Basics of Estate Planning

THE ESTATE AND GIFT TAX REGIME ASSESSES TAX ON THE VALUE OF THE ASSETS AT THE TIME OF TRANSFER. VALUE IS AN "ELASTIC" CONCEPT AND PRACTITIONERS HAVE USED A VARIETY OF TECHNIQUES TO DEPRESS THE VALUE OF AN ASSET FOR TAX PURPOSES.

Going… Going… Gone.

The IRS recently issued proposed regulations for Code Section 2704 which address discounts on certain common family estate or planning vehicles. If the proposed IRS 2704 regulations are adopted in their current form, they will have the effect of virtually eliminating all proverbial "icing on the cake" of a common estate planning technique used by most advisers and families of interests in family controlled entities, and leaving only the sponge. The minority or lack of control valuation discounts for transfer tax purposes in the context of family-controlled entities will effectively be eliminated, thereby reducing the effectiveness of traditional estate freeze techniques utilized under current law. This would have significant implications for the menu of current estate planning options available to taxpayers.

The regulations are intended to be prospective in application and will not take effect sooner than the first hearing, scheduled for December 1, 2016. While the final effective date, and form, of these provisions is unknown, it is certain that families must assess their existing structures as well as their short-term and long-term planning goals before the December first meeting and, if possible, execute any strategies before a possible effective date change. While unlikely, in the past the effective date has been changed during a committee hearing, so that regulations become retroactive in application at some point, even if the regulations themselves are not finalized for months or years to come. Our expectation is that these regulations will become effective in early 2017.

SO, WHERE TO FOCUS? The proposed changes specifically to intra -family transfers of interests in family controlled entities – LLCs, partnerships, S or C corporations. Essentially, the discounting on the transfer of these interests will be eliminated in many instances, unless challenges to the regulations are successful. Currently, the guidance on when discounts would be challenged or disregarded has been developed on a case-by-case basis through court cases or IRS rulings. These proposed regulations will provide clarity to an issue where previous guidance was uncertain.

The proposed Regulations begin by clarifying what entities are affected. In particular, LLCs are a relatively recent creation and these proposed regulations are updating certain provisions of the Code which currently only refer to Partnerships and more traditional entities. The IRS wants to ensure that any entity giving rise to these discounts and deductions in intra-family situations is covered by the regulations.

The regulations then propose to bring back into a decedent's estate any transfers made within 3 years of death, and treat these transfers as if they were made "on the deathbed." This means that that the full value of the asset (without any discount) would be added back into the estate for tax purposes.

The regulations would also eliminate any minority discounts where you are not a full owner, clarify that "control" in the context of an LLC or other entity that is NOT a corporation, partnership, or limited partnership requires an individual to hold at least 50% of the equity in the entity, or to have to an equity interest, such as a GP position, with the power to cause full or partial liquidation of the entity. Thus any lack of marketability discount would only arise to full owners (and likely would be less than currently available since a full owner could make an asset marketable). The regulations also would disregard any applicable state or federal law exceptions when determining fair market value of a transferred interest. In the last few decades, states have amended their statutes to permit discounting techniques in an effort to attract business to their jurisdictions. The regulations would ignore these state limitations on entities. The limitations can still exist, but the IRS is not going to recognize a discount on the ownership interests simply because of these state statutes.

Further, the regulations would eliminate a technique used by many practitioners in recent years of having a non-family member (often a charity) hold certain voting or liquidation rights. The proposed regulations would close this loophole and would disregard any such rights held by these entities unless the nonfamily member has held an interest for more than three years, owns a substantial interest in the entity, and has a put right to be redeemed for cash or property within six months' notice.

More troubling is that the proposed regulations will not exempt family- held *operating businesses* even if the family owns the business with distant relatives or strangers. The consequences are significant! For example, let's say Mom owns 60% of the voting stock in our family held enterprise. She gifts 15% of my voting stock to her two children, 50% equally to each of them. The current regulation values the children's 15% interest as a minority interest valued with a minority discount. Likewise, Mom's remaining shares (45%) are now considered a minority interest and would be valued with a minority discount. These newly proposed regulations would now require the donor (Mom) to survive 3 years after the gift is made; but, if death occurs within 3 years then the value of a lapse right that gave rise to the discount will have to be included in her estate for estate tax purposes. This is an outrageous effect considering the asset is gone from her estate and will be valued by the IRS as of her date of death, not the earlier date of the transfer value. It is worth noting that while the regulations are currently prospective only in application, it is unclear what would happen if Mom gifts interests before the regulations go into effect but dies after the regulations are effective and during the 3 year claw back for these pre-regulations transfers. This issue and others will undoubtedly be included in the commentary submitted for the Committee hearings.

To put this in perspective, Mark Mazur, Treasury assistant secretary for tax policy, said in a statement that the proposed regulations would eliminate a preference *"that certain taxpayers have long used to understate the fair market value of their assets for estate and gift tax purposes, and it is common for wealthy taxpayers and their advisers to use certain aggressive tax planning tactics to artificially lower the taxable value of their transferred assets."* Mazur added that the *"Treasury's action will significantly reduce the ability of these taxpayers and their estates to use such techniques solely for the purpose of lowering their estate and gift tax."*

Consider Action Today

If these regulations are enacted, this will be the biggest change in estate planning in the last 25 years. Even though the proposed regulations will drastically change (or eliminate) the minority valuation discounts associated with estate planning in the family-owned business context, there are steps clients can take in the next 90 *days* in regard to their own assets. Now may be the time to accelerate any gifting that have been under consideration. We are emphasizing the following four techniques because of the positive results in transferring appreciating assets from a client's estate, none of which require the use of any gift or GST exemptions.

GRANTOR RETAINED ANNUITY TRUSTS (GRATS)

The transfer of an appreciating asset into this type of trust will be beneficial because the fixed annuity paid each year will leave beneficiaries with little or no estate tax applied to the assets of this trust at the end of the annuity term. Coupling the current valuation discounts of FLP interests inside of a GRATs has the potential of dramatically increasing or "supercharging" the tax savings and performance of the GRAT. Indeed, GRATs may be particularly attractive because of the proposed disallowance of the discounts. A GRAT succeeds (or fails) by outperforming a predetermined rate of return. Funding a GRAT with discounted assets, knowing the discount may disappear, can ensure that the GRAT has some value at the end of its term, passing tax free to the beneficiaires.

INTENTIONALLY DEFECTIVE GRANTOR TRUSTS (IDGTS)

Transferring assets to this type of trust will be beneficial because the grantor of the estate will be able to make tax-free gifts to the estate and successfully transfer their money for the benefit of their beneficiaries. Families can supercharge the IDGT by using a traditional installment sale transaction to the IDGT which further reduces estate tax. Because this trust is considered a "grantor trust", the grantor is able to make tax free gifts to the trust in the amount of income taxes owed, thereby further reducing the client's estate for estate tax purposes. Another technique may be for clients to now sell interests in family-controlled entities to existing grantor trusts particularly if they are able to sell an asset to the trust at a discount and later "swap" that same asset out for assets of equivalent value; ultimately achieving the effect of allowing more assets into the trust on a transfer tax free basis.

FRACTIONAL INTERESTS

These are interests individuals own as "tenancy-in-common" – often real estate. It is possible these interests, used for real estate and personal property, will remain in affect with the new regulations. Section 2704 only applies to interests in family-controlled entities. Discounts for fractional ownership, real or personal, have been recognized in the past an ostensibly should be allowed. Assuming that fractional interest discounts will not be eliminated, transferring assets of real or tangible personal property may be beneficial because they will allow for the transfer of property with little transfer taxes.

GIFTS

Now is the time to accelerate any gifting that has been under consideration. Clients could benefit from gifting if they tailor their estate plans so charitable entities or non-family members who will be receiving gifts, hold small percentages of the company for the three-year kickback period prior to the transfer of funds. Then, their gifts to these organizations will not be disregarded by the new regulations in regards to transfer tax.

OTHER ACTIONS TO BE CONSIDERED

When reviewing estate plans, clients should also review their **insurance policies** with regard to their payment of estate taxes. These new regulations are removing common discounts clients depend on, therefore, when it comes time to pay the estate taxes, clients could be forced to sell a portions of the company in order to pay if they do not plan for payment of taxes in advance.

A review of a family's estate planning documents (wills and trusts) particularly the **tax apportionment provisions** or governing state law will be prudent because the estate tax might be different now than what was originally anticipated and the burden of payment might be more attributable to these family-controlled entities.

Finally, a review of **Shareholder Agreements**, Partnership Agreements, LLC or FLP agreements that affects the rights of shareholders, partners and owners of entity interests as some of the restrictions are derived from these governing documents and are affected by these new proposed regulations.

There are complex nuances in these newly proposed regulations and specific family issues should be evaluated quickly. We encourage families who are considering transferring interests in family-controlled entities to review their estate and transfer tax planning as soon as possible to secure the discounts available before the effective date of these Proposed Regulations. Furthermore, there is a need to look at insurance coverage or liquid assets and whether, with a loss of a discount, these are sufficient to pay taxes due on assets.

Although we expect that these proposed regulations will be hotly debated, we firmly believe that there are still several techniques for estate and gift tax reduction that families can execute in the coming weeks. In addition, there will need to be a re-evaluation of family gifting and estate planning strategies post adoption of proposed Section 2704 regulations.

Conclusion

The window is closing. It is important that families take action in the coming weeks, even though the regulations will not be effective until 2017. While the regulations are, at this time, prospective in application, we know only that there can be no changes until the first Committee hearing, currently scheduled for December 1, 2016. It is possible that the Committee could change an effective date for some or all of the regulations and expand (or narrow) their application. Indeed, it is not clear under the proposed regulations and effective date, what happens if a family member makes a transfer before the effective date, but dies within the three year look back? As such, careful planning all around is required.

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