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Negative Capital Freezes and Subchapter K

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Generally, gifts trigger no income tax. An exception can arise where the child/donee assumes (or takes subject to) the parent/donor's liabilities. If so, the parent may recognize a gain (but no loss), treating the debt relieved as the amount realized.[1] Similar rules apply where the gifted property is a partnership interest.[2] This is often described as the problem of ''negative basis'' or ''negative capital.''[3]

In theory, negative capital can arise wherever a debt is secured by a low-basis asset. In practice, the low-basis asset is usually real estate. Real estate's popularity is in part due to its effectiveness as an income tax shelter. Under *Crane*,[4] debt creates tax-free basis, which supports (tax-free) distributions or new (depreciable) acquisitions.[5] Real estate is good security for these loans, since it holds its value and appreciates in a fairly predictable way.

Setting aside the possibility of a basis step-up at death, the resulting tax deferral lasts until the investor sells or gifts the asset. As Boris Bittker famously put it: ''By holding that nonrecourse liabilities are includable in the taxpayer's basis for property, *Crane* laid the foundation stone of most tax shelters, while the corollary of this basis rule — that the termination of nonrecourse liability is an amount realized when the property is sold or disposed of — is the booby trap waiting for tax sheltered investors when their venture is wound up.''[6] In this sense, the negative capital problem can be delayed indefinitely, if not entirely avoided, by holding the asset until death.

Yet, for estate tax planning purposes, we encourage our wealthier clients to make lifetime gifts. Once again, real estate is often the choice for the gift, since the same trait that makes it good security for a debt — its predictable growth — also argues in favor of getting it out of the estate. Thus, ironically, the estate tax planner's good advice can bring the income tax problem to a head. To avoid this collision, estate tax planners need a tool which can shift wealth without triggering negative capital, and preferably one which incorporates the basis step-up at death to eliminate the negative capital entirely.

The use of entity freezes for this purpose has been explored in thoughtful articles by Stephen Breitstone and others, recently[7] and over the last decade.[8] I assume familiarity with these articles, in which they de-

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[1] *Johnson v. Commissioner*, 59 T.C. 791, 807 (1973), *aff'd sub nom. Johnson v. Commissioner*, 495 F.2d 1079 (6th Cir. 1974); *Levine v. Commissioner*, 72 T.C. 780, (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980); Louis A. Del Cotto and Kenneth F. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

[2] §752 (treat debt shift as cash distribution); §705 (cash distribution reduces parent's outside basis); §731 (when outside basis reaches zero, further distributions trigger gain). All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[3] Basis cannot be negative, and a negative capital account is just a symptom of the true cause of the problem, debt exceeding basis. Still, these terms have wide acceptance.

[4] *Crane v. Commissioner*, 331 U.S. 1 (1947).

[5] *See* Paul McDaniel et al., *Federal Income Taxation: Cases and Materials* 1191 (2008) (describing leveraged tax shelters as having ''three common elements: deferral, conversion, and leverage.'').

[6] *See* Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 Tax L. Rev. 277 (1978).

[7] Stephen Breitstone, N. Todd Angkatavanich, Joseph A. Medina, and Jerome M. Hesch, *Living With 'Freeze Partnerships' in the Real World: Formation Considerations and Practical Applications*, 47 Tax Mgmt. Ests., Gifts & Trs. J. No. 1 (Jan. 13, 2022) (herein, ''Breitstone 2022'').

[8] *See, e.g.*, Breitstone, *Estate Planning for Negative Capital*, Trusts & Estates (May 2012) (herein, ''Breitstone 2012''); Breit-

scribe the tax benefits of a freeze. These authors have long been recognized authorities on this topic, and I have no quarrel with their analysis.

Here, I describe some issues I've encountered while implementing freezes. These fall under two headings. First, while it is technically possible to do a freeze without a defective grantor trust (DGT) for the child, estate planners who wish to avoid complications under Subchapter K may prefer using the DGT, or avoiding a taxable partnership altogether. Second, the technique relies on a few propositions which may be true, which may have the tacit support of the IRS, and which may seem pedantic to question — yet which are difficult to prove. Practitioners should form their own opinions on these issues.

HOW TO IMPLEMENT A FREEZE

Frozen partnerships are not hard to draft. Since estate planners do not encounter these often, I start with some suggestions.

In a freeze, each existing membership interest converts into a stated number of preferred and common units. Preferred units are debt-like, in that they represent a defined (non-residual) claim to the company's value. In the operating agreement, I define ''Preferred Base'' to refer to this fixed principal-like amount; I define ''Appraised Rate of Return'' to refer to the interest-like expected growth rate; and I define the ''Accumulated Preferred Return'' at any given moment to mean: [Preferred Base] × [Appraised Rate of Return] × [years elapsed since the Effective Date]. Then, I provide for distributions as follows:

> *(i) First: to the Preferred units, as long as total distributions pursuant to this (i) are less than the Accumulated Preferred Return.*
>
> *(ii) Second (but only as to cash from a Capital Event): to the Preferred units, as long as total distributions pursuant to this (ii) are less than the Preferred Base.*
>
> *(iii) Third: to the Common units.*[9]

If the entity is a Subchapter K partnership, the operating agreement will also contain tax allocations. These should follow the distributions.[10]

REALIZATION AT DEATH?

Although the Tax Court has held that a gift will trigger gain if there is negative capital, no binding authority exists on whether the same would occur at death.[11] If so, then an entity freeze merely delays, but does not solve, the negative capital problem.

This question (whether transfers by reason of death are dispositions for purposes of §1001) remains unsettled.[12] In my view, the most compelling commentary is a 1979 article by Louis Del Cotto and Kenneth Joyce.[13] The authors argue that death is a disposition, because *Crane* imposes ''a deferred tax on past gain attributable either to tax-saving deductions without economic cost, or to tax-free borrowing on the value of property.''[14] They explain:

> Both types of tax benefit are given on condition that the owner of the property eventually pays the related debt. When the property is transferred subject to the debt and it becomes clear that the transferor will not pay it, he must account for his past gain. It should be emphasized at this point that this does not involve the taxation of unrealized appreciation, but rather the deferred taxation (i.e., recognition) of clearly realized gain (i.e., past rents or other income previously offset by depreciation deductions, or loan proceeds of a now effectively extinguished debt).[15]

After performing their own analysis, Breitstone et al. conclude that death is not a disposition.[16] That is fine; reasonable minds can differ. Even believers in death-as-disposition acknowledge that the opposite idea (death-is-not-a-disposition) has become so entrenched with time that the IRS will never try to con-

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stone and Hesch, *Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution*, 53 Tax Mgmt. Memo., No. 17 311 (Aug. 13, 2012) (''Breitstone & Hesch, 2012''); Breitstone, Angkatavanich, and Medina, *Preferred Partnership Freezes*, 47th Annual Notre Dame Tax & Estate Planning Institute (Oct. 21-22, 2021) (''Breitstone 2021'').

[9] For alternative language, see Terence Floyd Cuff, *Drafting and Understanding Partnership and LLC Allocation and Distribution Provisions*, at ch. 3 (''Operating Distributions — Preferred Return'').

[10] William F. Nelson, *The Partnership Capital Freeze: Income, Estate, and Gift Tax Considerations*, 1 Va. Tax Rev. 11 (1981), at p. 16.

[11] Monte A. Jackel, *Death as a Disposition Redux*, Tax Notes Fed. (Oct. 7, 2019) (''there remains the age-old question whether death is a disposition, which has not been tested in court or any IRS published pronouncement.'').

[12] *Id.* at p. 101; Robert Willens, *Partnership Interest Transfer From Decedent Is Not a Disposition*, Tax Notes Fed. (Oct. 14, 2019), p. 283; Jackel, *Death Remains a Disposition*, Tax Notes Fed. (Oct. 21, 2019), p. 471; Willens, *Dispositions, Plain and Simple*, Tax Notes Fed. (Oct. 28, 2019), p. 621; Jackel, *How to Read the Code, Regs, and Rulings: A Response to Willens*, Tax Notes Fed. (Nov. 4, 2019), p. 826.

[13] See Del Cotto and Joyce, Note 1, above.

[14] *Id.* at 571.

[15] *Id.*

[16] Breitstone 2022 at n.46; Breitstone 2012 at n.20.

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tradict it.[17] This is good news for clients, but it creates a dilemma for tax professionals who feel the IRS has got it wrong, which I discuss in the Conclusion.

CAN YOU START WITH A DISREGARDED LLC?

Technically, a freeze can be done to convert a disregarded entity into a Subchapter K partnership. However, doing so creates some valuation issues.

Rev. Rul. 99-5 sets forth the tax consequences when Y acquires an interest in X's wholly owned disregarded LLC. Assume the LLC holds appreciated widgets, and Y acquires the LLC interest for cash. The ruling describes two scenarios.

- In Situation 2, Y pays the cash to the LLC, such that the LLC's balance sheet now contains X's widgets and Y's cash. For tax purposes, this is viewed as a classical partnership formation: X and Y are deemed to contribute their respective assets into a new partnership (and X's widgets enjoy nonrecognition under §721).
- In Situation 1, Y pays the cash to X, such that the LLC's balance sheet continues to hold nothing but X's widgets. Unlike in Situation 2, X sold something. But what did X sell? Held: X sold widgets (not partnership interests). Then X and Y contributed their widgets into a new partnership.

If the donee/child acquires the LLC interests by gift, nothing is added to the LLC's balance sheet, so Situation 1 applies. Thus, the child will be deemed to receive an interest in the LLC's underlying assets. This is true even if the LLC had previously been recapitalized into common and preferred. The transaction would be viewed as: First, parent gifts widgets to child; second, parent and child contribute their widgets into a new Subchapter K partnership; third, parent's common is exchanged for preferred.

Because there is negative capital, some gain will be recognized on this gift. The amount of gain will be proportional to the quantity of widgets transferred. This quantity is not immediately clear; the only data we have is the size of the common interest transferred (as described in the partnership agreement) and the value of that interest (as described for gift tax purposes). The gift tax value may have reflected discounts for lack of marketability and control, but these discounts might not be appropriate for the income tax task of counting widgets transferred.[18] Also, if the LLC is too new, the IRS could disregard it, for valuation purposes, on step transaction grounds.[19] Another open question is whether the IRS can include Black-Scholes (option) values when valuing the transferred common units.[20] Any upward adjustments to the value of the transferred widgets will cause more gain to be incurred.

Similar issues have been identified in the corporate setting, where freezes are done to shift future income out of corporate solution without triggering the built-in gain in the corporation's underlying assets. As Michael P. Spiro explains, this raises questions of economic substance, with the possible result that the resulting tax partnership could be disregarded:

> It is difficult to articulate a nontax rationale for a partnership freeze when there is no or little value outside corporate solution at inception. On the other hand, when the common equity has meaningful value at the time of a partnership freeze, the freeze transaction itself constitutes a reasonable corporate risk mitigation tool, whereby the corporation is protected against losses to the extent of the common value in exchange for a limitation on its profit opportunity. The greater the downside protection, the more justifiable the transaction becomes as a nontax matter (and the lower the necessary coupon rate to substantiate the arm's-length nature of the transaction).[21]

Economic substance is less of a concern for estate planning freezes, in light of §7701(o)(5), which limits the doctrine's impact on individuals. Still, the same factors will come into play in demonstrating a ''legitimate and significant nontax purpose'' for creating the partnership.[22]

CAN YOU START WITH A SUBCHAPTER K PARTNERSHIP?

Starting with a tax partnership (rather than a disregarded LLC) could also cause issues. Specifically, where the frozen entity is a Subchapter K partnership, why is the exchange of common for preferred not an ''exchange of property for other property differing

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[17] Jackel, *No Escape: Proposals for Taxing Gains at Death*, Tax Notes Fed., Vol. 172 (July 6, 2021), at p. 77.

[18] *Cf. Pierre v. Commissioner,* 133 T.C. 24 (2009) (permitting discounts for estate and gift tax purposes, because under Reg. §301.7701-2, the LLC was disregarded only for income tax purposes).

[19] *Cf. Pierre v. Commissioner*, T.C. Memo 2010-106 (applying step transaction doctrine and rejecting valuation discounts).

[20] *See* Michael P. Spiro, *Liability Shifts in Leveraged Partnership Freezes, 2022*, Tax Notes State, Vol. 104 (June 20, 2022), at n.3.

[21] *Id.*

[22] *Estate of Bongard v. Commissioner*, 124 T.C. 95, 118 (2005).

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materially either in kind or in extent?''[23] Or if it is, what is the relevant nonrecognition provision?[24]

In the corporate context, the reason for nonrecognition is clear. Under §354(a)(1) and §368(a)(1)(E), a recapitalization does not trigger recognition.[25] But there is no such rule for partnerships. The presence of a nonrecognition rule for recapitalizations in the corporate setting, and the absence of one in the partnership setting, begs the question of whether Congress intended a different result for partnerships.

Writing in 1981, William Nelson (of McKee, Nelson, and Whitmire fame) considered a few answers to this puzzle. Ultimately, his discussion is inconclusive. One option he considered was to ''treat every modification of interests in a partnership as a section 721(a) contribution by all partners of their interests to a new partnership,'' followed by a liquidation of the original partnership.[26] Nelson acknowledged that this explanation is ''plausible,'' but lamented that ''like biblical solutions,'' it ''requires the ingredient of faith.'' Nelson did not discuss the possibility of a partnership liquidation followed by recontribution into a new partnership, presumably because he ran into the same ''ingredient of faith.''

According to Nelson, a better explanation for nonrecognition is that the partnership recapitalization qualifies as a §1031 exchange. However, three years after he wrote this, in 1984, §1031 was amended to no longer apply to ''interests in a partnership.''[27] And since 2017, it only applies to real property.[28] This makes §1031 another unlikely candidate.

Nelson also pointed to authorities giving tax-free treatment to specific kinds of changes to partnership interests. For example, in PLR 7948063, the IRS ruled that an exchange of a general partner interest for a limited partner interest in the same partnership is not a taxable disposition. However, he observes that ''A liability conversion is more susceptible of characterization as an exchange of distinct assets, because it seems to be a more drastic change than an alteration of profit shares.''[29]

As a practical matter, it may be that the IRS views these recapitalizations as nonrecognition events. But it would help to know why.

GUARANTEED PAYMENT VS. DISTRIBUTIVE SHARE

Another side effect of using a Subchapter K partnership is the issue of how to characterize the preferred payment. Although I have loosely characterized this as debt-like, these payments can be characterized as guaranteed payments or as distributive shares, depending on the circumstances. The rules here are still unresolved. In a recent report, the Tax Section of the New York State Bar Association summarized the scenarios.[30]

First, there is the case where the preferred return ''is dependent (in whole or part) on and limited to the partnership having sufficient income.'' This should be treated as a distributive share. However, payments of this kind would not be used in an estate planning freeze, since non-cumulative preferred returns do not constitute qualified payments under §2701.

Second, there is the case where the preferred return ''is not dependent on or limited to the partnership having sufficient income.'' Here, the report acknowledges several views. Under ''Approach 1,'' the accrued amounts are guaranteed payments. Under ''Approach 2,'' the partner's economic accruals should be matched, to the extent possible, by allocations of current-year income. Then, if this is less than the total accrued preferred return, either (Approach 2A) treat the difference as a guaranteed payment, or (Approach 2B) wait until future years to allocate income.

While weighing these options, keep in mind that if the payment to a preferred partner is effectively guaranteed, its status as a partner will be questioned.[31]

SHOULD YOU USE A DGT?

Freezes are commonly done with DGTs. If so, the transactions between parent and child will be disregarded for the income tax, even if the entity is otherwise a taxable partnership.[32] This makes the return preparer happy, because she can preparer post-freeze returns using the pre-freeze operating agreement.

However, the use of DGTs is not mandatory. Breitstone et al. describe some examples where the parent and child are distinct tax partners.[33] In my view, this can cause income tax complications.

Our overriding goal is to avoid having the transfer of common interests trigger the gain inherent in the parent's negative capital. Where a partnership interest

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[23] Reg. §1.1001-1; *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991).

[24] §1001(c) (''Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.'')

[25] *See* Rev. Rul. 74-269.

[26] Nelson, above, Note 10, at 31.

[27] Pub. L. No. 98-369, div. A, tit. I, §77(a) (July 18, 1984), 98 Stat. 595.

[28] Pub. L. No. 115-97, tit. I, §13303(a)–§13303(b)(5) (Dec. 22, 2017), 131 Stat. 2123, 2124.

[29] *Id.*

[30] N.Y. State Bar Ass'n Tax Section, Report No. 1357, *Report on Guaranteed Payments and Preferred Returns* (Nov. 14, 2016).

[31] *See* Heidi Pope, *Partnership Freezes After Castle Harbour*, The Tax Advisor (Mar. 31, 2007).

[32] *See* Rev. Rul. 85-13.

[33] Breitstone 2012, text at n. 49.

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is transferred (and where the donee is not a DGT), this gain arises when there is a debt shift from parent to child (i.e., a ''decrease in [the parent's] share of partnership liabilities''), since that is a deemed shift of cash from child to parent.[34] This won't be an issue if the company's liabilities are personally guaranteed by the parent. But if the liabilities are nonrecourse,[35] the answer depends on other facts.

Under Reg. §1.752-3(a), a partner's share of nonrecourse partnership liabilities equals the sum of his shares of partnership minimum gain (PMG, a.k.a. ''Tufts gain''); §704(c) minimum gain; and all other nonrecourse liabilities. Applying these rules to freeze partnerships, we get a favorable result when the parent and child create a new partnership from scratch, with the child paying cash for a common interest. In this case, all the liabilities will be allocated to the parent. This is because there is no PMG and the parent has §704(c) minimum gain.[36]

Things become more complicated if the parent is a partner in a longstanding partnership; the partnership purchased the encumbered asset; and the parent transfers an interest in that partnership. In this scenario, the parent has no §704(c) gain. Instead, since negative capital partners have enjoyed a history of debt-financed distributions and deductions,[37] the first tier (share of PMG) will be decisive.

The question, then, is whether there is a risk that a transfer of partnership interests would also convey the associated PMG. It appears that there is, at least, a risk. According to Reg. §1.704-2(g)(1), in calculating a transferee partner's share of PMG, the partner will be attributed the nonrecourse deductions, debt-financed distributions, and share of decreases in PMG of his ''predecessors in interest.'' This reference to predecessors in interest suggests that, when the parent transfers a common interest to the child, the parent might also transfer some or all of the PMG, thus triggering a deemed receipt of cash from the child.

Still, the law is unclear. As Terry Cuff has observed:

> A transferee partner inherits his transferor share of minimum gain unaffected by the purchase price paid by the transferee partner. *The regulations do not clarify how to determine the partner's predecessor in interest's minimum gain that is allocated to the partner.* The regulation is not so carefully drafted as is appropriate. . . . As partnership interests become economically complex, it often can be difficult to determine the transferee's share of minimum gain that is associated with a particular transferred partnership interest. *The tax law has not clearly identified how much minimum gain is associated with each of the different portions of a transferred partnership interest.*[38]

Assuming that a transfer of common interests could potentially bring with it a share of PMG, it is also unclear whether this is outcome is universally true, or whether it is a default rule. If merely a default rule, maybe we can draft a partnership agreement to permit the parent to transfer partnership interests without transferring PMG. We could call this a ''PMG Freeze.''

For example, imagine that the partnership agreement says: ''If a member who holds Preferred interests immediately after the Recapitalization (''Frozen Member'') should later transfer any units to another person, the Frozen Member will retain the Partnership Minimum Gain associated with the transferred units.'' And imagine that parent and child sold 100% of their common and preferred interests to a third party. In this scenario, the parent would be taxed on the so-called Tufts gain inherent in the negative capital property. In short, the PMG Freeze defers the tax on the Tufts gain, from the date of gift until the date of sale.

But what if the parent dies before selling the property? Under Reg. §1.742-1, when a partnership interest is inherited, its basis is calculated from three items, each measured at death:

1. The FMV of the partnership interest,
2. Plus the inherited share of partnership liabilities,
3. Minus the part of FMV attributable to IRD items (including partnership hot assets).

Here, we can focus on items 1 and 2. At the parent's death, item 2 will be a large number, and will augment the inherited basis. The question is, will this be offset by a decrease in item 1? That is, will the ''PMG Freeze'' mandate a meaningful reduction in FMV?

To determine the ''fair market value'' of an asset, we assume a sale.[39] Since the effect of the PMG Freeze is to burden the seller with an amount of gain equal to the Tufts gain, it creates a transaction cost to entering into a sale. This should reduce the FMV of the property somewhat, thereby depressing the basis under Reg. §1.742-1. However, this reduction will not necessarily exactly equal the amount of the deemed

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[34] *See* Reg. §1.752-1(c).

[35] In the §752 context, a partnership liability is a nonrecourse liability ''to the extent that no partner or related person bears the economic risk of loss for that liability under [§]1.752-2.'' *See* Reg. §1.752-1(a)(2).

[36] Breitstone 2022 at 15.

[37] Reg. §1.704-2(g)(1) (defining partner's share of PMG).

[38] See Cuff, above, Note 9, at ch. 17 (emphasis added).

[39] John A. Bogdanski, *Federal Tax Valuation*, at ch. 2.

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tax. Rather, the amount of the reduction is for an appraiser to calculate.

CONCLUSION

As noted, the freeze technique for negative capital relies on a few propositions (death is not a recognition event; partnership recapitalizations are not recognition events; PMG is nontransferable) which are hard to prove. For those of us who have the misfortune to not be persuaded by all these positions, this creates a dilemma. Can we write an opinion which reflects what we think the IRS will actually do, notwithstanding that we think the IRS is wrong to do it?

For purposes of avoiding penalties, nothing in Reg. §1.6664-4 (defining ''reasonable cause and good faith'') suggests that a taxpayer cannot rely on a reasonably grounded belief that the IRS misinterprets the law. The challenge is getting to ''reasonable cause'' or ''substantial authority,'' which require citation to actual authorities.[40] After reviewing the analysis in the Breitstone articles, and in the ongoing debate in the tax press, I think many practitioners will have no difficulty writing a persuasive-sounding opinion that death is not a disposition. As I read Circular 230, nothing more is asked of us.

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[40] Reg. §1.6662-3(b)(3), §1.6662-4(d)(iii) (identifying items which can show substantial authority or reasonable basis).

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