Client Alert *August 29, 2016*

PROPOSED IRS VALUATION REGULATIONS AFFECT FAMILY LIMITED PARTNERSHIPS

The IRS recently issued its much anticipated proposed regulations under Section 2704 of the Internal Revenue Code dealing with the use of valuation discounts when transferring (during life or at death) interests in family limited partnerships ("FLPs") and similar entities. FLPs and similar entities are frequently used in gift and estate tax planning to facilitate the transfer of minority or nonvoting interests to family members at values that are discounted from the *pro rata* value of the underlying assets.

Most clients are aware that transfers of minority or nonvoting interests in FLPs or similar entities are discounted for gift tax purposes because the transferred interest is usually subject to transfer restrictions, liquidation restrictions, the absence of an established market, absence of voting rights, or lack of control. Section 2704 of the Code was enacted to combat certain valuation techniques by disregarding those restrictions and limitations in cases that Congress considered abusive. But the practice of transferring discounted interests has continued apace since the enactment of Section 2704, and the IRS has now acted on its express authority to broaden the scope of Section 2704 by proposing a much more robust regulatory scheme. The proposed regulations, if finalized in their current form, would greatly limit the use of such valuation discounts. The major changes are as follows.

TRANSFERS WITHIN THREE YEARS OF DEATH/TRANSFER TO ASSIGNEE

Section 2704(a) generally provides that if an individual transfers an interest in an FLP to a family member such that his or her liquidation or voting rights in the FLP lapse as a result of the transfer, the value of the lapsed liquidation or voting right will be a taxable gift or included in the transferor's gross estate if the transfer occurs as the result of the transferor's death. The current Treasury Regulations clarify that Section 2704(a) does not apply when the rights associated with the transferred interest do not lapse. However, under the new proposed regulations, if the transfer is made within three years of death, even if there is no lapse of voting or liquidation rights at the time of transfer, those rights are *deemed to have lapsed* at the time of death. The proposed regulations further clarify that Section 2704(a) applies to a transfer to an assignee, even when the transferor retains his or her liquidation and voting rights with respect to the transferred interest.

For example, assume a father owns 90% of an FLP and transfers 49% of his interest to his children. After the transfer, the father no longer holds enough shares to force liquidation of his interest in the FLP. However, the value of this lapsed liquidation right is not a taxable gift under 2704(a) because the voting rights associated with the transferred interest were not eliminated. Under the new regulations, if the father dies within three years of the transfer, the value of the lapsed liquidation right will be included in his estate. In other words, the difference between the value of the 41% interest held by the father before his death (with no discounts due to lack of ability to liquidate) and the value of the 41%

interest after the father's death (with minority discounts due to the fact that father and children cannot each unilaterally force a liquidation) will be included in the estate. If the undiscounted value of the 41% interest is $5,000,000, and the discounted value of the interest is $3,000,000, then under the proposed regulations, an extra $2,000,000 in value will be included in the father's estate. We note, however, that, although this seems to be the plain meaning of the proposed regulations, some commentators already are adopting different (and more negative) interpretations of the mechanics of this provision.

No Discounts for Liquidation Restrictions in Partnership Agreement More Restrictive Than Those Mandated by State Law

Section 2704(b) of the Code provides that when an individual transfers an interest in a family controlled FLP to the transferor's family, certain liquidation restrictions will be disregarded when valuing the interest for transfer tax purposes if the transferor or transferor's family can remove such restrictions or if the restrictions will lapse after the transfer. Under current law, valuation discounts are permitted for liquidation restrictions imposed under the entity's agreement that are no more restrictive than the liquidation restrictions that would apply generally under state law in the absence of the provision. Most state partnership laws, including Texas, require the unanimous consent of partners to liquidate the entity (in the absence of a contrary provision in the agreement); therefore, a discount is currently permitted for similar liquidation restrictions.

Under the new proposed regulations, only those liquidation restrictions (including "applicable restrictions," which deal with the entity's ability to liquidate, and "disregarded restrictions" as detailed below) that are *required* to be imposed under state law (*i.e.,* only mandatory restrictions) will be taken into account for valuation purposes. Because most, if not all, state partnership laws can be modified pursuant to the partnership agreement, the proposed regulations effectively eliminate discounts attributable to liquidation restrictions imposed under default state law.

In short, this significant provision in the Proposed Regulations would eliminate in Texas any discount attributable to the fact that a limited partner or minority shareholder would have to secure the unanimous consent of the other equity holders to liquidate the entity.

Additional Disregarded Restrictions

The proposed regulations also identify new "disregarded restrictions" that can no longer be taken into account for valuation purposes. These are restrictions on an individual's ability to liquidate his or her interest in an entity that will also be disregarded for valuation purposes if the restriction will lapse after the transfer or if the transferor and/or the transferor's family may override the restriction. Such new "disregarded restrictions" include restrictions that do one or more of the following:

(i) limit the ability of the holder to liquidate the interest,
(ii) limit the liquidation proceeds to an amount that is less than the *pro rata* share of the net asset value of the entity,
(iii) defer the payment of liquidation proceeds for more than six months, or

(iv) permit the payment of the liquidation proceeds in any manner other than cash or other property, other than certain notes.

The new "disregarded restrictions," according to commentators, will effectively result in valuations as if the holder of the interest has the right to sell the interest within six months of the transfer for a value at least equal to the *pro rata* share of the entity's net asset value.

For example, a restriction in an FLP agreement that prohibits a limited partner from redeeming his or her interest will be disregarded for valuation purposes. The interest will instead be valued "under generally accepted valuation principles, including any appropriate discounts or premiums" as if such liquidation restrictions do not exist. In other words, the interest will be valued as if the holder had the right to liquidate his or her interest, within six months, at the interest's *pro rata* share of the net asset value of the FLP, even if default state law or the FLP documents do not allow liquidation on such favorable terms. There remains confusion as to what "appropriate discounts or premiums" would be available, if any, if liquidation restrictions are disregarded. Perhaps a discount will be available for lack of marketability of the assets themselves, or a "lack of continuity" discount taking into account the restructuring that would need to occur within the FLP to provide adequate liquidity in order to redeem the interest (for example, additional loans might be needed). In any event, the discounts will assuredly be greatly reduced in entities other than those that are actively operating businesses.

Certain Non-Family Member Interests Disregarded

Under the proposed regulations, in determining whether the transferor and/or the transferor's family have the right to remove a disregarded restriction after the transfer, any interest held by a non-family member is disregarded unless it is an economically substantial interest, as determined under a bright-line test. A non-family member interest will be disregarded if (i) the interest has not been held by the non-family member for more than three years; (ii) the interest constitutes less than 10% of the interests in the company; (iii) the interest, when combined with the interests held by other non-family members, constitutes less than 20% of the equity interests in the company, or less than 20% of the capital and profits interest in a business entity other than a corporation; or (iv) such non-family member holding the interest does not have the right to receive in exchange for such interest, on no more than six months notice, the *pro rata* share of the net value of the entity's assets. Due to the onerous requirements, it is unlikely that a non-family member will qualify under the bright-line test.

Covered Entities

While Section 2704 by its terms deals with corporations and partnerships, the proposed regulations clarify its application to LLCs and other business entities.

Effective Date

The regulations will only apply to transfers occurring after the final regulations are published. A public hearing on the proposed regulations is scheduled for December 1, 2016. Although we cannot predict whether and when the proposed regulations will be finalized, particularly as drafted, if a family is already contemplating the use of FLPs to reduce estate and gift tax burdens, it would be wise to consider making the transfer before the proposed regulations are finalized after the December 1 hearing.

These regulations are a shot across the bow of the estate planning community. It remains to be seen whether the IRS will retreat in any way when it receives comments from the bar. We should note that, if the regulations are finalized in something close to their current form, we expect court challenges to their validity. The IRS has broad authority to promulgate regulations under Section 2704, but a number of commentators believe the IRS has gone beyond its authority.

We will continue to provide updates as this important topic develops.

If you have additional questions, please do not hesitate to contact the Thompson & Knight attorney with whom you regularly work or one of the attorneys listed below.

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