I.R.S. ISSUES PROPOSED REGULATIONS AFFECTING VALUATION DISCOUNTS FOR GIFT AND ESTATE TAX PURPOSES

Authors
Fanny Karaman
Stanley C. Ruchelman
Kenneth Lobo

Tags
Draft Valuation Rules
Estate and Gift Tax
Estate Planning
Minority Discount

INTRODUCTION

For estate tax purposes, the taxable estate of a decedent includes the fair market value of all assets owned at the time of death, in the case of a U.S. person, or the fair market value of all U.S. situs assets, in the case of a nonresident, non-citizen individual. For gift tax purposes, the taxable basis is the fair market value of the transferred asset at the time of the gift. Value is thus the key to determining the tax base for gift and estate tax purposes. This value can be discounted when circumstances limit the full enjoyment of ownership rights to the transferred asset, such as in the case of a minority interest.

Recently proposed regulations, issued by the I.R.S., would change the way certain rules are used to reduce value in order to decrease the gift and estate tax liability in the context of a family-owned business. This article explains how the minority discount and other valuation rules are applied under current practice and the way those rules may be modified when, and if, the proposed regulations are adopted.

THE GENERAL CONTEXT OF MINORITY DISCOUNTS AMONG RELATED PARTIES

One tax planning tool used for estate, gift, and generation-skipping transfer tax purposes is to take into account an impairment to value that is suffered by the holder of a minority interest in a closely-held entity.

If the value of the business is the starting point to the value of shares or partnership interests, the shares held by the person who controls the entity are worth more than the shares held by a minority interest holder. The shares of the former have a premium, while the shares of the latter suffer a discount in value. In essence, no buyer would pay full value for a non-controlling interest in a company that is controlled by a single person or a small control group.

Similarly, shares in a holding of more than two-thirds of the voting stock will be worth proportionately more than shares in a holding of 50% of the voting stock, if only the holder of a more-than-two-thirds interest can cause a liquidation of the corporation without the approval of other shareholders.

In preparing the estate plan of a family patriarch that owns or controls a closely-held business, the planner may recommend giving minority interests to various trusts established for the benefit of the patriarch's heirs. In each case, the value of the asset given to the trust is reduced because of its minority position in the company. In practice, minority interests that do not afford the holder with a power to remove

management, or to control the operation of the business, are simply worth less than the same proportional value of the business itself. The savings will be compounded at the death of the patriarch if the total number of shares given away during his lifetime precludes his estate from having the power to liquidate the company.

The I.R.S. accepts the concept of minority discounts among independent parties, but it is concerned that family members are not always in the same position as independent parties. Thus, the I.R.S. maintains that gifts from patriarchs to family members should not systematically reduce value for gift and estate tax purposes under the valuation discount rules.

CODE §§2701-2704 VALUATION RULES

Special valuation rules, applicable to transactions involving family limited partnerships and family-held corporations, were enacted in 1990 to replace an earlier provision, the former Code §2036(c), enacted in 1987. Code §§2701-2704 are intended to prevent the use of estate valuation freeze techniques, such as those described above, that are considered to be abusive. They were not, however, adopted to eliminate minority interest discounts.[1]

Originally, Code §2036(c) provided that transferred property and interests in property were included in the transferor's taxable estate if a disproportionate share of the future appreciation was transferred to the next generation while the patriarch retained rights to income or management. In comparison, Code §2701 applies special valuation rules to the initial transfer and provides for adjustments to taxable gifts upon a subsequent transfer of a retained interest or the death of the transferor.

In broad terms, Code §2701 provides that – solely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift – the value of certain distribution, liquidation, put, call, or conversion rights must be determined as if each right were exercised in the manner resulting in the lowest value being determined for all such rights. The effect is that for estate tax purposes, the value of the patriarch's taxable estate is increased.

Code §2703 provides that the value of any property is to be determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property or any restriction on the right to sell or use such property. This rule does not apply to any option, agreement, right, or restriction that meets the following criteria:

- It is a *bona fide* business arrangement.
- It is not a device to transfer property to members of the decedent's family for less than a full and adequate consideration in money or money's worth.
- It contains terms that are comparable to similar arrangements entered into by persons in an arm's length transaction.

Code §2704 is better understood in light of the case law that led, in part, to its

[1] H.R. Rep. 101-964, at 1122 (1990) (Conf. Rep.).

enactment.[2] In *Estate of Harrison v. Commr.*,[3] the decedent and his sons entered into a partnership agreement. The decedent contributed assets with a fair market value of approximately $59 million at the time of contribution, in exchange for a 1.0% general partnership interest and a 77.8% limited partnership interest. Each son contributed approximately $4 million in exchange for a 10.6% general partnership interest. The partnership agreement provided that each general partner had the right to dissolve the partnership during his lifetime. That right lapsed at death. One of the questions at issue was the valuation of the decedent's limited partnership interest for estate tax purposes. The right to dissolve the entity and receive all the assets is a valuable right. However, because it lapsed at death, the heirs could not receive that right. The estate argued that because the decedent's right to liquidate the partnership lapsed at the time of death, the value of his limited partnership interest amounted to $33 million. Pursuant to this reasoning, the court concluded in favor of the estate. In support of its decision, the court cited *U.S. v. Land*,[4] for the following proposition:

> Brief as is the instant of death, the court must pinpoint its valuation at this instant – the moment of truth, when the ownership of the decedent ends and the ownership of the successor begins. It is a fallacy, therefore, to argue value before or after death on the notion that valuation must be determined by the value either of the interest that ceases or of the interest that begins.

As a result, the value of the limited partner interest was less than its value either in the hands of the decedent immediately before death or in the hands of his two sons immediately after death.

Partly to negate the approach of the court, Code §2704 limits the application of the valuation rules with regard to certain types of intra-family transfers of interests in corporations and partnerships subject to voting or liquidation rights and restrictions that lapse. In early August, the I.R.S. proposed regulations[5] that will raise the standards which must be met for these types of restrictions to be taken into account. The proposed regulations will be effective when adopted in final form.

Treas. Reg. §25.2704-1(a)(2)(v) defines a liquidation right as the right or ability, including by reason of aggregate voting power, to compel the entity to acquire all or a portion of the holder's equity interest in the entity, whether or not its exercise would result in the complete liquidation of the entity.

Further, for purposes of Code §2704, certain restrictions are not taken into account when determining the value of the transferred interest. The scenario in which these restrictions are disregarded is the following:[6]

---

[2] *Id.*

[3] *Estate of Harrison v. Commr.*, T.C. Memo 1987-8 (1987).

[4] *U.S. v. Land*, 303 F2d 170, 171-173, (1962).

[5] REG-163113-02. The amount of the transfer would be the excess of the fair market value of all interests held by the transferor, determined as if the voting or liquidation rights were non-lapsing, over the fair market value of such interests after the lapse.

[6] Code §2704(b)(2).

- An interest in a corporation or partnership is transferred to, or for the benefit of, a member of the transferor's family.
- The transferor and members of the transferor's family hold control of the entity immediately before the transfer.

In that situation, the restriction must be disregarded for valuation purposes if the restriction

- effectively limits the ability of the corporation or partnership to liquidate, and
- either of the following conditions apply to the restriction:
    - The restriction lapses, in whole or in part, after the above-mentioned transfer.
    - The transferor or any member of the transferor's family, either alone or collectively, has the right to remove the restriction, in whole or in part, after such transfer.

In addition, Treas. Reg. §25.2704-1(c)(1) provides that a lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. However, under the regulation, a transfer of an interest that results in the lapse of a liquidation right generally is not subject to this rule if the rights, with respect to the transferred interest, are not restricted or eliminated. The effect of this exception is that *inter vivos* transfers of a minority interest by the holder of an interest with the aggregate voting power to compel the entity to acquire the holder's interest is not treated as a lapse, even though the transfer results in the loss of the transferor's presently exercisable liquidation right.

The I.R.S. believes that the Treas. Reg. §25.2704-1(c)(1) exception should not apply when the *inter vivos* transfer resulting in the loss of the power to liquidate occurs on the decedent's deathbed.

SUMMARY OF THE PROPOSED CHANGES TO THE CODE §2704 VALUATION RULES

The proposed regulations would amend Treas. Reg. §25.2701-2 to address what constitutes "control" of an L.L.C., or another entity or arrangement that is not a corporation, partnership, or limited partnership. The proposed regulations would amend Treas. Reg. §25.2704-1 to address deathbed transfers that result in the lapse of a liquidation right and to clarify the treatment of a transfer that results in the creation of an assignee interest that is short of being a partnership interest. The proposed regulations would also amend Treas. Reg. §25.2704-2 to refine the definition of the term "applicable restriction," by eliminating the comparison to the liquidation limitations of state law. Further, the proposed regulations would add a new section, Treas. Reg. §25.2704-3, to address restrictions on the liquidation of an individual interest in an entity and the effects of insubstantial interests held by persons who are not members of the family.

The following discussion outlines the proposed regulations in light of the currently applicable provisions and planning trends, which are under attack by the I.R.S.:

- The proposed regulations acknowledge that many taxpayers utilize L.L.C.'s as the preferred business or investment form. Although Code §2704 speaks in terms of corporations and partnerships, the proposed regulations address two situations in which it is necessary to go beyond this division of entities. Hence, the entities covered by the proposed regulations would also include (i) L.L.C.'s and (ii) other entities and arrangements that are business entities within the meaning of Treas. Reg. §301.7701-2(a), whether domestic or foreign. These situations require consideration of the differences among various types of business entities under local law, which mandates the creation and governance of these entities. As a result, the proposed regulations look to the form of the entity or arrangement under local law for the purposes of determining control of any business entity or arrangement that is not a corporation and whether a restriction is imposed at the state level. The determination would be made regardless of how the entity is classified for other Federal tax purposes and whether it is disregarded, for such purposes, as an entity separate from its owner.

- The proposed regulations define control in the context of an L.L.C. or of any other entity or arrangement that is not a corporation, partnership, or limited partnership. The hurdle to be met for control to exist is the holding of (i) 50% or more of either the capital or profits interests, or (ii) any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. In general, concepts of local law – *viz.*, the law under which the entity or arrangement is created or organized – will control. Attribution rules apply, which will cause an individual, an individual's estate, and members of the individual's family to be treated as holding interests that are held indirectly through a corporation, partnership, trust, or other entity.

"The proposed regulations look to the form of the entity or arrangement under local law for the purposes of determining control of any business entity or arrangement that is not a corporation."

- The current regulations provide an exemption from the definition of an applicable restriction for a restriction on liquidation that is no more restrictive than the state law that would apply in the absence of the restriction. Consequently, only restrictions that are more restrictive than local law are not covered. Due mostly to case law and changes in state laws that are designed to assist taxpayers in meeting the standard of the regulations, the I.R.S. views the exception under current regulations to be too broad. The proposed regulations would thus eliminate the comparison to the liquidation limitations of state law so as to prevent the use of artificial restrictions for valuation discount purposes.

- An exception for restrictions imposed, or required to be imposed, by any Federal or state law in Code §2704(b)(3)(B) would be clarified by limiting the provision to laws of the U.S., the individual states, and the District of Columbia. Restrictions imposed by the law of any other jurisdiction are not covered by the exception.

- A restriction is imposed or required to be imposed by law if (i) the restriction cannot be removed or overridden and (ii) it is mandated by the applicable law and is required to be included in the governing documents. In addition, a restriction imposed by state law may constitute an applicable restriction in two situations. In each situation, although the statute itself is mandatory and cannot be overridden, another statute is available to be used for the entity's governing law, which does not require the mandatory restriction. The first

situation involves a state law that is limited in its application to family-controlled entities. The second situation involves contradictory state laws allowing the mandatory restriction to be elective in practice.

- Code §2704(b) does not apply to transfers to nonfamily members and thus has no application in valuing an interest passing to charity or to a person other than a family member. If part of an entity interest passes to family members and part to nonfamily members, and the part passing to the family members is valued under Code §2704(b), the proposed regulations treat that part as a property interest separate from that passing to nonfamily members. Consequently, the valuation of the same property interest may differ if the transferee is a family member, rather than a charity. The fair market value of the part passing to the family members is determined taking into account the special valuation assumptions of Code §2704(b), as well as any other relevant factors, such as those supporting a control premium. The fair market value of the part passing to nonfamily members is determined in a similar manner but without the special valuation assumptions of Code §2704(b).

“The valuation of the same property interest may differ if the transferee is a family member, rather than a charity.”

- In the case of a family-controlled entity, certain restrictions on an owner’s right to liquidate an interest in the entity will be disregarded if (i) the restriction will lapse at any time after the transfer or (ii) the transferor, or the transferor and family members, may remove or override the restriction without regard to certain interests held by nonfamily members. This rule applies to restrictions that
    - limit the ability of the holder to liquidate the interest;
    - limit the liquidation proceeds to an amount that is less than a specified minimum value;
    - defer the payment of the liquidation proceeds for more than six months; or
    - permit the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.
- Treas. Reg. §25.2704-1 provides that a transfer of an interest that results in the lapse of a liquidation right is not a lapse of a liquidation right if the rights with respect to the transferred interest are not restricted or eliminated. This exception would be narrowed by the proposed regulations, in that they provide for a three-year look-back period. If the interest was transferred within the three-year period prior to the transferor’s death, the transfer would be treated as a lapse occurring on the transferor’s deathbed. The transferred interest would be included in the decedent’s gross estate (although the transferred interest would continue to be owned by the transferee), but the identity of the beneficiary of any resulting step-up in basis is unclear.
- Currently, certain taxpayers transfer their partnership interests to an assignee, rather than a partner. They claim that, because the assignee does not have the right to liquidate his or her partnership interest, the restriction is less than would be imposed upon an assignee under state law. Thus, the assignee status of the transferred interest is not an applicable restriction and a valuation discount can be claimed on the transferred interest. In order to

avoid this type of scenario, the proposed I.R.S. regulations would assimilate an assignee interest to a lapsed voting or liquidation right.

CONCLUSION

It is clear that the proposed regulations will have a drastic effect on estate plans of high net worth individuals whose lives conclude after the effective date of the regulations – expected to be the date of adoption in final form. In certain cases, the proposed regulations may even have effects for the three-year period prior to the date of final adoption. Until then, a cottage industry has emerged within tax advisory firms, recommending damage control for existing plans. Many include the acceleration of a giving plan during the client's lifetime and before the effective date of the proposed rules.

Disclaimer: *This newsletter has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*