Wills, Trusts and Estates Newsletter

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IRS Proposes Special Valuation Rules for Intra-Family Transfers of Interest

(also known affectionately as the harmonious family regulations of 2016)

By Jonathan C. Kinney

The IRS announced August 2 (published August 4, 2016 in the Federal Register) proposed new regulations that affect estate, gift and generation skipping transfers between family members. The basic underlying assumption of the new rules is that families will act as a unit and vote together in all circumstances.

The IRS is proposing new disregarded restriction provisions that will have a dramatic impact on the valuation of interests in family limited liability companies, partnerships and other entities that effectively reduce or eliminates minority discounts and reduce marketability discounts.

Section 2704 was enacted approximately 25 years ago in an attempt to limit discounts for family transfers of interest in family partnerships, family limited liability companies, etc. The new regulations are being implemented under Section 2704. In situations where you have a transfer of interest in one family entity to another family member, and where the family controls 50% or more of the entity prior to the transfer, effectively the proposed new regulations provide that you disregard any provisions of the operating agreement or partnership agreement that are more restrictive than the limitations that apply under state law. These limitations could be restrictions on terminating the entity, requirements that the entity interests be offered to the entity prior to sale to third parties, a restriction that the entity has the right when they purchase a member interest that payments can be deferred over a period of time (i.e., Note payments) and restrictions that mandate the time a holder of an interest must hold the interest prior to liquidating the interest.

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The proposed regulations do, however, provide that if the entity is actively engaged in a trade or business and periodic payments are made for entity interest by way of a note or mortgage at market rate, said payments are likely to be a "non-disregarded" restriction.

Probably the largest kicker in the new regulations is a provision that intra-family transfers of family controlled entities will be valued under the assumption that the holder has a six-month put option to sell the interest in the entity at a value equal to the pro rata share of the "net value of the entity" value in return for cash or property, regardless if required in the entity agreement or not.

The reality is that while in most family situations the entity may be able to redeem small interests they would not be able to redeem large interest, say 10% or more without potentially destabilizing the business operation. The IRS has effectively inserted this provision (i.e., the put option) in situations where it does not currently exist.

In partnerships or limited liability companies where there are other unrelated persons to the controlling family, the fact that these parties exist do not affect the removal of the disregarded restriction unless the unrelated party has (i) held the interest for three years; (ii) the interest is at least 10% of the total equity interest; or (iii) nonfamily members hold at least 20% of all equity interest and the interest holder has a right to receive the minimum value of their investment on no more than six months' notice. Note, however, that non-related persons are still counted for determining if a family controls the entity immediately prior to the transfer (i.e. the 50% rule).

The unrelated person limitations determining the removal restriction requirement applies only for disregarded restrictions and not other restrictions.

Effectively, the IRS is making the predetermination that a family is a harmonious unit and there are never situations where different family members will have different objectives. In our experience, if there are three children who inherit an interest, there is most likely a difference of needs and desires of the beneficiaries. For example, one family member has three children and wants to ensure the children receive an ongoing stream of income after their death. One family member has no children and would like to be able to enjoy their funds as soon as possible, a third family member has a special situation – either the fear of an impending divorce, a special needs child or other factors that makes their needs totally different than the other two family members. Basically, the heart of these regulations seems to be that a family will always act in a harmonious manner. In our experience, however, this is usually not the realty because of differing family needs and objectives.

It is anticipated that the new regulations, if approved, could become fully effective by the second quarter of next year. Comments on these proposals must be received by the Department of Treasury/ Internal Revenue Service prior to November 1, 2016. Submission should be sent to CC:PA:LPD:PR (Reg-163113-02), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044 or sent electronically via Federal eRulemaking portal at www.regulations.gov

(IRS REG-163113-02). A public hearing is scheduled for December 1, 2016.
It is important to consider how these new rules will apply to prior transactions and to consider implementing new transactions before the rules become effective.

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Estate Planning in a Low Interest Rate World

By Jonathan C. Kinney

The current low interest rate environment favors certain estate planning strategies.

- Grantor Retained Annuity Trust (GRAT);
- Charitable Lead Annuity Trust (CLAT);
- Installment sale; and/or
- Low-interest family loan

<u>Grantor Retained Annuity Trust</u>

In a GRAT, property is transferred to a trust but the grantor retains the right to annuity payments for a specified number of years. Once the trust term ends, the property remaining in the trust passes to your designated beneficiaries. The value of the property remainder interest is discounted for gift tax purposes reflecting the fact that it will be received in the future. Further, if you survive the specified trust term, the property in the trust is not included in your gross estate for estate tax purposes. In short, the lower the published IRS interest rate, the more effective this technique is by allowing a higher value of trust assets to pass free of estate and gift taxes.

<u>Charitable Lead Annuity Trust</u>

In a CLAT, property is transferred to a trust, giving a charity the right to annuity payments for a specified number of years. After the trust term ends, the remaining property passes to your designated beneficiaries, such as family members. While similar to a GRAT, with a CLAT you receive a gift tax charitable deduction. The CLAT may also be structured so that you are taxed on the trust income, at which point you receive an up-front charitable deduction on your income taxes for the gift of the annuity interest. Like with a GRAT, the lower the IRS interest rate, the more effect this technique is by allowing a higher value of trust assets to pass free of estate and gift taxes.

<u>Installment Sale</u>

An installment sale with family members will generally permit you to defer taxation of any property gains until payments are received. If the property is sold by the family member within two years of the installment sale, deferred gains will be accelerated.

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You are required to charge a minimum interest rate –based on IRS published rates – in order to make installment payments. With the current low interest rates, family members pay for property in installments with only minimal interest costs.

Low Interest Loan

A low interest loan to family members might also be a useful strategy. Usually you are required to charge a minimum interest rate on loans. Otherwise, interest is deemed to be charged for income tax and gift tax purposes. With current low interest rates, family members retain earnings in excess of the interest amount they pay you.

Charitable Remainder Unitrust

In a CRUT, property is transferred directly to a trust. You would retain a stream of payments for life (or for a set number of years), after which the remaining property passes to a designated charity. You receive a current charitable deduction for the gift of the remaining interest. Interest rates have no effect if payments are made annually at the beginning of each year. A Charitable Remainder Unitrust is generally not affected by low or high interest rates

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