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Estate & Succession Planning Corner

Code Sec. 2704 Proposed Regulations: Will Transfer Tax Valuation Discounts for Intra-Family Transfers of Closely Held Entities Become Extinct?

By Louis S. Harrison and John M. Janiga

On August 2, 2016, the IRS and the U.S. Treasury Department (the "Treasury") issued proposed regulations (the "Proposed Regulations") under Code Sec. 2704 aimed at curbing, and arguably eliminating, valuation discounts associated with the transfer of interests in closely held entities to family members, such as lack of control (sometimes referred to as "minority"[1]), and lack of marketability.[2] Practitioners have been anxiously awaiting the Proposed Regulations since late April 2015. Then, Catherine Hughes, an Estate and Gift Tax Attorney Advisor in the Office of Tax Policy of the Treasury, spoke about the on-going work related to, and the possible scope of, the Proposed Regulations and speculated as to an issuance date.[3]

Since that time, numerous commentators have conjectured as to the content of the Proposed Regulations based on the Obama Administration's Code Sec. 2704 proposals,[4] last included in the Fiscal Year 2013 Greenbook.[5] However, the Proposed Regulations contain rules that seem to be more expansive than most anticipated.[6]

If the Proposed Regulations are made final in their current form, they appear to eliminate most—if not all—lack of control discounts and would likely suppress lack of marketability discounts in the context of intra-family transfers of family held entities for purposes of federal gift, estate and generation-skipping-transfer tax (collectively, "transfer taxes") purposes. As discussed later, if this occurs, it is likely that the validity of the Final Regulations would be challenged as beyond statutory authority. However, of course, the results of such a challenge are uncertain and, in the interim, there would be a substantial chilling effect on certain estate planning strategies.

Given the substantial increase in the exclusion amount[7] in recent years, at $5.45 million ($10.9 million for a married couple) for 2016, the elimination or suppression of valuations discounts for transfers in family-controlled entities will not be a major concern for many clients. However, for clients that have assets valued in

LOUIS S. HARRISON is a Partner in the firm of Harrison & Held in Chicago, Illinois.

JOHN M. JANIGA is a Professor in the Quinlan School of Business at Loyola University Chicago and of Counsel to Spagnolo & Hoeksema in Hoffman Estates, Illinois.

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excess of the exclusion amount that either have—or are contemplating establishing—a family-controlled entity, practitioners must be immediate in advising them about the potential impact of the Proposed Regulations.

Historical Background

Code Sec. 2704 was enacted primarily to statutorily overrule the Tax Court's holding in *D.J. Harrison, Jr. Est.*[8] The facts of that case involved an individual whose death was imminent, Daniel Harrison, Jr. ("Father"). His sons, acting under a power of attorney, transferred some of the Father's assets to a family partnership, with their Father receiving a one-percent general partnership interest and a 77.8-percent limited partnership interest, and each of themselves receiving a 10.6-percent general partnership interest. Under the terms of the partnership agreement, each general partner was granted the right to compel the dissolution and liquidation of the partnership. When the Father died, his general partnership power to dissolve and liquidate the entity expired. Accordingly, his estate claimed a substantial discount for the remaining 77.8-percent limited partnership interest.[9]

[A] number of commentators have conjectured as to the content of the Proposed Regulations based on the Obama Administration's Code Sec. 2704 proposals, last included in the Fiscal Year 2013 Greenbook.

The estate successfully argued that the general partner's ability to dissolve and liquidate the partnership lapsed on his death under state law and, consequently, the limited partnership interest should not be valued as if the partner's power to liquidate still existed. As one commentator noted, "[t]he IRS was outraged, and persuaded Congress to pass the anti-lapse provisions of Section 2704."[10]

How Does Code Sec. 2704 Currently Work?

While the details of Code Sec. 2704 are extremely confusing and nuanced, the essence of how it currently works is not. Its operational rules are contained in Code Sec. 2704(a), which was the direct response to *Harrison*, and Code Sec. 2704(b).

Code Sec. 2704(a) treats certain lapses of a voting right[11] or liquidations right[12] with respect to an entity as transfers by the person holding such right(s) for transfer tax purposes. It applies if (1) there is a lapse[13] of any voting or liquidation right in a corporation or partnership, and (2) the holder of the right at the time of the lapse and members of the holder's family control the entity before and after the lapse.[14] If the lapse occurs while the holder is alive, the lapse is treated as a transfer by gift.[15] If the lapse occurs upon the holder's death, the lapse is treated as a transfer includible in the decedent-holder's gross estate.[16]

The value of the transfer as a result of the lapse is the excess, if any, of the value of all interests in the entity held by the holder of the lapsed right immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing) over the value of such rights immediately after the lapse (determined as if all such rights were held by one person). Thus, the value of the transferred interest for transfer tax purposes is the sum of (1) the Code Sec. 2704(a) amount and (2) the normal transfer tax value of the transferred interest.

Example. Mother is the general partner in a partnership, whose interest is worth $1 million. As a general partner, she can unilaterally liquidate the partnership. The partnership agreement provides that a general partnership interest is converted to a limited partnership interest on transfer. A limited partner cannot liquidate the partnership. As the result of assigning her general partnership interest to her son, the interest is turned into a limited partnership interest, and there is a lapse of the liquidation right. Assume the reduction in value from the general partnership interest (that allows liquidation) to a limited partnership interest (that cannot liquidate) is $650,000. The value of the transfer as a result of the lapse is $350,000 ($1 million value of interest held by Mom before the transfer less $650,000 value of the same interest after the transfer, valued as held by one person after the transfer). The total taxable covered transfer for gift tax purposes would be $350,000 plus the actual value of the transferred interest, $650,000, or $1 million.[17]

Code Sec. 2704(b) provides that certain voluntarily imposed restrictions on the ability to liquidate an entity—an "applicable restriction"—are ignored for purposes of determining the value of an interest in the entity for transfer tax purposes. It applies if (1) there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family,[18] and

(2) the transferor and members of the transferor's family control the entity immediately before the transfer.[19]

An applicable restriction is any restriction that (1) effectively limits the ability of the entity to liquidate,[20] (2) either lapses or can be removed after the transfer, in whole or in part, by the transferor or any of his or her family members, either alone or collectively[21] and (3) is more restrictive than state law.[22]

The term has three exceptions, of which only the second, below, has turned out to be of significance in planning. It does not include: (1) any commercially reasonable restriction arising as part of any financing by the entity with a person who is not related to the transferor or the transferee, or a family member of either;[23] (2) any restriction imposed, or required to be imposed, by any Federal or State law;[24] or (3) any option, right to the property, or agreement that is subject to Code Sec. 2703 and that is disregarded under that section.[25]

The key planning variable is to create restrictions that occur because of state law. As to other restrictions that are synthetically created, those restrictions are ignored. "[T]he value of the interest in the entity is determined as if the right to liquidate were currently exercisable and as if the rights of the transferor were determined under the state law that would apply but for the restriction."[26]

Example. Father is a general partner and limited partner of a family limited partnership (FLP). Under the terms of the partnership agreement, the FLP will not liquidate after Father's death as long as 51 percent of the limited partners vote to continue. Under applicable state law, the FLP will not liquidate unless 100 percent of the limited partners vote to continue. If Father dies, the value of his general and limited FLP interests will be valued as if 100 percent of the limited partners must vote to continue—the state law that would govern absent the partnership agreement. The requirement that the FLP cannot liquidate if 51 percent of the limited partners vote to continue is an applicable restriction that will be disregarded in valuing the Father's FLP interests for estate tax purposes.[27]

What Triggered the Proposed Regulations?

For decades, practitioners have recommended the use of a corporation, various forms of partnership and a limited liability company (LLC) to clients as a means of accomplishing a number of important objectives. These include numerous ones based on behavioral economics[28] and portfolio management,[29] the desire to perpetuate a family business, asset protection, probate avoidance,[30] qualification for special tax provisions[31] and the ability to use discounted values for transfers of interests in the entity for transfer tax purposes.[32]

It is the last objective—the ability to use discounted values for transfer tax purposes—that has raised the ire and continual focus of the IRS. Even before Code Sec. 2704 was passed, the IRS became increasingly frustrated with the increased use of the closely held corporation, the family limited liability company (FLLC), and the FLP as vehicles used by individuals to hold business and investment assets, when such vehicles were used to provide valuation discounts for transfer tax purposes—even when the use of the such vehicles was justified for many other nontax and tax reasons and the valuations discounts were arguably justifiable based on the underlying facts.

The IRS's expectation was that Code Sec. 2704 would eliminate or minimize many of what they viewed as valuation abuses for transfer tax purposes, but a confluence of events caused that expectation to go unmet. Perhaps the most significant events were the Tax Court's decision in *B.P. Kerr*,[33] followed by the decision to affirm by the Fifth Circuit Court of Appeals.[34]

In that case, Baine and Mildred Kerr ("Parents") formed two FLPs under the Texas Revised Limited Partnership Act (TRLPA)—Kerr Family Limited Partnership (KFLP) and Kerr Interests Limited Partnership (KILP)—in 1993 to make gifts to their four adult children. The partnership agreements for both FLPs stipulated that the "partnerships will dissolve and liquidate on the earlier of (1) December 31, 2043, (2) by agreement of all the partners, or (3) on the occurrence of certain narrowly defined acts of dissolution." The Parents made all of the capital contributions to both KFLP and KILP. Immediately, the Parents assigned to their four adult children a portion of their general partnership interests in KFLP and a limited partnership interest in KILP. In June 1994, the Parents transferred limited partnership interests in KFLP and KILP to the University of Texas (UT). Later that year, after the Parents created separate grantor retained annuity trusts (GRATs), they each transferred a limited partnership interest in KFLP to their GRATs, in which the remainder interests were intended to benefit their grandchildren through generation-skipping trusts, and transferred additional limited partnership interests in KILP to their children. On their respective gift tax returns, the Parents applied lack of marketability discounts to the transfers to their children and minority and lack of marketability discounts to the transfers to the GRATs.

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The IRS argued that Code Sec. 2704(b) barred the Parents from applying valuation discounts in computing the value of the partnership interests transferred to either the children or the GRATs because the restrictions on liquidation set forth in the partnership agreements constituted applicable restrictions. They made several arguments, including that the failure to give the partners a six-month put right[35] under the terms of the TRLPA was an "applicable restriction" under Reg. §25.2604-2(b) as a "limitation on the ability to liquidate the entity." The Parents filed a motion for partial summary judgment arguing that Code Sec. 2704(b) did not apply, alternatively, because: (1) the trustees of the GRATs received only assignee interests, not limited partnership interests; (2) the disputed transfers must be valued as assignee interests under Reg. §25.2512-1; or (3) the restrictions on liquidation set forth in the partnership agreements did not constitute applicable restrictions under Code Sec. 2704.

Given the uncertainty surrounding the Proposed Regulations, the most prudent course of action would be to take the conservative position that they will be finalized in their current form and can withstand a challenge to their validity.

While the Tax Court rejected the first two arguments, it accepted the third, holding that the restrictions on liquidation contained in the FLP agreements were not applicable restrictions because the FLP agreements did not impose greater restrictions on the ability to liquidate the FLPs than what would apply to the FLPs under the TRLPA in the absence of the restriction. On a basis of a comparison of the FLP's liquidation provisions to those contained in the TRLPA, it supported its conclusion by stating that: "because Texas law provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the partnership agreement or upon the written consent of all the partners, and the restrictions contained in … the partnership agreements are not more restrictive than the limitations that generally would apply to the partnerships under Texas law." Additionally, it concluded that the six-month put right under the TRLPA was not a "limitation on the ability to liquidate the entity," but rather a limitation on a limited partner's right to withdraw from a partnership."

On appeal, the Fifth Circuit affirmed the Tax Court's decision on the inability of a family member to unilaterally remove a restriction pursuant to Code Sec. 2704(b). Since the ability to remove the restriction on liquidation required the UT's consent, the requirement of Code Sec. 2704(b)(2)(B)(ii) that "[t]he transferor or any member of the transferor's family, either alone or collectively" was not met. Because the first of three required tests for an applicable restriction was not met, the appellate court did not address the issues of whether restrictions on a partner's right to withdraw should be considered a limitation on the ability to liquidate under Code Sec. 2704(b)(2)(A) or whether the restrictions under the partnership agreements were more restrictive than State law under Code Sec. 2704(b)(3)(B).

Collectively, the *Kerr* decisions were significant for at least two reasons. First, they established that an applicable restriction did not include a restriction on the right of a partner to force the liquidation/redemption of strictly its interest in the partnership if the default provisions of state law impliedly had this restriction already. Second, they reinforced the importance of the so-called state law exception. As one commentator noted:

> The exception for restrictions imposed by State Law has dramatically reduced the applicability of §2704 to partnership and LLC transfers. Many state legislatures have revised limited partnership and LLC laws after the passage of §2704 to provide various limitations on the rights of limited partners or LLC members to make transfers under default rules that apply unless the partnership or operating agreement specifically overrides those default rules.[36]

Put another way, by states shifting their default laws to become more restrictive, while still allowing partnerships or LLCs to choose less restrictive rules, they ensured that Code Sec. 2704(b) would be rendered relatively meaningless. As another commentator stated:

> Section 2704(b) granted the IRS the ability to invalidate 'applicable restrictions' that went beyond otherwise lax default state laws; it hadn't contemplated a future where the state law would become restrictive by default (e.g., by requiring a unanimous vote of partners to liquidate, and preventing a limited partner from withdrawing), and then give business owners the ability to choose to be more lax instead if they wanted to for other business reasons.[37]

The combination of *Kerr*, other cases in which the IRS was unsuccessful in applying Code Sec. 2704 to invalidate valuation discounts, and the shift in state laws governing partnerships and LLCs brought significant attention to the area of valuation discounts for intra-family transfers of closely held entities for transfer tax purposes by both practitioners and the government. One commentator summarized the government's focus as follows:

> An item promising additional guidance regarding restrictions on liquidation under … [Code Sec.] 2704 first appeared in the IRS "Priority Guidance Plan" for 2003 – 2004. The promise of "Guidance" was changed to a promise of "Regulations" in the 2010 – 2011 plan. Meanwhile, in May, 2009, the Obama Administration first promulgated the Greenbook Proposal. Proposed statutory changes to … [Code Sec.] 2704(b) were contained in the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals … The proposal was repeated without substantive change in the Greenbooks for Fiscal 2011, 2012, and 2013. The Greenbooks for Fiscal 2014, 2015, and 2016, however, omitted the proposal. The last version of the Greenbook Proposal appeared in the Greenbook for fiscal 2013, released on February 13, 2012.[38]

Since the proposals were not contained in any post-2013 Greenbook, it would appear that the Obama Administration concluded that Congressional authorization was not needed (or, more likely, could not be obtained), instead relying on implementation through new Treasury regulations.

How Do the Proposed Regulations Change Existing Law?

The Proposed Regulations would change existing law in numerous ways, primarily by amending three parts of the existing regulations under Code Sec. 2704 and adding an entirely new part to the related regulations. Specifically, they would:

1. amend Reg. §25.2701-2 to address what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership or limited partnership;
2. amend Reg. §25.2704-1 to address deathbed transfers that in effect create a minority interest *via* a transfer within three years of death of enough equity to move the transferor from a control to non-control position prior to death) and to clarify the treatment of a transfer that results in the creation of an assignee right;
3. amend Reg. §25.2704-2 to refine the definition of the term "applicable restriction" by possibly eliminating the comparison to the state law liquidation limitations; and
4. add new Reg. §25.2704-3 to address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interests held by persons who are not family members.

While both the amendments and the addition contain excruciating details, the key elements of each are discussed below.

Amendments to Reg. §25.2701-2

Neither Code Sec. 2704(a) nor Code Sec. 2704(b) is triggered unless there is "control" of the family-owned entity involved. The proposed amendment to Reg. §25.2701-2 would bring clarity to that term.

Under the existing regulations, control in the context of a corporation means "the holding of at least 50 percent of the total voting power or total fair market value of the equity interest in the corporation."[39] In the context of a partnership, it means "the holding of at least 50 percent of either the capital interest or the profits interest in the partnership … In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner."[40]

While the existing regulations only refer to entities that are a corporation or a partnership, the Proposed Regulations expand this to include a "corporation, partnership, or any other entity or arrangement that is a business entity with the meaning of §301.7701-2(a) … "[41] It also specifies that "any business entity described in §301.7701-2(b)(1), (2), (3), (4), (5), (6), (7), or (8) … a qualified subchapter S corporation … and a qualified subchapter S subsidiary" are treated as a corporation.[42] Further, for any business entity that is not treated as a corporation, the entity form will be determined "under local law, regardless of how the entity is classified for federal tax purposes or whether it is disregarded as an entity separate from its owners for federal tax purposes."[43]

The Proposed Regulations do not change the meaning of "control" for a corporation or partnership. However, it now defines that term for "any other entity or arrangement that is not a corporation, partnership, or limited partnership"[44] to mean "the holding of at least 50 percent of either the capital interests or the profits interests in the entity or arrangement. In addition, control means the holding of any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part."[45] The preamble to the Proposed Regulations highlights that this rule would apply to LLCs that are not S corporations for federal tax purposes.[46] Although there

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are many clarifications needed in the proposed regulations, the cited provision exemplifies those needs. Control requires more than 50 percent, not "at least 50 percent."

Amendments to Reg. §25.2704-1

The key portion of the first amendment to Reg. §25.2704-1—dealing with deathbed transfers—serves as an expansion of the IRS's success in *Murphy Est.*[47] by establishing a three-year bright-line test. In that case, the decedent transferred 0.88-percent interest in a corporation to each of her children 18 days before her death. Prior to the transfer, the decedent controlled a 51.41-percent block of voting stock in the corporation. By virtue of the transfer, the decedent reduced her ownership to 49.65 percent. On the gift tax return, the decedent took the position that the transfers constituted minority interests and, therefore, that a minority discount was appropriate in valuing the shares for gift tax purposes. For estate tax valuation purposes, the decedent's estate sought to obtain a minority discount for decedent's 49.65-percent interest in the corporation voting stock held at her death. The court refused to allow a minority discount on either the gift or estate tax issues. It reasoned that the transfer of 1.76 percent of the stock, the purpose of which was to relinquish control, "lacked substance and economic effect."

Shortly after the decision was rendered, we wrote that "*Murphy* may illustrate a straightforward application of the 'step transaction' doctrine."[48] The amendment takes that idea to an extreme by taking the position that a lapse will be deemed to occur at the time of death if a transfer that results in the transferor moving from a control position to a non-control position was made within three years of death.

One commentator's take on the significance of this amendment is that "[g]oing forward, it will no longer be feasible to winnow down a majority interest to a minority interest at/near death just to obtain a minority valuation discount on the remaining shares held at death."[49]

Amendments to Reg. §25.2704-2

Under current law, a liquidation restriction in an entity's governing instrument that was not more restrictive than the default state law was not an applicable restriction. As a result, valuation discounts appropriately could be taken in valuing any intra-family transfers.

Under the Proposed Regulations, this so-called state law exception, which was upheld by the Tax Court's decision in *Kerr*, would be modified. Specifically, a restriction would be considered as imposed or required to be imposed by Federal or State law only if the restriction is mandatory, not where it is strictly a default rule. As noted by commentators, "because partnership and corporate statutes are largely default rules, not mandatory ones, it is difficult to imagine how this exception could be beneficial for taxpayers if this regulatory provision is made final."[50] This severe narrowing of the state law exception would apply to "disregarded restrictions," discussed below.

In addition, the Proposed Regulations clarify that the reference to "Federal or State law" includes only laws of the United States, any state thereof, and the District of Columbia. It does not include the laws of any other jurisdiction.[51]

Addition of New Reg. §25.2704-3

Code Sec. 2704(b)(4) grants authority to Treasury to issue regulations to provide other restrictions, beyond applicable restrictions, that would be "disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of such interest to the transferee." Relying on this authority, the first key part of the new Proposed Regulation creates a new concept, termed "disregarded restrictions."[52] It is defined to include any one of the following restrictions:

1. Limit or permit the limitation of the ability of the holder of the interest to compel liquidation or redemption of the interest. In most family discounted planning with marketable assets, this is the key restriction currently relied on. The new regulations would effectively eliminate that discount.
2. Limit or permit the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a "minimum value" (defined as the interest's share of the net value of the entity determined on the date of liquidation or redemption). This is a "belts and suspenders" approach to eliminating the restriction noted in 1 above.
3. Defer or permit the deferral of the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder's interest to have the holder's interest liquidated or redeemed.
4. Permit the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property.[53]

Example 1 in the Proposed Reg. §25.2704-3 provides the following illustration of the concept, and how it eliminates partnership discount planning relied on currently by marketable asset partnership planning:

(i) D and D's children, A and B, are partners in Limited Partnership X that was created on July 1, 2016. D owns a 98-percent limited partner interest and A and B each own a 1 percent general partner interest. The partnership agreement provides that the partnership will dissolve and liquidate on June 30, 2066, or by the earlier agreement of all the partners, but otherwise prohibits the withdrawal of a limited partner. Under applicable local law, a limited partner may withdraw from a limited partnership at the time, or on the occurrence of events, specified in the partnership agreement. Under the partnership agreement, the approval of all partners is required to amend the agreement. None of these provisions is mandated by local law. D transfers a 33 percent limited partner interest to A and a 33 percent limited partner interest to B.[54]

The example concludes that the partnership agreement, by prohibiting the withdrawal of a limited partner, imposes a restriction on the ability of a partner to compel a liquidation of their interest in the partnership that is not required by federal or state law and which could be removed by agreement of the transferor or members of the transferor's family after the transfer. As a disregarded restriction, the transferred interests must be valued without consideration of the provision in the partnership agreement that prevents the withdrawal (*i.e.,* liquidation or redemption) of a limited partner. As noted by commentators, "[t]his would presumably have the effect of denying any minority discount and also largely suppressing any lack of marketability discount. If the holder of an interest in the entity is deemed to have a right to be redeemed, the value of the interest will not be significantly affected by lack of marketability."[55]

The Proposed Regulations would have "the effect of reading into ... the entity's governing instrument a put right, unless there is mandatory law precluding it, thereby eliminating any minority discount and suppressing marketability discount"[56]—in effect, establishing a deemed put right.

Some states have enacted (or may be tempted to enact) a statute creating special entities that are subject to the mandatory provisions contained within the statute. In order to prevent the use of these special entities to avoid the deemed put right concept, the Proposed Regulations would ignore any such mandatory provisions that applied only to certain entities under state law. Further, any mandatory laws outside of the United States would not be considered.[57]

The second key part of the new Proposed Regulation relates to assessing the ability, either alone or collectively, of the transferor's (or the transferor's estate) or any member of the transferor's family, to remove a disregarded restriction. For these purposes, a nonfamily member is ignored unless the interest they hold in the entity (1) is held for at least three years immediately before the transfer, (2) constitutes at least 10 percent of the equity or capital and profits interest in the entity, (3) constitutes at least 20 percent of the equity or capital and profits interest in the equity when combined with all interests held by nonfamily members and (4) provides the holder with an enforceable put right to receive the "minimum value" of the holder's interest upon liquidation or redemption with no more than six months' notice.

This part seems directly aimed at the Firth Circuit's holding in *Kerr,* in which it held that the restriction on liquidation could not be removed by the transferor or any member of the transferor's family after the transfer because the consent of a nonfamily member (*i.e.,* UT) was required. This was true even if such consent was probable.

Between now and the enactment of Final Regulations, the planning bar could develop other strategies in light of these new regulations.

Going Forward

The amendment to Reg. §25.2701-2 would be effective when the rules are adopted as final.

The amendments to Reg. §25.2704-1 would apply to lapses of rights, and the amendments to Reg. §25.2704-2 would apply to transfers of property subject to restrictions, created after October 8, 1990, occurring on or after the date the regulations are published as final.

New Reg. §25.2704-3 would apply to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date the regulations are published as final.

Thus, all of the Proposed Regulations would take effect on the date that the regulations were issued as Final Regulations or, at worse, 30 days thereafter.

How likely is it that the Proposed Regulations will be finalized in their current form? The Proposed Regulations provide for the submission of written and electronic comments by November 2, 2016, followed by a public hearing scheduled for December 1, 2016. The Treasury has received a significant amount of feedback on the Code Sec. 2704 Proposed Regulations, substantially more than is typical. Given the response, we should anticipate that the breadth of these regulations will be cut back, and many uncertainties clarified.

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Exhibit 1

Popular Estate Planning Strategy May Soon Be Eliminated

Earlier this month, the IRS published proposed tax regulations designed to significantly limit the use of valuation discounts that are commonly applied to transfers of interests in various family controlled entities for estate and gift tax planning purposes. Once these regulations are finalized, they will significantly limit the use of valuation discounts to reduce the value of the entity being transferred to family members.

While much has already been written about the new proposed regulations, we at Harrison, Held & Carroll & Wall have been independently analyzing the proposed regulations and considering what they mean for our clients. We will provide you with our detailed analysis in the following weeks, but for now, here are some answers to your potential questions.

What Has Happened?

After years of Congress failing to enact legislation to curb what was seen as an abuse in the use of family-limited partnerships, family LLCs and corporations in estate and gift tax planning, the Treasury Department recently proposed new tax regulations curtailing the application of discounts to the values of gifts, bequests and sales of interests in family-controlled entities that are transferred to family members.

What Specifically Do the Regulations Address?

The proposed regulations address perceived abuses in the application of valuation discounts. These valuation discounts, commonly referred to as minority interest, lack of marketability and lack of control discounts, can be applied under current law to the valuation of interests in family-controlled entities that are transferred to family members. Such discounting provides estate and gift tax savings by reducing the value of the transferred interests. The proposed regulations, once enacted, will greatly reduce—if not entirely eliminate—the applicability of these various discounts, resulting in higher asset values and potentially higher gift and estate taxes.

What Might This Mean for You?

If the regulations become final, the ability to discount noncontrolling interests in family-controlled entities will be greatly diminished, though there may be rare cases in which these discounts may still be applied. Despite initial predictions that the proposed regulations may only affect passive entities, such as family-limited partnerships with a portfolio of real estate or securities, our interpretation is that the proposed regulations will affect all entities owned by families, including operating and active businesses.

What Should You Do?

We are analyzing these proposed regulations and crafting the appropriate advice for our clients. Under appropriate circumstances, we are likely to suggest a gift or sale of interests in family-controlled entities before the regulations are finalized. Though the proposed regulations are just that, "proposed," there will be hearings on them on December 1, 2016. Tax professionals across the nation are submitting questions and comments prior to this hearing in order to better understand the regulations, improve them or dispute them altogether. Right now, we anticipate that the final regulations will be issued in the first half of 2017 and will become law 30 days after issuance. In the meanwhile, we still have time to consider and implement estate and gift tax planning techniques that apply valuation discounts. The proposed regulations are not to be applied retroactively to eliminate discounts on gifts or sales completed before they are made final, but there will be nuances as to the application of the regulations even with current gifts.

If you have any questions regarding how these proposed regulations may impact your estate planning, please reach out to your attorney at Harrison, Held, Carroll & Wall.

If, in the worst case scenario, the Proposed Regulations were to be finalized in an overly broad form, a second question arises: Could they be successfully challenged as being invalid because they are contrary to the origin, purpose and scope of the current statute? On this question, there are a few commentators that believe the answer is in the affirmative.[58] Of course, even if that is true, it is always possible that Congress, if so moved, could enact legislation that would mimic the language of the Code Sec. 2704 Proposed Regulations, thereby making any challenge

moot. In addition, in the interim, before the validity of the Regulations is litigated, the Regulations would provide a "chilling" effect to discounted gift and transfer planning.

Given the uncertainty surrounding the Proposed Regulations, the most prudent course of action would be to take the conservative position that the Regulations will at some point be finalized and eliminate certain discounts. As such, there are various steps that practitioners should take before December 1, and most certainly, before year-end.

First, practitioners must send a notice to clients about the Proposed Regulations. This can be a short one, and an example is provided in Exhibit 1.

Second, transactions that are in process—or even in planning mode—involving closely held family business transfers, including outright gifts, sales to trusts or outright and grantor retained annuity trusts, should be completed now. Those transactions must be completed currently to take advantage of any potential discounted gifts.

Associated with these transactions should be a caveat that the Final Regulations, though effective going forward, may contain a three-year lookback that could apply to the transaction. [59] In this regard, practitioners should not underestimate the creativity of the IRS in expanding the regulations to include a three-year rule under circumstances that will match certain transactions, though that three-year look-back could be reduced to a more reasonable one year requirement and could be only for post effective date transactions.

Third, and most difficult, practitioners should identify and contact other clients that could be impacted by the Proposed Regulations and who have not yet done any discount planning, assuming their net worth could invoke a possible estate tax under current law. This is very difficult because there are nontax elements in determining whether to engage in lifetime transfers, and many clients who could, and should, engage in this planning, will not for a variety of noneconomic reasons. To pressure those clients into doing the strategies now could result in buyer remorse, so practitioners need to approach this area with great sensitivity.

This is further exacerbated by the negative income tax effects that could result from discount planning,[60] and possible increased audit risk.

We would suggest that in addition to a "client alert," noted above, that practitioners approach the discussion with an even weighing of the pluses and minuses of discount planning. Suffice to say that clients who have not engaged in this planning in the past, or who have stagnated on it for nontax reasons, probably should not be doing it now even with the potential law changes. And as with any proposed regulation of this magnitude, it may be awhile before the final regulations are enacted.

Fourth, practitioners should consider reviewing existing gifting plans to determine if acceleration of the plan (using lifetime taxable gifts to increase the value of the gifted interest when discount planning for annual exclusion gifts is being used, for example) is feasible and economically beneficial or developing new gifting plans that can be effectuated quickly.

Fifth, and most interesting, is what could develop in the future. Estate planners could be among the most creative in their interpretation of laws and development of planning ideas. Between now and the enactment of Final Regulations, the planning bar could develop other strategies in light of these new regulations. The practitioner should stay involved and read all updates involving this planning to see what further opportunities develop (and risks that should be avoided).

This is a scary time for planners, but one also intellectually interesting, and accompanied with planning strategies that will be valuable to clients.

ENDNOTES

1 A lack of control discount is appropriate in valuing an interest in an entity if the interest does not enable the owner to control either the management of, or the distributions from, the entity. As one commentator notes, "the term 'minority discount' is misleading, since an interest does not actually have to be a minority interest to be subject to the discount ... For example, a gift of a 75 percent limited partnership interest might receive a 'minority' discount, despite the fact that it is not truly a minority interest, because a limited partner has no actual control over day-to-day partnership management. Limited partnership interests, nonvoting stock, and minority interests in corporations are frequently eligible for minority discounts simply because these interests will carry little (if any) control of the operation of the entity." Kathryn G. Henkel, ESTATE PLANNING AND WEALTH PRESERVATION—ABRIDGED EDITION, at 26-6 (Warren, Gorham & Lamont, 1998).

2 A lack of marketability discount is "an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability," and "marketability" is defined as "the ability to quickly convert property to cash at minimal cost." International Glossary of Business Valuation Terms, as adopted in 2001 by American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts and The Institute of Business Appraisers. A lack of control discount is conceptually distinct from a lack of marketability discount. Despite this, the concepts often overlap to a great extent, so much so that many courts often do not distinguish between the two.

3 Her remarks came during the American Bar Association's Real Property, Trust and Estate Conference in Washington, D.C. At that time, she stated that she expected the Proposed Regulations to come out prior to the American Bar Association's Tax Section Conference in September 2015, about 11 months prior to their actual issuance.

4 *See, e.g.*, Steve R. Akers, *Speculation About Upcoming Section 2704 Proposed Regulation*, June 2015, available online at *www.naepc.org/journal/issue21c.pdf*.

5 "Greenbook" is the informal term used for the "General Explanations of the Administration's

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Fiscal Year Revenue Proposals," in this case, the one for 2013, dated February 2012.

[6] For example, one commentator stated that "[m]any experts who had anticipated some action on the part of Treasury in this area prior to the issuance of these proposed regulations but did not expect that operating family businesses would be impacted. However, the regulations, in their current proposed form, do not distinguish between operating family businesses and family entities holding investment assets, such as Family Limited Partnerships or Family Limited Liability Companies." Abbot Downing, *Proposed Regulations Under IRC Section 2704 Target Business Valuation Discounts,* August 2016, available online at *www.wellsfargo.com/the-private-bank/insights/planning/wpu-proposed-irc-2704/.*

[7] This is also termed the exemption equivalent and bypass amount.

[8] *D.J. Harrison, Jr. Est.*, 52 TCM 1306, Dec. 43,609(M), TC Memo. 1987-8.

[9] The IRS argued that the Father's limited partnership interest should be valued at its liquidation value, stipulated to be $59,555,020, while the estate argued that the interest should be valued without regard to liquidation rights, stipulated to be $33 million.

[10] Henkel, *supra* note 1, at 26-6.

[11] A "voting right" is the right to vote with respect to any matters of the entity. Reg. §25.2704-1(a)(2)(iv).

[12] A "liquidation right" is the right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity. Reg. §25.2704-1(a)(2)(v).

[13] A "lapse" of a voting or liquidating right occurs at the time such a presently exercisable right is restricted or eliminated. Reg. §25.2704-1(c)(1).

[14] Code Sec. 2704(a)(1)(A)–(B).

[15] Code Sec. 2704(a)(1).

[16] *Id.*

[17] This example is adapted from an example in Henkel, *supra* note 1, at 26-4.

[18] Code Sec. 2704(b)(1)(A).

[19] Code Sec. 2704(b)(1)(B).

[20] Code Sec. 2704(b)(2)(A). Although Code Sec. 2704(b) focuses on the ability to liquidate the entity, not an interest in the entity, the IRS has interpreted it as applying to a restriction on a right to liquidate an interest in the entity. TAM 9725002 (Mar. 25, 1997). As one commentator noted, "[t]his interpretation is based on the theory that [Code Sec.] 2704(b) applies to a restriction on the right to liquidate an entity in whole or in part, and the liquidation of an interest in the entity constitutes a partial liquidation of the entity." Henkel, *supra* note 1, at 26-10. As discussed later, the Proposed Regulations contain a rule that would effectuate the IRS's interpretation.

[21] Code Sec. 2704(b)(2)(B)(i)–(ii).

[22] Reg. §25.2704-2(b) (first sentence).

[23] Code Sec. 2704(b)(3)(A).

[24] Code Sec. 2704(b)(3)(B).

[25] Reg. §25.2704-2(b).

[26] Richard B. Stephens, Guy B. Maxfield, Stephen A. Lind & Dennis A. Calfee, FEDERAL ESTATE AND GIFT TAXATION—ABRIDGED EDITION, at 19–149 (Warren, Gorham & Lamont, 1996).

[27] This example is adapted from an example in Henkel, *supra* note 1, at 16–45.

[28] These include ensuring cash flows that are not tied strictly to accounting income, avoiding *status quo* bias, preventing constant changing of investment managers and minimizing short-term focus on returns. All of these topics are discussed in detail in Louis S. Harrison & John M. Janiga, *The Interplay of Behavioral Economics and Portfolio Management with the Current Examination of Family Partnerships by the Courts*, 40 REAL PROPERTY, PROBATE AND TRUST JOURNAL 117 (2005), at 136–142.

[29] These include the ability to reduce trading costs by pooling of assets and the preventing of momentum investing. Both topics are discussed in detail in Harrison & Janiga, *supra* note 28, at 142–147.

[30] Certain assets held by the entity will avoid probate at the owner's death versus if they were held individually or as a tenant in common. For example, personal property held individually will be subject to probate in the state in which such property is located, whereas the same property held inside an entity will not. The owner's interest in the entity would be subject to probate in the state in which the owner is domiciled, unless the interest in the entity is held in a revocable living trust or other such probate-avoiding vehicle. However, by not having to list all of the personal property as part of the publicly available probate records, the use of the entity provides the owner with some measure of privacy regarding the nature and disposition of such property.

[31] For example, some entities may qualify for the special estate tax benefits provided by Code Sec. 303 (redemption of corporate stock to pay estate taxes), Code Sec. 2032A (valuation discounts for farm and ranch property) and Code Sec. 6166 (deferred payout of estate taxes).

[32] For transfer tax purposes, assets are supposed to be valued at "fair market value." Reg. §§20.2031-1(b) and 25.2512-1. This term is, in turn, defined as "the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." *Id.* Therefore, as one commentator notes, "[t]he term 'discount' is therefore somewhat of a misnomer. That is, to the extent the term 'discount' implies that the value of any asset for transfer tax purposes is less than its true fair market value, the term is misleading. However, for transfer tax purposes, the term 'discount' is commonly used to indicate that the fair market value of an asset is less than its apparent face value ... " Henkel, *supra* note 1, at 25-2.

[33] *B.P. Kerr*, 113 TC 449, Dec. 53,667 (1999).

[34] *B.P. Kerr*, CA-5, 2002-1 USTC ¶60,440, 292 F3d 490 (2002), *aff'g*, 113 TC 449, Dec. 53,667 (1999).

[35] The term "put right" refers to the right of a partner to demand to have their interest in the partnership liquidated by the entity.

[36] Akers, *supra* note 4, at 2.

[37] Michael Kitces, *Most FLP Valuation Discounts Would End Under Proposed Regulations*, available online at *www.kitces.com/blog/disregarded-restrictions-in-proposed-section-2704-regulations-would-eliminate-flp-valuation-discounts/.*

[38] Richard L. Dees, *Attorney Criticizes Possible Changes in Valuation Discount Rules*, in a letter written by Richard Dees, published in TAX NOTES TODAY (Aug. 31, 2015), available online at *https://sites-mwe.vuturevx.com/27/1960/uploads/tax-notes---dees-valuation.pdf.*

[39] Reg. §25.2701-2(b)(5)(ii)(A).

[40] Reg. §25.2701-2(b)(5)(ii)(B).

[41] 51 FR 51419 (2016).

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] *Id.*, at 51416.

[47] *Murphy Est.*, 60 TCM 356, Dec. 46,770(M), TC Memo. 1990-403.

[48] John M. Janiga and Louis S. Harrison, *Valuation of Closely Held Stock for Transfer Tax Purposes: The Current Status of Minority Discounts for Intrafamily Transfers in Family-Controlled Corporations*, 69 TAXES 309 (1991), at 315. We also wrote that "On the other hand, *Murphy* may be broadly read as the genesis of a judicial trend accepting the underlying reason, although not the actual theory, of the Service's application of family-attribution principles to the transfer tax arena." *Id.* As it turns out, while the IRS often attempted to use a family-attribution principle in later cases, it was often unsuccessful.

[49] Kitces, *supra* note 37.

[50] *Id.*

[51] 51 FR, at 51423.

[52] *Id.*, at 51422.

[53] For these purposes, a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related to either the entity or any holder of any interest in the entity, is not considered property. The only exception would be a note issued by certain entities engaged in an active trade or business and only if the note meets a number of requirements.

[54] 51 FR, at 51424.

[55] Jonathan G. Blattmachr & Mitchell M. Gans,Commentary in *Steve Leimberg's Estate Planning Newsletter* (Aug. 5, 2016).

[56] *Id.*

[57] 51 FR, at 51423.

[58] A particularly forceful and persuasive set of arguments is contained in Dees, *supra* note 38.

[59] The Treasury has indicated informally that the three-year lookback will be only for transactions after the effective date.

[60] This topic is discussed in a 2014 column. Louis S. Harrison and John M. Janiga, *Estate & Succession Planning Corner Discounts vs. Step-Up Basis: Tax Rate Arbitrage Gone Bad (or Not as Good as Expected)?* J. PASSTHROUGH ENTITIES, Mar.–Apr. 2014, at 15.