McDonald & Kanyuk PLLC
ATTORNEYS AT LAW

CLIENT BULLETIN
August 2016

IRS Proposed Regulations
Target Wealth Transfer Tax Valuation Discounts

Bottom Line: Consider Making Hay while the Sun Still Shines on Discounting

A. Executive Summary

- Long-awaited proposed Treasury Regulations, issued this month, will severely limit wealth transfer tax valuation discounts for transfers of interests in closely-held entities if they are made final in their current form.

- After a 90-day comment period, the Treasury Department will hold a public hearing on the proposed regulations on December 1, 2016. Uncertainties remain regarding the specifics of any final regulations, which probably will be effective in early 2017.

- The proposed regulations seek to significantly limit valuation discounts for transfers of interests in closely-held businesses. If you are considering transferring an interest in a partnership, limited liability company ("LLC"), or S corporation to family members or to irrevocable trusts, consider completing it sooner rather than later to have a chance to get it in under the wire.

B. Detailed Analysis

1. Background

In 1990, Congress enacted Chapter 14 of the Internal Revenue Code. Chapter 14 includes sections 2701 through 2704 of the Code, and was intended to prevent the use of estate planning techniques designed to "freeze" the value of assets, and reduce the gift and estate (or "transfer") tax costs of transferring those assets to family members, *without* reducing the economic benefit received by those family members. In particular, Code §2704 was meant to limit the valuation discounts for transfers among family members of interests in "closely-held," corporations and partnerships. §2704(a) generally treats the lapse of a voting or liquidation right in a corporation or partnership right as a transfer subject to gift or estate tax, if the family controls the entity both before and after the transfer. Under §2704(b), if: (1) an interest in a family-owned corporation or partnership is transferred within the family, (2) the ability of the corporation or partnership to liquidate is restricted, and (3) that restriction can be removed by the

family, then the restriction is disregarded for purposes of determining the gift or estate tax value of the transferred interest. Exceptions to these rules currently allow individuals to take advantage of valuation discounts if the restrictions are imposed by federal or state law (and the laws of many states, including New Hampshire, do impose restrictions on liquidation).

We at McDonald & Kanyuk, PLLC have been expecting these regulations for some time now. The Treasury Department and Internal Revenue Service (IRS) have prioritized this project every year since 2003. The Obama Administration's annual budget proposals from 2009 through 2012 recommended that Congress clarify or enlarge Treasury's regulatory authority to disregard other restrictions, referred to as "disregarded restrictions". However, because of a lack of Congressional support, the administration dropped it in proposals issued in 2013 and later years. Treasury has now decided to try to make up for Congress' inaction.

2. Important Elements of the Proposed Regulations

The proposed regulations would:

- Treat as an additional transfer the lapse of voting and liquidation rights for transfers of interests in a family-controlled entity made *within three years of death*, thereby eliminating or substantially limiting the lack of control and minority discounts for them.

- Eliminate any discount based on the transferee's status as a *"mere assignee"* and not a full owner and participant in the entity.

- Disregard restrictions on liquidation that are not *mandated* by federal or state law.

- *Add LLCs and other entities* and business arrangements to the list of entities covered by the regulations (corporations and partnerships were the only entities specifically mentioned in §2704 itself).

If the final regulations are similar to the proposed regulations, taxpayers will lose a significant estate tax reduction opportunity. The tax cost of transferring interests in family-owned entities will increase, and one of the important tools that we have frequently used to help our business-owner families avert an estate tax-related liquidity crisis will be severely restricted.

3. Lapses of Voting or Liquidation Rights

Since the enactment of §2704 in 1990, the government has been concerned about the ability of taxpayers to structure transfers of interests in a family-owned entity so that the transferees, individually, would not have the power to liquidate or control the entity, but the transferees, together, would be able to do so. Careful structuring by attorneys ensured that the transferor's right to control or liquidate the entity would not pass to any of the transferees individually and would not be subject to transfer taxes. We did this most often by inserting restrictive provisions in our clients' LLC operating agreements that ensure that recipients of the gifted LLC member interests had no liquidation or control rights that would be disregarded for

gift tax valuation purposes under the plain language of §2704. Because those transferees would not have voting control or the right to liquidate the entity, the values of the gifted interests would, for transfer tax purposes, be discounted, sometimes by as much as 50%. We successfully defended virtually all of these discounts when the gift tax returns that we prepared for our clients were audited by the IRS.

§2704(a) treats the lapse of a voting or liquidation right in a family-owned entity as a transfer by the individual holding the right immediately before its lapse. The current regulations exempt these transfers if the rights inherent in the transferred interest are not restricted or eliminated. The proposed regulations would deny that exemption for transfers occurring within three years before the transferor's death if the entity is controlled by the transferor and members of the transferor's family immediately before and after the lapse.

The proposed regulations modify an example in the existing §2704 regulations to illustrate how Treasury contemplates that this will work. They posit that an individual owns 84% of the stock in a corporation with bylaws that require at least 70% of the vote to liquidate. That shareholder gives one-half of his stock in equal shares to his three children (i.e., each child receives 14% of the stock). The gifting shareholder in this example gave up his right to liquidate or control the corporation by making the gift. If these transfers had occurred within three years of the gifting shareholder's death, the example concludes that the transfers would have been treated as if the lapse of the liquidation right occurred at donor's death. This would produce the same result as including in the donor's gross estate an additional "phantom asset" that will not qualify for the estate tax marital or charitable deduction, presenting tremendous risk for planners who might, for example, rely on the marital deduction to defer the payment of an estate tax on the donor's death if survived by his wife.

4. Disregarding Certain Restrictions on Redemption or Liquidation

The proposed regulations would make important changes to the transfer tax valuation rules for interests in a family-controlled entity that are subject to restrictions on the ability of the owner of the interest to require the entity or other owners to redeem or buy-out that owner. Under the proposed regulations, the threshold element of the new type of disregarded restriction is still that after the transfer the restriction will lapse or can be removed by the transferor or any member or members of the transferor's family. Interests held by non-family members, which otherwise might give those non-family members the power to prevent the removal of a restriction, are disregarded for this purpose unless those interests have been held for at least three years, represent at least 10% of the entity (and 20% in the aggregate with other non-family members), and can be redeemed by the non-family holder on no more than six months' notice. This responds to the commonly-employed technique of giving a modest, short-term "preferred" interest in the entity to a non-family member, such as a charity or the donor's private foundation. That structure interposed that interest holder's veto power between the family members and the exercise of their powers to amend the entity's governing document to remove the restrictions that supported the discounts. The proposed rules would all but neutralize that strategy.

The drafters of the proposed regulations could have described the *types* of such lapsing or removable restrictions that will be disregarded in making such valuations. Instead, however, they chose to define those restrictions with reference to the *effect* they would have on gift or estate tax value. If the effect of a restriction on an interest in an entity is to limit the ability of the holder of that interest to compel liquidation or redemption of that interest on no more than six months' notice for cash or property equal at least to what the proposed regulations call "minimum value," then the restriction is disregarded. "Minimum value" is defined as the fair market value of the entity's assets, reduced by its debts, multiplied by the share of the entity represented by that interest. The valuation of interests when those restrictions are disregarded remains a complex matter, and the proposed rules do not mean that *all* interests in entities will necessarily be valued on a "look-through" basis at their *pro rata* share of the net value of their assets. But the proposed regulations come much closer than we expected they would to imposing such a requirement.

The property for which the interest may be redeemed at the holder's election cannot include a promissory note or other obligation of the entity, its owners, or persons related to the entity or its owners, except for a note issued by an entity engaged in an active trade or business that "is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds." Note the requirements of "market interest rates" and "fair market value," rather than an "applicable federal rate" or other objective rate determined from published sources and a value inferred from that rate. This choice of language is likely to produce a big headache in the administration of these new rules should they be included in final regulations.

5. Restrictions Imposed or Required by Law

Restrictions on an owner's ability to liquidate a closely-held entity are not disregarded for valuation purposes (i.e., a discount may apply because the restrictions make the interest in the entity less valuable), if the restrictions are "imposed or required to be imposed, by any federal or state law." Since 1990, we have relied on this exemption to achieve valuation discounts for our clients. When §2704 was enacted and the current regulations were issued, the state law applicable to partnerships and LLCs granted owners certain rights to liquidate the entity. Since then, state legislatures have tightened the default laws of their LLC and limited partnership acts to make them more "Chapter 14 friendly". These state laws support provisions in partnership and LLC operating agreements that more significantly restrict the liquidation rights of the owners. Because the restrictions that we have used, for example, in our LLC operating agreements were not more restrictive than the default rules of the New Hampshire LLC Act, the restrictions were not applicable restrictions and were respected for transfer tax valuation purposes.

The proposed regulations effectively provide that a default state law restriction that may be superseded by the governing documents is <u>not</u> a restriction imposed or required to be imposed by federal or state law. Most states (including New Hampshire) allow the governing documents of an entity to override any restrictions on transfer. There will therefore be few, if

any, applicable restrictions that will reduce the value of an interest in a family-controlled entity for transfer tax purposes if the proposed regulations become final.

6. Entities Affected

Although §2704, when it was enacted, referred only to corporations and partnerships, the proposed regulations also would apply to limited liability companies and other entities and business arrangements. This presumably is intended to include LLCs, which were not popular when §2704 was enacted, but also prevent the use of other emerging "hybrid" business entities, such as state law "business trusts", to circumvent the new rules.

7. Effective Dates

The provisions of the proposed regulations applicable to voting and liquidation rights are proposed to apply to rights and restrictions created after October 8, 1990, but only to transfers occurring after the date the regulations are published as final regulations. The new rules described above under the heading "Disregarding Certain Restrictions on Redemption or Liquidation" will not take effect until 30 days after the date the regulations are published as final regulations.

We expect that there will be significant comments to the proposed regulations and lively discussion at the public hearing scheduled for December 1, 2016. We anticipate that the earliest the regulations will become final will be sometime in 2017.

8. Suggestions for Immediate Action

Clients who are considering transferring interests in family-controlled entities that are not controlling interests and do not have liquidation rights should consider making the transfers as soon as possible. ***Caveat*** – it is possible that a client dying within three years of the transfer and after the date that the proposed regulations become final may be subject to the final regulations, so caution is in order. Note also that the proposed regulations would apply to determine and measure any gift component of transfers that are structured as sales. Clients who have recently made transfers and die after the regulations are finalized but within three years of the transfer may be affected by the final regulations.

9. Longer Term

The proposed regulations have a surprisingly broad application. We expect that there will be challenges during the comment period and at the public hearing to Treasury's authority to adopt them in their present form. In the meantime, attention should be given to the provisions in existing and future LLC operating agreements and other governing documents and also to the source for payment of the tax on any potential "phantom asset."

10. Talk to Us

Over the years, we at McDonald & Kanyuk, PLLC have assisted many of our clients to achieve significant gift, estate and generation-skipping savings by transferring non-controlling, illiquid interests in limited partnerships, LLCs and corporations to their children, and, more frequently, to irrevocable trusts. Now, however, the clock may be winding down to zero on those strategies. The proposed regulations would apply to all family-controlled corporation, partnerships, and LLCs, regardless of whether they owned an operating business, or only "passive" assets such as an investment account or residential real estate.

Undoubtedly, many estate planning professionals will accept Treasury's invitation during the 90-day comment period to criticize the approach of the proposed regulations as an administrative overreach, beyond an agency's power granted by Congress under the provisions of §2704(b)(4) that Treasury cites as its authority. It may well be that Treasury listens to some of these comments and limits the scope of the proposed rules. Thus, there is great uncertainty concerning the details of any final regulations. Our best guess is that while the critical comments might produce some changes at the margins, the final regulations will be similar to the proposed regulations. In any event, it is almost certain that the final regulations will be ***less favorable*** than the current environment for clients seeking the wealth transfer tax savings of valuation discounts.

The process Treasury has chosen to exert its authority under §2704(b) creates a window of opportunity. If you are contemplating giving or selling interests in your entity to family members or trusts for them, it makes sense to consider capturing what is likely more favorable treatment by completing the transfer sooner rather than later.

If you feel that you are a candidate, we urge you to contact your McDonald & Kanyuk, PLLC estate planning attorney without delay.