WRMarketplace

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Thursday, 20 October 2016 **WRM 16-42**

TOPIC: Not So Fast: Update on Proposed Regulations on Valuation Discounts – Where Are We Now?

MARKET TREND: For decades, the industry standard for determining the fair market value ("**FMV**") of intra-family transfers of family-controlled entities ("**FCEs**") has been that of the "willing buyer-willing seller." Any change to this standard is seen as a significant departure from well-established law. Accordingly, there has been industry uproar over proposed regulations impacting the valuation of FCEs, which has generated Congressional activity and may lead the IRS to re-work or at least significantly clarify its initial proposals.

UPDATE: On August 2, 2016, the IRS issued proposed regulations under IRC §2704 addressing so-called "valuation discounts" in the transfer tax valuation of intra-family transfers of FCE interests.

Most Discounts Eliminated. Previous WRMarketplace No. 16-33 (see report below), along with many other industry practitioners and commentators, interpreted these proposed regulations as disregarding any restriction on an owner's ability to liquidate an FCE interest for transfer tax valuation purposes, effectively prohibiting the use of traditional valuation standards and eliminating almost all minority interest discounts in valuing intra-family transfers of FCE interests.

Congressmen Respond. Based on this interpretation and its potential impact on small businesses and family farms, Republican Senators and Congressmen introduced companion bills in the House (H.R. 6100) and Senate (S.3436) seeking to prevent implementation of the proposed regulations.

IRS Intent More Limited? Some practitioners believe the proposed regulations are not, in fact, so draconian and merely seek to remove restrictions that could be added to increase permitted discounts. Recent comments by Catherine Hughes, Treasury Office of Tax Legislative Counsel representative, appear to follow this view. Speaking at the American Bar Association Section of Taxation meeting on September 30, 2016, Ms. Hughes indicated that the proposed regulations were not intended to do away with typical minority discounts.[1] She also indicated that, given the industry commentary, implementation of the proposed regulations was unlikely before year-end.

TAKE-AWAY: Given the ambiguity surrounding how the proposed regulations impact valuation discounts, they likely require substantial clarification from the IRS and Treasury Department. However, as the scope and timing of any such clarifications are uncertain, it remains advisable for individuals considering transfer planning with FCEs to complete the process promptly. AALU continues to monitor the proposed regulation implementation process and will provide updates on any developments.

MAJOR REFERENCES: Restrictions on Liquidation of an Interest, REG-16113-02.

PRIOR REPORTS: WRM #16-33 (see full text below); WRM #15-23; WRN #16.08.10.

WRM 16-33

TOPIC: Valuation Discounts Gone? Don't Lose Hope.

MARKET TREND: The IRS is pursing all manner of estate planning transactions involving family-controlled entities ("FCEs") and now has gone straight to the heart of the matter - valuation.

SYNOPSIS: Unfortunately, for many years, the industry has used the misnomer "valuation discount" when discussing fair market valuations of speculative, illiquid, or unmarketable assets based on long-standing valuation principles. Now, the IRS has issued proposed regulations designed to eliminate these so-called valuation discounts for intra-family transfers of interests in FCEs, effectively prohibiting the use of traditional valuation standards in these transactions. These proposed regulations disregard any restriction on an owner's ability to liquidate an interest in a FCE for transfer tax valuation purposes. As the proposed regulations will not take effect until December 2016, at the earliest, however, there may still be some opportunities for transfer planning with FCEs.

TAKE-AWAY: Given the potential for issuance of final regulations by year-end, individuals already engaged in transfer planning with FCEs should complete the process promptly, while those seeking to rely on existing laws should plan now. While the new transfer tax valuation standards for FCEs will change the economics of many traditional legacy planning approaches, those approaches remain viable and will continue to play a significant role in family wealth succession. Life insurance also will play an ever-more important part in legacy planning in the post-regulation world.

MAJOR REFERENCES: Restrictions on Liquidation of an Interest, REG-16113-02.

SAMPLE CLIENT LETTER: IRS Issues New Guidance on Valuation Discounts.

PRIOR REPORTS: WRM #15-23; WRN #16.08.10.

Families have long used FCEs, like family limited partnerships ("FLPs") and LLCs, to serve several purposes, including for family governance, centralized asset management, and creditor protection. Applying the traditional willing buyer-willing seller principle, fair market valuations of intra-family transfers of FCE interests often reflected adjustments for lack of marketability, lack of control, and other voting or liquidation restrictions. The IRS, however, has recently issued proposed regulations under IRC §2704 ("**Prop. Regs**"), which **appear to eliminate the willing buyer-willing seller standard for valuation of FCEs for transfer tax purposes, even if the FCE is engaged in an active business.** These changes will create new challenges and opportunities for legacy and life insurance planning.

NEW VALUATION RULES

For transfer tax valuation, the Prop. Regs dramatically alter traditional fair market valuations of intra-family transfers of FCE interests by eliminating minority and most marketability "discounts," as follows:

Mandatory Put Right. The Prop. Regs disregard any restrictions on an FCE owner's ability to liquidate or redeem an FCE interest,[2] which creates a valuation assumption that each FCE owner has a mandatory put right. Any restriction on an "assignee" of FCE interests (who may be limited to only receiving FCE distributions) versus a full FCE owner is also ignored.

Minimum Value. The Prop. Regs disregard any restriction that provides less than a "minimum value" for liquidation of the FCE interest. "Minimum value" equals **the FCE interest's pro rata share of the net fair market value of the FCE's property**[3] (i.e., a 10% interest in a $10 million entity = $1 million minimum value), effectively mandating a baseline value for the FCE interest and abandoning the traditional willing buyer-willing seller valuation standard.[4]

Payment within Six Months. The Prop. Regs disregard any restriction delaying the full liquidation payment for more than **six months** after the FCE owner gives notice of liquidation.

Available Liquidity. The Prop. Regs disregard any restriction that would require a liquidation payment other than in cash or other property ("property" for this purpose generally does not include promissory notes),[5] without regard to the actual circumstance of the FCE or its assets. This requirement essentially creates a **valuation assumption that the FCE holds liquid assets that can be easily converted to satisfy the deemed mandatory put right**.

No State Law Exceptions. Unlike current regulations, the Prop. Regs disregard a liquidation restriction imposed by federal/state law if the restriction (1) is only a default provision that FCE owners could agree to modify or could avoid entirely by organizing under other statutes of the chosen state, or (2) applies only to entities that would otherwise be subject to IRC §2704 (like FCEs). Thus, **most state law restrictions will be ignored** under the Prop. Regs.

No Distinction for Active Businesses. Although many thought the IRS would focus on FCEs structured primarily as passive holding companies, the Prop. Regs simply apply to FCEs based on family ownership and control. **No distinction is made between FCEs engaged in active, operating businesses and those primarily holding passive investments.**

Limited Consideration of Non-Family Owners. In valuing an intra-family transfer of FCE interests, the Prop. Regs also **ignore any requirement that a non-family FCE owner consent to the liquidation** of a FCE interests **unless**: (1) the non-family member owns at least 10% of the FCE for at least three years prior to the transfer, (2) a total of 20% of the FCE interest is held by non-family members overall, and (3) each non-family owner has a put right to liquidate their FCE interests for minimum value (as specified above).

Three-Year Look Back. The Prop. Regs also impose **a three-year "look-back" on lifetime transfers of FCE interests by a controlling owner** who could compel liquidation of his/her FCE interests before the transfer, but not after. Such transfers would result in estate tax inclusion of the value attributable to the loss of the right to compel liquidation if the transferor dies within three years of the transfer.

DIRECT IMPACT – NO "DISCOUNTS"

Legacy Planning. Most legacy planning approaches, such as gifts, GRATs, installment sales to grantor trusts, self-canceling installments notes (SCINs), etc. target highly-appreciating assets and seek to transfer those assets and the appreciation out of the taxable estate. Valuations reflecting an asset's lack of marketability, control or other adjustments can enhance these approaches. As fair market valuations of intra-family transfers of FCE interests typically reflected such adjustments, they have been a natural complement to legacy planning. The Prop. Regs **directly impact the use of FCEs in legacy planning by eliminating most of these minority and marketability "discounts" in valuing FCE interests for transfer tax purposes**.

> Example: John owns a 99% limited partner ("**LP**") interest in XFLP, which he received when he contributed $10 million of interests in various hedge funds to XFLP. An LLC wholly-owned and created by an irrevocable trust owns the 1% general partner ("**GP**"). Per XFLP's agreement, the LP has no control over XFLP's management and cannot withdraw without the GP's consent. Full liquidation of XFLP requires consent of all partners. John sells a 20% LP interest to a grantor dynasty trust (**LP Trust**) in exchange for a 20-year installment note at 2.3% annual interest. XFLP anticipates a 5% annual return on its investments. Compare if no discount applies to the LP interests sold versus a 25% discount.

Compare	**No Discount**	**25% Discount**	**Benefit of Discount**
Value of 20% FLP Interest	$2,000,000	$1,500,000	+$500,000

"Additional" Value Transferred without Transfer Tax	$0	$500,000	+$500,000
Trust Balance After Note Term	$1,790,000	$2,670,000	+$880,000
Estate Tax Difference (40%)	$716,000	$1,068,000	+$352,000

Life Insurance Planning. Many legacy plans incorporate the use of life insurance. Valuation standards applicable to the plan can impact the economics of a legacy transaction and the amount of funds available to support life insurance acquisitions. For example, assume in the facts above that the LP Trust will use its annual income remaining after paying the note interest to acquire life insurance. Without discounts, the first-year income remaining in the LP Trust after servicing the note is $54,000 versus $65,500 if a 25% discount applied (a benefit of $11,500).

HOPE IS NOT LOST

Delayed Effective Date. The proposed regulations **will not take effect until some time in December 2016 at the earliest**, following a 90-day comment period and a public hearing set for December 1st. This delayed effective date **leaves an important window of opportunity** for FCE transfer planning. But advisors and clients must proceed carefully, with the understanding that FCE planning during this time may receive heightened attention from the IRS.

Non-Discount Planning. **Traditional legacy planning approaches are still effective** to transfer assets and appreciation (e.g., in the above example, the **non-discounted plan still provided a benefit of over $700,000**). Commentators have long noted that, of the main factors impacting legacy plan performance -- (1) grantor trust status, (2) investment performance (e.g., above the IRS set IRC §7520 rate or applicable federal rate), and (3) valuations -- the **largest value is found in long-term planning with grantor trusts.**[6] **Valuation discounts generally provide the smallest benefit** as a one-time transfer with a much more limited impact on the overall trust return. GRATs, particularly short term GRATS, will likely be even less affected by the Prop. Regs, as the potential for having to return the discounted assets through in-kind annuity payments has often led planners to avoid discounts in GRAT funding.

Life Insurance Needs. The **need for life insurance to complement traditional legacy planning remains and likely will be enhanced in the post-regulation world**.

- **Greater Liquidity Needs**. For transfer tax purposes, illiquid FCE interests will be valued based on a pro rata portion of the FCE's entire value, generally resulting in a higher value than under traditional valuation approaches. As this will increase the

estate tax burden for FCE interests held at death, clients will need more estate liquidity to cover the deemed value of the FCE interests. Life insurance is a natural fit for this need.

- **Redemption Planning.** FCE agreements providing for redemption of family owners based on the "fair market value" of their FCE interests may need to revise these standards to avoid a whipsaw effect (e.g., the FCE redeems a deceased owner at traditional fair market value, but the FCE interest in the decedent's estate is taxed at the higher "minimum value"). FCEs may need to revise their redemption formulas and also need additional liquidity to fund these redemptions. Life insurance may be the solution.

- **Covering Mortality Exposure**. Many legacy planning approaches, such as GRATs or installment sales, carry some mortality exposure relative to the client. Under the valuation approach of the Prop. Regs, clients must rely almost entirely on an asset's expected appreciation to carry these transactions, likely extending the transaction term to achieve desired performance goals, and thus increasing the mortality exposure. Life insurance provides a simple and effective method to offset this exposure.

Practical FCE Planning. FCEs still provide many practical benefits for the long-term legacy management, including as a tool for (1) centralizing family wealth management and succession, (2) developing a coherent family investment philosophy, (3) pooling assets to achieve greater cost efficiencies, investment diversification and risk allocation, and access to certain investment opportunities, and (4) providing confidentiality and creditor protection to family members.

TAKE AWAYS

- Given the potential for issuance of final regulations by year-end, individuals already engaged in transfer planning with FCEs should complete the process promptly, while those seeking to rely on existing laws should plan now.

- While the new transfer tax valuation standards for FCEs will change the economics of many traditional legacy planning approaches, those approaches remain viable and will continue to play a significant role in family wealth succession.

- Life insurance also will play an ever-more important part in legacy planning in the post-regulation world.

SAMPLE CLIENT LETTER

Dear ____________:

The IRS just issued proposed regulations that will **effectively eliminate the availability of important valuation discounts** currently applicable to transfers of interests in family controlled entities. These sweeping regulations may have some very important implications to your ability to create a legacy for your family.

The proposed regulations, however, **will not take effect until some time in December 2016 at the earliest**, following a public hearing set for December 1st. This delayed effective date leaves an **important window of opportunity for transfer planning with family-controlled entities**.

We have attached an article released by the AALU explaining this matter in more detail. We urge you to contact us with any questions or to review with you how the proposed regulations might affect you and what your current and future planning options may be.

DISCLAIMER
This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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NOTES

[1] See, e.g., comments reported in "Washington News," dated October 12, 2016, The Salvation Army USA Western Territories web page at http://salwest.org/?pageID=38.

[2] Assumes the restriction will either lapse after the transfer or may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family (indirect ownership of interests through trusts or other entities will be attributed to these persons for purpose of determining if a restriction is disregarded).

[3] Specifically, the FCE interest's minimum value would be a pro rata portion of the "net value of the entity," defined as the fair market value, as determined under IRC §§ 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under IRC § 2053 if those obligations instead were claims against an estate. For this purpose, the interest's share of the entity value is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity. Note that, depending on the interpretation of the Prop. Regs, the "net value" of an FCE invested in primarily illiquid or unmarketable assets (e.g., minority interests in non-FCEs, real estate, private equity investments, etc.) may still reflect adjustments for the underlying assets' lack of marketability/control based on traditional valuation principles.

[4] Note that the Prop. Regs impose "look-through" provisions, such that, if a FCE's property, directly or indirectly, includes an interest in an underlying FCE that would be subject to the Prop. Regs, the underlying FCE will be ignored and the initial FCE will be treated as directly owning a share of the underlying FCE's property, as valued under the Prop. Regs.

[5] Promissory notes issued by the FCE, other FCE owners, or related persons do not constitute property for this purpose, with a very limited exception. The exception applies if the note: (a) is from an FCE with at least 60% of its value in active businesses (and the liquidation proceeds cannot be attributable to passive investments), (b) is adequately secured, requires periodic payments on a non-deferred basis, and is issued at market interest rates, and

(c) has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds.

[6] See Todd Steinberg, Jerome M. Hesch, and Jennifer M. Smith, "Grantor Trusts: Supercharging your Estate Plan," *BNA Tax Management Estates, Gifts and Trusts Journal,* Vol. 32, No. 1, Jan. 11, 2007.