Estate Planning Insights

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SPECIAL ALERT!

Proposed Regulations to Section 2704. On August 2, 2016, the Internal Revenue Service (the "IRS") released long-"threatened" proposed regulations to Section 2704 of the Internal Revenue Code (the "Code"). Section 2704 of the Code applies to family owned business entities, whether in the form of Limited Liability Companies (LLCs), S Corporations, C Corporations, Family Limited Partnerships or other arrangements. As currently drafted, the proposed regulations do not distinguish between active businesses and "passive" businesses (i.e., entities holding passive, investment-type assets, such as marketable securities).

The proposed regulations to Section 2704 of the Code contain two (2) major components: subpart (a) and subpart (b). Subpart (a) has to do with the lapse of voting rights and liquidation rights and subpart (b) has to do with restrictions on transfer that suppress the value of the transferred interest in the entity.

The effect of the proposed regulations will be to eliminate virtually all lack of control and minority interest discounts in the value of transferred interests in family entities for gift, estate and GST tax (collectively, "transfer tax") purposes.

A hearing on the proposed regulations is scheduled for December 1, 2016. Prior to that date, comments will be submitted to the IRS. The proposed regulations could become final as early as the end of this year, although it is more likely that they will become final during the first part of 2017.

Effect of the Proposed Regulations. As noted, the effect of the proposed regulations is to eliminate discounts in value for transfer tax purposes when interests in family business entities are transferred to family members. What are we referring to? Suppose parent ("Parent") created a family limited partnership ("FLP") several years ago that owns various assets which are now worth $10 million. An FLP has at least one General Partner (GP)—which is often another entity, such as an LLC—and at least one Limited Partner (LP). [We are going to ignore the GP's interest (which is usually 1% or less) for simplicity.] If Parent makes gifts of 50% of her LP interests (25% each) to her two children ("Children"), the fair market value of those interests is *not* $2.5 million each because of the terms of the FLP and applicable state law. The LP interests are not freely marketable and have no management rights. In addition, the holder of an LP interest has no right to withdraw from the FLP and receive assets from the FLP. Further, he cannot force the FLP to liquidate and distribute all of its assets. Under current law, the value of the LP interests transferred by Parent to Children might be discounted by 35% to 40% below the liquidation value of those interests. Thus, the gift tax value of Parent's gift could be reduced from $5,000,000 (total) to $3,250,000 or $3,000,000. Obviously, this reduces the amount of gift tax (or gift tax exemption) on those gifts.

3 year rule. Subpart (a) of the proposed regulations imposes a "3 year rule." Thus, if a person with control over a family entity and/or a liquidation right makes a transfer that results in him losing control/that right (so that the value of his interest in the entity is greatly reduced) and that person dies within 3 years of the transfer, a "phantom amount" is added back to his estate at death and is subject to estate taxes. This 3 year rule appears to apply *even if the person makes the transfer before the 2704 proposed regulations become final*.

We do not know what the final regulations will look like or when they will actually become final, but we do know that the "window" for completing transactions like the ones described is closing.

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Who Needs To Come In Now? Section 2704 primarily affects single individuals with a total net worth exceeding $5,450,000 and married couples with a total net worth exceeding $10,900,000 (i.e., clients who have "taxable estates"), who want to make "taxable gifts" to their children/trusts for their children of assets having discounted values. (Note that Hillary Clinton is proposing to reduce the estate tax exemption amount to $3.5 million, which will result in more clients having taxable estates.) Also, when we say *taxable gifts*, we primarily mean "large" taxable gifts, such as giving away one's entire remaining lifetime gift tax exemption amount (which would be $5,450,000 per donor in 2016 if no prior taxable gifts have been made). Ignoring the 3 year rule, "typical" estate planning that we have been doing for years can only be "successfully" done *before* the proposed regulations to Section 2704 become final (which, again, is likely to be sometime during the first part of 2017). Clients with taxable estates who are **not ready** to make *significant* taxable gifts to their children or trusts for their children do not necessarily need to come in to discuss this type of planning if they are not seriously interested in it.

But note: if the proposed regulations become final, typical discount planning in the family context will be gone. Clients with *very large* taxable estates should at least consider making gifts/transfers to trusts for children (usually, "intentionally defective grantor trusts") before the Section 2704 regulations become final.

Clients with taxable estates who have already done significant "charitable planning" to reduce estate taxes upon their deaths may not be interested in doing 2704 planning, although, again, we would be glad to discuss these matters in a consultation.

If one does *not* have a taxable estate, one is less likely to want to transfer assets at discounted values because, when no estate taxes are payable, a higher, rather than a lower, income tax basis is desirable.

Contact us:

If you have any questions about the material in this publication, feel free to contact us by phone, fax or mail at the address and phone number shown above. You can also send an email message to:

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