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Mark R. Williamson is a partner at Alston & Bird LLP and the leader of its Wealth Planning practice group.

In this article, Williamson discusses the significance of long-awaited proposed regulations under section 2704 that restrict the way family limited partnerships or similar business entities are valued for tax purposes.

On August 4 Treasury issued long-awaited proposed regulations under section 2704. The regulations target estate planning techniques that involve contributing assets to a family limited partnership or similar business entity with voting and nonvoting interests and making gifts with interests in the FLP or arranging it so that any interest owned at death will be nonvoting (or at least noncontrolling). Taxpayers routinely claim combined discounts of 35 percent or more for lack of marketability and lack of control, even when the assets owned by the FLP are highly liquid, such as marketable securities. With the federal estate and gift tax exemption now at $5.45 million per individual ($10.9 million for a married couple) and with exemption portability rules that allow a deceased spouse's unused exemption to pass to the surviving spouse, many taxpayers no longer have to worry about estate and gift taxes at all. But for those who do, those discounts can be important.

Planning strategies involving FLPs are based on the principle that 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 — defined for these purposes as the amount at which an asset would change hands between a willing buyer and a willing seller.[1] For example, if a taxpayer who has already fully used her estate and gift tax exemption dies owning $10 million of marketable securities, the estate tax on those assets will simply be $4 million because the fair market value of marketable securities is easily determined by reference to the trading price at the time of death.

But if the taxpayer contributes the marketable securities to an FLP in which the children own the 1 percent general partner interest and the taxpayer owns the 99 percent limited partner interest (with virtually no voting power or control), the value of the limited partner interest for federal estate tax purposes may be closer to $6.5 million, or even less, because a willing buyer would not purchase the limited partner interest without steep discounts because it 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 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; discounts would apply to those gifts because the children would receive interests that aren't marketable and don't carry control. Of course, the same strategies could also be accomplished with a properly designed limited liability company, S corporation, or similar business entity or arrangement.

In the past, the IRS has not had much success with broad-based arguments that FLP discounts should not be allowed or that the discounts claimed by taxpayers are too high. But the IRS has had more success challenging those discounts when the FLP was not respected by the family that created it or when the taxpayer used the FLP as a personal piggy bank. In those cases, the IRS could argue that the FLP was a sham or that the taxpayer retained the right to the income from FLP assets or to control the enjoyment of that income so that on the death of the taxpayer, the assets the taxpayer transferred to the FLP during life should be included in the gross

[1] Reg. section 20.2031-1(b).

estate under section 2036(a) as if the taxpayer still owned them outside the FLP.[2]

In the IRS's view, if section 2036(a) applies to taxpayers who transfer property in trust for their children and retain the right to trust income or to control the enjoyment of trust income, it should also apply to taxpayers who transfer assets to FLPs and retain similar rights. Importantly, however, that line of attack has not been fruitful for the IRS in situations involving FLPs that are operated and administered in a businesslike manner.[3] And the IRS appears to recognize that a general partner's power to determine the timing of partnership distributions is not a retained power over income within the meaning of section 2036(a) if the general partner is subject to fiduciary duties in making those determinations.[4] Because that line of attack has generally been successful for the IRS only in cases in which the FLP was not administered in a businesslike manner, it's important for families that create FLPs to understand that formalities count and that some amount of rigmarole for the family should be expected.

The proposed regulations seek to provide the IRS with a broader attack on FLPs that does not require identifying improprieties in the FLP's organization or administration. In particular, the proposed regulations reflect the IRS's position that under section 2704(b), if a family controls an FLP, outsiders can't block liquidation, and there aren't any restrictions on liquidation imposed by local law, then it will be assumed that each family member can liquidate her interest at any time so that valuation discounts will be disallowed, at least when the FLP primarily owns marketable securities. (If the FLP owns real estate or an operating business, taxpayers will likely argue that discounts should still be allowed, notwithstanding section 2704(b), because operating businesses and real estate can't be divided as equally upon liquidation as marketable securities.)

The proposed regulations provide that a liquidation restriction isn't imposed by local law if it can be superseded in the governing instrument (such as the partnership agreement) or otherwise removed.[5] (That is important because many states have default rules — many of which were enacted specifically in response to section 2704(b) — that make it very difficult to liquidate a partnership or LLC, but those default rules can be changed in the partnership agreement or operating agreement.) And the proposed regulations provide that an outsider won't be considered as having the ability to block liquidation of a family member's interest in the FLP unless the outsider has held his interest for at least three years, the interest is at least 10 percent of the FLP, outsiders as a group have at least 20 percent of the interests, and each outsider can "put" her interest for its undiscounted value with six months' notice.[6] If the proposed regulations go into effect and are upheld, that will make it very difficult to avoid the rules of section 2704(b) by including non-family members or charities as partners in the FLP because their interests will be disregarded unless those requirements are satisfied, which will be difficult in cases involving family controlled entities. Importantly, commercially reasonable shareholder agreements that meet the requirements of section 2703 are *not* disregarded restrictions under the new proposed regulations.[7]

The proposed regulations also provide for an addback to the taxable estate when a taxpayer has control of the FLP and makes gifts of noncontrolling interests within three years of death (based on section 2704(a)). In general, if a taxpayer owns a controlling interest in an FLP and gives one-third of it to each of three children, discounts for lack of marketability should be allowed because each child receives a nonmarketable, noncontrolling interest, even though the taxpayer had a controlling interest before the gifts.[8] But under section 2704(a), if the family controls the FLP, a "lapse" of a liquidation or voting right results in a taxable gift or an inclusion in the gross estate. In the example given, did the rights associated with control of the FLP lapse within the meaning of section 2704(a) when the taxpayer gave a third to each child, given that none of those rights were actually eliminated but just dispersed among the three children? Under the proposed regulations, in a situation like that, there is no lapse if the gifts occur more than three years before the taxpayer's death, but if the taxpayer dies within three years, a deemed lapse occurs at death, and the amount of discounts claimed on the gifts to the children is added to the taxpayer's gross estate.[9]

The proposed regulations clarify that the IRS will apply the same principles to other family business entities, including LLCs, S corporations, and other

[2]*See, e.g., Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66, *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011).

[3]*See, e.g., Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004).

[4]*See, e.g.*, LTR 9415007; *see also United States v. Byrum*, 408 U.S. 125 (1972) (no inclusion under section 2036 when the taxpayer retained similar control over corporate distributions through retained power to vote corporate stock; statutorily overturned by section 2036(b) but only for retained power to vote stock of a controlled corporation).

[5]Prop. reg. section 25.2704-2(b)(4)(ii) and -3(b)(5)(iii).

[6]Prop. reg. section 25.2704-3(b)(4).

[7]Prop. reg. section 25.2704-2(b)(4)(iii) and -3(b)(5)(iii).

[8]*See* Rev. Rul. 93-12, 1993-1 C.B. 202.

[9]Prop. reg. section 25.2704-1(c)(1).

similar arrangements.[10] However, the proposed regulations won't be effective until published as final regulations, following a hearing on December 1, for which comments are due by November 2. (More favorable effective dates may apply to FLPs created before October 8, 1990.) That presents planning opportunities for anyone who has an FLP or is currently contemplating one. But it's important to remember that 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 may 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. (The likely argument is that the proposed regulations exceed the scope of the statutory provisions of section 2704, and the likely IRS response is that Treasury was given broad authority under section 2704(b)(4).) But proactive planning will often be a better course than simply waiting for those results. ■

[10]Prop. reg. section 25.2704-2(b)(5)(i).

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