



Estate Planning for Family Businesses

Major Changes Proposed in IRS Tax Regulations

November 1, 2016

Estate planning for closely held family businesses could be significantly affected by proposed regulations that have been published by the Internal Revenue Service.

The IRS proposed regulations and their effect on federal gift and estate taxes need to be considered with respect to estate planning by family business owners along with whether alternative business succession and estate planning approaches may be advisable and feasible.

The IRS proposed regulations are to implement section 2704 of the Internal Revenue Code concerning valuation of interests in corporations and partnerships for federal estate, gift and generation-skipping transfer (GST) tax purposes. Section 2704 can apply for federal gift and estate tax purposes if there is a transfer of an interest in a family owned and controlled corporation or partnership to a member of the transferor's family and there is a restriction on liquidation or redemption of the interest by the entity, or restriction on the corporation or partnership to liquidate.

A stated purpose of the IRS for the proposed regulations is to address its concern over tax treatment of certain lapsing rights and restrictions on liquidation of a closely held and family owned corporation, partnership or limited liability company.

The IRS proposed regulations, if issued in final form, could limit or eliminate discounted or reduced valuation of interests in a family business that result when ownership of it is subject to mutually agreed upon restrictions on the ability of the family member owners to cause a liquidation and dissolution of the business, or liquidation and redemption of an owner's interest in the business without the unanimous consent and agreement of all the owners or a stated supermajority of the owners. The regulations would refer to and treat these as "disregarded restrictions" in many cases. That would differ from the treatment given to such restrictions by the IRS in a prior ruling and by certain court decisions. This "disregarded restrictions" rule under the regulations would result in transfers of family business interests having greater taxable value for federal gift or estate tax purposes if transferred by a lifetime gift or by will or trust upon death of an individual business owner.

The proposed regulations will generally be effective on or after the date they are published by the IRS as final regulations in the Federal Register, with one provision in the regulations to apply to transfers occurring thirty (30) or more days after the date the final

regulations are published. A hearing on the proposed regulations by the Treasury Department to receive and consider comments and proposed changes is scheduled for December 1, 2016.

The proposed regulations can be found at the IRS website, www.irs.gov/, Internal Revenue Bulletin 2016-36, September 6, 2016, REG-163113-02.

A hypothetical example of possible application of the proposed regulations is below.

Example

IRS Proposed Estate and Gift Tax Regulations Code Section 2704

The following is a hypothetical example of the application of the IRS proposed section 2704 regulations providing that restrictions on liquidation of a family owned business be disregarded:

Example. A is the father of B and C. A, B and C are partners in a family owned business organized as a limited partnership. A, the father, is a 90% limited partner, and his children, B and C are each 5% limited partners. The partnership agreement contains a restriction that provides that the partnership cannot be dissolved and liquidated without the unanimous agreement of all of the limited partners, and that liquidation or redemption of a limited partner's interest also requires unanimous agreement of all limited partners. Therefore, the owner of A's limited partner interest cannot require that the partnership or such limited partner interest be liquidated and the owner be paid for that interest in the partnership. In the event of A's death his will provides that all of his limited partner interest would be transferred to B and C in equal shares. An appraisal of the value of A's limited partner interest determined that without any restriction on liquidation or redemption it could have a fair market value of \$6,700,000, but that amount should be considered to be reduced or discounted by twenty percent to take into account the stringent restrictions contained in the partnership agreement, thereby giving it an estimated actual fair market value of \$5,360,000. Under the IRS proposed regulations the restrictions in the partnership agreement on dissolution and/or liquidation would be required to be treated as "disregarded restrictions" for purposes of valuation in determining federal estate tax. The reason indicated by the proposed regulations, and the IRS' explanation, is that the partnership is controlled by A and his children, they are all in the same family, and therefore restrictions on liquidation of A's limited partner interest in the partnership agreement between them should be disregarded because it can or should be presumed that if A requested the restriction be removed or disregarded his children would agree and consent to it. Therefore, under the proposed regulations the IRS would disregard the restrictions and apply the higher undiscounted valuation of \$6,700,000 for A's limited partner interest in determining federal estate tax imposed. As a result, federal estate tax of \$500,000 would be imposed on A's transfer of the limited partner interest at the time of his death. In comparison, if instead the rules in the IRS proposed regulations were not adopted and applied, and the restriction on liquidation or redemption of A's limited partnership interest in the partnership agreement was recognized and given effect as under previous interpretations, the discounted

fair market value of A's limited partner interest transferred would be \$5,360,000, and no federal estate tax would be imposed on the transfer.

Sheppard F. Miers, Jr.
Gable Gotwals
100 West Fifth Street
Suite 1100
Tulsa, Oklahoma 74103-4217
918-595-4800
smiers@gablelaw.com

This article is provided for educational and informational purposes only and does not contain legal advice or create an attorney-client relationship. The information provided should not be taken as an indication of future legal results; any information provided should not be acted upon without consulting legal counsel.