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IRS Targets Popular Estate Planning Technique

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This month the ***IRS*** issued proposed regulations designed to limit, or eliminate, popular estate tax planning transactions. Estate planners all over the country have used valuation discounts as a primary tool in managing the estate tax burden. A "valuation discount" is a technique used by transferors of closely-held businesses to reduce the value of a small percentage of their ownership interest (on a per share basis), which reduces the amount of the transfer subject to tax. The basic concept is that the sum of the parts of closely-held business ownership is not the same value as the entire business enterprise. Under these proposed regulations, family limited partnerships, corporations, LLCs and similar family business entities may be subject to estate and gift tax without the benefit of valuation discounts.

These proposed regulations are designed to "close a tax loophole that certain taxpayers have long used to understate the fair market value of their assets for estate and gift purposes" according to the Treasury Department. The public is welcome to comment on these regulations; most comments so far have focused on the fact that there is no "loophole" and that the fair market value of the asset transfers are not "understated" in the first place. Click here to view the public comments.

Following are two highlights of these wide-sweeping proposed regulations.

- The most material change is the elimination of a regime of factors that are currently used to drive minority interest valuation discounts, but would now be ignored when valuing gifts or bequests to family members. Transactions with related parties are subject to what is referred to as "disregarded restrictions" in the proposed regulations.
- For example, the sole owner of a business transferred 25% to each of three children, no party alone could liquidate the business. Prior to the new regulations, the 25% interest transferred to each of the three children would have resulted in a value per share much lower than the value per share of the 100% controlling interest. Under the new regulations discounts are limited or eliminated.
- Transfers (gifts or bequests) to unrelated parties should only be recognized when the interest is "economically substantial and a longstanding one that is likely to have a more substantive effect." Here, there is a new "bright-line test" that establishes when an interest held by an unrelated party is disregarded. Generally, when the state law restrictions drive discounts from the presence of an unrelated party, the percentage of ownership transferred, and other

factors enumerated in the regulations, will determine whether the discounts will be allowable or whether they will be disregarded. The IRS also superimposes a new "deemed put right" in determining the fair market value of the interest transferred under this test.

- In the past a taxpayer would put assets into a limited liability company, which under state law, would require a supermajority vote (for example, unanimity is required in some states) to withdraw. This state-law-mandated lack of control would then drive valuation discounts. Taxpayers would transfer some nominal interests to a charity or unrelated party (e.g., key non-family employee) and discounts would be taken because of this lack of control under state law. The proposed regulations now disallow these types of planning techniques unless burdensome tests are met.

These changes will directly limit the ability to incorporate applicable restrictions through valuation discounts, which can typically range from 15% to 40%.

If you are considering a transaction affected by these regulations, here are some planning tips to contemplate:

1. Evaluate all provisions for liquidation and voting rights in existing family businesses, bylaws, operating agreements, voting trusts and other forms of corporate governance.

2. Immediately create new entities to protect liability of family owned assets, which may include operating companies, real estate, investment partnerships, intellectual property protection, leasing entities, and any other forms of business organizations, such that the entity is in place before the proposed regulations are finalized.

3. If transfers (i.e., gifts) are anticipated to specific assignees, make those transfers now, after evaluating the asset's tax basis and the benefit of a basis adjustment if the asset is held until death. Usually the issuance of final regulations, even non-controversial, takes years before regulations are enacted.

4. Update your estate planning documents to adopt the so called Wandry provisions, designed to adjust the amount of a gift or bequest to a specific dollar amount. While the IRS does not like these so-called defined value clauses, the Wandry court instructed us on how to structure them appropriately.

5. Begin discussing valuation principles for planned transfers of interest so that transferors can move quickly to make taxable transfers and file gift tax returns before the new regulations are finalized. For example, the so-called "deemed put right" is an attempt by the IRS to eliminate valuation discounts. However, basic valuation principles would mandate the imputation of a balance sheet liability to the entity if there wasn't enough working capital to pay the deemed put right, thereby reinstating a valuation discount, albeit in a different form.

In closing, it is important to note that the proposed regulations are still subject to much debate. The legislative history behind Chapter 14 is clear, "The bill does not affect minority discounts or other discounts available under present law." (Referring to the enactment of this Chapter of the Internal Revenue Code.) These proposed regulations are currently open for public comment and a hearing will be held on the regulations on December 1, 2016 in Washington D.C. Since it takes time for the

proposed regulations to become final, there is still a window of planning available in 2016.

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