Is Chief Counsel Resurrecting The Chapter 14 ‘Monster’?

by Richard L. Dees

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In this article, Dees argues that ILM 201442053 should be withdrawn because it applies section 2701 to a recapitalization outside its scope.

Congress enacted chapter 14 of the Internal Revenue Code to provide special valuation rules for transfer tax purposes in specific situations when it viewed the fair market value standard to be inadequate. The IRS Office of Chief Counsel had a rare opportunity to clarify the operation of section 2701, which is part of chapter 14, when it determined the gift tax consequences of the recapitalization of a limited liability company in ILM 201442053. Although the gift tax result in the memorandum is probably close to correct, almost none of its analysis is. The IRS failed to properly apply the regulations under section 2701. It is doubtful that section 2701 applies to the recapitalization described in the memorandum. Instead, the ordinary gift tax rules under chapter 12 of the IRC are adequate to reach the appropriate gift tax result without resorting to the special valuation rules under chapter 14.

Enacted in 1990, chapter 14 replaced section 2036(c), which Congress had enacted in 1987. Congress intended section 2036(c) to target preferred stock recapitalizations and gifts of common stock while retaining preferred stock by imposing an estate tax on the value of the family-owned business determined as if all of the post-recapitalization appreciation was attributable to the preferred stock. Treasury applied section 2036(c) so broadly that I termed it “The Monster That Ate Estate Planning.” Congress ultimately repealed section 2036(c) retroactively and replaced it with section 2701, which provides special valuation rules for preferred equity. Congress, Treasury, and the professional groups that collaborated on developing

1In invited remarks before a subcommittee of the Senate Finance Committee, I described section 2036(e) as follows: Child is graduated with a Ph.D. in English. Parent loans Child a typewriter, perhaps one that has been in the family for years. Child writes the “Great American Novel” on the typewriter. The book rights will bring $1 million a year in royalties. Parent dies and IRS claims Child owes 55% estate tax on top of the income tax the Child pays on the royalties. This example satisfies the requirements of Section 2036(c) for a “freeze” transaction. First, the writing of the Novel is for gain and, therefore, an “enterprise.” Second, the Parent “retained the right” to the return of the typewriter. Third, this retained right had little appreciation potential when compared to the Child’s interest in the enterprise (“disproportionate appreciation”). Finally, the lending of the typewriter was a “transfer” of the right to use it in the enterprise. In fact, in this example all of the capital of the enterprise was attributable to Parent. Thus, under Section 2036(c) the entire value of the book rights could be subject to estate tax in Parent’s estate. The child’s efforts in the enterprise are disregarded.

3The estate, gift, and generation-skipping transfer taxes.

4Chapter 14 contains other special valuation rules: Section 2702 applying to gifts in trust, section 2703 applying to options and buy-sell agreements, and section 2704 applying to lapsing voting and liquidation rights.

5One must remember that an ILM, unlike a technical advice memorandum or private letter ruling, does not require the taxpayer’s input. Thus, an ILM is less reliable than a memorandum or letter ruling, and none are authority.

(Footnote continued on next page.)
COMMENTARY / VIEWPOINT

the chapter 14 statutory language intended to provide administrable, targeted special valuation gift tax rules to supplement the FMV standard, including when preferred equity carries specific bells and whistles or noncumulative dividends.

Almost from its enactment, commentators seemed to disregard the precise language in section 2701 and its regulations and instead speculated on its broad scope. I have tried to counter an overly broad interpretation by explaining in my 2009 article why “it is not a Monster.”

During the more than 20 years that have elapsed since section 2701 became law, neither Treasury nor the IRS ever engaged in that kind of folly. ILM 201442053, however, breaks that streak by applying section 2701 to a recapitalization outside its scope. Because of that mistake, the echo chamber that is the estate planning community is likely to declare inappropriately the return of the chapter 14 monster, particularly because the recapitalization involves the creation of a profits interest. I hope that chief counsel acknowledges its mistake and withdraws the memorandum.

A. Memorandum Facts

The family in ILM 201442053 consisted of Mom, two Sons, and Grandchildren. Mom funded an LLC solely with real estate she owned and then made gifts of LLC interests to two Sons and Grandchildren. The original LLC agreement provided for proportionate sharing of capital, profits, and losses according to positive capital account balances. For estate planners more familiar with units or percentage interests, that may sound odd. Mom’s gifts carried a proportionate share of her capital account to the donee of each gift. The LLC agreement provided that the LLC would terminate at the end of its 20-year term unless it terminated earlier. No member could withdraw before the end of the term.

The LLC is family controlled, although the memorandum does not discuss the division of the control among Mom, two Sons, and Grandchildren before or after the recapitalization.

Before the end of the 20-year term, the LLC’s members agreed to recapitalize it. The stated reason was to reward two Sons for agreeing to manage the LLC. Mom and Grandchildren agreed to surrender any right to future profits or gains to two Sons. Mom and Grandchildren, however, retained their respective rights to the return of their capital account balances determined on the date of the recapitalization. The memorandum implies that the two Sons retain their rights to receive back their respective capital account balances. The memorandum also implies that all distributions of capital will be proportionate among the members according to their capital investment until the liquidation of the LLC in year 20. The memorandum does not explain the order of capital and profit distributions, although for the reasons discussed below, that timing could affect the application of section 2701.

In this instance, two Sons reaped all the benefit from their management.

The IRS’s first mistake was not to apply the regular gift tax rules under chapter 12 to the recapitalization. The last section of this article does so. When section 2701 applies, it results in an increase of the amount of the gift determined using FMVs.

1. Definitional rules.

a. Applicable retained interest. ILM 201442053 states:

other statute whose language was developed in such a transparent manner with extraordinarily broad input from professionals, except section 2704, which was added in secrecy at the last minute. See the details in Dees, supra note 5, at 569-571. However, it is the regulation writers, and not the bar, who deserve the credit of defining “liquidation rights” narrowly in the final regulations under section 2701 to preserve congressional intent. Chief counsel’s disregard of their efforts troubles me.


Dees, supra note 5, at 573, details the IRS’s reluctance to apply section 2036(a) to family limited partnerships and other evidence of its respect for the legislative history of chapter 14. The evolution of the government’s view of the term “liquidation rights” in section 2701 through proposed regulations and finally to the final regulations’ use of the term “right to compel liquidation” represents the understanding of the government lawyers who wrote both the statute and the regulations of the need to narrow its application. That evolution is mentioned below but is detailed in Dees, supra note 8, at 711-714.
An applicable retained interest is an interest in a family-controlled entity with respect to which there is a distribution right.

The above quote omits much of the regulation’s lengthier definition of an applicable retained interest, which includes not only a distribution right but an extraordinary payment right (EPR). An EPR is a right to convert an equity interest into cash or other property.

On the other hand, according to the regulations, a distribution right is the right to payments of cash or other property with respect to the equity interest. The regulations reinforce that distinction by excluding an EPR from the definition of a distribution right.

ILM 201442053, however, erases the distinction between an EPR and a distribution right in its analysis:

On Date 3, Company was recapitalized and Donor surrendered her right to participate in future profit and loss, including future gain or loss attributable to Company’s assets. Both before and after the recapitalization, Donor held an applicable retained interest, an equity interest in Company coupled with a distribution right.

i. Applicable retained interest before recapitalization? Because Mom had a distribution right, ILM 201442053 states that she held an applicable retained interest before the recapitalization. The regulations exclude from the definition of distribution right a right to receive distributions from an interest of the same class.

The memorandum states that before the recapitalization, each member of the LLC had the same economic rights in the LLC: the right to profits in proportion to capital account balances. Therefore, before the recapitalization, no member held a distribution right, although all members had a right to distributions. However, did any member have an EPR — the one part the memorandum omitted from the actual definition of an applicable retained interest?

The memorandum states that no member had a right to withdraw before the end of the term. Accordingly, no member had an EPR before recapitalization. The regulations further exclude from the definition of EPR other rights that may have existed before the recapitalization, such as a mandatory payment right or the right to participate in a liquidating distribution.

If the transferor, members of the transferor’s family, or applicable family members have the ability to compel liquidation, the liquidation participation right is valued as if the ability to compel liquidation —

(A) Did not exist, or

15Reg. section 25.2701-1(c)(3) would exempt the LLC from the application of section 2701. Rather than rely on that exception, however, the text discusses in more detail the difference between an EPR and a distribution right. Presumably, that same class exception would continue to apply if one or more of the members of the LLC had an EPR.

16Before recapitalization, the LLC may have had only “interests of the same class.” If so, the exception in reg. section 25.2701-1(c)(3) would exempt the LLC from the application of section 2701. Rather than rely on that exception, however, the text discusses in more detail the difference between an EPR and a distribution right.


18Reg. section 25.2701-2(b)(4):

(4) Rights that are not extraordinary payment rights or distribution rights. Mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under section 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.

(i) Mandatory payment right. A mandatory payment right is a right to receive a payment required to be made at a specific time for a specific amount. For example, a mandatory redemption right in preferred stock requiring that the stock be redeemed at its fixed par value on a date certain is a mandatory payment right and therefore not an extraordinary payment right or a distribution right. A right to receive a specific amount on the death of the holder is a mandatory payment right.

(ii) Liquidation participation rights. A liquidation participation right is a right to participate in a liquidating distribution.
(B) If the lower of rule applies, is exercised in a manner that is consistent with that rule.

The right of a member to receive the value of her equity interest in the LLC at the expiration of its term could be considered either (1) a mandatory payment right,\(^1\) or (2) the right to participate in a liquidating distribution. Neither right is an EPR. Thus, before the recapitalization, Mom did not own an applicable retained interest in the LLC.

ii. Applicable retained interest after the recapitalization? The capital interest held by Mom after the recapitalization is probably not an applicable retained interest either. Although ILM 201442053 does not distinguish a distribution right from an EPR, the regulations do. The mere right to distributions in extinguishment of the equity interest itself is at most an EPR — it is never a distribution right. The right to capital distributions can only be an EPR because any capital distribution results in a partial or complete extinguishment of the capital interest. The facts assume that no member may withdraw before the end of the term before the recapitalization, and presumably that would continue to be true after the recapitalization. Without the right to compel liquidation after the recapitalization, the capital interest would not be an applicable retained interest.

The EPR requirement of section 2701 was enacted to prevent bells and whistles from being used to artificially support the value of preferred stock. Those included the right to liquidate the preferred stock at any time at par value or convert it into common stock or other property. If the owner of the preferred stock did not have the right to compel its liquidation or conversion at par value, the preferred stock would not have a FMV equal to its par value. Without an EPR attached to the capital interest, the special valuation rules of section 2701 are unnecessary to prevent the inflating of its FMV.

Absent the right to force the liquidation of the capital interest after the recapitalization, section 2701 would not apply to the capital interest, which would lack both an EPR and a distribution right.

b. Capital interest: Senior or subordinate? ILM 201442053 states that the capital interest is senior to the profits interest:

Donor’s interest, which carried a right to distributions based upon an existing capital account balance, is senior to the transferred interests, which carried only a right to distributions based on future profit and gain. That statement assumes facts not in the memorandum. Whether the capital interest is senior or subordinate to the profits interest is relevant only if the capital interest is an applicable retained interest. It is an applicable retained interest only if Mom had an EPR with respect to her capital interest after the recapitalization. If she did, it may not be true that the capital interest is a senior interest.

As in many private equity partnerships, the amended LLC agreement might provide that all capital would be distributed before any profits are distributed. If so, the memorandum is correct that the distributions of profits would be subordinate to distributions of capital, although a capital distribution still would not be a distribution right for the above reasons. The memorandum states that distributions of capital were permitted, but capital distributions may have been permitted only after all profits were distributed. If that was the case, the profits interest would be senior to the capital interest. Alternatively, capital distributions may have been prohibited until the end of the term, at which time all capital would be distributed pro rata to the members. The right to participate proportionately in that kind of liquidating distribution would not be a senior interest or a distribution right. Further, the capital account approach that the memorandum prescribed before the LLC was recapitalized may have been retained. If that was the case, any future profits would have been added equally to the capital accounts of two Sons. Under that scenario, all distributions were likely to remain proportionate to capital accounts, including in the case of two Sons, distributions from increases in their capital account due to future profits. If that happened, neither the capital interest nor the profits interests would be senior to the other.

ILM 201442053 avoids discussing those three alternatives by declaring without any explanation that any right to a distribution results in an equity interest being an applicable retained interest and that the right to future profits was subordinate to the rights to capital interests. If the memorandum is correct, it would erase the distinction in the regulations between an EPR and a distribution right. Because nearly every equity interest has a distribution right, moreover, the memorandum would mean that every equity interest would be an applicable retained interest. That interpretation is obviously incorrect because section 2701 was intended to apply only to a limited number of partnerships and corporations, not all of those entities.
c. What consideration did Mom receive? ILM 201442053 states:

Donor received property in the form of the agreement of Child A and Child B to manage Company. Accordingly, the recapitalization constitutes a transfer by Donor for purposes of section 2701.

Mom did not receive any property in the form of an agreement from two Sons to manage the LLC assets. That agreement ran directly to the LLC, not to Mom. She could benefit from that agreement only if she maintained an investment in the LLC. Therefore, economically, the management agreement actually was not consideration paid to her.

When section 2701 applies to a recapitalization, the subtraction method of valuation requires that consideration passing to the entity be treated as consideration passing to the holder of the applicable retained interest for purposes of Step 4 of the subtraction method discussed below. Thus, the memorandum would be correct under the subtraction method that the management agreement was consideration treated as received by Mom (although, as discussed below, the memorandum does not treat it as consideration for that purpose). However, the deemed transfer rule referenced here meant actual property received by Mom.

d. Was the recapitalization a deemed transfer? ILM 201442053 argues that the recapitalization was a deemed transfer because it satisfied the regulation that required her to hold an applicable retained interest before the recapitalization. Above, we proved that Mom’s equity interest before the recapitalization was not an applicable retained interest. Therefore, the requirement that an applicable retained interest existed before the recapitalization was not satisfied. The capital interest may not have been an applicable retained interest after the recapitalization; the answer is unclear. Mom received no property personally for her surrender of an equity interest, and, therefore, that requirement was not satisfied either.

The regulation was intended to treat as a deemed transfer a particular situation: An individual owns preferred and common stock, and the common stock is redeemed for cash or other property. In that case, the subordinate common stock is transferred to the corporation in exchange for cash received by the shareholder. The common stock is treated as transferred for the cash received by the individual for her common stock. The individual holds the same preferred stock before and after the transaction. The memorandum’s facts do not fit that structure, whether or not the capital interest is senior or subordinate to the profits interest.

However, the proposed recapitalization might fit within the rule that treats a capital structure change as a deemed transfer: “The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction.” If the capital interest received in the recapitalization had been an applicable retained interest, which is not true under the memorandum’s facts, the LLC’s recapitalization would be a deemed transfer. That recapitalization would be the same as surrendering common stock in exchange for preferred stock, obviously a deemed transfer. But the capital interest is an applicable retained interest only if it has an EPR and is a senior interest only if the capital has to be paid before any profits distribution. Was the IRS worried that this type of regulatory deemed transfer — whose requirements are easier to satisfy — might be contrary to the statutory requirement of a retained applicable interest?

2. How did ILM 201442053 apply the subtraction valuation method of section 2701? ILM 201442053 provides a step-by-step application of the subtraction method under the section 2701 regulations. Although it is doubtful section 2701 applied to the recapitalization, we will still review the steps of the subtraction method applied by the memorandum for any insights that might be gained, beginning with Step 1:

Step 1 — Determine the fair market value of all family-held equity interests in the entity immediately after the transfer assuming that the interests are held by one individual, using a consistent set of assumptions. Here, all equity interests are held by Donor, her children, and her grandchildren, all members of Donor’s family. The result of Step 1 is an amount equal to the fair market value of 100 percent of the Company interests valued as if they were held by a single holder.

Step 1 is correct.

Step 2 — Subtract: (A) the sum of the fair market value of all family-held senior equity interests determined after the transfer as if all interests were held by a single holder; and (B)
the value determined under section 25.2701-2 of all applicable retained interests held by the transferor and any applicable family members.

A senior equity interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. Section 25.2701-3(a)(2)(ii).

The interests of Child A, Child B, and the grandchildren are senior to the transferred interests in that each carried a right to distributions based upon an existing capital account balance, whereas the transferred interests did not. Accordingly, the amount determined in Step 1 is reduced by the fair market value of Child A’s, Child B’s and the grandchildren’s interests.

If the capital interests are senior interests — which is unclear from the memorandum’s facts — that part of the analysis seems correct, too. However, the facts do not provide that anyone can force the redemption of his capital interest. Thus, the FMV of the capital interests for two Sons and Grandchildren should be determined by discounting a member’s capital account value by an appropriate rate of return over the remaining term of years. The memorandum continues describing Part (B) of Step 2:

The amount determined in Step 1 is further reduced by the value of Donor’s post-recapitalization applicable retained interest. In valuing Donor’s interest, the distribution right, which does not constitute a qualified payment right, is valued at zero, and the liquidation participation right is valued as if the family’s ability to compel liquidation did not exist.

The implication is that Mom’s retained capital interest has a zero value, but it does not. Under any set of facts, Mom ultimately receives her capital interest back at the end of the remainder of the 20-year term. The value of that right is determined just like for two Sons and Grandchildren, by discounting her capital account value by an appropriate rate of return over the remaining term of years. It is a common misconception that an applicable retained interest has either a zero value or par value. However, discounting is used to value the preferred equity when the preferred dividend rate is less than FMV.23

If Mom can receive her capital back before the end of the term, section 2701 would not permit her to increase the value of her capital interest. If it did, that would allow the right of the family to compel liquidation to enhance the value of the capital interest in contradiction of the regulations. Mom’s capital interest, therefore, does not have a zero value. If none of the capital interests have an EPR, the FMV of any of the capital interests is the same as under section 2701. Without an EPR, section 2701 does not apply because it is unnecessary:

Step 3 — Allocate the remaining amount among the transferred interest and other non-transferred subordinate equity interests held by the transferor, applicable family members, and members of the transferor’s family. A subordinate equity interest is an interest as to which an applicable retained interest is a senior interest. Section 25.2701-3(a)(2)(iii). Here, all applicable retained interests carried a distribution right based upon an existing capital account balance, whereas the interest transferred by the grandchildren did not. That interest, which was not transferred by Donor, is a subordinate equity interest. Based on Donor and the grandchildren’s relative ownership percentages immediately prior to the recapitalization, X/X+Z percent of the Step 2 amount is allocated to the transferred interest.

Donor is treated as transferring one-half of that amount to Child A and one-half to Child B.

Grandchildren have the same capital interest as two Sons and Mom. They don’t have different capital interests as the statement suggests. Also, the statement implies that Mom is treated as transferring all of the subordinate equity interests that are not transferred by the Grandchildren. However, two Sons continue to hold the profits interest that they held before the recapitalization. Mom could not be considered as transferring the profits interest the two Sons retained. Therefore, the portion of the profits interest transferred by Mom would only be X, her percentage of the LLC before the recapitalization:

Step 4 — If the value of the transferred interest determined without regard to section 2701 would be determined after application of a minority discount, the Step 3 amount is reduced by a pro rata portion of the fair market value of the family-held interests of the same class determined as if they were held by one person, over the fair market value of a transferred interest. The Step 3 amount is also reduced by the amount, if any, of any consideration in money or money’s worth received by the transferor. Here, Donor transferred an interest to each of two transferees, implicating a minority discount. The reduction for each gift is the excess, if any, of a pro rata portion of

23See Dees, supra note 8, at 716-717.
the fair market value of the transferred interests determined as if all voting rights were held by a single holder over the fair market value of a single transferred interest. In the event that Donor establishes the value in money or money’s worth of any consideration provided by either Child A or Child B, a further reduction may be appropriate.

The memorandum above concludes that two Sons’ management agreement is consideration provided to Mom, but does not provide a reason for that conclusion. Perhaps it is silently acknowledging that the value of two Sons’ management agreement is illusory, because they retain all the profits from their efforts.

3. How should ILM 201442053 have applied the chapter 12 ordinary gift tax rules? ILM 201442053 quotes the relevant provisions of the ordinary gift tax rules in chapter 12 of the IRC without actually applying them. However, section 2701 operates only to increase the amount of the chapter 12 gift when specific valuation bells and whistles (such as an EPR) exist, which can be disregarded under its special valuation rules. The FMV of a gift under chapter 12 is the value of a gift for GSTT purposes under chapter 13, but the increased value under section 2701 is recognized only for gift tax purposes and not for GSTT purposes. Therefore, the starting point for any gift tax analysis, including one actually subject to section 2701, remains the gift determined under chapter 12.

The chapter 12 gift tax analysis seems straightforward enough. Two Sons contributed to the LLC their agreement to provide the management of the assets owned by the LLC. The value of that agreement is determinable by reviewing other similar third-party arrangements. The share of the profits to which a manager may be entitled would likely range between 10 to 20 percent of profits. Under almost no circumstances would anyone retain a manager and pay them 100 percent of profits and gains. Clearly, any LLC member could legally object to the recapitalization terms. Thus, the value of the profits above the market rate, say 20 percent, would be a transfer of the profits of the other LLC members to two Sons. The value of 80 percent of the profits times the percentage ownership of the LLC by Mom and Grandchildren before recapitalization would be a gift. The Sons could not receive a gift of the profits they retained.

Obviously, something other than estate tax savings motivated Grandchildren to surrender their profits interest. Perhaps the senior generations were unhappy about the uses Grandchildren made of their distributions. The senior generations might have believed that delaying Grandchildren’s receipt of any benefits from the LLC assets for several years would be better for them. Section 2701 would not apply to the “gift” from Grandchildren to their fathers, because the transfer would be from a junior to senior generation. However, chapter 12 could impose gift tax consequences if Grandchildren’s participation in the recapitalization was “voluntary.”

There are several ways to determine the FMV of the profits interest. The most obvious way would be to apply discounted cash flow techniques to projected future profits until the end of the LLC term. Another way would be to begin with the assumption that the LLC capital and profits interests valued together (before discounts) comprised 100 percent of the LLC’s FMV. The present value of the capital interest receivable at the end of the term could then be determined using a market discount rate. The discounted value of the capital interests would then be subtracted from the entire value of the LLC to determine the value of the profits interests. Whichever approach is used to determine the FMV of the profits interests, as ILM 201442053 acknowledges in Step 4, that value then would need to be discounted to reflect that neither Son alone could control or liquidate the LLC.

If the memorandum had applied the subtraction method properly, the value of Mom’s retained capital interest would be similarly determined by present valuing the right to the return of her capital at the end of the 20-year term. The memorandum implies that the value of her capital interest under section 2701 is zero, which would be a misreading of the section’s regulations. As discussed above, the proposed regulations were revised before being finalized to make that distinction clear.

If Mom had the right to withdraw her capital immediately (an EPR), the FMV rules would assume that she would do so, reducing the profits on her capital interest to zero. In that case, section 2701 should apply to prevent her from increasing the value of her capital interest to its current capital

24Treasury explained in its preamble to proposed regulations under chapter 14, 56 F.R. 14321, 14322 (1991), that section 2701 does not apply for GSTT purposes: “Although these two [sections — 2701 and 2702 —] apply to determine the amount of the gift, they do not change the value of the transferred property for other tax purposes. Thus, in general, [sections 2701 and 2702] do not apply for purposes of the generation-skipping transfer tax.”

25Section 2701(a)(1). The “members of the family of the transferor” is defined in section 2701(e)(1) as the transferor’s spouse, the transferor’s descendants or spouses of the transferor’s descendants, not ancestors.
account balance. The difference between the discounted value at the end of the term and her current capital account balance would be an increased gift under section 2701 to two Sons. On the other hand, if Grandchildren had an EPR too, section 2701 would not increase their gift to their fathers, because the statute recognizes that transfers from younger generation LLC members to older generation LLC members are not motivated by estate tax reduction. Therefore, it is appropriate to recognize the ability of Grandchildren to liquidate their capital interests, if they held that power, for gift tax purposes.

C. Conclusion

Little of the memorandum’s analysis is correct. Yet, if it had correctly applied section 2701, the gift tax result would be essentially the same for Mom as it would be under chapter 12. ILM 201442053 proves only that the IRS has as much trouble understanding section 2701 as taxpayers and their advisers do. The assumption should always be that section 2701 does not apply unless the analysis under chapter 12 revolves around bells and whistles or the equity carries noncumulative dividends.