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## The Partnership Capital Freeze in the Farm and Ranch Context†

### I. INTRODUCTION

In recent years, various techniques have been developed by commentators and practitioners which attempt to freeze the value of assets includible in a decedent's estate at death, thereby mitigating the effect of the progressive-rate estate tax measured on the value of such assets. In essence, estate freezing techniques<sup>1</sup> divide the rights which are inherent in an asset into two primary units, one representing the present value of the asset (the frozen interest) and the other representing the right to future income and appreciation on the asset (the growth or participating interest).<sup>2</sup> The rights to be divided among the two units include management rights, rights to present and future income derived from the asset, rights to current equity in the asset, rights to future potential value appreciation in the asset, and control rights.<sup>3</sup> The frozen interest is structured so as to represent most of the present value of the assets involved, while the growth or participating interest is assigned a nominal value, enabling it to be gifted with little or no gift tax consequence. Foremost among estate freezing techniques are

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† Editor's Note—This comment supplements a comment on the same general subject previously published in the Nebraska Law Review, Comment, *Limited Partnerships: Estate Planning Vehicle for the Family Farm*, 59 NEB. L. REV. 55 (1980).

1. One commentator suggested that a more apt description of these techniques would be "value shifting" rather than "estate freezing" because the techniques often involve actual transfers of assets to younger generation family members or employees and a shifting of the opportunity to participate in future value appreciation to such individuals. Fiore, *Dual Capital Partnerships as an Estate Planning Device*, 39 N.Y.U. INST. FED. TAX. § 54.01, at 54-3 (1981).
2. Nelson, *The Partnership Capital Freeze: A Précis*, 15 REAL PROP., PROB. & TR. J. 99 (1980).
3. J. Eubank & J. Wallace, *Frozen Partnership Interests* (Feb. 29, 1980) (paper presented to the workshop of American College of Probate Counsel, Scottsdale, Arizona).

the corporate recapitalization,<sup>4</sup> the multi-class partnership,<sup>5</sup> the family holding company, the private annuity, and the installment sale.

Farm and ranch operations may be particularly well-suited for application of estate freezing techniques.<sup>6</sup> Frequently, such operations are family-oriented with children or grandchildren of the parent-operator taking control upon the death or retirement of the operator. This presents an opportunity to structure an estate plan which gradually shifts control and asset values from the parent-operator's estate to the successor-heirs. Perhaps the greatest incentive for the use of an estate freeze in the farm and ranch context is the potential for substantial appreciation, both real and inflationary, in the value of the farmland,<sup>7</sup> which generally accounts for the majority of the value of a farm enterprise.

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4. For a brief discussion of the corporate recapitalization, see notes 22-29 & accompanying text *infra*.
  5. Partnerships using a capital freeze are either referred to as "dual capital partnerships," see, e.g., Fiore, *supra* note 1, § 54.02, or "multi-class partnerships," see, e.g., Abbin, *Using the Multi-Class Partnership to Freeze Asset Values for Estate Planning Purposes*, 52 J. TAX. 66 (1980).
  6. Several Internal Revenue Code sections assist the farmer or rancher in avoiding potentially disastrous estate tax consequences. Section 2032A permits certain qualified real property to be valued for estate tax purposes according to its use as farmland, rather than at its highest and best use, as in the case of commercial or residential property. I.R.C. § 2032A. This often results in substantially lower estate tax values. For example, according to figures from the Internal Revenue Service's Omaha office, the average discount from fair market values obtained through § 2032A elections on returns filed with that office was 45%. The discounts ranged from 23% as reported by the service's Albany, New York, office to 76% as reported by the Philadelphia office. Hartley, *Final Regs. under § 2032A: Who, what and how to qualify for special use valuation*, 53 J. TAX. 306, 308 (1980). For a discussion of the application of § 2032A to a partnership capital freeze, see notes 175-88 & accompanying text *infra*. Sections 6166 and 6166A allow for extensions of time for the payment of estate taxes where the estate consists mainly of interests in closely-held businesses. I.R.C. §§ 6166-6166A. The Economic Recovery Tax Act of 1981 consolidates these two sections for estates of decedents dying after 1981. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 422, 50 U.S.L.W. 46-47.
  7. Abbin, *The Partnership Capital Freeze—An Alternative to Corporate Recapitalization*, 13 U. MIAMI EST. PLAN. INST. ¶ 1800 (1979). Abbin states that this potential appreciation, coupled with reasonably ascertainable value computations based on recent sales transactions and the cash flow generated from the land, makes farms and ranches "eminent candidates for contribution" to frozen or multi-class partnerships. *Id.* ¶ 1802. However, one commentator has stated that considerations such as the fluctuating income flow, family partnership rules, and donor retained interest rules mandate that "[t]he use of farmland for capital freeze purposes will require a great deal of extra homework, a propensity for risk taking and an abundance of faith and optimism about the future." Scheify, *Partnership Recapitalization: Achieving a Capital Freeze*, 32 U. SO. CAL. INST. FED. TAX ¶¶ 500, 511.5 (1980).

### A. Nebraska Agriculture and Farm Values

The importance of agriculture to Nebraska's economy is beyond question.<sup>8</sup> Nebraska ranks fifth nationally in total land area devoted to agricultural uses: ninety-five percent or 46.8 million acres.<sup>9</sup> The great majority of Nebraska farm operations are owned and operated by sole proprietors.<sup>10</sup> Sole proprietors and husband-wife combinations own nearly seventy percent of Nebraska's agricultural land.<sup>11</sup>

Most of Nebraska farmland, paralleling the national trend, substantially increased in value during the 1970's.<sup>12</sup> For example, the market value of Nebraska cropland increased an average of fourteen per cent annually during the past decade.<sup>13</sup> Although this appreciation surpassed the rate of inflation, which averaged 6.8 per cent annually over the same period, that inflation eroded about seventy percent of the gain in land values.<sup>14</sup> This appreciation in value has resulted in reassessments in the farm and ranch context of the economic assumption that a direct relationship is expected

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8. In 1978, for example, the market value of agricultural product sales and other farm-related income for Nebraska totaled \$5,162,408,000. 1978 CENSUS OF AGRICULTURE, PRELIMINARY REPORT—NEBRASKA, U.S. DEPT. OF COMMERCE, BUREAU OF THE CENSUS 2 (July 1980) (hereinafter cited as 1978 CENSUS).
  9. B. Johnson, Perspectives on Land Use and Ownership in Nebraska 3 (1981) (unpublished manuscript available from Dept. of Ag. Econ., U. Neb.—Lincoln).
  10. In 1978, Nebraska farms were operated by 56,912 individuals or families, 6,464 partnerships, and 2,427 corporations. 1978 CENSUS, *supra* note 8, at 2. It has been projected that nationally, the number of corporations operating farms will continue to increase and the number of partnerships will decline. W. Lin, G. Coffman & J. Penn, *Farm Numbers, Sizes & Related Structural Dimensions: Projections to Year 2000*, U.S. DEPT. OF AGRICULTURE, ECONOMICS, STATISTICS, AND COOPERATIVE SERVICE, TECH. BULL. No. 1625 (July 1980). For a quantitative analysis of farming corporations in Nebraska, see J. Pribbeno, B. Johnson & M. Baker, *Farm Corporations in Nebraska*, Dept. of Ag. Econ., U. Neb.—Lincoln, Rep. No. 78 (July 1977). For a discussion of the tax issues involved in deciding whether to incorporate a farm operation, see Eastwood, *The Farm Corporation from an Income Tax Viewpoint: Friend or Foe?* 54 NEB. L. REV. 443 (1975).
  11. B. Johnson, *supra* note 9, at 11. Family partnerships own 9.8% and non-family partnerships, 1.1%. *Id.*
  12. In 1978, Nebraska had 65,991 farms. The average value of the land and buildings per farm was \$373,270 and the average value per acre was \$525. The figures for 1974 were \$192,574 and \$282, respectively. 1978 CENSUS, *supra* note 8, at 1. The 48-state average of farmland value appreciation for the 1970's was nearly 250%, with the majority of the increase occurring between 1975-79. D. Jewell & B. Johnson, *Farm Real Estate Investment in the 1980's*, at 1 (1981) (unpublished manuscript available from Dept. of Ag. Econ., U. Neb.—Lincoln).
  13. B. Johnson & R. Hanson, *Nebraska Farm Real Estate Market Developments in 1979-80*, at 3, Dept. of Ag. Econ., U. Neb.—Lincoln, Rep. No. 105 (June 1980).
  14. *Id.* at 5.

to exist between earnings generated by a productive asset and the underlying value of that asset. However, current earnings generated by Nebraska farms simply do not justify the market values of farmland.<sup>15</sup>

Nevertheless, valuation increases create greater potential estate tax liability. Additionally, the discrepancy between farmland valuation and earnings potential could preclude younger, potential farmers who lack sufficient financial resources to service debt incurred on land purchases from entering the field.<sup>16</sup> A partnership capital freeze, accompanied by a gifting program, could help alleviate both problems. The younger generation successor-operator would be able to develop an equity base in the farmland and operations prior to the death or retirement of the parent-operator, which presumably would open more avenues of financing; and the parent-operator would be able to reduce the amount of the estate subject to tax.

## II. ESTATE FREEZING: PRELIMINARY CONSIDERATIONS

### A. Goals and Objectives

Foremost among the goals of any estate planning freeze is to place a lid on the value of the parent-operator's interest by limiting his rights to participate in future appreciation, both real and inflationary. A freeze can provide the parent-operator with security, by providing him a relatively stable, guaranteed cash flow, important particularly in a retirement situation, and by transferring the risk of depreciation of the business' value to his successors. Additionally, if the freeze provides the parent-operator a "put" or liquidation right with respect to his interest, he is guaranteed liquidity for his interest, again important upon retirement. By granting the parent-operator such rights, he is more likely to be encouraged to give up the daily control of the business.<sup>17</sup> The freeze thereby can aid

15. *Id.* at 5-6.

16. *Id.* at 7; S. Bartruff & B. Johnson, Selected Economic Characteristics of Nebraska's Farming Sector 19, Dept. of Ag. Econ., U. Neb.—Lincoln, Rep. No. 91 (Nov. 1978). It has been projected that the total number of farms in the United States will decline from 2.9 million in 1974 to 2.1 million in 1990 and 1.8 million in 2000. W. Lin, G. Coffman & J. Penn, *supra* note 10, at iii. The total proportion of large farms (those with annual gross sales of \$100,000 or more) is projected to increase from 5% to 32%, with the capital requirements for such farms to rise to \$2 million. According to Lin, Coffman and Penn, "[t]he accelerating capital requirements imply that the low-equity, young, potential farmers will have even more difficulty getting started in farming." *Id.* at iii-iv. In light of the increasing size of farms projected, they predict the number of new farmers under 35 years of age will decline 40%, from 475,000 in 1964-74 to 284,000 in 1994-2004. *Id.*

17. Nelson, *supra* note 2, at 100.

in transferring control of the business to younger generation family members who will be induced to actively maintain the business because they will receive growth interests in the operation which participate in future income and appreciation.<sup>18</sup>

While an estate freeze is designed to accomplish precisely what the name implies, it may also result in favorable income tax consequences. If the amount of current income which the frozen interest annually receives is limited, income beyond that amount flows to the participating or growth interests. Presumably the latter interests are held by younger generation individuals who are in lower tax brackets than the older generation holder of the frozen interest; thus favorable income splitting can occur. However, depending on the structure of the freeze and the method by which the growth units are acquired, the assignment of income doctrine<sup>19</sup> and the family partnership rules<sup>20</sup> may require a reallocation of income from the younger to the older individuals.

An additional benefit resulting from an estate freeze is that since the value of the frozen interest is established, subsequent valuation disagreements with the Internal Revenue Service upon audit of the estate containing the frozen interest may be avoided.<sup>21</sup>

## B. Corporate Recapitalization

A corporate recapitalization achieves results analogous to those obtained through a partnership capital freeze.<sup>22</sup> Generally, a corporate recapitalization is a tax-free event involving the exchange of the common stock of an existing corporation for new preferred

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18. The use of a freeze, however, does not mandate relinquishment of all control by the older generation owner. The frozen interest can be given voting rights; however, the nature and extent of the control afforded the frozen interest must be closely scrutinized to avoid § 2036 and § 2038 problems. See notes 169-74 & accompanying text *infra*. Control retention can be accomplished in both the corporate and partnership contexts. See, e.g., Oshins & Segal, *Freezing asset values need not result in loss of control of business*, 6 EST. PLAN. 322 (1979).

19. See note 59 & accompanying text *infra*.

20. See notes 110-23 & accompanying text *infra*.

21. Abbin, *supra* note 7, ¶ 1806.

22. The corporate recapitalization is reviewed briefly both because of its similarity to the partnership capital freeze and the increasing prevalence of farm corporations. Merely because this Comment does not address the use of other estate freezing techniques, such as the family holding company, private annuity, and installment sale, does not imply such techniques are not appropriate in the farm and ranch context. Rather, in certain situations, such techniques may provide better results than a partnership capital freeze or a corporate recapitalization. For a discussion of these and other estate freezing techniques in the farm situation, see D. KELLY & D. LUDTKE, *ESTATE PLANNING FOR FARMERS AND RANCHERS* (1980).

and common stock.<sup>23</sup> A business purpose for the recapitalization must exist.<sup>24</sup> The parent-operator receives the preferred stock (the frozen interest), representing most of the present value of the corporation, while the children-employees receive, through gift or purchase, most or all of the nominal value common stock (the growth interest). The value of the preferred stock is frozen by being accorded certain preferences as to income and liquidation.

An inherent problem with a corporate recapitalization is the double taxation on corporate earnings. A corporation using a recapitalization will be required to pay a tax on its income at the corporate level, and shareholders must report ordinary income when the earnings of the corporation are distributed as dividends. Since the recapitalization requires the issuance of two classes of stock, it may not be utilized by a Subchapter S corporation to avoid the double taxation.<sup>25</sup> In contrast, a partnership under the provisions of Subchapter K operates much like a Subchapter S corporation: there is no tax at the partnership level and the partnership's tax consequences flow directly to the partners who are liable for income tax in their individual capacities.<sup>26</sup>

Other potential problems associated with corporate recapitalizations include: the risk that preferred stock received by the parent-operator may be affected by the taint of section 306,<sup>27</sup> the personal holding company tax,<sup>28</sup> and the accumulated earnings tax.<sup>29</sup> Therefore, although a corporate recapitalization and a partnership capital freeze achieve analogous results, the potential tax problems raised by the recapitalization may make the use of the partnership preferable.

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23. I.R.C. §§ 368(a)(1)(E), 354.

24. Treas. Reg. § 1.368-1(b) (1955).

25. A Subchapter S corporation may only issue one class of stock. I.R.C. § 1371(a)(4).

26. *Id.* §§ 701, 702(a), 704(a). One commentator notes that a principal disadvantage inherent in a partnership capital freeze, due to the fact that a partnership is not a separate taxpayer, is that the timing of income realization is "more difficult" (less flexible) than with a corporation. Fiore, *supra* note 1, § 54.03[1], at 54-17.

27. Section 306 provides that dispositions of certain preferred stock will generate ordinary income, rather than capital gain. I.R.C. § 306. A retiring shareholder may be able to avoid the application of § 306 by completely terminating his interest or by liquidating the corporation under § 306(b)(1)(2), *id.*, alternatives which may not be consistent with his personal objectives.

28. *Id.* §§ 541-542.

29. *Id.* §§ 531-537.

### III. PARTNERSHIP CAPITAL FREEZE

#### A. General Description

A partnership capital freeze can be utilized in nearly all types of partnerships—general or limited,<sup>30</sup> new or existing,<sup>31</sup> family<sup>32</sup> or unrelated. Ownership of the partnership is split into at least two separate units: the frozen interest with predetermined liquidation values and preferential rights to partnership income, and the regular (growth or participating) interests with some rights to current income, the risk<sup>33</sup> of future depreciation and, in effect, a preferential right to future appreciation. The frozen interest may or may not be assigned voting rights, depending on the circumstances involved, including the parent's willingness to relinquish control and the stability of the family situation.

Any or all of the partners may receive both regular and frozen interests.<sup>34</sup> Generally, however, the parent-operator<sup>35</sup> will receive the frozen interest, while the successor-heirs, usually children, receive the regular interests. If there are on-farm and off-farm heirs, it may be necessary to further divide the regular interests to give the on-farm heir a control element exercisable without interference from off-farm heirs. If the parent desires to treat the children

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30. See notes 156-68 & accompanying text *infra*.

31. See notes 66-67 & accompanying text *infra*.

32. See notes 110-23 & accompanying text *infra*. Regardless of the type of partnership used, one commentator has concluded that the practical and tax-related problems involved with partnership capital freezes are so substantial as to limit their application to only sizeable estates. Fiore, *supra* note 1, § 54.07, at 54-47. While the potential estate tax savings obviously are greater in larger estates, this author feels that through careful and well-documented planning, the partnership capital freeze can benefit smaller-sized farms (in terms of total acreage) which may constitute significant estates. See note 12, *supra*.

33. One author states the regular partnership interest "represents the risk-taking partner's capital interest." Abbin, *supra* note 7, ¶ 1801.1. In the farm and ranch context, the individuals holding the regular interests may bear substantial risks. With commodity market prices frequently fluctuating widely from year-to-year, such individuals, on occasion, could be hard-pressed to make any fixed level payments on the frozen interests.

34. If a partner receives both regular and frozen units, the basis of his partnership interest must be allocated between both units. An individual's basis in his partnership interest is equal to the amount of money contributed and the adjusted basis (to the contributing partner at the time of contribution) of property contributed, increased by any gain recognized upon contribution. I.R.C. § 722. It has been suggested that since there is a lack of authority directing the method by which to allocate such basis, the corporate recapitalization provisions should be followed. Those provisions require allocating basis according to the fair market value of the units when received. Abbin, *supra* note 7, ¶ 1805.2. For a discussion of valuation of the frozen and regular units, see notes 126-55 & accompanying text *infra*.

35. One commentator refers to the senior family members who receive the frozen interests as the "preferred partners." Fiori, *supra* note 1, § 54.02.



equally, such a division in interests meets that objective as all children participate equally in future appreciation. Alternatively, the off-farm heirs could receive only frozen interests but with voting rights to give them investment-type interests, while the on-farm heirs would receive all the regular interests.<sup>36</sup> If the parent wishes to continue the farming operation for several years prior to retirement, he could retain control through a frozen interest with voting rights.<sup>37</sup>

While a partnership presents greater complexity in tax treatment than a corporation, its flexibility makes it particularly amenable for use in the farm and ranch context. The partnership agreement, which controls the allocation of voting control, partnership income and deductions, may be easily amended; this may ease the concerns of a parent who is reluctant to irrevocably transfer control of the farm.<sup>38</sup> Additional contributions may be made to a partnership with greater ease than to a corporation since contributions to a partnership are tax-free,<sup>39</sup> while control requirements may limit tax-free treatment of contributions to corporations.<sup>40</sup> Generally, property withdrawals and the liquidations are not taxable in the partnership context,<sup>41</sup> but are taxable in the corporate area.<sup>42</sup> Partnership distributions which result in taxation because

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36. One commentator suggests the use of a three-class partnership freeze using a limited partnership. Special limited partners would hold frozen interests, principal limited partners would hold the regular interests and the control interest would be held by the managing general partner. D. Carlson, *Partnership Tax Considerations*, Great Plains Federal Tax Institute, Lincoln, Neb. (Dec. 4, 1980).

37. The parent's desire to continue in day-to-day active control of the farming operation must be balanced with the potential application of § 2036 in such a situation. See notes 169-74 & accompanying text *infra*.

38. J. Eubank & J. Wallace, *supra* note 3, at 9. See L.R.C. §§ 704(a)(b), 761(c). L.R.C. § 761(c) provides:

For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

39. L.R.C. § 721(a).

40. *Id.* §§ 351(a), 368(c). Property may be transferred tax-free to a corporation only if immediately after such transfer, the transferors own stock representing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. *Id.*

41. Gain is not recognized unless money distributed exceeds the adjusted basis of the partner's interest in the partnership. L.R.C. § 731(a). Distributions of unrealized receivables or inventory items which have appreciated substantially in value may generate ordinary income tax consequences. *Id.* § 751.

42. *Id.* §§ 301, 302, 331. Such distributions will be includible in gross income if classified as dividends from the corporation's earnings and profits, or may

in excess of basis generally are afforded capital gain treatment,<sup>43</sup> while corporate distributions must meet the tests of section 302(b) redemptions<sup>44</sup> to qualify for capital gain treatment.

The partnership capital freeze is not, however, free from problems. A primary problem is the uncertainty associated with the technique due to the lack of any direct authority for it.<sup>45</sup> Additionally, some of the limited liability afforded corporate shareholders is not available in the partnership context, even if a limited partnership vehicle is used.<sup>46</sup> Finally, a frozen partnership with multi-classes of ownership interests may generate potential conflicts of interest requiring separate counsel for owners of the various units.<sup>47</sup> If such conflicts do arise, the problem of obtaining independent counsel may be compounded in rural areas which lack sufficient counsel, or when distant off-farm heirs own interests.

## B. Partnership Formation

A partnership is defined in the tax regulations as including: a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Code. The term "partnership" is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships.<sup>48</sup>

By excluding from partnership status undertakings merely to share expenses, the regulations imply the necessity of an intent to share in profits as proprietors.<sup>49</sup> The classic test of partnership

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receive capital treatment if construed as made in payment for exchange of stock.

43. I.R.C. § 741. However, distributions of unrealized receivables or substantially appreciated inventory may give rise to ordinary income. See note 41 *supra*.

44. Redemptions which are treated as exchanges and thereby qualify for capital gain treatment fall into three categories: (1) not essentially equivalent to a dividend; (2) substantially disproportionate; or (3) in complete termination of the shareholder's interest. I.R.C. § 302(b)(1)-(3).

45. D. KELLEY & D. LUDTKE, *supra* note 22, § 7.28; Fiori, *supra* note 1, § 54.04[3]. Fiori suggests the uncertainty should cause the practitioner to adopt a generally conservative approach in establishing a partnership capital freeze. *Id.*

46. See, D. KELLEY & D. LUDTKE, *supra* note 22, § 7.23. The authors state when the parents, as limited partners, continue participation in day-to-day farm management, their limited liability may be lost. In addition, the authors maintain that limited partnership units may provide little protection against tort judgments since the limited partnership units often compose the bulk of the parents' estates. *Id.*

47. Fiore, *supra* note 1, § 54.02[2]. Conflicts of such nature would not be unique to a partnership situation, but could arise in any ownership structure.

48. Treas. Reg. § 1.761-1(a) (1972).

49. *Id.* See, e.g., Rev. Rul. 43, 1975-1 C.B. 383, in which a cattle-fattening agree-

status was enunciated by the United States Supreme Court in *Commissioner v. Culbertson*.<sup>50</sup>

The question is . . . whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.<sup>51</sup>

Although common law or state partnership statutes are not determinative of whether a partnership exists for federal income tax purposes, they may be significant in making such a determination.<sup>52</sup> When a partnership capital freeze is used in the farm and ranch area, it is important that partnership formalities are observed and that partners holding the regular units receive interests in (and actually receive when available) partnership income.<sup>53</sup>

If the partnership capital freeze is effectuated by the creation of a new partnership, most of the operating assets of the farm and the farmland may be contributed to the partnership tax-free.<sup>54</sup> A partner receives a partnership interest with a basis equal to the sum of money contributed, the adjusted basis of property contributed,<sup>55</sup> and gain recognized by the contributor upon contribution.<sup>56</sup> The partnership's basis in the contributed assets is essentially a carry-over basis, equal to the adjusted basis of the assets in the hands of

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ment between a corporate feedlot owner and an individual cattle owner was held not to be a partnership because one individual lacked a proprietor's interest in the net profits.

50. 337 U.S. 733 (1949).

51. *Id.* at 742 (footnotes omitted).

52. See Abbin, *supra* note 7, ¶ 1805.3 n.78 and cases cited therein.

53. See notes 169-74 & accompanying text *infra*.

54. If both on-farm and off-farm heirs exist, an attractive alternative to a single partnership would be to utilize multiple entities, and contribute the operating assets to a farm corporation with the ownership interests held by the parent and on-farm heirs; and contribute the farmland to a three-class limited partnership employing a capital freeze. See note 36 *supra*. The corporation would then lease the farmland from the partnership on a long-term basis. For a discussion of the use of multiple entities in the farm and ranch context, see D. KELLEY & D. LUDTKE, *supra* note 22, §§ 11.01-21. Despite the ease and minimal tax cost with which property can be removed from a partnership, it may be desirable to exclude the parent's residence from the partnership (unless the situation is such that the partnership can deduct the cost of the house as a § 162 ordinary and necessary business expense) to permit the parent to receive the benefits of § 121, which allows a \$125,000 exclusion from gain for an individual 55-years old or older selling a personal residence. I.R.C. §§ 162, 121.

55. I.R.C. § 722. The adjusted basis is determined as of the time of the contribution. *Id.*

56. *Id.*

the contributing partners at the time of contribution.<sup>57</sup> The contribution of assets such as machinery and buildings, upon which depreciation or investment tax credit has been taken, should not give rise to recapture.<sup>58</sup> However, if the parent transfers growing crops, harvested and stored crops, or livestock into the partnership, the Service may attempt to allocate the income inherent in such assets back to the parent under the assignment-of-income principle<sup>59</sup> or the Service's general power to allocate income and deductions to clearly reflect income.<sup>60</sup>

The transfer of farmland to the partnership may merit special consideration because of two factors: liabilities encumbering the property and gain inherent in the property through appreciation prior to contribution. The partnership tax provisions provide that when a partnership assumes liabilities attached to contributed property, the contributing partner shall realize a constructive distribution of money to the extent to which the assumption reduces his share of liabilities.<sup>61</sup> Additionally, gain must be recognized

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57. *Id.* § 723.

58. *Id.* §§ 1245(b)(3), 1250(d)(3); Treas. Reg. § 1.1245-4(c)(1)(4) (1972); I.R.C. § 47(b); Treas. Reg. § 1.47-3(f) (1971). If § 731(a) causes some gain to be recognized because the contributing partner receives a distribution of money in exchange for his contribution which is in excess of the adjusted basis of his partnership interest, limited depreciation recapture will be required. I.R.C. §§ 1245(b)(3), 1250(d)(3). If interests in an existing partnership are exchanged in a tax-free transaction for interests in a newly-formed partnership, see notes 66-67 & accompanying text *infra*, depreciation recapture will not be required, *id.* §§ 1245(b)(4), 1250(a)(4), nor should recapture of investment tax credit be required. See W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 4.05[3] (1977).

59. The assignment-of-income, or "fruit of the tree," doctrine was first developed in *Lucas v. Earl*, 281 U.S. 111 (1930). The doctrine has been applied to the transfer of growing crops to a corporation. *Weinberg v. Commissioner*, 44 T.C. 233 (1965), *aff'd per curiam sub nom.*, *Commissioner v. Sugar Daddy, Inc.*, 386 F.2d 836 (9th Cir. 1967), *cert. denied*, 392 U.S. 929 (1968). Kelley and Ludtke maintain the doctrine should not apply to such a transfer because in the context of gift tax and income in respect of a decedent, livestock and growing crops are deemed property and the transfer of such items is merely a transfer of property, not income. D. KELLEY & D. LUTKE, *supra* note 22, § 10.30. Based on *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974) and *Briggs v. Commissioner*, 15 T.C.M. 440 (1956), McKee, Nelson and Whitmire state that the nonrecognition policy underlying § 721 should have precedence over assignment-of-income principles so as to facilitate such transfers. W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 58, ¶ 4.02[2].

60. I.R.C. § 482.

61. *Id.* § 752(b). Gain must be recognized only if such deemed distribution exceeds the adjusted basis at the transfer of the partner's partnership interest. *Id.* § 731(a). One way to avoid a deemed distribution would be to have other partners borrow on property they contributed to the partnership and have the partnership assume the liabilities. However, in the farm situation, many successor-heirs will lack sufficient property to contribute or value to encum-

when land transferred is subject to liabilities in excess of basis.<sup>62</sup> The gain inherent in appreciated farmland or other property which is contributed to the partnership by the parent-operator should be specially allocated in the partnership agreement to him.<sup>63</sup> If it is not, then upon a subsequent sale of the property by the partnership, the timing of any gain or loss may be distorted,<sup>64</sup> or the regular partners may bear more than their proportionate share of pre-contribution appreciation and less of their share of depreciation.<sup>65</sup>

If the partnership capital freeze is effectuated by the restructuring of an existing partnership, it is important that the exchange of the existing partnership interests for the newly-created interests be accomplished tax-free. The weight of authority is that an ex-

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ber. Also, under the family partnership rules, an individual contributing only borrowed capital will not rise to the status of a partner. See note 114 *infra*.

62. Such gain is treated as from the sale or exchange of the partner's partnership interest, a capital asset. L.R.C. §§ 731(a), 741. Under the analogous corporate provision, L.R.C. § 357(c), the character of the gain depends on the nature of the encumbered asset contributed to the corporation. W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 58, ¶ 4.03[1][c]. It has been stated that the operation of L.R.C. §§ 752(b) and 357(c) makes it "easier" to contribute encumbered property to a partnership than to a corporation. J. Eubank & J. Wallace, *supra* note 3, at 8.

63. L.R.C. § 704(c)(2) provides:

(2) EFFECT OF PARTNERSHIP AGREEMENT.—If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

A special allocation will generally be recognized by the Service if it has "substantial economic effect," i.e., allocation of the various items must be charged to the partner's capital account and the liquidation proceeds must follow the capital account. *Id.* § 704(a)-(b). See P. Baker, Estate and Income Tax Planning, Using the Partnership Capital Freeze (July 1980) (paper presented to Denver Estate Planning Council, Denver, Colo.). Baker advocates such an allocation of the pre-contribution appreciation but cautions against allocating post-contribution appreciation to the frozen partner. Any such allocation would increase that partner's capital account without increasing the value to be received by him upon liquidation. If the frozen partnership interest then is disposed of at a capital loss, the frozen partner may not be in a position to use such loss. (e.g., if the frozen partner dies, the heir would get no benefit from such a loss because of the step-up in basis rule of L.R.C. § 1014(a)(1)). *Id.* at 5.

64. W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 58, ¶ 10.08[1]. The authors provide an example illustrating the potential distortion. Essentially, the contributing partner has some of the inherent gain deferred, while the other partner(s) are required to report their share of the gain during the year of sale without being able to realize an offsetting loss until termination of the partnership.
65. Scheiffy, *supra* note 7, ¶ 5.03.2 n.7.

change of general partnership interests between two partnerships consisting of similar underlying assets should be tax-free;<sup>66</sup> however, such treatment may not be available where the parent general partner exchanges a general partnership interest for a newly-created limited partnership interest.<sup>67</sup>

Depending upon the value of the interests exchanged, an imputed gift may be deemed made upon the formation or restructuring of the capital freeze partnership.<sup>68</sup> In the majority of farm and ranch situations where the parent owns all or most of the assets

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66. *Gulfstream Land & Dev. Corp. v. Commissioner*, 71 T.C. 587 (1979). In *Gulfstream*, the exchange of a general partnership interest in a real estate development partnership for a general partnership interest in a similar partnership qualified for nonrecognition treatment under I.R.C. § 1031(a). The court said the analysis is not concluded merely by focusing on the nature of the assets actually exchanged, *i.e.*, the partnership interests, rather, the substance-over-form doctrine required an examination into the nature of the underlying assets to prevent abuse of § 1031. The argument made by the Service, and reflected in Rev. Rul. 135, 1978-1 C.B. 256, that partnership interests are "choses in action" and within the exclusionary parenthetical of § 1031(a), was rejected by the *Gulfstream* court. *Id.* at 593-94.

67. *Estate of Meyer v. Commissioner*, 58 T.C. 311 (1972), *aff'd*, 503 F.2d 556 (9th Cir. 1974). In *Meyer*, a father and son were general partners in a real estate partnership and exchanged their partnership interests for interests in a second real estate partnership in which the son was a general partner and the father was a limited partner. The court held the exchange of the son's interest was tax-free while the father's was not. In the second partnership, the father's

personal assets were no longer at stake. He was no longer involved in making the day-to-day decisions of the business. He had ceased to become a participant in the business and had become primarily an investor, dependent upon the efforts of others to make a profit. The different character of his ownership interest made it property of a different class rather than property of a different grade.

503 F.2d at 558. It should be noted *Meyer* involved two different partnerships. *Contra*, Priv. Let. Rul. 7948063 (Aug. 29, 1979). In the latter ruling, a general partnership with four partners (a mother and her three sons) was engaged in ranching and selling timber. One of the general partners died and his interest was distributed to a trust for the benefit of his children. The parties proposed to amend the partnership agreement to convert it into a limited partnership, with the four former general partners owning a combined 99% limited partnership interest and a one percent general partner. The Service, without explanation, ruled the conversion did not constitute a sale or exchange. The Service may have concluded that since the same business and approximate ownership interests apparently would exist in the new partnership, a mere change of form had occurred. Depending on the factual circumstances, the Service may conduct an analysis of the interests similar to that in *Meyer* if the parent's position before and after the freeze restructuring differ substantially.

68. I.R.C. § 2512(b). Imputed gifts occur when property is transferred for less than an adequate and full consideration in money or money's worth. The amount by which the value of the transferred property exceeds the consideration received will be deemed a gift.

contributed to the partnership, such an imputed gift probably would be deemed made from the parent to the children—the regular partners—because the frozen interest received by the parent could not be structured to absorb most of the present value of the partnership's assets. While great flexibility exists in structuring the frozen and regular interests, providing adequate support of the values assigned to each interest may be the most complex and difficult problem presented by a partnership capital freeze.<sup>69</sup>

### C. The Frozen Interest

In structuring the frozen interest, consideration must be given to the cash flow required by the frozen partner, both currently and upon retirement, and the potential cash to be generated by the partnership which will be available for distribution.<sup>70</sup> Whether the parent desires to retain active management powers, and the extent, nature and duration of any such powers, must be analyzed. In addition, the partnership must be designed to guarantee adequate liquidity of the frozen interest in the event of the frozen partner's decision to retire from the partnership operations. In essence, the freeze is accomplished by structuring the frozen interest so that the rights to present and future income and the liquidation preferences afforded to the interest are sufficient to support most (as much as possible) of the current value, at contribution, of the partnership's assets assigned to the frozen interest.

Generally, distributions by a partnership to its partners may fall within one of three categories. First, the distribution may be of the partner's distributive share of income or gain and, if available, loss or deductions.<sup>71</sup> Second, the distribution may be one deemed to have been made to a partner not acting in his capacity as a partner.<sup>72</sup> Such a distribution could be the result of a loan, a sale of property, or the rendering of services by the partner to the partnership.<sup>73</sup> Third, the distribution may be one made to a partner without reference to partnership income which is in payment for services performed by, or for the use of capital contributed by such

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69. See notes 126-30 & accompanying text *infra*.

70. If the rate of return on the frozen interest is set so high that it generates cash in excess of the needs of the frozen partner, such excess will accumulate in the frozen partner's estate and the effect of the capital freeze will be frustrated to that extent. J. Eubank & J. Wallace, *supra* note 3, at 14.

71. I.R.C. § 704(a)-(b). A partner's distributive share of tax attribute items (income, gain, loss, deduction, or credit) generally shall be determined according to the partnership agreement, or if not provided for therein, in accordance with the partnership agreement's provisions for dividing general profits and losses. Treas. Reg. § 1.704-1(a)-(b)(1) (1964).

72. I.R.C. § 707(a).

73. Treas. Reg. § 1.707-1(a) (1960).

partner. Such a distribution may be deemed a guaranteed payment made to the individual not acting in his capacity as a partner.<sup>74</sup>

### 1. *Guaranteed Payments - Section 707(c)*

One method to supply the frozen partner with a cash flow would be to provide him with guaranteed payments. Such payments are deductible by the partnership<sup>75</sup> and are reportable as ordinary income by the partner-recipient. Guaranteed payments will not reduce the frozen partner's capital account<sup>76</sup> since they are not deemed to be a return of capital. The concept of a partner's capital account is particularly important in the context of a partnership capital freeze since liquidation proceeds are usually distributed in accordance with such an account. By establishing a set value upon contribution for the partner's capital account and requiring liquidation proceeds to follow the capital account, the set-value liquidation preference has the effect of freezing most of the partner's interest.

Guaranteed payments cannot be made contingent upon partnership income<sup>77</sup> but must be payable in all events. Thus, guaranteed payments are inherently cumulative and cannot effectively be

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74. I.R.C. § 707(c) provides:

GUARANTEED PAYMENTS.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

75. Such payments may be deductible as "ordinary and necessary" business expenses, I.R.C. § 162(a), or may be required to be capitalized. *Id.* § 263. Abbin states that such payments rarely would not qualify for deductibility since they represent a "bargain for reasonable return on capital that is required for the conduct of partnership business." Abbin, *supra* note 7, ¶ 1805.9.

76. A capital account represents a partner's equity in the partnership and initially equals the sum of money and fair market value of property contributed to the partnership. A partner's share of partnership profits increases his capital account while his share of losses decreases it. Any distribution decreases the capital account while additional contributions increase it. A partner's capital account does not necessarily equal the basis for his partnership interest. Treas. Reg. § 1.705-1(a)(1) (1960). However, a partner's basis generally will equal the amount of his capital account and share of partnership liabilities. W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 58, ¶ 6.05.

77. A payment keyed to partnership profits would not be a guaranteed payment under I.R.C. § 707(c). A partnership is not a taxable entity and the tax attributes of various items flow through to the partners; therefore, where it is desired that certain items flow through to a frozen partner in order to take advantage of such tax attributes, distributive share payments rather than guaranteed payments should be utilized. Abbin, *supra* note 7, ¶ 1805.10.



made noncumulative.<sup>78</sup> Because the payments are not dependent on the partnership's generation of income, they are more reliable than the analogous cumulative dividend rights (dependent upon corporate income) afforded a corporation's preferred stockholder. Therefore the guaranteed payments may aid strongly in supporting the value assigned to the frozen interest.<sup>79</sup>

The guaranteed nature of the payments, however, should immediately raise a precautionary flag in the farm and ranch context. The income generated by a farm operation is by no means stable from year-to-year, and the variability of agricultural earnings may actually be increasing.<sup>80</sup> Guaranteed payments set in excess of partnership income may impose a great economic burden on the successor-operator. Since arrearages for delinquent payments may be required, the partnership agreement should specify how to fund the arrearages, *e.g.*, when cash flow exceeds the current guaranteed payment level, by the sale of partnership property, or by additional contributions by regular partners. When such arrearages are finally paid, the frozen partner may be in a lower tax bracket than the regular partners;<sup>81</sup> however, if such arrearages can be funded only by selling partnership assets, some of which have appreciated in value, a "leak" in the freeze occurs to the extent that appreciation is used to pay the frozen partner.<sup>82</sup>

If the guaranteed payments are structured in such amounts that they exceed the income generated by the partnership, the value of the entire partnership may be includible in the estate of the frozen partner as a retained life estate.<sup>83</sup> Nevertheless, it has been suggested that it may be beneficial to set guaranteed payments at an amount greater than the partnership's current and short-term earnings potential.<sup>84</sup> Establishing guaranteed and cumulative payments in that manner would concentrate current value and some short-term earnings growth potential in the frozen interest, tending to support the position that such interest carries most of the partnership's current value, thereby avoiding any substantial gift tax liability upon creation.<sup>85</sup>

If guaranteed payments are used to provide cash flow to the parent-operator, a careful review of the farm's prior operating his-

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78. Nelson, *supra* note 2, at 102.

79. *Id.* See J. Eubank & J. Wallace, *supra* note 3, at 11.

80. D. Jewell & B. Johnson, *supra* note 12, at 9-10. The potential increasing variability may occur as "commodity markets take on world context and input price levels adjust abruptly." *Id.* at 10.

81. Abbin, *supra* note 7, ¶ 1802.2.

82. Carlson, *supra* note 36, at 11.

83. I.R.C. § 2036(a)(1). See notes 169-74 & accompanying text *infra*.

84. Abbin, *supra* note 7, ¶ 1802.2.

85. *Id.* See note 68 & accompanying text *supra*.

tory should be undertaken to insure that a realistic payment provision is established. Guaranteed payments can then be set either at a fixed dollar amount with provisions to increase the payment annually in accordance with cost-of-living increases, or at a specific percentage of the frozen partner's original capital account.<sup>86</sup>

There is an element of risk involved in the use of guaranteed payments. To qualify as a partner, an individual must share in partnership profits as a proprietor. Thus, if the frozen partner's only interest in the profits is a guaranteed payment, such interest may be akin to debt and he may not be deemed a partner but rather a creditor of the debtor-partnership.<sup>87</sup> In this event, the original contribution to the partnership may not be tax-free but may instead be deemed a sale.<sup>88</sup> To avoid the frozen partner's interest being classified as a debt, the guaranteed payments should be expressly subordinated to the claims of creditors and no fixed repayment schedule should be set for arrearages.<sup>89</sup> Active participation in the management of the partnership will also cut against creditor status; however, if the frozen partner's interest is a limited partnership interest, such participation would probably cause the frozen partner to lose his status as a limited partner. The debtor-creditor problem can be minimized by giving the frozen partner an equity "kicker"—a small interest in profits and possibly asset

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86. J. Eubank & J. Wallace, *supra* note 3, at 10-11. Disproportionate allocations under I.R.C. § 704(b) may be easier to justify when the frozen interest is structured and referenced to the frozen partner's capital account. Nelson, *supra* note 2, at 101.

87. See note 49 & accompanying text *supra*.

88. Treas. Reg. § 1.707-1(a) (1960). If sale treatment results, one commentator has suggested that the sale be deemed an installment sale with a contingent sales price as permitted under the Installment Sales Revision Act of 1980, I.R.C. § 453. Fiore, *supra* note 1, § 54.01, at 54-3 n.2. If the frozen partner is not considered a partner, the assignment-of-income principle, from which Subchapter K generally provides an exclusion, may apply. Nelson, *supra* note 2, at 104.

89. In *Hambuechen v. Commissioner*, 43 T.C. 90 (1964), the Tax Court considered whether advances made by a limited partner to his partnership were capital contributions or loans. The court stated the factors relevant to the issue of whether a debtor-creditor relationship was established for tax purposes included:

adequacy of the capitalization of the debtor, issuance of any notes, provision for and payment of interest, presence or absence of a maturity date, intention to repay, whether the alleged debt is subordinated to claims of outside creditors, whether outside creditors would have made similar advances under the circumstances, presence or absence of security for the alleged loan, reasonableness of expectation of payment, use to which the funds were put, and whether payment can only be paid out of future profits.

*Id.* at 99.

appreciation.<sup>90</sup>

## 2. Profits Share

In lieu of, or in addition to, any rights to guaranteed payments attached to the frozen interest, the frozen partner may be given an interest in partnership profits. With such an interest, there should be no question as to the frozen partner's status as a partner. An interest in profits provides greater flexibility than guaranteed payments, and, if keyed to a percentage of annual profits, may avoid the potential economic burdens associated with guaranteed payments as well as retained life estate problems. The use of a profits interest may be particularly suitable where the parent-operator desires to actively participate in farm management.

The Service will respect allocations of the various tax items if the partners are dealing at arms-length.<sup>91</sup> Therefore, the frozen partner's interest in profits need not be proportionate to his interest in partnership capital,<sup>92</sup> and there is no requirement that cash actually be distributed. Obviously, however, if cash is not distributed to the frozen interest the value of that interest will be diminished.<sup>93</sup> If the profits allocation is tied to a percentage of the frozen partner's capital account and cash is not distributed, the frozen partner's interest strongly resembles noncumulative, preferred stock.<sup>94</sup>

Several alternatives exist for structuring the profits allocation. A substantial share of profits up to a certain amount could be allocated to the frozen interest with minimal participation in profits beyond that amount.<sup>95</sup> Such an allocation would provide strong incentive for the successor, regular interest partners to expend substantial efforts to operate the farm efficiently in order to obtain profits in excess of the frozen partner's percentage. However, a "ceiling" on the frozen partner's share which is unrealistically high

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90. If the frozen partner is given at least a one percent regular interest, the Service will rule regarding the status of such partner. Rev. Proc. 17, 1974-1 C.B. 438.

91. Any such allocations must have substantial economic effect to be so recognized. See note 63 *supra*. Several factors considered by the Service when examining the validity of such allocations are listed in Treas. Reg. § 1.704-1(b)(2) (1964).

92. However, the family partnership rules may not respect such allocations and may require a reallocation of items for income tax purposes. See notes 110-23 & accompanying text *infra*.

93. Nelson suggests that if gift tax consequences are important in a particular partnership freeze, the allocation should contain a requirement that cash be actually distributed to the full amount of the allocation. Nelson, *supra* note 2, at 103. For the effect of diminished interest see text at notes 127-28 *infra*.

94. J. Eubank & J. Wallace, *supra* note 3, at 12.

95. *Id.*

when compared with current operating results, may diminish that incentive and, in addition, may enhance the threat of potential retained life estate problems.<sup>96</sup>

A second alternative for profits allocation in farm and ranch operations, which traditionally have had relatively low annual profits and currently have rapidly appreciating land values, would be to allocate to the frozen partner a large percentage of operating profits and a small percentage of capital gain.<sup>97</sup> Thus, the regular partner would be allocated a large percentage of capital gain. However, since the typical farm operation would not involve the sale of substantial amounts of land generating capital gain, the successor-operator, regular partner's cash flow presumably would arise through a salary paid by the partnership.

A third alternative would be to provide the frozen partner with an allocation of income equal to the amount of income produced by the contributed assets prior to the formation of the partnership, with all remaining income going to the growth interests.<sup>98</sup>

### 3. *Cash Flow Share*

Distributions of partnership money which are not guaranteed payments nor referenced to partnership income are treated as tax-free returns of basis.<sup>99</sup> Such distributions reduce the capital account of the distributee partner. If the frozen partner receives distributions which reduce his capital account, such reduction could impact adversely on the value initially assigned to the frozen interest. Therefore, the partnership agreement should provide for adjustments to rebuild the frozen partner's capital account. Distributions of cash flow to the frozen partner may be useful when the partnership has a positive cash flow but generates a tax loss. This situation could arise in a farm operation which has highly-mortgaged land and substantial relatively new machinery. A

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96. See notes 169-74 & accompanying text *infra*.

97. Nelson, *supra* note 2, at 103. Such an allocation may provide the parent with retirement income, with such distributions being subject to a lower tax rate if the parent is in a relatively low tax bracket. D. KELLEY & D. LUDTKE, *supra* note 22, § 7.41. Kelley and Ludtke suggest it may be necessary to allocate post-contribution capital gain and § 1231 gain to the growth units, presumably to prevent a claim that the frozen partner has an interest in appreciation. *Id.* § 7.31.

98. See P. Baker, *supra* note 63, at 9. However, such an allocation would be similar to that used in the factual situation of Priv. Let. Rul. 7824005, discussed in notes 169-74, *infra*, which caused substantial retained life estate problems.

99. I.R.C. § 731(a)(1). Gain will be recognized if the money distributed exceeds the distributee partner's adjusted basis in his partnership interest immediately prior to the distribution. The general nonrecognition rule applies to both current distributions and distributions in liquidation of a partner's complete interest in the partnership. Treas. Reg. § 1.731-1(a)(1)(i) (1960).

stable cash flow may be required to support the value assigned to the frozen interest; however, the frozen partner may be unwilling to take his distribution in the form of a guaranteed payment, taxable to him as ordinary income, when the partnership has had a taxable loss. A tax-free distribution of cash flow would avoid this result.<sup>100</sup>

#### 4. *Loss Shares*

Generally, since the regular partners have the right to future appreciation and bear the risk of future depreciation,<sup>101</sup> partnership losses should be allocated to their interests to the extent of their capital accounts. Allocating partnership losses to the frozen interest would be inherently inconsistent with freezing the value of that interest by establishing a preferential liquidation value.<sup>102</sup> Losses should be allocated to the frozen interest only after the capital accounts of the regular partners have been exhausted, making the frozen partner, in effect, a "second-tier loss bearer."<sup>103</sup> If losses are allocated to the frozen partner, the partnership agreement should provide for the subsequent readjustment of his capital account. In the event the frozen partner desires the allocation of some expected losses, they may be specially allocated to him (assuming substantial economic effect) at the potential cost of a reduction of the frozen interest to less than the original capital value assigned to it. This may generate gift tax problems. Where the frozen partner participates fully in losses but has limited rights to partnership income, the arrangement may be open to the argument that the partnership freeze constitutes an assignment of future income.<sup>104</sup>

#### 5. *Conversion and Liquidation Rights*

The frozen partner may be given a right to convert his interest into a regular interest. A conversion right may help ameliorate parent-frozen partner concerns about transferring all future appreciation in the operation. If the partnership agreement sets the conversion price at the amount of the regular interests, with a value

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100. Nelson, *supra* note 2, at 103. If future partnership income is subsequently allocated to the frozen partner to rebuild his capital account, the partner is then, according to Nelson, obtaining tax-free distributions against his share of future profits; an advantageous situation. *Id.* at 104.

101. See note 33 & accompanying text *supra*.

102. J. Eubank & J. Wallace, *supra* note 3, at 12.

103. Nelson, *supra* note 2, at 100-01.

104. Scheify, *supra* note 7, ¶ 503.3 n.9. Scheify states that if the assignment-of-income doctrine applies to the frozen partner, the interest is not frozen but will be required to share in future appreciation. *Id.* at n.10.

which equals the original value of the frozen partner's capital account, the conversion feature may aid in supporting the original value of the frozen interest for gift tax purposes.<sup>105</sup> It has been suggested that the conversion price should be set at the value of the regular units at the date of conversion,<sup>106</sup> apparently to prevent the frozen partner from losing any appreciation occurring between the date of formation of the partnership and the conversion date. However, unless such a conversion right is limited in time, it may be questionable whether any freeze has been accomplished; thus, this right, in effect to subsequent appreciation, may cause the frozen partner's share to be viewed as a retained life estate.

The frozen partner may also be given a right to require the partnership to liquidate his interest on demand. While a liquidation or "put" right may not be essential to establish a value for the frozen interest, if the partnership agreement affords the frozen interest a fixed, preferential liquidation position (such liquidation position being the key to freezing the interest), such a right may further support the interest's value. The "put" right guarantees liquidity to the frozen partner's interest, which is particularly important where the parent gives up control or family relationships may not remain harmonious. The partnership agreement may provide for payment of the frozen partner's interest on an installment basis, as the regular partners may be unable to satisfy the entire value of the frozen interest with liquid assets. Assuming stability of the underlying assets supporting the value of the frozen interest, an outside party should be willing to pay the full value of the frozen interest to obtain the "put" right for liquidation purposes, thereby establishing the value of the frozen interest at its capital account, and substantially reducing gift tax problems.<sup>107</sup>

#### D. The Regular/Growth Interests

The structure of the regular interests depends in large part upon the factual circumstances. If both on-farm and off-farm heirs exist, these interests could be divided into separate units, with control resting in one of them.<sup>108</sup> The regular interests may be general or limited partnership units, and should have a right to some current income to avoid retained life estate classification of the frozen partner's interest. Additionally, the regular interests will be entitled to future income (the amount depending on the structure of the frozen interest), losses, and appreciation.

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105. Fiori, *supra* note 1, ¶ 54.05[1].

106. Carlson, *supra* note 36, at 20.

107. Nelson, *supra* note 2, at 106.

108. See note 36 & accompanying text *supra*.

Special consideration must be given to the manner by which the regular partners acquire their interests. Generally, acquisitions may be by gift, purchase, or direct asset contribution. In the farm and ranch context, the regular partners frequently will be children of the frozen partner, and they may not have assets available to contribute to the partnership in exchange for their interests. The partnership may be structured so that the frozen interest bears most of the current value of the partnership upon formation, and the children acquire all the regular interests through a combination of minimal contributions and gifts from the parent who may utilize the present interest annual exclusion.<sup>109</sup> However, if the children acquire all or part of their interests through gifts from the parent, the effect of the family partnership rules must be determined.

### 1. *Family Partnership Rules*<sup>110</sup>

The family partnership rules are an exception to the general exemption from assignment-of-income principles provided by Subchapter K. The rules require that an individual meet certain tests to qualify as a partner for income tax purposes. If an individual is a donee of his partnership interest, his distributable share of income may require allocation to the donor-partner to the extent necessary to provide such partner with a reasonable compensation for services, and also to the extent that the donee's distributable share exceeds the donor's distributable proportionate share based on his initial capital contribution.<sup>111</sup>

For recognition as a partner, an individual must own a capital interest in a partnership in which capital is a material, income-producing factor. The interest may be acquired by purchase or gift<sup>112</sup> as long as the individual acquired it in a bona fide transaction and

109. I.R.C. § 2503(b). The annual exclusion is currently \$3,000 per donee, but it will increase to \$10,000 effective January 1, 1982. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 441, 50 U.S.L.W. 48. A present interest for purposes of the exclusion is defined as "[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from the property." Treas. Reg. § 25.2503-3(b) (1972). Arguably, the regular interests should have some right to current income to qualify as present interests.

110. I.R.C. § 704(e). A comprehensive analysis of the family partnership rules is beyond the scope of this Comment. For an excellent article on the subject, see Nash, *Family Partnerships—A Viable Planning Alternative?* 13 U. MIAMI EST. PLAN. INST. 1000 (1979).

111. Treas. Reg. § 1.704-1(e)(1)(ii) (1964). Such a reallocation may result in a constructive tax imposed on the donor on income received by the donee. This result may not be as disadvantageous as first appears, as the frozen partner can use up assets to pay taxes on income which is not includible in his estate, thereby effecting a tax-free, gift transfer. Nelson, *supra* note 2, at 109.

112. I.R.C. § 704(e)(1); Treas. Reg. § 1.704-1(e)(1)(ii) (1964). If the interest is

is the actual owner of the interest.<sup>113</sup> Capital is a material, income-producing factor if a substantial portion of the partnership's income is derived from the employment of capital in the business.<sup>114</sup> This test should be easily met by most farm partnerships. The "actual ownership" test may be more difficult to meet due to the mechanics of the capital freeze in the farm and ranch context, particularly where off-farm heirs hold interests. The regulations contain a comprehensive list of the factors to consider in determining whether the donee has acquired ownership of the capital interest.<sup>115</sup> For example, if the donor-parent retains certain controls over the interest, such as control of income distributions, the donor will be deemed the substantial owner of the interest.<sup>116</sup> Compliance with partnership formalities and treatment of the donee as an actual partner will aid in establishing partnership status.<sup>117</sup>

Where off-farm partners exist, the partnership agreement often will contain buy-sell agreements restricting the sale of the units to outsiders in order to assure that the farm remains in family hands. Such restrictions could lead to a determination that the donor has retained substantial control over the interests and is in essence the actual owner.<sup>118</sup>

Where one or more of the regular partners is a minor, the family partnership rules generally will not recognize the minor as a part-

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purchased by one family member from another, it shall be considered as being created by gift from the seller. I.R.C. § 704(e)(3).

113. Treas. Reg. § 1.704-1(e)(1)(iii) (1964). For a transfer to be recognized as a complete transfer of the partnership interest from the donor to the donee, such "transfer must vest dominion and control of the partnership interest in the transferee." *Id.*
114. Treas. Reg. § 1.704-1(e)(1)(iv) (1964). Borrowed capital may not constitute capital for § 704(e)(1) purposes. *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119 (1977). The *Carriage Square* case should impact mainly in farm partnership freezes where the regular-partner children are borrowing their initial contributions. If such contributions are small in proportion to total capital, *Carriage Square* may not apply.
115. Treas. Reg. § 1.704-1(e)(2)(i)-(x) (1964). In essence, it is ownership of the capital interest and dominion and control over such interest which is important, rather than the method of acquisition. I.R.C. § 704(e)(3); Abbin, *supra* note 7, ¶ 1805.5.
116. Treas. Reg. § 1.704-1(e)(2)(ii)(a) (1964).
117. *Id.* § 1.704-1(e)(2)(vi). Of primary importance is whether the donee has been publicly held out as a partner in the conduct of the business and in relationships with customers, creditors, or other financing sources. *Id.*
118. Treas. Reg. § 1.704-1(e)(2)(ii)(b) (1964) provides that a factor indicating substantial retained control by the donor is "[l]imitation of the right of the donee to liquidate or sell his interest in the partnership at his discretion without financial detriment." Treas. Reg. § 1.704-1(e)(2)(ix) (1964) provides further that "[i]f the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions . . . such restrictions . . . will be considered strong evidence as to the lack of reality of ownership by the donee."



ner unless control of the interest is vested in a fiduciary;<sup>119</sup> therefore, it is advisable to transfer the minor's interest to a trust established for his benefit both for purposes of the family partnership rules<sup>120</sup> and the present interest exclusion.<sup>121</sup>

The consequences of failing to meet the family partnership rules is the nonrecognition of the partnership for income tax purposes, requiring reallocation of income to the donor-frozen partner. That result, in the context of a farm and ranch partnership capital freeze, should not be particularly damaging in light of the generally low income generated by many of such operations and the overriding estate tax goal of shifting future appreciation. Since the family partnership rules relate to income tax consequences, nonrecognition of a partnership and reallocation of income from the donee to the donor should not affect the partnership freeze for estate and gift tax purposes<sup>122</sup> nor prevent future appreciation from attaching to the donee's partnership interest.<sup>123</sup>

## 2. *Acquisitions Other Than by Gift*

Upon formation, the individuals acquiring regular partner interests may purchase some or all of their interests from the frozen partner. If full and adequate consideration is paid, the value of the regular interests should not be included in the estate of the parent-

119. Treas. Reg. § 1.704-1(e)(2)(viii) (1964).

120. A trustee may be recognized as a partner if he is unrelated to and independent of the grantor, and actually participates as a partner. Treas. Reg. § 1.704-1(e)(2)(vii) (1964). Possible application of the grantor trust rules in this context should also be examined. See L.R.C. §§ 671-678.

121. L.R.C. § 2503(c).

122. Nash, *supra* note 110, ¶ 1018. Compare, however, *Aldrich v. United States*, 346 F.2d 37 (5th Cir. 1965), in which the court considered whether a spouse had a valid interest in her decedent-husband's partnership sufficient to exclude her share of the partnership from the one-half of their community property included in his estate. The court, citing from the government's brief, said:

The courts have not developed a rule against estate tax splitting similar to the income tax rule because estate taxes apply whether the property owned at death was acquired through earnings or by gift. The splitting of an estate by giving away property prior to death is not considered to be tax avoidance (where the gift is not in contemplation of death) because the gift is subject to a separate tax and because the estate tax is limited to transfers on death.

*Id.* at 39 (footnotes omitted). The court continued: "[t]he government concedes, and we think properly so, that because of the nature of the two taxes the [family partnership] rule applicable to income taxes does not apply to estate taxes." *Id.* at 38.

123. Several commentators have suggested the family partnership rules could require a continual readjustment of current income allocable to the donor-frozen partner based on the appreciation occurring in the value of the partnership's assets. Fiore, *supra* note 1, ¶ 54.04[2] (citing Nelson, *supra* note 2, at 109, and W. McKee, W. Nelson & R. Whitmire, *supra* note 58, ¶ 14.05).

frozen partner as a retained life estate.<sup>124</sup> However, the family partnership rules would remain applicable.<sup>125</sup> A better alternative, well-suited for on-farm heirs who have acquired farm-related assets, would be direct contributions of those assets to the partnership in exchange for regular interests. Direct contributions would bypass the family partnership rules and avoid some of the potential exposure under the retained life estate rules.

## E. Valuation

Establishing an appropriate value upon creation of the regular and frozen interests is of critical importance in structuring a partnership capital freeze.<sup>126</sup> Value used in this context is fair market value.<sup>127</sup> Where the value of the frozen unit is subsequently determined to be less than that assigned it upon creation, an imputed gift will be deemed to have been made to the regular partners. If the frozen unit is structured to generate returns in excess of income available for distribution on the frozen unit, the entire value of the partnership could be exposed to tax in the frozen partner's estate under section 2036,<sup>128</sup> thereby frustrating the effect of any

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124. I.R.C. § 2036(a). The sale could be structured as an installment sale, using an interest-free note, with the parents forgiving the annual installments. An installment sale would be a device to bring children with few assets into the partnership; however, the transaction may be questioned as to whether an actual sale (versus a gift) occurred, whether adequate consideration was paid, and other similar arguments. The regulations require that a purchase of a family partnership interest be accompanied by all the usual characteristics of an arm's-length transaction. Treas. Reg. § 1.704-1(e)(4)(i)(ii) (1964).

125. I.R.C. § 704(e)(1).

126. According to one commentator: "Probably no single greater hazard is presented to a partnership capital freeze than erroneous valuation." Scheifly, *supra* note 7, ¶ 502.2.

127. Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b) (1965).

128. I.R.C. § 2036(a). Section 2036(a) provides:

(a) GENERAL RULE.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

*Id.*

freeze.<sup>129</sup> Therefore, an inherent trade-off between gift and estate taxes exists in structuring the interests, as attempts to minimize the potential exposure to one tax tend to maximize potential exposure to the other.<sup>130</sup>

The frozen interest will consist of two primary valuation items: the right to current income (the rate of return or yield) and the preferential liquidation position. The various rights accompanying the frozen interest will aid in supporting its value.<sup>131</sup> Generally, upon formation of a partnership capital freeze, care should be taken to assign as much of the value of the business as possible to the frozen interest, thereby reducing the gift tax exposure when the regular partners receive their interests. However, it should not be assumed that the frozen interest can automatically absorb all the present value of the business upon formation. Rather, practical considerations such as the pre-partnership rate of return for the business and its future financial outlook may not justify such an assignment. While valuation of a farm operation may be relatively simple in terms of establishing the value of farmland and other major assets contributed to the partnership, the valuation of the frozen interest by assigning it a high income yield, *e.g.*, ten to fifteen percent, may be difficult to justify in view of the traditional low rate of return for farms.<sup>132</sup>

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129. If the frozen interest is assigned a value in excess of the value of the business, much of the current value of the business will be embodied in that interest. However, a freeze has not occurred as to the excess because future appreciation (up to the initial value assigned the frozen interest) will inhere in the frozen interest to support the initial valuation placed upon it. Meyers, *Valuation Problems in Preferred Stock Recapitalizations and Estate Freezing Techniques*, 1980 U. MIAMI EST. PLAN. INST. 1-221, 1-224, App E (1980).

130. The Economic Recovery Tax Act of 1981 raised the unified credit from \$47,000 to \$192,800 (an exemption equivalent to \$600,000) for the tax year beginning in 1987. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 401, 50 U.S.L.W. 41. There is a six-year phase-in period during which the unified credit and exemption equivalent will equal the following amounts: 1982: \$62,800, \$225,000; 1983: \$79,300, \$275,000; 1984: \$96,300, \$325,000; 1985: \$121,800, \$400,000; 1986: \$155,800, \$500,000. *Id.* This liberalization of the estate tax should make taxpayers less reluctant to attempt the various freeze techniques as "erroneous" valuations may not result in the imposition of tax. *Id.*

131. See notes 171-74 & accompanying text *infra*. By structuring management and voting rights, the attendant estate tax problems can be avoided or at least mitigated.

132. Generally, preferred stock with a value equal to its par value will have asset and income coverage ratios of 2:1. Scheify, *supra* note 7, ¶ 502.2. Scheify has suggested that preferred stock or frozen partnership interests are inherently limited to absorbing only 60-70% of the value of a business, since discounts on the value are required when asset and income coverage drop below 2:1. *Id.* Meyers states it is virtually impossible for preferred stock to absorb the entire value of a business. Meyers, *supra* note 129, at 1-222. Meyers states further that by definition, the mere fact that a freeze is being attempted

Because partnership capital freezes are relatively new, no direct authority exists for establishing the value of a frozen interest. However, the similarity of such an interest to preferred stock may render analogous preferred stock valuation principles. Major factors affecting preferred stock valuation include: 1) the strength of the liquidation preference (measured by the available net worth and termed "asset coverage"); 2) the preferred income position (determined by available earnings and termed "income coverage"); 3) the yield or rate of return; and 4) the premiums or discounts afforded for special features of the stock (*e.g.*, voting rights, "put" rights, and management rights).<sup>133</sup>

The problem in valuing a frozen interest in a farm partnership lies in the great disparity between the relatively large value of the partnership assets (due to the built-in appreciation in land contributed to the partnership) and the low rate of return on farm operations, traditionally around four percent.<sup>134</sup> The problem can be illustrated through a simple example. Assume Mom and Dad have an average-size Nebraska farm of 700 acres with a conservative value of \$525 per acre.<sup>135</sup> They contribute to a partnership the farmland and machinery worth \$50,000 for a capital account of \$417,500, in return for a frozen interest. If the frozen interest were given an annual guaranteed payment equal to four percent of Mom and Dad's capital account, they would be entitled to \$16,700 annu-

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makes the growth interests worth something since substantial appreciation apparently is expected. *Id.* at 1-223. Another commentator, reviewing recent case law, states that common stock issued in an estate freeze corporate recapitalization will have a "significant value" and suggests a minimum floor on the value of such common stock of at least 10% of the business' value. Covey, *Recent Developments Concerning Estate, Gift and Income Taxation—1978*, 1979 U. MIAMI EST. PLAN. INST. 1 (1979).

133. Scheify, *supra* note 7, ¶ 502.2. The Service has enumerated the factors to consider in valuing the stock of a closely-held company, including, *inter alia*, the nature of the business, the general outlook for the economy and the industry involved, the book value and financial condition of the company, the earning capacity, the dividend-paying capacity, the presence of goodwill and other intangible factors, the sales price of the stock being valued and the market prices of comparable securities. Rev. Rul. 60, 1959-1 C.B. 237, *modified by* Rev. Rul. 193, 1965-2 C.B. 370. The latter revenue ruling was amplified by Rev. Rul. 287, 1977-2 C.B. 319.

134. Interview with Bruce Johnson, Associate Professor in the Department of Agriculture Economics, University of Nebraska-Lincoln, in Lincoln, Nebraska (Apr. 10, 1981). This figure tracks closely an indicator of the rate of return for agricultural operations—the average *gross* cash rents as a percentage of land value. In Nebraska for the 1978-80 period the ratio of *gross* rents to land value for irrigated land, dry cropland, and grazing land was 6.9%, 6.1%, and 4.9% respectively. B. Johnson & R. Hanson, *supra* note 13, at 27.

135. See notes 9-12 & accompanying text *supra*. It should be noted that the \$525 figure is based on 1978 statistics. Irrigated farmland may sell for \$2000-3000 per acre today.

ally. An income coverage of two to one would require the partnership to generate annual income of \$33,400 to make the annual payment. However, the average net income per Nebraska farm in 1978 was only \$12,768,<sup>136</sup> indicating there may not be income coverage adequate to avoid a discount. Thus, in valuing Mom and Dad's frozen interest, the question becomes whether a buyer would be willing to purchase, at the stated capital account amount, an interest with a fixed liquidation position, no appreciation possibility, and a rate of return of four percent when current market rates range from fourteen to sixteen percent. Assuming a reasonable investor would not be willing to purchase the interest for that price, then it becomes worth something less, but the question remains—worth what? Often the question may be answered only with the aid of an independent appraiser or investment banker. The practitioner is well-advised to enlist the aid of such an individual, particularly where potential gift tax exposure is substantial.

It is important to establish in the partnership agreement a liquidation preference for the frozen interest. Liquidation rights have been termed "the keystone to valuation of frozen interests."<sup>137</sup> A "put" right will aid in supporting the value of the interest to the amount of proceeds payable to the frozen partner upon liquidation. The crux of the estate freeze lies in the liquidation preference—if the upside potential (appreciation) is taken away, it is absolutely essential to also remove the downside risk in order to support the valuation of the interest.<sup>138</sup> Subchapter K provides that payments in liquidation of a partner's interest can be divided into two categories: 1) payments for the partner's interest in partnership property, which are treated like usual partnership distributions, *i.e.*, generally tax-free;<sup>139</sup> and 2) all other payments, which are determined with or without regard to partnership property.<sup>140</sup> Payments for the retiring partner's interest in partnership property generally receive capital treatment while other distributions normally yield ordinary income. Therefore, it would appear most beneficial if the frozen partner received liquidating distributions as payments for his interest in partnership property. The partnership agreement should establish the amount of such payments and such valuation of the partner's interest in partnership property will be regarded as "correct" if the agreement is at arms-length.<sup>141</sup>

136. 1978-1979 Annual Report, Nebraska Agricultural Statistics 154, Neb. Dept. Agriculture (July 1980).

137. J. Eubank & J. Wallace, *supra* note 3, at 15.

138. *Id.* at 16; Meyers, *supra* note 129, at 1-225.

139. I.R.C. § 736(b).

140. *Id.* § 736(a).

141. Treas. Reg. § 1.736-1(b)(1) (1965).

An alternative to liquidating a frozen partner's interest would be to provide for its purchase by other partners.<sup>142</sup> A purchase on an installment basis would probably be required to enable the successor-children to obtain the frozen interest. Frequently, in closely-held businesses, the ownership interests will be subject to limitations to prevent their transfer to individuals foreign to the immediate circle of ownership. Buy-sell agreements typically provide that an individual who desires to sell his interest and finds a willing third-party purchaser must give the other owners a right of first refusal. An interest may be further restricted by options held by other owners to purchase the interest upon the occurrence of certain conditions at a price set in an option agreement.<sup>143</sup> The regulations state that such restrictions will be a factor in valuing ownership interests and suggest that the validity of an option is contingent upon the existence of a business purpose and fair and adequate consideration being exchanged for the option.<sup>144</sup> A sufficient business purpose in the farm and ranch context should be the preservation of the farm in family hands<sup>145</sup> or the inducement for younger generation family members to become actively involved in the operation. Sufficient consideration should exist in the mutual covenants made by the parties to the option agreement if such parties held equity ownership interests upon execution of the agreement.<sup>146</sup>

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142. For a comparison of the tax consequences of liquidations and purchases of partnership interests, see W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 58, ¶ 15.02[2].

143. The value of an option exercisable in all events could be includible in the estate of an individual owning such option at death. Rhodes, *How to Reduce the Value of Farms and Other Closely-held Businesses While Keeping Assets*, 7 EST. PLAN. 38, 38-39 (1980). Rhodes suggests as possible conditions to the exercise of options, the death of a partner or an intention to sell the interest to an outside party. *Id.* at 38.

144. Treas. Reg. § 20.2031-2(h) (1970).

145. Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977); Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970).

146. Rhodes, *supra* note 143, at 39. It has been held that an option agreement included in a partnership agreement established the value of a decedent's partnership interest at the option price, even though it was less than the fair market value of the interest at the date of death. Florito v. Commissioner, 33 T.C. 440 (1959). The partnership agreement provided that the option was exercisable for 90 days from the end of the month in which the managing partner died, and the purchase price was related to the capital account of the managing partner as of the date of death. The court said:

But even though the price set in the agreement relates only to the price to be paid for an interest after the death of a partner, if the agreement effectively restricted a partner's right to sell his interest prior to death, the value of the partnership interest for estate tax purposes is limited by the option price for purchase of the interest after his death.

Where the partners are concerned about the value assigned to a frozen interest, a clause may be included in the partnership agreement which: 1) requires a partner to make additional capital contributions should the Service determine that the value of his interest is different than the partnership agreement provides;<sup>147</sup> or 2) allows the frozen partner the payment of interest on contributed capital should subsequent events render the rate of return on the frozen interest inadequate for the maintenance of the frozen partner.<sup>148</sup> With limited exceptions, a three-year statute of limitations exists in which the Service can revalue the fair market value of gifted property and correspondingly adjust the gift tax paid.<sup>149</sup> However, the statute begins to run only if and when a gift tax is actually paid.<sup>150</sup> Since the unified credit against the gift tax is not elective<sup>151</sup> and assuming no previous gifts have been made, a substantial gift to the regular partners would be required to cause the statute to begin running.<sup>152</sup>

While it is important upon the formation of the partnership to design the frozen interest with features which enable it to absorb as much of the current value of the farming operation as possible, it may be equally important, upon the death of the frozen partner, to argue that the nature of the interest requires a discount in its valuation. In the closely-held corporation context, courts frequently allow discounts on minority interests due to their lack of marketability. By analogy, discounts should be permitted on a frozen partnership interest, particularly where the frozen partner has limited or no voting and management rights.<sup>153</sup> In two reported

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*Id.* at 445-46. The option, therefore, should restrict transferability both during a partner's lifetime and at death. See also *Estate of Weil v. Commissioner*, 22 T.C. 1267 (1954).

147. See *King v. United States*, 545 F.2d 700 (10th Cir. 1976). The taxpayer in *King* created four trusts for his children and sold certain stock to the trusts. Letter agreements between the taxpayer and trustee required the readjustment of the purchase price to the fair market value of the stock if subsequently determined by the Service to vary from the initial value determination. The *King* court held the revaluation clause sufficient to defeat any Service claim that gift tax liability existed based on the original purchase price. It should be noted that the Service will not rule for purposes of private requests on valuation amounts. Rev. Proc. 6, 1969-1 C.B. 398.

148. Carlson, *supra* note 36, at 19.

149. I.R.C. § 6501(a). If a substantial omission of items subject to estate and gift tax occurs, a six-year statute may be applicable. *Id.* § 6501(e)(2).

150. *Id.* § 2504(c); Treas. Reg. § 25.2504-2 (1972).

151. I.R.C. § 2505(a). See note 130 *supra*.

152. The \$47,000 tax credit provided in I.R.C. § 2505(a) equals approximately \$175,625 in value of property gifted. The tax credit will be different under the Economic Recovery Tax Act of 1981. See note 130 *supra*.

153. See Comment, *Estate and Gift Tax Valuation: Discounts of Partnership Interests*, 59 NEB. L. REV. 737 (1980). The author states that since a frozen inter-

cases, *Estate of Bischoff v. Commissioner*<sup>154</sup> and *Estate of Brown v. Commissioner*,<sup>155</sup> discounts of partnership interests were permitted. The availability of a discount on a frozen interest would depend on the factual circumstances, including any voting, management or dissolution rights held by the frozen partner.

#### F. Type of Partnership

A capital freeze can be achieved with either a general or a limited partnership.<sup>156</sup> Selection of the type of partnership is a function of practical<sup>157</sup> and tax<sup>158</sup> considerations. Where off-farm children will receive regular interests, a limited partnership may be appropriate because it permits such children to receive limited partnership growth units without management participation. A limited partnership more closely resembles a corporation than a general partnership. Because no direct authority for partnership capital freezes exists, that resemblance alone may encourage the use of a limited partnership so analogy to corporate recapitalization principles and case law can be utilized in valuation and other "gray" areas. The limited partnership also provides greater flexibility in structuring ownership and control. Use of certificates representing units of limited partnership ownership would facilitate any gifting program employed as part of the capital freeze.

A limited partnership can be formed with as few as two part-

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est carries a relatively low rate of return with no opportunity for sharing appreciation it might justify being discounted due to lack of marketability; however, other features such as the priority to income and capital distributions afforded the frozen interest enhance its value and cut against discount application. *Id.* at 754-55.

154. 69 T.C. 32 (1977). The Tax Court in *Bischoff* allowed a 15% discount on limited partnership interests because of their lack of management rights and inability to compel dissolution. *Id.* at 49.

155. 36 T.C.M. (CCH) 375 (1977) (discount permitted due in part to decedent's minority interest in general partnership).

156. A revised version of the Uniform Limited Partnership Act was adopted by the first session of the eighty-seventh Nebraska legislature, approved by Governor Thone on March 16, 1981, and becomes operative as of January 1, 1982. Act of Mar. 16, 1981, L.B. 272, 87th Neb. Legis., 1st Sess. (codified at NEB. REV. STAT. §§ 67-233 to -297 (Supp. 1981)). Since this revision will repeal the Uniform Limited Partnership Act, NEB. REV. STAT. §§ 67-201 to -232 (Reissue 1976 & Cum. Supp. 1980), all references in this Comment to the statutory requirements for limited partnerships will be under the new Act.

157. For an excellent discussion of the use of limited partnerships in the farm context, see Comment, *Limited Partnerships: Estate Planning Vehicle for the Family Farm*, 59 NEB. L. REV. 55 (1980). See also Bock, *Formalizing the Farm Partnership*, 54 NEB. L. REV. 558 (1975); Dahl & Burke, *The Use of Limited Partnerships in Upper Midwest Agriculture*, 1979-80 AG. L.J. 345 (1980).

158. Banoff, *Tax Distinctions Between Limited and General Partners: An Operational Approach*, 35 TAX. L. REV. 1 (1979).



ners—one general and one limited.<sup>159</sup> Since individuals can be both general and limited partners,<sup>160</sup> a parent unwilling to relinquish complete control may remain as a general partner. The partnership agreement can provide any or all of the limited partners with the right to vote on any matter.<sup>161</sup> A limited partner will lose his status as a limited partner by participating in the control of the business; however, if such participation is not substantially the same as that exercised by the general partner, limited partner status is lost only with respect to third parties who transact business with the limited partnership with knowledge of the limited partner's participation in control.<sup>162</sup> Merely being an employee of, or consulting and advising the limited partnership, does not cause a loss of limited partner status.<sup>163</sup>

A primary disadvantage of a general partnership is the ability of any partner to force a dissolution of the partnership.<sup>164</sup> A dissolution could completely frustrate many of the goals and objectives of the partnership capital freeze. A limited partner may withdraw upon the occurrence of events specified in the certificate of limited partnership and in accordance with the partnership agreement.<sup>165</sup> If no such events are specified, a limited partner may withdraw upon six months notice to the general partner.<sup>166</sup> Therefore, it is imperative that the partnership agreement expressly state that the limited partner has no dissolution rights, if that is the parties' intention.

One drawback of the limited partnership is the possibility that it may be deemed an association taxable as a corporation.<sup>167</sup> Generally, this treatment will occur if the limited partnership has a majority of the following factors: continuity of life, free transferability of interests, limited liability, and centralized management.<sup>168</sup> If the duration of the entity is limited in the partnership agreement

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159. NEB. REV. STAT. § 67-240 (Supp. 1981).

160. *Id.* § 67-251(a).

161. *Id.* § 67-250.

162. *Id.* § 67-251(a).

163. *Id.* § 67-251(b)(2). However, as discussed earlier, limited liability in the context of a farm limited partnership may be illusory. See note 46 & accompanying text *supra*.

164. D. KELLEY & D. LUDTKE, *supra* note 22, § 7.29.

165. NEB. REV. STAT. § 67-265 (Supp. 1981).

166. *Id.*

167. *Cf. Morrissey v. Commissioner*, 296 U.S. 344 (1935) (business trust deemed an association taxable as a corporation); *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954) (medical clinic operated as an association taxable as a corporation).

168. Two other enunciated "factors," associates and an objective to carry on a business, are excluded since common to all corporations and partnerships.

and restrictive buy-sell or option agreements are employed, the association issue should not cause problems.

### G. Estate Tax Implications

The primary purpose of the partnership capital freeze—transferring the future appreciation to others—can be totally frustrated if section 2036 applies and the frozen partner is deemed to have retained a life estate with respect to the regular partnership interests.<sup>169</sup> Application of section 2036 could cause the inclusion of all or most of the value of the regular interests in the frozen partner's estate. Concern over the applicability of section 2036 was recently increased because of a private letter ruling which could seriously affect the viability of a partnership capital freeze in the farm and ranch context.

#### 1. *Private Letter Ruling 7824005*<sup>170</sup>

The facts underlying the ruling were as follows. In 1973 the decedent-widow transferred her 811-acre farm to a limited partnership making herself the sole general partner and her heirs and herself limited partners. The land was leased to others and not actually farmed by the partnership. The partnership agreement provided that sixty percent of the land was the decedent's contribution as general partner, twenty percent was decedent's contribution as limited partner, and twenty percent was the heirs' contribution as limited partners. As general partner, the decedent had the power to manage, encumber, or sell the property and to determine whether to distribute or accumulate partnership profits. The decedent received an annual salary of \$12,000 as a guaranteed payment and continued to reside on the farm. She subsequently

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169. For the text of I.R.C. § 2036(a), see note 128 *supra*. I.R.C. § 2036(b) provides:

(b) Voting Rights.—

(1) IN GENERAL.—For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

(2) CONTROLLED CORPORATION.—For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

(3) COORDINATION WITH SECTION 2035.—For purposes of applying section 2035 with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.

170. Priv. Let. Rul. 7824005 (Mar. 2, 1978).

transferred her limited partnership interest to the other limited partners.

The Service ruled that the value of all the limited partnership interests gratuitously transferred to her heirs was includible in her estate. The Service said the partnership was not formed exclusively for business purposes and the limited partners contributed nothing in exchange for their interests. It found the salary paid to the decedent was not compensation for services rendered, but rather a mere conduit for lease payments. The effect of the guaranteed payment and a sixty percent interest in profits was a retention of substantially all the net income from the property. Additionally, the decedent's continued residence on the farm was deemed the retention of another portion of the farm's income potential.

The impact of the letter ruling on capital freezes in the farm and ranch context is potentially devastating. If the frozen unit is structured so as to absorb substantially all of the partnership's net income, a retained life estate could be found, bringing part or all of the value of the regular partnership interests back into the frozen partner's estate. Conversely, a frozen interest created with lesser income rights may be insufficient to support the value assigned to the interest. In many farm and ranch freezes children, as regular partners, receive their interests gratuitously and the frozen partner often desires to continue residing in the farm residence. According to the Service, both are evidence of a retained life estate.

Several precautionary measures should be taken to mitigate the potential consequences of the letter ruling. If successor-children have substantial assets, they should make direct contributions of such assets to acquire regular interests, or purchase such interests for full and adequate consideration. The frozen partner may be given limited partnership interests to limit the extent of his control, or general partnership interests with limited managerial rights and little or no control over distributions. It has been suggested that any decision-making powers held by the frozen partner should be limited to an ascertainable standard.<sup>171</sup> The donor's retention of management or investment powers over gifted property should not cause the application of section 2036 or section 2038.<sup>172</sup> The frozen unit should be designed so that it does not receive substantially all of the partnership income for any prolonged period of time.<sup>173</sup> The partnership agreement could limit the right

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171. Fiore, *supra* note 1, ¶ 54.05[3].

172. R. STEPHENS, G. MAXFIELD & S. LIND, *FEDERAL ESTATE AND GIFT TAX* ¶ 4.08[6][a] (1978).

173. Abbin states that retention of most or all of the income for some period of time should not cause § 2036 problems because of the *quid pro quo* given the

to retain and accumulate income.

While there is no guaranteed route to avoid the retention problem, individuals who structure partnership capital freezes prior to further amplification or explanation of the letter ruling are advised to proceed with caution and to observe all partnership formalities. Perhaps the best route is to give the frozen partner a limited partnership interest to limit his control rights, and possibly, if off-farm children exist, use a three-class partnership.<sup>174</sup> The successor-operator would be the sole general partner and the off-farm children and parent would take different classes of limited partnership units with the parent's frozen in value.

#### H. Section 2032A—Special Use Valuation

Election of special use valuation for farmland under section 2032A can substantially reduce the size of the estate which is subject to estate tax.<sup>175</sup> Section 2032A applies specifically to the valuation of "qualified real property;"<sup>176</sup> therefore, the application of the section to farm partnership interests which indirectly represent ownership in qualified real property must be examined. Presumably, the farm frozen capital partnership will own assets, *e.g.*, machinery, supplies, livestock, in addition to any qualified real property. Unless partnership assets are distributed prior to the decedent's death, the decedent's estate will not directly include the value of such assets; rather, the partnership interest which represents the right to share in partnership assets and income will be includible.<sup>177</sup> However, a valuation of a partnership interest necessarily requires a consideration of the underlying partnership assets.<sup>178</sup>

Prior to analyzing what effect section 2032A may have on the valuation of a frozen interest, an initial determination of the application of special use valuation in the partnership context must be made. Section 2032A expressly authorizes the Secretary to prescribe regulations detailing the application of the section in the

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regular partners—the potential for future appreciation. Abbin, *supra* note 7, ¶ 1806.1. *Contra*, Schiefly, *supra* note 7, ¶ 510.2.

174. See note 54 *supra*.

175. See note 6 *supra*. The Economic Recovery Tax Act of 1981 made several technical and substantive changes to § 2032A, several of which apply retroactively to estates of decedents dying after 1976 and for which a timely special use valuation election was made. The changes generally are beneficial to the farmer or rancher since qualification under the section is made easier. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421, 50 U.S.L.W. 43.

176. I.R.C. § 2032A(a)(1).

177. Rev. Rul. 154, 1968-1 C.B. 395.

178. *Id.*

case of a partnership interest.<sup>179</sup> The regulations provide that the same material participation requirements<sup>180</sup> exist where property is owned by a qualified closely-held business as where the property is directly owned.<sup>181</sup> Where property is owned by a partnership, the regulations state "participation in the management and operation of the real property itself as a component of the closely held business is the determinative factor."<sup>182</sup> Merely having the status of a partner and sharing in profits and losses is not sufficient to support material participation.<sup>183</sup> In many farm partnership capital freezes, material participation by the frozen partner-operator will not be difficult to establish as such individual will continue to be actively involved in the day-to-day operations of the farm. Problems arise when the frozen partner retires from farming while retaining his partnership interest for income flow purposes. In such a situation, the frozen partner still can materially participate through advice and consulting arrangements and provision of necessary financial resources.<sup>184</sup>

Assuming a decedent-frozen partner has met the material participation requirement (and all other requirements of section

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179. I.R.C. § 2032A(g).

180. I.R.C. § 2032A(b)(1)(C)(ii) states that, in order for qualified real property to obtain special use valuation, the following condition must be met: during the eight-year period ending on the date of the decedent's death (or, under § 421 of the Economic Recovery Tax Act of 1981, the date the decedent became disabled or retired) there must have been periods totalling at least five years during which "there was material participation by the decedent or a member of the decedent's family in the operation of the farm." (emphasis added). I.R.C. § 2032A(e)(6) provides that § 2032A material participation shall be determined in the same manner as under § 1402(a) concerning net earnings from self-employment. Treas. Reg. § 1.1402(a)-2(a)(4) (1974) states several factors indicating material participation in the farm context, including: periodic consultations, inspections and rendering of advice, furnishing substantial portions of the machinery, implements, or livestock required, and furnishing, advancing, or assuming responsibility for a substantial part of the expenses incurred for commodity production.

Section 1402(a), however, expressly prohibits an owner from materially participating through the activities of an agent. I.R.C. § 1402(a)(1)(B). Section 2032A permits an individual to qualify through the material participation of a family member, who in such a situation could be an agent. *Id.* § 2032A(b)(1)(C)(ii).

181. Treas. Reg. § 20.2032A-3(f)(2) (1980).

182. *Id.*

183. *Id.*

184. Obviously, where the frozen partner retires and moves some distance from the farm, his material participation will be more difficult to establish. In that situation, careful documentation of the frozen partner's activities should be made. The Economic Recovery Tax Act of 1981 permits a member of the decedent's family, rather than the decedent alone, to use property in a qualified use. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421, 50 U.S.L.W. 43-45.

2032A), the relationship between the frozen value and special use valuation is critical. Valuation of the frozen interest (at least its "claim" on partnership land) under section 2032A could be accomplished in one of two manners. The value of the entire farm could be determined under section 2032A with a portion of that value, based on the frozen interest's proportionate capital account, assigned to the frozen interest. Alternatively, a portion of the farm land (determined in the same proportion to total farm acreage as the frozen interest's capital account bears to the combined capital accounts of all partners) could be separately valued, with that value assigned to the frozen interest. Presumably, no great difference should arise between the two methods.

If the frozen interest can be given a value through section 2032A valuation, the question remains whether that value or the value for the frozen interest established in the partnership agreement should control.<sup>185</sup> If the frozen interest has a liquidation preference of \$400,000, for example, and special use valuation will result in a higher figure, such valuation probably should not be elected. Where it appears the resulting values will be similar, or that special use valuation will be substantially lower, an executor should at least attempt to value the frozen interest under section 2032A. Since an election under section 2032A is irrevocable,<sup>186</sup> the executor should make a protective election<sup>187</sup> to avoid the risk that the frozen interest will eventually be accorded a value in excess of that established in the partnership agreement. A protective election makes the application of special use valuation contingent upon the values, as may be finally determined, complying with the requirements of section 2032A. Once this valuation is determined, an additional sixty days exists to make the irrevocable final election to apply special use valuation,<sup>188</sup> thereby giving the executor some flexibility (in absence of guidance from the Service or court rulings) in determining the value of the frozen interest.

#### IV. CONCLUSION

If farmland continues to appreciate at the dramatic rate seen during the 1970's, the need for more sophisticated estate planning for farmers and ranchers will intensify. A partnership capital freeze, though yet to be tested by judicial interpretation, appears to be a viable technique for attempting to limit the value of an individual's estate. The flexibility inherent in the partnership vehicle

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185. No authority apparently exists on this issue.

186. Treas. Reg. § 20.2032A-8(a)(1) (1980).

187. Treas. Reg. § 20.2032A-8(b) (1980).

188. *Id.*

makes it particularly well-adapted for application in the farm and ranch context. Individuals contemplating the use of freeze techniques should, however, pay careful attention to developments and refinements of such techniques which are certain to arise in the immediate future.

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