The taxpayer then would need to show that the value of the services provided by the GP exceeded the value of its profits interest — an analysis under chapter 14 that is no different than the analysis under chapter 12. Both should be satisfied by showing that unrelated parties are investing on the same terms.

As discussed above, however, if the fund has no specific term, the right to receive back 80 percent of the profits on termination, whenever that might occur, is part of the liquidation participation rights. Just as a compounded market rate of return makes the timing of the distribution irrelevant, receiving all of the profits from an interest should make the timing irrelevant: The longer the delay in liquidating, the more profits to make up for that delay. Thus, if the 8 percent compounded return and return of capital are given value under section 2701, that amount merely reduces the value of the 20 percent profits interest granted the GP for her contribution of services and other benefits.

C. Chapter 14 Valuation: Blessing or Curse?

Planners have avoided gifts of profits interests out of a concern that chapter 14 would produce severe gift tax results; however, it is possible that chapter 14 might be better than chapter 12 for the valuation of a gift of a bucket profits interest. Of course, chapter 14 only increases a chapter 12 gift, but returning the value of a transferred profits interest that is clearly subject to section 2701 using its subtraction method is likely to be accepted as the gift tax value of the profits interest. Consider this example:

> Daughter wants to plan ahead by transferring 10 percent of her GP units in Samuel LP to a new trust exempt from generation-skipping transfer tax, although she has no children. Samuel LP has a seven-year life.

Because of the seven-year term, we are able to determine the value of the distribution and liquidation rights using discounting. We assumed above that an investor in Samuel LP would want a 12 percent annual return for investing. Although subject to challenge, of course, an appraiser is likely to be able to determine an appropriate discount rate in a manner that is understandable and predictable.

The chapter 14 gift tax value of Daughter's profits interest is shown above to be $3,669,260, and her capital interest is shown to be $226,175, for a total value of $3,895,435. The transfer of 10 percent of these interests under the subtraction valuation method, therefore, is $389,435, before any discount. Because this example involves a gift of a profits interest rather than its creation, a discount would be appropriate in Step 4. This value of the profit interests turns on the selection of the appropriate market discount rate, but once the rate is selected, the valuation and the discount are mathematical.

Compare this with determining the FMV of a profits interest under chapter 12. The most likely method would be to project possible returns of the profits interest and assign probabilities to the different returns. The value of those blended cash flows would then be discounted by a factor that approximated a buyer of the profits interest expected return. The discount rate would be higher to reflect lack of control and marketability.

Chapter 12 and chapter 14 appraisals of the profits interest are so rare it is difficult to know how the values under those two different chapters might compare. Chapter 14 is unlikely to assign any additional option value to the profits interest under the minimum gift rule. The appraisal may find that the option value of the profits interest under chapter 12 is much greater than 10 percent of the value of the entity. By following the regulations, a chapter 14 appraisal may seem more precise to the IRS than a market value appraisal of the profits interest for which no consistent valuation procedure exists. Finding the appropriate market rate may be simpler for the investors' capital than for the profits interest. As those appraisals become more common, we may find that valuing profits interests in venture capital and private equity funds under section 2701 is a blessing rather than a curse.

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V. Conclusion

The above analysis shows that section 2701 operates properly when applied to profits interests, providing transfer tax results that are consistent with the economics of those interests. The widely held belief that section 2701 would produce draconian gift tax consequences seems unjustified, especially with a little bit of planning. Despite its vagaries, when properly interpreted, chapter 14 continues to apply to business transactions as Congress intended: Granting family business owners wide discretion to arrange their affairs without adverse transfer tax results, while providing close scrutiny to a handful of identified transactions in which Congress believed the FMV standard was inadequate.

One of the sources of the uncertain transfer tax results in connection with profits interests in funds is the unwillingness of the corporate and partnership lawyers who create those profits interests to accommodate the important estate planning objectives of their clients. As we have seen, even the most complex profits interests in funds can be tweaked to allow gifts of those interests without creating adverse gift tax results. Fund lawyers who are willing to design complex and sophisticated fund structures to save the 2.9 percent Medicare tax for their clients are surprisingly unwilling to design their funds to save their clients estate taxes ranging from 45 percent to 53 percent depending on the state of residence. The result is more complexity when interests in those funds are given away.

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