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FLPs and Other "Discounting" Strategies: Targets for IRS Scrutiny? Act Now!

Proposed regulations issued by the Treasury Department in August 2016 under Section 2704 of the Internal Revenue Code seek to limit valuation discounts afforded by family limited partnerships (FLP) and other common planning techniques. The combination of a $5.45 million federal estate and gift tax exemption for individuals plus "exemption portability" rules allowing a deceased spouse's unused exemption to pass to his or her surviving spouse shield most estates from federal estate and gift taxes. But such taxes are still a major concern to high-net-worth individuals and families because of the 40% tax rate that applies once exclusions have been fully utilized. Thoughtful advance planning is necessary to avoid additional estate and gift tax liability should the proposed regulations become final.

FLPs as an Estate Planning Technique

Federal estate and gift taxes are imposed on the *fair market value* of assets that pass to someone other than a spouse or charity at death or via a lifetime gift. Many planning strategies are based on the concept of fair market value, which is defined for these purposes as the amount at which an asset would change hands between a willing buyer and a willing seller. For example, if a taxpayer who has already fully utilized his or her estate and gift tax exemption dies owning $10 million of marketable securities, the estate tax on those assets will be $4 million, because the fair market value of marketable securities is easily ascertainable at the time of death.

If the taxpayer instead contributes the marketable securities to an FLP of which the children own the 1% general partner interest and the taxpayer owns the 99% limited partner interest (with virtually no votes or control), the fair market value of the limited partner interest for federal estate tax purposes will be closer to $6.5 million. The value is reduced because a willing buyer would not purchase the limited partner interest without a steep discount since the interest is not readily marketable (even though the securities the FLP owns are readily marketable) and does not carry control over the FLP.

There are many variations on this common strategy. For example, the taxpayer could retain control of the FLP by receiving some or all of the general partner interests and making gifts to the children of limited partner interests. If this variation is adopted, discounts would apply to those gifts because the children would be receiving interests

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that are not readily marketable and do not carry control. Of course, the same strategies could also be accomplished with a properly designed limited liability company (LLC), S corporation or similar business entity or arrangement.

Impact of Proposed Regulations

Many of you may have already created an FLP or may be considering forming one in the future. If so, you may be wondering how much rigmarole this will add to your life, and whether the discount you are anticipating will reduce your federal estate or gift tax bill will be allowed if challenged by the IRS. In the past, the IRS has not had a lot of success with broad-based arguments that FLP discounts should not be allowed or that the discounts claimed by taxpayers are too high.

However, the IRS has had better success challenging these discounts in cases in which the structure of an FLP was not respected by the family that created it or where the taxpayer used the FLP as a personal piggy bank. For example, the IRS succeeded with this line of attack in a 2009 Tax Court decision that was affirmed by the Eleventh Circuit (*Estate of Jorgensen v. Commissioner*). This decision and others show that formalities count, so a certain level of rigmarole should be expected!

The recent proposed regulations provide the IRS with more ammunition with which to attack FLP valuation discounts. In particular, the proposed regulations reflect the IRS's position that under Section 2704(b) the ability for any family member to liquidate his or her interest at any time will be presumed if a family controls an FLP, outsiders can't block liquidation of the FLP and there aren't any restrictions on liquidation imposed by local law. This presumption prevents valuation discounts from being applied, at least when the FLP primarily owns marketable securities. The proposed regulations further provide that a liquidation restriction isn't imposed by local law if it can be superseded in the governing instrument, e.g., the partnership agreement. This is important because many states have "default rules" that make it very difficult to liquidate a partnership or LLC—many of those rules were enacted specifically in response to Section 2704(b)—but these default rules can be (and usually are) changed in the partnership agreement or operating agreement.

The proposed regulations also provide that an outsider won't be considered to possess the ability to block liquidation unless the outsider has held his or her interest for at least three years, that interest is at least 10%, outsiders as a group have at least 20% of the interests *and* each outsider can "put" his or her interest for its *undiscounted* value on six months' notice. If the proposed regulations go into effect and are upheld, this will make it *very* difficult to avoid the rules of Section 2704(b) by including nonfamily members or charities as partners in the FLP. The proposed regulations also include an "add-back" to the taxable estate when a taxpayer has control of the FLP and makes gifts of smaller, noncontrolling interests within three years of death. The proposed regulations clarify that the IRS will apply the same principles to other family business entities, including LLCs, S corporations and other similar arrangements.

Planning Opportunities Before Proposed Regulations Become Final

The proposed regulations won't be effective until published as final regulations; there will be a hearing on December 1, 2016, for which comments are due by November 2. (More favorable effective dates may apply to FLPs created before October 8, 1990.) This presents planning opportunities for anyone with an FLP or contemplating one at this time! But it's important to remember: *forming an FLP before the regulations become final is not enough*. Gifts of nonmarketable, noncontrolling interests should be *complete before the effective date* so that valuation discounts can be claimed without reference to the new regulations.

Needless to say, whether the proposed regulations become final could be highly dependent on the results of the upcoming presidential election, and taxpayers can be expected to challenge the regulations in court if they become final as proposed. But proactive planning will often be a better course of action than simply waiting for those results.

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