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Proposed Regulations Issued That Would Impact Valuation Discounting*

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Overview

Over the past few decades, valuation discounting through the use of family-owned business entities has become a popular estate and gift tax planning technique. If structured properly, the courts have routinely validated discounts ranging from 10 to 45 percent. Valuation discounting has proven to be a very effective strategy for transferring wealth to subsequent generations. It is a particularly useful technique with respect to the transfer of small family businesses and farming/ranching operations. Similar, but lower, valuation discounts can also be achieved with respect to the transfer of fractional interests in real estate.

The basic concept behind discounting is grounded in the IRS standard for determining value of a transferred interest – the willing-buyer, willing-seller test. In other words, the fair market value of property is the price it would changes hands at between a hypothetical willing-buyer and a willing-seller, with neither party being under any compulsion to buy or sell. Under this standard, it is immaterial whether the buyer and seller are related – it's based on a hypothetical buyer and seller. Thus, there is no attribution of ownership between family members that would change a minority interest into a majority interest.

Now, IRS has issued new I.R.C. §2704 regulations that could seriously impact the ability to generate valuation discounts for the transfer of family-owned entities.[1] The proposed regulation was issued by itself, and not also as a temporary regulation, and does not have any provision stating that taxpayer can rely on it before it is issued as a final regulation.

The effective date of the proposed regulation is to any lapse of any right created on or after October 8, 1990 occurring on or after the date the proposed regulations is published in the Federal Register as a final regulation. Which would make it nearly impossible to avoid the application of the final regulation by various estate planning techniques.

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[1] Prop. Reg. – 163113-02 (Aug. 2, 2016).

Discounting Before the "Freeze" Rules

Buy-sell agreements. Before 1990, discounts based on restrictive agreements were allowed.[2] However enactment of the "freeze" rules in 1990 (effective for transfers after October 8, 1990) called that line of cases into question.[3] Relative to buy-sell agreements, the value of property is determined without regard to any option, agreement, right or restriction unless: (1) the option, agreement, right or restriction is a bona fide business arrangement; (2) the option, agreement, right or restriction is not a device to transfer the property to members of the decedent's family for less than full and adequate consideration; and (3) the terms of the option, agreement, right or restriction are comparable to those obtained in similar arrangements entered into by persons in an arm's length transaction. A binding agreement exclusively among persons who are not natural objects of each other's bounty meets the three requirements.[4]

> **Note:** Buy-sell agreements are used for more than just valuation purposes. Buy-sell agreements and purchase options for farm and ranch operations have as their primary objective holding the farming and ranching operation together and re-concentrating complete ownership in the hands of the farm operator.
>
> **Observation:** For situations involving multiple operators, the *form* of the buy-sell agreement traditionally used by unrelated parties would be appropriate. But, in agriculture, the focus is usually on the arrangement between operators and non-operators.

Options. A well-drafted buy-sell agreement should provide a mechanism for attaining the organizational objectives of the current owners and minimizing conflict among the next generation. As an alternative, the operator may be given an option through contract or by the will of the parents to purchase interests of the non-operators at a specified value. But, realization must be made that the successor-operator may not be financially able to purchase the non-operators' interests. This may be particularly the case if the children received equal portions according to value and non-operators are more numerous than operators. For farming operations, often, the sole source of cash for such purposes is farm income.

The option can possibly control the estate value of interests in the real estate entity (in multiple entity situations), which are includible in the parents' gross estates. But, the option price must be set in good faith and be supported by adequate and full consideration, and the agreement must restrict the parents' market for their interests so that they cannot sell the real estate entity or the farmland without permitting the successor-operator to buy at the option price (i.e., the parents must be restricted from obtaining a better price during their lifetimes). IRS may disregard an option price unless the agreement is a bona fide business arrangement and not a device to pass property to the natural objects of the decedent's family for less than adequate and full consideration.[5] The bona fides of an option with the successor-operator should be possible to support. The activities of a child as successor-operator, and compliance with the other terms of the lease, substantiate the bona fides of the agreement and the option.

> **Note:** It may be desirable to permit the successor-operator to make the purchase

[2] See Estate of Novak, 87-2 U.S.T.C. ¶13,728 (D. Neb. 1987)(discount based on buy-sell agreement); Priv. Ltr. Rul. 200502035 (Sept. 30, 2004)(sale of family-owned properties not subject to gift tax under I.R.C. §2702 because proceeds subject to trust agreement entered into before Oct. 8, 1990).
[3] Pub. L. No. 101-508, §§11601, 11602, 104 Stat. 1388-490 (1990), *adding* I.R.C. §2701 *et seq*.
[4] See Estate of Gloeckner v. Comr., 153 F.3d 208(2d Cir. 1998), *rev'g*.,T.C. Memo. 1996-148 (restrictive agreement controlled valuation; testamentary purpose not behind agreement).
[5] Treas. Reg. § 20.2031-2(h).

at a price determined by the value for estate tax purposes, so as to minimize the possibility of inflation creating a nominal purchase price.

While buy-sell agreements and options were utilized either as part of an overall valuation discounting strategy before the "freeze" rules of 1990, they remain viable planning tools today.

The "Freeze" Rules

The "freeze" rules of I.R.C. §§2701, 2703 and 2704 became effective for transfers after October 8, 1990. On the valuation issue, of particular concern is I.R.C. §2703(b). Under I.R.C. §2703(a)(2), the value of property for transfer tax purposes is determined without regard to any restrictions on the right to use property. But, I.R.C. § 2703(b) exempts a restriction that is a bona fide business arrangement, is not a device to transfer property to family members for less than full consideration, and has terms comparable to those in an arm's-length transaction.

I.R.C. §2704(b) applies when an interest in a corporation or partnership is transferred to a family member, and the transferor and family members hold, immediately before the transfer, control of the entity. In such instances, any applicable restrictions (such as a restriction on liquidating the entity that the transferor and family members can collectively remove) are disregarded in valuing the transferred interest.[6] The regulations provide that an applicable restriction is a limitation on the ability to liquidate the entity that is more restrictive than the restriction that would apply under state law in the absence of the restriction.[7] If there is an overlap between I.R.C. §2704(b) and I.R.C. §2703(a), the provision subject to I.R.C. §2703 is not an applicable restriction under I.R.C. §2704.

I.R.C. §2704(b)(1) provides that for estate and gift tax purposes, if 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, and the transferor and members of the transferor's family control the entity immediately before the transfer, any "applicable restriction" shall be disregarded in determining the value of the transferred interest. Under I.R.C. §2704(b)(2), the term "applicable restriction" means any restriction that effectively limits the ability of the corporation or partnership to liquidate if (i) the restriction lapses after the transfer of the interest, or (ii) the transferor or a member of the transferor's family, either alone or collectively, has the right to remove the restriction after the transfer. But, under I.R.C. §2704(b)(3), the term "applicable restriction" does not include any restriction imposed by federal or state law. Thus, a restriction on the ability to liquidate the entity may only be disregarded if it is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction in the partnership agreement. So, it is important to form the entity in a jurisdiction where state law backs up liquidation and dissolution provisions of the partnership agreement for I.R.C. §2704(b) purposes.

> **Observation:** From a planning perspective, the I.R.C. §2704(b) issue should not arise if partnership interests are given to non-family members who are likely to consent, if necessary, to a removal of the restrictions.

If I.R.C. §2704(b) applies, the minority interest discount may still apply, but the lack of marketability discount will be reduced by the deemed right to "put" the interest – a "lock-in" discount. The question then becomes whether the interest being transferred is an LP interest or

[6] I.R.C. §2704(b)(1).
[7] Treas. Reg. §§25.2704(a).

merely that of an assignee. If a partnership interest is transferred to an individual who is an unrelated person, the individual is an assignee with no voting privileges. Consequently, the individual's right to dissolution does not exist and I.R.C. §2704(b) should not apply. But, the use of "assignee interests" (where the interest is not transferred - only the income from the interest) for intra-family transfers to get around the limitations of I.R.C. §2704(b) has been disapproved.[8]

Under I.R.C. §2704(a), a lapse of a voting or liquidation right in an FLP where the individual holding the right immediately before the lapse controls (along with family members) the entity (both before and after the lapse), is treated as a transfer by gift or a transfer that is includible in the decedent's gross estate. Since it is treated as a gift, however, the gift could reduce the transferor's interest below that of a controlling interest. The IRS position is that I.R.C. §2704(a) applies when a partnership interest converts to an assignee interest. However, in *Kerr v. Comr.*,[9] the court held that the restriction of I.R.C. §2704(a) did not apply because the facts involved an equity holder's redemption of their interest in the entity, rather than the liquidation of the entire entity. The court held that I.R.C. §2704(a) was limited in its application to liquidation of the entire entity, and the restriction at issue was not more restrictive than that allowed under state law. Also, the addition of a charity into the mix resulted in the family not having the ability, by itself, to remove the "applicable restriction."

Family Limited Partnership (FLP)

The principal objective of an FLP is to carry on a closely-held business where management and control are important. FLPs have non-tax advantages, but a significant tax advantage is the transfer of present value as well as future appreciation with reduced transfer tax.[10] Commonly in the ag setting, the parents contribute most of the partnership assets in exchange for general and limited partnership interests. The nature of the partnership interest and whether the transfer creates an assignee interest (an interest where giving the holder the right to income from the interest, but not ownership of the interest) with the assignee becoming a partner only upon the consent of the other partners, as well as state law and provisions in the partnership agreement that restrict liquidation and transfer of the partnership interest can result in discounts from the underlying partnership asset value. However, as the use of FLPs expanded, so did the focus of the IRS on methods to avoid or reduce the discounts. In general, FLPs have withstood IRS attack and produce significant transfer tax savings. But, there are numerous traps for the unwary.

> **Typical scenario:** In a typical scenario, a married couple who owns a family business sets up an FLP with the interest of the general partnership totaling 10% of the company's value and the limited partnership's interest totaling 90%. Each year, both parents give each child limited-partnership shares with a market value not to exceed the gift tax annual exclusion amount. In this way, the parents progressively transfer business ownership to their children without having to incur estate or gift taxes. Even if the limited partners together own 99% of the company, the general

[8] See Kerr v. Comr., 292 F.3d 490 (5th Cir. 2002), *aff'g,* 113 T.C. 449 (1999)(partnership agreement did not contain "applicable restriction" within meaning of I.R.C. § 2704(b) because of statutory exception of provisions based on state or federal law and restrictions in question were no more restrictive than limitations that would apply under state RLPA); see also Jones v. Comr., 116 T.C. No. 121 (2001)(limited partnership interests not assignee interests, were transferred by gift; overall discount limited to 44.8%); but see, Adams v. United States, 218 F.3d 383 (5th Cir. 2000), *rev'g,* 99-1 U.S.T.C. ¶60,340 (N.D. Tex. 1999).

[9] Kerr v. Comr., 292 F.3d 490 (5th Cir. 2002), *aff'g,* 113 T.C. 449 (1999).

[10] See Estate of Kelley v. Comr., T.C. Memo, 2005-235 (FLP interest valued under net asset value method with 35 percent discount).

partner will retain all control and is the only partner with unlimited liability.

Discounts with FLPs. Discounts for non-marketability and for a minority interest have been allowed with family partnerships.[11] However, a family limited partnership formed two days before death has been disregarded for valuation purposes by IRS.[12] Similarly, a limited partnership formed pursuant to a power of attorney two months before a decedent's death has been disregarded by IRS for federal estate tax valuation purposes.[13] Indeed, if the only purpose behind the formation of a family limited partnership is to depress asset values, with nothing of substance changed as a result of the formation, the restrictions imposed by the partnership agreement are likely to be disregarded.[14]

The Internal Revenue Service evaluates such transactions in light of whether the arrangement –

- Was a device to transfer property to a family member for less than adequate consideration;
- Was not the result of arm's length negotiations having a valid business purpose; and
- Involved an implied understanding for gifts made that grantor would retain economic benefits of gifted property.

What about business purpose? While an FLP formed without a business purpose may be ignored for income tax purposes, lack of business purpose, it had been thought, would not prevent an FLP from being given effect for transfer tax purposes, thereby producing valuation discounts. But, the Tax court, in *Estate of Bongard v. Comr.*,[15] held that, for or estate tax purposes, these must be a legitimate and significant non-tax reason for creating the FLP. In *Estate of Strangi v. Comr.*,[16] the taxpayer formed an FLP and transferred assets to it in return for a 99% limited partnership interest. The FLP was formed in accordance with state law. The court held that I.R.C. § 2702(a)(2) didn't apply on the basis that the Congress did not

[11] See Estate of Watts, T.C. Memo. 1985-595 (35% discount of 15% partnership interest for non-marketability for federal estate tax purposes); Peracchio v. Comr., T.C. Memo. 2003-280 (gifts of FLP interests discounted 6 percent for minority interest and 25 percent for lack of marketability).

[12] Priv. Ltr. Rul. 9719006 (Jan. 14, 1997)(only purpose for partnership was to depress value of partnership assets through decedent's gross estate into control of children). See also Estate of Murphy v. Comr., T.C. Memo. 1990-472 (transaction entered into for sole purpose of reducing estate tax; valuation discount disallowed). Compare Estate of Lehmann, T.C. Memo. 1997-392 (value of decedent's interest in limited partnership owning real property determined from discounted cash flow methodology with adjustments; discounts by estate rejected as producing unrealistically low value).

[13] Priv. Ltr. Rul. 9723009 (Feb. 24 1997) (transfer of decedent's two residences and personal property in exchange for 98% limited partnership interest followed by transfer of partnership interest to revocable trust for distribution to son treated as single testamentary transaction; IRS believed nothing of substance was intended by partnership arrangement). See also Priv. Ltr Rul. 9725002 (Mar. 3, 1997) (partnership formed from assets held in revocable trust two months before death at time when taxpayer incompetent; partnership disregarded for property valuation purposes as serving no business purpose and not bona fide arm's length business arrangement).

[14] Priv. Ltr. Rul. 9730004 (Apr. 3, 1997) ($400,000 of farmland exchanged for 99% limited partnership interest; unsuccessful attempt to value partnership interest 54 days later for federal estate tax purposes with 40% discount); Priv. Ltr. Rul. 9842003 (Jul. 2, 1998) (sole or primary purpose was reduction of federal estate tax for transfer within six weeks of death; existence of family limited partnership disregarded); F.S.A. 200049003 (Sept. 1, 2000)(listing of IRS arguments for attacking family LLCs).

[15] 124 T.C. 95 (2005).

[16] T.C. Memo. 2003-145, *on rem. from,* Gulig v. Comr., 293 F.3d 279 (5th Cir. 2002), *aff'g in part and rev'g in part, sub. nom,* Estate of Strangi v. Comr., 115 T.C. No. 35 (2000).

intend partnership assets be treated as assets of the estate where the decedent's legal interest at the time of death was the limited partnership (or corporate) interest. The court allowed a 31% discount as to the limited partnership interest and 19% for the general partnership interest.

> **Note:** In *Strangi*, the Tax Court held that IRS failed to raise *I.R.C. § 2036* argument in timely manner, but Fifth Circuit reversed Tax Court's denial of IRS's leave to amend on *I.R.C. §2036* claim. On remand, Tax Court held that decedent retained by implied agreement the possession, enjoyment or right to income from property under *I.R.C. §2036(a)(1)*. Court noted instances where FLP expended funds to meet transferor's personal needs. Court adopted alternative holding that value of assets included in decedent's estate at full value (for those assets in deficiency notice) under *I.R.C. §2036(a)(2)*. The Fifth Circuit affirmed.[17]

New Proposed Regulations

Under the proposal, three types of entities would exist for purposes of the test to determine control of an entity and to determine whether a restriction is imposed under state law – corporations, partnerships and other business entities (LLC that are not S corporations, for example). The proposal defines "control" as the holding of at least 50 percent of either the capital or profits of the entity or arrangement, or the holding of an equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. In addition, an individual's estate, and members of an individual's family are treated as holding interests indirectly through a corporation, partnership, trust or other entity. As to the lapse provision, the IRS proposed regulation imposes a three-year rule. That is, if the transferor of the interest fails to outlive the transfer by three years, the lapse of the voting or liquidation right caused by the transfer is treated as a lapse that occurs on the transferor's date of death and is included in the transferor's gross estate under I.R.C. §2704(a). Also, the proposed regulation[18] would remove the existing exception for local law and define an "applicable restriction" as one imposed under the terms of the entity's governing documents, a buy-sell agreement, a redemption agreement, or an assignment or deed of gift or any other document, and a restriction imposed by local law. The proposal also defines "an applicable restriction" as any local law that requires a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of I.R.C. §2704. In addition, the proposal adds a list of specifically disregarded restrictions as anything that – limits the holder's ability to liquidate the interest; limits the liquidation proceeds to an amount that is less than a minimum value; defers the payment of the liquidation proceeds for more than six months; or permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes. The preamble to the regulation provides for an additional disregarded restriction – any limitation on time and manner of payment of the liquidation proceeds that defers payment beyond six months. Also, the preamble bars any payment of liquidation proceeds in any manner other than cash or property.

The proposed regulation also contains a rule for notes, entities operating business that contain passive assets, non-family equity holders (to reverse the government's loss in the *Kerr* case), and a provision that says that "disregarded restrictions are to be ignored when determining fair market value of an asset. There also is a provision that appears to be designed to eliminate the

[17] Strangi, *et. al.* v. Comr., 417 F.3d 468 (5th Cir. 2005).
[18] Prop. Treas. Reg. §1.2704-2(b)(2).

"charitable lead" estate planning concept that has been validated numerous times by the court for both estate and gift tax purposes.

Conclusion

When the "freeze" rules were initially enacted in 1990, I.R.C. §§2701, 2703 and 2704 (and the regulations thereunder) they were designed to deal with what IRS viewed as abuses with respect to partnerships and limited liability companies (LLCs) that restricted the ability of a partner/member to liquidate the entity. However, the legislative history of Chapter 14 (I.R.C. §§2701, 2703 and 2704) indicates that the Congress intended ordinary minority and marketability valuation discounts to be respected, even in a family context.[19] In addition, the courts have validated various planning concepts that have preserved valuation discounts.

Clearly, the Treasury has wide latitude to issue regulations impacting valuations. But, the Code is clear that the asset being transferred (such as an FLP interest) is the asset that is subject to valuation under the willing-buyer/willing-seller test. Valuation in the entity context is not tied to the value of the underlying assets. The proposed regulation sets forth more restrictive rules to crack-down on valuation discounts, but the Courts may have a different view based on the longstanding Congressional intent to allow discounts in a family context. Having discretion does not mean that Treasury has discretion to determine value as it pleases.

The new regulations will have to be analyzed and paid attention to. Comments on the proposed regulation are due by 90 days from August 4, 2016.

[19] See Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-580, section 11602a; H.R. Conf. Rept. No. 101-964.