BROWNEDWARDS

TAX WATCH

August 12, 2016

IRS PROPOSED REGULATIONS TARGET GIFT AND ESTATE TAX PLANNING STRATEGIES

The IRS has released proposed regulations that would close so-called tax loopholes that many wealthy taxpayers have used to minimize transfer taxes (such as gift and estate taxes) when transferring interests in a closely held family business to relatives. If finalized, the regulations would significantly limit the effectiveness of certain tax-saving vehicles, including family limited partnerships, for reducing the taxable value of transferred interests. They would apply to family-controlled corporations, partnerships and limited liability companies.

If you've been considering such a strategy, you may need to act soon to take advantage of current tax provisions in the event the rules change.

Deathbed transfers targeted

Among other things, the proposed regulations address deathbed transfers of interests in family businesses that result in the lapse of a liquidation right (the right or ability — including by reason of voting power — to force the business to buy all or part of the transferor's interest in the business). A lapse generally is treated either as a gift or as a testamentary transfer (that is, a transfer at death) includible in the transferor's gross estate. In other words, it could be subject to transfer taxes.

Current regulations include a rule that a lapse of a liquidation right occurs at the time an exercisable liquidation right is restricted or eliminated. But under an exception, a *transfer* that results in a liquidating right's lapse generally isn't subject to this rule if the rights associated with the transferred interest aren't restricted or eliminated. The effect has been that a transfer of a minority interest in a business by a living individual with the voting power to force the business to acquire his or her interest isn't treated as a lapse, even though the transfer results in the loss of the transferor's liquidation right.

The IRS opposes the use of this exception when the transfer occurs on the transferor's "deathbed." According to the IRS, these transfers generally have minimal economic effects but produce a transfer tax value that's less than the interest's actual value.

The proposed regulations would limit the exception to transfers occurring more than three years

before death, when the loss of a liquidation right is likely to have a more substantive effect. Transfers made within three years of death that result in a liquidation right lapse would be treated as testamentary transfers.

In addition, the proposed regulations would treat a transfer that results in the restriction or elimination of any of the rights associated with a transferred interest as a lapse, regardless of whether the transferor can exercise the right after the transfer.

Valuation discounts narrowed

Additional changes in the proposed regulations would dramatically limit the availability of discounts when transferred interests in family businesses are valued for tax purposes. Currently, taxpayers can obtain significant discounts for lack of control and marketability. These discounts can help keep the value of taxpayers' estates within the lifetime gift and estate tax exemption. (For 2016, the exemption is $5.45 million for individuals or $10.9 million for married couples filing jointly.)

When quantifying discounts for lack of control and marketability, valuators consider a variety of factors, including the nature of the partnership's underlying assets, historical and expected income distributions, market conditions, rights and restrictions granted in the partnership agreement, state laws, and legal precedent. The proposed regulations would significantly limit the partnership provisions that could be considered when discounting a family-business interest.

Among the changes proposed to limit discount availability are:

Applicable restrictions. Under the tax code, certain "applicable" restrictions on transferred interests in a family business (*which would typically justify discounts in the value of those interests*) are disregarded when valuing the interests for gift or estate tax purposes.

An applicable restriction is one that effectively limits the ability of the business to liquidate (in whole or in part) but that will lapse or can be removed by the transferor, the transferor's family or the transferor's estate. If, for example, a taxpayer transfers an interest in a family business to his daughter — and the interest has a restriction limiting the business's ability to liquidate that the taxpayer can remove (or that will lapse) — the restriction can't be one of the factors used to justify the discounts for lack of control or marketability when estimating the interest's fair market value on a minority, nonmarketable basis.

Current regulations limit this definition by requiring that an applicable restriction be more restrictive than the limitations that would apply under local law in the absence of the restriction. The IRS found that changes in state laws and other developments have essentially rendered the current regulations regarding applicable restrictions ineffective.

The proposed regulations refine the definition of applicable restriction. They would eliminate the comparison to the liquidation limitations of state law, meaning that more liquidation limitations will qualify as applicable restrictions to be disregarded in valuation. The regulations also would clarify that an applicable restriction limits the ability to liquidate the business, not a particular owner's interest in the business, and includes a restriction imposed under the terms of the

governing documents (for example, bylaws or a partnership agreement) or under a local law.

Disregarded restrictions. The proposed regulations also identify some additional restrictions that may reduce the transfer tax value of an interest in a family business despite not reducing the interest's value to the family member receiving it — and therefore that should be disregarded for transfer tax valuation purposes.

Specifically, a restriction on an interest owner's right to sell that interest would be disregarded if the restriction will lapse after the transfer or if the transferor (or the transferor and family members) may remove or override the restriction. Such disregarded restrictions include one that:

- Limits the interest owner's ability to liquidate the interest,
- Limits the liquidation proceeds to an amount less than the minimum value (the interest's share of the business's net value on the date of liquidation, or the fair market value of the property held by the business reduced by the business's outstanding obligations),
- Defers the payment of the proceeds for more than six months, or
- Permits the payment of the proceeds in any manner other than cash, property or certain notes.

These restrictions would be ignored for valuation purposes under the proposed regulations, generally resulting in higher values for tax purposes.

Insubstantial transfers to nonfamily members. The proposed regulations also tackle the treatment of the transfer of an interest in a family business to a nonfamily member. The IRS says that taxpayers have avoided the applicable restriction trap by transferring a nominal interest in their family business to a nonfamily member, such as a charity or an employee, to ensure that the family alone doesn't have the power to remove a restriction.

Under the proposed regulations, the existence of such an interest would be recognized only if the interest is economically substantial and longstanding. Specifically, a nonfamily member's interest would be disregarded if:

- It has been held for less than three years before the transfer,
- It represents less than 10% of the value of all of the ownership interests,
- It constitutes less than 20% of the value of all of the ownership interests, when combined with the interests of other nonfamily members, or
- It lacks a right to "put" the interest to the business and receive a minimum value (the interest's share of the business's net value on the date of liquidation, or the fair market value of the property held by the business reduced by the business's outstanding obligations).

If all nonfamily member interests are disregarded, the entity is treated as if it's controlled by the family.

Act now

A public hearing on the proposed regulations has been scheduled for December 1, 2016, and the regulations won't take effect until at least 30 days after they're finalized. But the IRS faces an uphill

battle against many taxpayers, estate planning advisors and some lawmakers when it comes to closing the door on this gift and estate planning tool. Opponents argue that the IRS may have overstepped its authority in issuing these proposed regulations. The IRS might be persuaded to water down its proposal before finalizing it.

If the regulations are approved as-is or in a modified format, they'll apply prospectively, so you still have a window to take advantage of the current regulations if you're considering transfers of interests in family businesses. Contact Brown Edwards tax professionals for assistance in structuring transfers and applying discounts in a way that will pass muster with the IRS.

Your Success Is Our Focus. **BrownEdwards@BEcpas.com**

www.BEcpas.com