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Demystifying the Qualified Payment Right: Structuring and Administering a Sec. 2701-Compliant Entity

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by Nathan R. Brown and John F. DeStefano

Demystifying the Qualified Payment Right: Structuring and Administering a §2701-Compliant Entity

Estate planning practitioners commonly utilize business entities, such as partnerships and limited liability companies (investment entities), to maximize the transfer tax efficiency of their clients' estate plans. Often, these investment entities are structured with two classes of equity interests: preferred interests and common interests. The preferred interests generally entitle the holder to a preferred return on the holder's investment and the common interests generally entitle the holder to all future growth in excess of the preferred return. Generally, a senior-generation family member holding both preferred interests and common interests will sell or gift his or her common interests to one or more trusts for the benefit of younger-generation family members and retain the preferred interests. This allows the senior-generation family member to transfer all future appreciation in excess of the preferred return to younger-generation family members without the imposition of transfer tax.

Planning with multi-class investment entities is complicated by the application of I.R.C. §2701.[1] I.R.C. §2701 is a special valuation rule that applies to determine the gift-tax value of a transferred equity interest in a privately held investment entity if the transferor or a senior family member holds certain equity interests in the investment entity immediately after the transfer. If the retained equity interests are not properly structured, I.R.C. §2701 may treat the transferor as having made a deemed gift of the retained equity interests.

Fortunately, the draconian consequences of I.R.C. §2701 may be avoided by structuring the preferred return as a qualified payment right (QPR).[2] If the preferred return is structured as a QPR, there should be no deemed gift under I.R.C. §2701 upon the initial gift or sale of the common interests by a senior-generation family member to, or in trust for the benefit of, younger generation family members. For purposes of this article, a multi-class investment entity having a preferred return that is structured as a QPR is referred to as a "§2701-compliant entity."

When using a §2701-compliant entity to avoid the application of I.R.C. §2701, it is imperative that the QPR is properly structured, valued, and administered. The remainder of this article provides a brief overview of I.R.C. §2701[3] and discusses the proper structure, valuation, and tax implications of administrating a §2701-compliant entity.

Overview of I.R.C. §2701

Generally, I.R.C. §2701 applies when an individual (the transferor) transfers an equity interest in a privately held entity to, or in trust for the benefit of, a younger-generation member of the transferor's family (referred to in the statute as a member of the family)[4] if, immediately after the transfer, the transferor or an older-generation member of the transferor's family (referred to in the statute as an applicable family member)[5] holds an equity interest in the entity that is classified as an "applicable retained interest."[6]

• *Applicable Retained Interests* — Two types of applicable retained interests exist: extraordinary payment rights and distribution rights in family-controlled entities.[7] An extraordinary payment right is any put, call, conversion right, or right to compel liquidation of the entity, the exercise or nonexercise of which could affect the value of the transferred interest.[8] A distribution right generally includes any right to receive distributions with respect to a retained equity interest that is senior to the right to receive distributions with respect to the transferred equity interest.[9] In the multi-class investment entity context, the preferred return would be classified as a distribution right under I.R.C. §2701 if the transferor, either alone or together with applicable family members and any lineal descendants of the transferor's parents or the transferor's spouse's parents, controls the investment entity.[10]

• *The Zero-Value Rule* — If I.R.C. §2701 applies, the gift-tax value of the transferred equity interest is determined under the subtraction method.[11] The subtraction method determines the gift-tax value of the transferred equity interest by subtracting the aggregate value of all equity interests in the entity held by the transferor immediately after the transfer from the aggregate value of all equity interests in the entity held by the transferor immediately before the transfer. If the retained equity interest is classified as an applicable retained interest, its value for purposes of applying the subtraction method is determined by assigning a zero value to any extraordinary payment right and any distribution right (the zero-value rule). I.R.C. §2701 is designed to prevent value being assigned to retained rights that are discretionary

in nature. I.R.C. §2701 assigns a zero value to distribution rights because there is an implicit assumption that no discretionary distributions from a family-controlled investment entity will be made to senior-generation family members in order to preserve value for younger-generation family members.

The result of the zero-value rule is that, for gift tax purposes, the transferor is deemed to have made a gift of his or her retained preferred interest in addition to the common interests that are actually transferred.

If the distribution right is structured as a QPR, however, the zero-value rule does not apply. Instead, the fair market value of the QPR is used to determine the gift-tax value of the transferred interest.

The Qualified Payment Right Exception

• *What is a Qualified Payment Right?* — The first step to avoiding the zero-value rule through the use of a §2701-compliant entity is to ensure that the distribution right is properly structured as a QPR. A QPR is a right to receive qualified payments.[12] A qualified payment is a cumulative distribution that is payable at least annually with respect to an equity interest, to the extent such distribution is determined at a fixed rate[13] or as a fixed amount.[14] For example, an annual cumulative 7 percent preferred return is a qualified payment. Because the amount of the qualified payment is fixed from the outset and is required to be paid at least annually, the potential abuse that the zero-value rule is intended to prevent does not exist. That is, because the qualified payment is mandatory and quantifiable, the QPR can be accurately valued at the time of the transfer.

• *Qualified Payment Right Elections* — If a distribution right does not fit neatly into the definition of a QPR, for example, if the distribution right is noncumulative, an election may be made by the individual holding the preferred interest to treat the distribution right as a QPR.[15] Such an election is valid only to the extent that the amounts and times so specified in the election are consistent with the underlying instrument giving rise to such right.[16] For example, an election cannot be made to value a noncumulative right to receive $100 per year on the assumption that it would pay $110 per year.[17] An election may also be made by the individual holding a preferred interest conferring a QPR to treat the QPR as a distribution right that is not a QPR.[18] If the preferred interest is held by an applicable family member, a special election must be made by the applicable family member to treat the distribution right as a QPR, even if it otherwise qualifies as such.[19] The apparent purpose of this rule is to prevent an applicable family member from unknowingly becoming subject to the accumulated qualified payment rule (discussed below). An election made to treat a distribution right as a QPR or a QPR as a distribution right that is not a QPR is irrevocable.[20]

The election must be made by the individual holding the preferred interest conferring the distribution right on the gift tax return on which the transfer subject to I.R.C. §2701 is reported.[21] Otherwise, the election is considered untimely and invalid.[22] To make a valid election, a separate statement must be attached to the gift tax return.[23] The separate statement must set forth the name, address, and taxpayer identification number of the individual making the transfer, which is subject to I.R.C. §2701, specifically identify the transfer, and describe in detail the distribution right to which the election applies.[24] If the election is being made to treat a distribution right as a QPR, the statement must provide a schedule of the expected amounts and dates of payments[25] and must include a signed declaration whereby the individual making the election agrees that his or her taxable gifts or taxable estate will be increased (as discussed below) if the payments are not made as provided in the schedule, and that he or she will be personally liable for the resulting increase in tax liability.[26]

• *Qualified Payment Right Valuation Rules* — For purposes of determining the gift tax value of the transferred common interests, the zero-value rule assigns a zero value to any distribution right in a controlled entity. As a result, the transferor is deemed to have gifted his or her retained preferred interest as well as any common interests actually gifted. However, if a distribution right is structured as a QPR, the zero-value rule does not apply. Instead, general valuation principals apply, and the QPR is assigned its fair-market value for purposes of applying the subtraction method.[27]

Although structuring the distribution right as a QPR avoids a deemed gift under I.R.C. §2701, there may still be a gift under traditional valuation principals if the QPR's preferred return is less than what it would have been in an arm's-length transaction. For example, if the QPR's preferred return under the partnership agreement is 5 percent, but a 7 percent preferred return would be required in an arm's-length transaction, then a gift has still been made by the holder of the preferred interest conferring the QPR to the extent of the shortfall; albeit not as dramatic a gift as would occur by violating I.R.C. §2701.

Vital to arriving at the proper preferred return for the QPR is the retention of a qualified appraiser to prepare a valuation appraisal. In preparing the appraisal, the appraiser will need to take into account the factors set forth by the Internal Revenue Service in Rev. Rul. 83-120.[28] The starting point under this guidance is to analyze comparable preferred interest returns from high-quality, publicly traded securities. Additional factors for consideration include the security of the preferred return, the size and stability of the entity's earnings, asset coverage, management expertise, business and regulatory environment, and any other relevant facts or features of the §2701-compliant entity.

A special valuation rule, referred to as the "lower-of rule," applies if the retained preferred interest confers upon its holder an extraordinary payment right in addition to a QPR. In that case, the value of all rights is determined by assuming that each extraordinary payment right is exercised in a manner that results in the lowest total value being determined for all the rights.[29] The restriction on extraordinary payment rights is intended to make sure that the holder of the preferred interest conferring the QPR does not retain any discretionary rights that could otherwise ascribe additional value to

the retained preferred interest, but if not exercised would shift value to the common interests as a result of such inaction. Inadvertently retaining an extraordinary payment right along with a QPR would result in a deemed gift upon the transfer of the common interests in the investment entity.

• *10 Percent Minimum-Value Rule* — If I.R.C. §2701 applies to the transfer of an interest in an investment entity, the value of the gifted common interests cannot be less than its pro-rata portion of 10 percent of the sum of 1) the total value of all equity interests in the investment entity; and 2) the total amount of any indebtedness of the investment entity owed to the transferor and applicable family members.[30]

Administering the §2701-Compliant Entity

Properly administering a §2701-compliant entity is equally as important as properly structuring and valuing the QPR. One of the most important aspects of administering a §2701-compliant entity is ensuring that the qualified payments are timely paid. Because the valuation of a QPR for purposes of I.R.C. §2701 assumes that all qualified payments will be paid on their respective due dates, failure to make a timely qualified payment can have substantial adverse transfer tax consequences.

• *When are Qualified Payments Due?* — A qualified payment is due on the date specified in the governing instrument as the due date for such payment.[31] If the trust agreement is silent, the qualified payment is due on the last day of each calendar year.[32] Any qualified payment made within four years of such payment's due date is deemed to have been paid on the due date; provided, however, this four-year grace period does not extend beyond a taxable event (defined below) (*i.e.*, the payment must be received before a taxable event to be deemed paid on the due date).[33] The qualified payment may be satisfied with a debt obligation, provided that the debt obligation bears compound interest from the original due date at an appropriate discount rate and the term of the debt obligation does not exceed four years.[34] This effectively allows the qualified payment to be deferred for up to eight years without any adverse transfer tax consequences.

• *Late and Unpaid Qualified Payments* — If a qualified payment is not paid by such payment's due date, interest essentially begins accruing on the unpaid qualified payment at the discount rate applied in determining the value of the QPR at the time of the transfer that was subject to I.R.C. §2701 (the appropriate discount rate). If, upon the transfer of the preferred interest conferring the QPR (the QPR interest) during life or at death (each a taxable event), any qualified payment remains unpaid, the taxable gifts or the taxable estate (as the case may be) of the individual holding the QPR interest (the QPR interest holder) are increased by the tax adjustment amount (as defined below) (the accumulated qualified payment rule). Any payment of a qualified payment is first applied in satisfaction of the unpaid qualified

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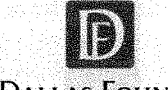

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payment with the earliest due date.[35]

The application of the accumulated qualified payment rule varies depending on the identity of the transferee.

• *Transfers to a Third-Party Transferee* — If the transferee is a person who is not the QPR interest holder's spouse or an applicable family member of the QPR interest holder (a third-party transferee), the transfer is a taxable event, and the QPR interest holder's taxable gifts or taxable estate are increased by the tax adjustment amount. After the transfer of the QPR interest to the third-party transferee, the accumulated qualified payment rule will no longer apply with respect to the third-party transferee. This makes sense from an I.R.C. §2701 standpoint because the third-party transferee is not a member of the family who controls the §2701-compliant entity, and, therefore, should not be "penalized" for the entity's failure to timely make the qualified payments.

• *Transfers to Spouse* — If the transferee is the QPR interest holder's spouse, and the transfer qualifies for the marital deduction, the transfer is not a taxable event and, therefore, the QPR interest holder's taxable gifts or taxable estate are not increased by the tax adjustment amount. However, the QPR interest holder's spouse will step into the QPR interest holder's shoes and will be treated as if he or she were the holder of the QPR interest from the date that the QPR interest holder acquired the QPR interest for purposes of the accumulated qualified payment rule. Thus, if the QPR interest holder's spouse subsequently transfers (either during life or at death) the QPR interest received from the QPR interest holder, the taxable gifts or taxable estate of the QPR interest holder's spouse are increased by the tax adjustment amount with respect to all unpaid qualified payments, even those qualified payments that were due prior to the spouse receiving the QPR interest.

• *Transfers to Applicable Family Members* — If the transferee is an applicable family member of the QPR interest holder, such transfer is a taxable event and the QPR interest holder's taxable gifts or the taxable estate are increased by the tax adjustment amount. The accumulated qualified payment rule will continue to apply to the applicable family member only with respect to unpaid qualified payments due after the transfer of the QPR interest to the applicable family member.

• *Taxable Event Election* — The QPR interest holder may elect to treat as a taxable event the payment of an unpaid qualified payment occurring after the four-year grace period (a taxable event election). If a taxable event election is made, the taxable gifts of the QPR interest holder are increased by the tax adjustment amount. Any qualified payment for which a taxable event election is made is treated as having been timely paid for purposes of subsequent taxable events.

The taxable event election is made by attaching a statement to the gift tax return filed by the QPR interest holder for the year in which the qualified payment is received. If the taxable event election is made on a timely filed gift tax return, the taxable event is deemed to occur on the date the qualified payment is received. If the taxable event election is made on a gift tax return that is not timely filed, the taxable event is deemed to occur on the first day of the month immediately preceding the month in which the gift tax return is filed.

• *Example* — *A* holds a partnership interest in ABC Partnership conferring upon *A* a QPR that *A* retained in a transfer to which I.R.C. §2701 applied. No distributions were paid in to *A* in year one through year five following the transfer. In year six, *A* received a qualified payment that is considered to be in satisfaction of the unpaid qualified payment for year one. No election was made to treat that payment as a taxable event. In year seven, *A* received a qualified payment that is considered to be in satisfaction of the unpaid qualified payment for year two. *A* elects to treat the payment in year seven as a taxable event. The election increases *A's* taxable gifts in year seven by the tax adjustment amount with respect to the payments due in year one and year two. For purposes of any future taxable events, the payments with respect to year one and year two are treated as having been timely paid.

• *Tax Adjustment Amount* — As noted above, the QPR interest holder's (or the individual treated as the QPR interest holder under the above rules) taxable gifts or the taxable estate are increased upon the occurrence of a taxable event by the tax adjustment amount. Generally speaking, the tax adjustment amount is determined through a series of computations that assume all qualified payments were paid on the due date and reinvested at the applicable discount rate. The general effect of these assumptions is to increase the QPR interest holder's taxable gifts or taxable estate by the value of any unpaid qualified payments as of the date of the taxable event plus an interest penalty.

More specifically, the "tax adjustment amount" is equal to the excess, if any, of:

> The sum of –
>
> (a) The amount of qualified payments payable during the period beginning on the date of the transfer to which I.R.C. §2701 applied (or in the case of an applicable family member receiving the QPR interest from the QPR interest holder, the date the applicable family member received the QPR interest) and ending on the date of the taxable event, and
>
> (b) The earnings on those qualified payments, determined as if all such payments were paid on the due date and reinvested by the QPR interest holder as of each payment's due date at a yield equal to the discount rate used in determining the value of the QPR,
>
> Over the sum of – 0
>
> The amount of qualified payments actually paid during the same period, and
>
> The earnings on those qualified payments, determined as if all such payments were reinvested by the QPR interest holder as of the date such payments were actually received at a yield equal to the discount rate used in determining the value of the QPR.[36]

• *Limitation on Tax Adjustment Amount* — I.R.C. §2701 places a cap on the amount by which the taxable gifts or taxable estate of the QPR interest holder may be increased. Under these rules, the tax adjustment amount may not exceed the "applicable percentage" of the increase in value of the junior equity interest in the investment entity (*i.e.*, the common interests) from the date of the transfer to which I.R.C. §2701 applied to the date of the taxable event.[37] The "applicable percentage" is equal to the QPR interest holder's ownership percentage with respect to the investment entity's equity inter-

ests that are classified as applicable retained interests on the date of the taxable event.[38]

Conclusion

Although §2701-compliant entities are often incorporated into estate plans to reduce estate tax liability, in order to fully realize the transfer tax benefits afforded by a §2701-compliant entity, it is imperative the estate planning practitioner carefully structure and administer the §2701-compliant entity. Failure to do so may have harsh unintended gift tax consequences.❑

[1] All references herein to I.R.C. are to the Internal Revenue Code of 1986, as amended.

[2] I.R.C. §2701 may also be avoided by structuring the preferred return as a mandatory payment right. *See* Treas. Reg. §25.2701-2(b)(4)(i).

[3] This article is not intended to provide a detailed analysis of I.R.C. §2701. For a more detailed analysis of I.R.C. §2701 and various planning techniques that may be utilized to avoid application of I.R.C. §2701; *see* Ivan Taback & Nathan R. Brown, *Estate Planning Ideas for Private Equity Fund Managers*, Estate Planning (Apr. 2015); Nathan R. Brown, *Planning with Carried Interests: Navigating I.R.C. §2701*, 89 Fla. B. J. 65 (July/Aug. 2015).

[4] I.R.C. §2701(e)(1). Members of the family include the transferor's spouse, the lineal descendants of the transferor and the transferor's spouse, and spouses of such lineal descendants.

[5] I.R.C. §2701(e)(2). Applicable family members include the transferor's spouse, ancestors of the transferor and the transferor's spouse, and the spouses of such ancestors.

[6] I.R.C. §2701(a).

[7] Treas. Reg. §25.2701-2(b)(1).

[8] I.R.C. §2701(b)(1)(B); Treas. Reg. §25.2701-2(b)(2).

[9] I.R.C. §2701(b)(1)(A); Treas. Reg. §25.2701-2(b)(3); I.R.C. §2701(c)(1)(B)(i).

[10] In the case of a partnership, control means the holding of at least 50 percent of the capital or profits interests in the partnership, or, in the case of a limited partnership, the holding of any interest as a general partner. I.R.C. §2701(b)(2)(B). I.R.C. §2701 and the current regulations thereunder do not contain a control test for limited liability companies. However, Prop. Reg. §25.2701-2(b)(5) would clarify that, in the case of a limited liability company, control means the holding of at least 50 percent of the capital or profits interest in the limited liability company or the holding of an equity interest with the ability to cause the liquidation of the entity in whole or in part.

[11] Treas. Reg. §25.2701-3.

[12] Treas. Reg. §25.2701-2(b)(6)(i).

[13] A payment is treated as fixed as to rate if the payment is determined at a rate that bears a fixed relationship to a specified market interest rate. I.R.C. §2701(c)(3)(B); Treas. Reg. §25.2701-2(b)(6)(ii).

[14] Treas. Reg. §25.2701-2(b)(6)(i).

[15] Treas. Reg. §25.2701-2(c)(2). Such an election may not cause the value of the preferred interest conferring the distribution right to exceed the fair market value of the preferred interest (determined without regard to I.R.C. §2701).

[16] I.R.C. §2701(c)(3)(C); Treas. Reg. §25.2701-2(c)(2).

[17] H.R. Conf. Rep. No. 101-964 at 154 (1990).

[18] Treas. Reg. §25.2701-2(c)(1).

[19] Treas. Reg. §2701-2(c)(4).

[20] Treas. Reg. §25.2701-2(c)(3).

[21] Treas. Reg. §2701-2(c)(5).

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] Treas. Reg. §2701-2(c)(5)(vi)(A).

[26] Treas. Reg. §2701-2(c)(5)(vi)(B).

[27] Treas. Reg. §2701-2(a)(4).

[28] 1983-2 C.B. 170.

[29] I.R.C. §2701(a)(3)(B); Treas. Reg. §25.2701-2(a)(3).

[30] I.R.C. §2701(a)(4)(A); Treas. Reg. §25.2701-3(c)(1).

[31] Treas. Reg. §2701-4(c)(2).

[32] *Id.*

[33] Treas. Reg. §25.2701-4(c)(5).

[34] *Id.*

[35] Treas. Reg. §25.2701-4(c)(4).

[36] Treas. Reg. §25.2701-4(c). This amount may be further reduced, to the extent necessary to prevent double inclusion, by the portion of the fair market value of the QPR interest solely attributable to any right to receive unpaid qualified payments, the fair market value of any equity interest in the investment entity held by the QPR interest holder at the time of the taxable event that was received by the QPR interest holder in lieu of qualified payments and the amount by which the QPR interest holder's aggregate taxable gifts were increased by reason of his or her failure to enforce the right to receive the qualified payments. Treas. Reg. §25.2701-4(c)(ii)(C).

[37] Treas. Reg. §25.2701-4(c)(6).

[38] I.R.C. §2701(d)(2)(B)(ii).

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This column is submitted on behalf of the Tax Law Section, William Roy Lane, Jr., chair, and Christine Concepcion, Michael Miller, and Benjamin Jablow, editors.

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