Getting Burnt by a Cross-Border Freeze: Traps for the Unwary Under Code Sec. 2701

By Peter A. Glicklich and Heath Martin

The U.S. Congress has fought a long war against the "freeze" transaction—a wealth planning technique under which senior family members avoid gift and estate tax by passing assets to the junior generation in anticipation of future appreciation in the assets' value. In the United States, a special valuation rule under Code Sec. 2701 is widely regarded as having killed purely domestic freezes, but freezes continue to be an essential part of estate plans in many other countries. When a non-U.S. family pursues a freeze, junior family members who live in the United States may not expect Code Sec. 2701 to result in any tax liability, because U.S. gift tax generally applies to the donor, and not the donee. However, we have identified a handful of "traps for the unwary" that should be considered in this situation.

The Biden administration has delivered several tax policy proposals that are expected to increase the estate and gift tax burden on high net worth individuals. In the short term, we may see an increase in foreign freezes as a way to transfer assets to junior family members resident in the United States before Biden's proposals mature into law and before the transferred assets appreciate in value. In addition, the IRS budget for audits of high net worth individuals is expected to be increased significantly over the next decade. Because of the potential for increased taxes and more vigorous enforcement, these traps for the unwary may become more important in the next few years.

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History of Freezes

During the 1970s and 1980s, business owners and other wealthy taxpayers faced high economic inflation and estate tax rates hovering around 70%. This environment challenged tax advisors to find new ways of passing assets from a senior generation to a junior generation without triggering gift or estate tax liability. One wealth planning technique that emerged at that time was the freeze transaction, which accelerates the transfer of an asset to a time before the asset has increased in value. A freeze transaction requires faith that an asset's value

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would, in fact, appreciate, but since the government has not (yet) found a way to tax wealth before it materializes, freezes were generally successful.

An asset freeze enables the owner of an asset to transfer future appreciation to the junior generation free of any taxes at all. A typical freeze transaction might be structured as follows: If the owner holds the asset in a corporation, the owner first recapitalizes his or her shares into a class of common stock and a class of preferred stock. The preferred stock is given the face amount and coupon necessary so that, under standard valuation principles, the value of the preferred stock is equal to the value of the corporation as a whole at the time of the freeze. As a result, the value of the common stock would necessarily be zero when the freeze takes place. The preferred stock could carry rights to management, so the senior generation could remain in control of the underlying asset going forward, if desired.

The senior generation then transfers the zero-value common stock to the junior generation and retains the preferred stock. The transfer of the common stock is a taxable gift, but since the value of the common stock would be zero on the date of transfer, the amount of gift tax would also be zero. The value of the preferred stock was essentially fixed at the time of the freeze, so when the value of the underlying asset increases, all of the additional value accrues to the common stock.

Freeze transactions have been a successful way to structure intergenerational transfers of assets with a potential for significant appreciation, such as an operating business or rental real estate. Control of the underlying asset could remain with the senior generation, which would manage the asset as it grew in value. The preferred stock would remain in the senior generation's estate and be taxed at death, but when the gift of the common stock took place early enough, the value of the preferred stock subject to estate tax might be dwarfed by the untaxed value of the common stock.

The most basic version of a freeze transaction involved operating assets held in a corporation, although assets held in a partnership or trust could also be frozen. Other freeze-like arrangements have been developed, such as an installment sale to an intentionally defective grantor trust or grantor retained annuity trusts.

The party was not destined to last, however. In 1987, Congress made its first attempt at curtailing freeze transactions by enacting Code Sec. 2036(c).[1] This provision required the transferred interest in a freeze transaction to be included in the transferor's estate at death. Code Sec. 2036(c) was heavily criticized as overbroad, since the types of transfer that could be covered by the statutory language were not well defined.

In 1990, Code Sec. 2036(c) was repealed, and in its place Congress enacted Chapter 14 of the Code. Chapter 14 includes Code Sec. 2701, covering transfers of interests in corporations and partnerships, as well as Code Secs. 2702, 2703 and 2704, which cover transfers of interests in trusts and other arrangements.[2]

Although Congress and the IRS have targeted freeze transactions as abusive, there is no evidence that Congress intended Code Sec. 2701 and its related provisions to impose tax or reporting requirements on transfers that would not otherwise be subject to the U.S. estate or gift tax, such as a gift of non-U.S. situs assets by a nonresident alien. Nevertheless, as discussed below, there are some situations where Code Sec. 2701 might do so.

Operation of Code Sec. 2701

Code Sec. 2701 does not prohibit or regulate freeze transactions directly. Instead, Code Sec. 2701 provides a special valuation rule which mandates a value greater than zero for the transferred interest in a freeze transaction. Since the transferred interest has a positive value under Code Sec. 2701, the transfer results in gift tax.

The valuation rules of Code Sec. 2701 are triggered when a transferor (or an "applicable family member" of the transferor) transfers an interest in a corporation or a partnership to a "member of the family," but retains an "applicable retained interest." For the purposes of Code Sec. 2701, the term "members of the family" generally refers to the junior generation, including the transferor's spouse, a lineal descendant of the transferor or the transferor's spouse, and the spouses of any such lineal descendants. On the other hand, the term "applicable family member" generally refers to the senior generation, including the transferor's spouse, an ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor.

"Applicable retained interests" include (i) a distribution right, but only if the transferor (or an applicable family member) is in control of the corporation or partnership immediately before the transfer, or (ii) an "extraordinary payment right," which generally means a forced liquidation right or a put, call, or conversion right where the timing of exercise is discretionary.

Transfers that are gifts under the general gift tax rules are subject to the special valuation rule of Code Sec. 2701. In addition, regulations under Code Sec. 2701

apply the special valuation rule to a broad range of other transactions that would not otherwise be considered gifts. For example, Code Sec. 2701 applies to a transfer for full and adequate consideration,[3] which is usually not treated as a gift at all for gift tax purposes. In such a case, if the value of the transferred interest as determined under Code Sec. 2701 exceeds the value of the full and adequate consideration, the excess can be recharacterized as a gift. The following transactions are also specifically subject to Code Sec. 2701:

A. A contribution of capital to a new or existing entity,
B. A "capital structure transaction," which generally means a redemption, recapitalization or similar transaction where the transferor (or an applicable family member) ends up with an applicable retained interest after the transaction, and
C. Certain transfers relating to the termination of a grantor trust.[4]

There are several exceptions from Code Sec. 2701 for transfers where:

- The applicable retained interest or the transferred interest is publicly traded,
- The applicable retained interest is of the same class of equity as the transferred interest, or
- The transfer is a "vertical slice," *i.e.*, it reduces each class of equity held by transferor proportionately.

If a transfer of an interest in a corporation or partnership triggers Code Sec. 2701, the values of the applicable retained interest and the transferred interest are determined under the "subtraction method": First, the value of the applicable retained interest is determined under the rules provided in Code Sec. 2701, and then the value of the applicable retained interest is subtracted from the total value of the corporation or partnership. That difference (subject to a minimum) is the value of the transferred interest, which may be treated as a gift.

The valuation of an applicable retained interest under Code Sec. 2701 can be complex. Generally, the value of an applicable retained interest is zero, which forces the value of an applicable retained interest to be borne by the transferred interest, which increases the value of the gift. However, a right to "qualified payments," which is essentially the coupon on preferred stock, is valued without regard to Code Sec. 2701 unless it is combined with an extraordinary payment right. If a right to qualified payments is combined with an extraordinary payment right, then the valuation must reflect an assumption that all extraordinary payment rights will be exercised in such a manner as to result in the lowest possible value for the combined rights.

Code Sec. 2701 includes a minimum value rule for the transferred interest. Under the minimum value rule, the transferred interest cannot be less than a *pro rata* portion of 10% of the sum of the total value of all of the entity's equity interests and all indebtedness owed to the transferor or an applicable family member.

Cross-Border Observations

Code Sec. 2701 is generally not thought of as an issue for a freeze transaction where the senior generation is not subject to U.S. tax and one or more members of the junior generation is a U.S. taxpayer. Liability for the U.S. gift tax falls on the donor of a gift and not the donee, and non-U.S. donors are only liable for U.S. gift tax on the transfer of U.S.-situs assets. Accordingly, families should generally be indifferent to the application of the Code Sec. 2701 valuation rules, because the value of a gift that is not subject to gift tax is generally irrelevant.

Some situations where Code Sec. 2701 should be considered, even though the transferor is outside of the United States, are described below.

Attribution

If a foreign freeze does not involve a U.S. transferor who could be subject to U.S. federal gift tax, the family tax advisors may be tempted to disregard Code Sec. 2701 considerations. However, Code Sec. 2701 provides attribution rules which may attribute ownership of the transferred interest to a U.S. taxpayer, which could raise gift tax issues for the transferee. Since ownership and wealth planning structures are increasingly complex, the ownership structure of a foreign freeze should be analyzed carefully to rule out unexpected Code Sec. 2701 concerns.

Code Sec. 2701 includes two sets of attribution rules. First, there are rules that attribute ownership to and from entities[5]:

- An individual is treated as owning his or her *pro rata* share of an equity interest in a corporation or partnership that is held indirectly through another corporation, partnership, estate, trust or other entity.
- A person (*i.e.*, not just an individual) that owns stock of a corporation is treated as owning a share of an equity interest held by that corporation, based on the fair market value of the person's stock in the corporation *vis-à-vis* the total fair market value of all of the stock of the corporation. For this purpose, the fair market value of corporate stock is determined

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without regard to minority discounts or the special valuation rule of Code Sec. 2701.[6]

- A person that owns an interest in a partnership is treated as owning a share of an equity interest held by that partnership, determined in a manner similar to the rule for corporations described immediately above.
- A person is treated as owning a share of an equity interest held by a trust, to the extent that the person's beneficial interest in the trust may be satisfied by a distribution of the equity interest itself, income from the equity interest, or proceeds from a sale of the equity interest.
- The grantor of a grantor trust is treated as owning a share of an equity interest held by the grantor trust, even if the grantor is not a beneficiary of the grantor trust.

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These rules could wind up attributing ownership of the same equity interest to more than one person. Accordingly, Code Sec. 2701 includes a second attribution rule that prioritizes multiple owners. Different rules apply depending on whether the underlying equity interest is an applicable retained interest or the transferred interest:

- An applicable retained interest that is held in a grantor trust is attributed to the grantor first, and otherwise to the transferor, to the transferor's spouse and to the transferor's applicable family members, in that order.
- A transferred interest is attributed to the transferee, to the members of the transferee's family, to the grantor of a grantor trust that holds the transferred interest, to the transferor, to the transferor's spouse and to the transferor's applicable family members, in that order.[7]

These attribution rules are designed to maximize the likelihood that an applicable retained interest will be attributed to the transferor (or an applicable family member) and that a transferred interest will be attributed to a member of the transferor's family. In addition, attribution is not limited to domestic entities. Accordingly, a transfer of equity interests that may superficially take place between foreign individuals or entities may raise issues under Code Sec. 2701 if ownership can be attributed to a U.S. taxpayer.

For example, consider a Canadian individual that manages assets for investors in a Canadian limited partnership. The individual holds a "carried interest" in the partnership as well as a limited partnership interest that provides a right to withdraw capital. If the individual contributes his carried interest to a Canadian trust for the benefit of his wife and adult children, including a child that is a U.S. taxpayer, the transferred interest could be attributed to the child and could raise Code Sec. 2701 concerns, such as the information reporting issue described below.

Information Reporting

Code Sec. 6039F requires a U.S. taxpayer to report large gifts from a foreign donor. This reporting requirement applies to any large gift, and not just gifts that are taxable under the U.S. estate and gift tax regime. The disclosure must be made on IRS Form 3520, which is also used for reporting distributions from foreign trusts and certain other information relating to foreign trusts and estates.

The information reporting requirement under Code Sec. 6039F applies if a U.S. taxpayer receives gifts in excess of $100,000 from a foreign individual in a particular year.[8] Different thresholds apply for gifts from other types of taxpayers. This reporting obligation is an obligation of the donee and not the donor.

If a U.S. taxpayer fails to disclose a gift from a foreign donor, he or she may end up owing steep penalties to the IRS. Code Sec. 6039F authorizes the IRS to determine the tax consequences of an unreported foreign gift and provides that a penalty will be imposed equal to 5% of the value of the gift for each month that the gift is not reported, up to a maximum penalty of 25%.[9]

The IRS has not provided guidance on whether the special valuation rules of Code Sec. 2701 apply to the determination of a penalty under Code Sec. 6039F. However, Congress has given the IRS a broad grant of authority to determine the tax consequences of a gift under Code Sec. 6039F, and applying the Code Sec. 2701 valuation principles could increase the amount of the penalty.

A penalty for failing to report a gift on Form 3520 may be especially onerous in the context of a non-U.S. freeze. The transferred interest in a freeze is likely to be illiquid, so the gift itself may not be available to pay the penalty. Moreover, since the transferee is necessarily a member of the junior generation, the transferee may not be well-established in a career or otherwise have alternative sources of income to provide liquidity. Finally, because the penalty may be unexpected, the information required to report may not be available.

We do not believe that it is currently common practice to apply Code Sec. 2701 valuation principles in determining whether a junior family member has an obligation to report a freeze transaction on Form 3520, but there is at least a theoretical risk that the IRS could find a Form 3520 filing obligation in this situation. However, the penalties for a failure to report may be significant, and the IRS's enforcement budget is expected to be increased with the goal of collecting additional tax revenue from high net worth individuals (as well as corporations and certain other taxpayers). Accordingly, if a junior member of a non-U.S. family is a U.S. taxpayer and benefits from a non-U.S. freeze transaction, he or she would be well-advised to consider disclosing the transaction on Form 3520.

Covered Expatriates

The United States imposes a severe exit tax regime on U.S. citizens and certain residents who renounce their U.S. citizenship. Code Sec. 877A, enacted in 2008, requires a "covered expatriate" to pay tax on the unrealized appreciation in his or her assets before the covered expatriate can cease being subject to U.S. federal tax on his or her worldwide income.

When Congress enacted Code Sec. 877A, it also adopted a corresponding tax under Code Sec. 2801. Under this Section, a U.S. donee who receives a gift or bequest from a covered expatriate (and not the donor) is subject to tax on the value of that gift or bequest at the highest federal estate tax rate then in effect.

The question of whether the Code Sec. 2801 tax is imposed on the Code Sec. 2701 value of a gift or some other value is an open question.[10] The IRS has provided guidance that the special valuation rules of Code Sec. 2701 apply in determining a covered expatriate's exit tax under Code Sec. 877A,[11] but guidance has not been provided under Code Sec. 2801. Given the IRS's willingness to apply Code Sec. 2701 in the context of the exit tax, it is difficult to see why the IRS would forgo the opportunity to assert a Code Sec. 2701 valuation for a gift from a covered expatriate under Code Sec. 2801. Again, a U.S. donee risks finding himself or herself with a large tax bill without any liquidity to pay the tax.

Over the past decade or so, expatriations have become more and more common and there are thousands of covered expatriates all over the world. A covered expatriate who engages in a freeze transaction or similar planning should consider the effect of Code Secs. 2701 and 2801 on any of junior members of the family left behind in the United States.

Conclusion

Code Sec. 2701 is not usually thought of as raising issues for a freeze transaction unless the transferor of the underlying equity interest is subject to U.S. federal gift tax. Like so many U.S. tax provisions, however, issues under Code Sec. 2701 are always lurking beneath the surface. Although the usefulness of freezes makes them indispensable for wealth planning outside of the United States, tax practitioners should carefully consider Code Sec. 2701 when a U.S. taxpayer benefits from a foreign freeze.

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ENDNOTES

1 The Omnibus Budget Reconciliation Act of 1987, P.L. 100-203, §10402(a).
2 The Revenue Reconciliation Act of 1990, P.L. 1010-508, §11602.
3 Reg. §25.2701-1(b)(1).
4 Reg. §25.2701-1(b)(2)(i)(A), (B) and (C).
5 Reg. §25.2701-6(a).
6 Reg. §25.2701-6(b) *Ex. 2*.
7 Reg. §25.2701-6(a)(5).
8 Notice 97-34, §VI(B)(1).
9 Code Sec. 6039F(c)(1).
10 When the IRS was drafting regulations under Code Sec. 2801, commentators suggested that gifts taxed to donees under Code Sec. 2801 should not be subject to the Code Sec. 2701 valuation rules. This suggestion was not adopted. *See, e.g.*, Comment Letter from American Institute of CPAs re IRS Proposed Regulations on Guidance Under Section 2801 Regarding the Imposition of Tax on Certain Gifts and Bequests from Covered Expatriates (REG-112997-10) (May 17, 2016).
11 Notice 2009-85, §3(A).

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