WRMarketplace
An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Time to Act Now: Family Limited Partnerships and Valuations Discounts.

MARKET TREND: The popularity of family limited partnership and LLCs in gift and estate tax planning continues to attract IRS scrutiny.

SYNOPSIS: Family limited partnerships and LLCs have proliferated over the years, with families using them for multiple purposes, including centralized asset management, creditor protection, and efficient legacy planning. Intra-family transfers of interests in these entities often generate valuation discounts. By year-end, however, it appears that the IRS will issue proposed regulations that restrict these valuation discounts, likely limiting many planning techniques used to support the acquisition of large life insurance policies. The exact scope and timing for release of the proposed regulations remain uncertain.

TAKE-AWAY: To take advantage of possible "grandfathering" for transactions completed before the effective date of any proposed regulations, individuals already engaged in transfer planning with family limited partnerships and LLCs should complete the process in a timely manner, while those seeking to rely on existing laws should begin planning immediately.

***MAJOR REFERENCES**: Internal Revenue Code ("Code") § 2704; Proposal to Modify Rules on Valuation Discounts from General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals ("FY2013 Green Book").*

Family limited partnerships and LLCs have proliferated over the years, with families using them for multiple purposes, including centralized asset management, creditor protection, and efficient transfer tax planning. Intra-family transfers of interests in these entities often generate valuation discounts for lack of marketability, lack of control, or other voting or liquidation restrictions, which allow for more efficient tax transfers.

The IRS has consistently scrutinized family limited partnerships and LLCs (collectively, "**FLPs**") that are funded mostly with passive, marketable investments and used primarily as wealth transfer vehicles. Now it appears that the IRS will issue proposed regulations severely limiting the use of discounts with these FLPs by year-end or sooner, which could limit many planning techniques that are often used to support the acquisition of life insurance.

PRACTIAL BENEFITS OF FLPs

FLPs offer several practical benefits, including centralized family wealth management and succession, the development of a coherent family investment philosophy, and confidentiality and creditor protection for family members. The family can use the FLP to teach fiscal responsibility for younger generations by giving them a role in the FLP's investment management, with family oversight. FLPs also can facilitate the transfer of diverse investments among generations by consolidating assets under a single ownership structure. This permits transfers of FLP interests to family members or trusts for their benefit, rather than a fractional ownership in each underlying assets that would require re-titling with each transfer. Further, the pooling of assets within the FLP may provide the family with greater access to certain investment opportunities and the ability to achieve better diversification and risk allocation for its overall wealth.

VALUATION DISCOUNTS & FLPs

Intra-family transfers of the interests, whether through a gift, sale, or bequest, may generate discounts for gift and estate tax valuation purposes due to their limited marketability and their lack of control over the FLP. The transferor is not subject to gift or estate tax on the value discounted (or any appreciation thereon). Thus, valuation discounts can improve the performance of many wealth transfer planning techniques, such as gifts, GRATs, installment sales to grantor trusts or beneficiary defective inheritance trusts (BDITs), planning with self-canceling installments notes (SCINs), etc. Many of these techniques are used in tandem with the purchase of life insurance.

Example 1: John owns a FLP funded with marketable investments valued at $10 million. John sells a 20% FLP interest to an irrevocable, grantor "dynasty" trust in exchange for an interest-only installment note with a 20-year term, bearing annual interest at 2.3%. The trust anticipates a 5% annual return and may use the annual income remaining after paying the note interest to acquire life insurance. Compare the benefits if no discount applies to the FLP interests sold versus a 25% discount.

Compare	No Discount	25% Discount	Advantage of Discount
Value of 20% FLP Interest	$2,000,000	$1,500,000	$500,000
"Additional" Value Transferred without Transfer Tax	$0	$500,000	$500,000
Initial Amount Remaining for Premiums after Debt Service	$54,000	$65,500	$11,500
Trust Balance After Note Term	$1,790,000	$2,670,000	$880,000

As shown above, valuation discounts can significantly impact the economics of a proposed transaction, and their availability may determine whether certain clients proceed with planning.

PERCEIVED INADEQUACIES OF CURRENT REGULATIONS

For intra-family gifts or bequests of interests in family-controlled entities, Code § 2704(b) generally requires that certain "applicable restrictions" be ignored when valuing the interests transferred. Current regulations under Code §2704(b) define an "applicable restriction" as a restriction: (1) on the ability to liquidate a family-controlled entity that is more restrictive than would apply under state law, and (2) that, by its terms, will either lapse or may be removed by the transferor or a family member of the transferor immediately after the transfer.

According to the IRS and the Obama Administration, although Code §2704(b) should limit application of valuation discounts for intra-family transfers of FLP interests due to lack of marketability or control, various judicial decisions and state statutes interpreting "applicable restrictions" have made this Code section ineffective in many of these situations.

EXPECTATIONS FOR PROPOSED REGULATIONS

Code § 2704(b) also provides that the IRS may issue additional regulations that provide other restrictions that should be disregarded in valuing intra-family transfers of family-controlled entities. After appearing on the IRS's priority guidance plan for the past 11 years, it seems that the IRS will finally issue such proposed regulations by year-end or sooner, based on the following proposal set forth in the Obama's Administration's FY2013 Green Book:

- Creation of an additional category of "**disregarded restrictions**" that would be ignored in valuing family entity interests if, after a transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family.

- Valuation of the transferred interest by substituting certain assumptions (to be specified) in place of the disregarded restriction.

- Classification as disregarded restrictions of any limitation on:

    - An owner's right to liquidate a family entity interest that is more restrictive than a standard to be identified in regulations, or

    - A transferee's ability to be admitted as a full partner or to hold an equity interest.

- Attribution of ownership of interests held by certain charities or non-family members (to be identified) when determining whether the "family" can remove restrictions, post-transfer.

- Grant of authority to the IRS to create safe harbors to avoid application of Code § 2704.

Clearly, the FY2013 Green Book only provides a broad outline of the proposed regulations, leaving most specifics to the IRS's discretion. Thus, it is difficult to predict with certainty the full scope of the regulations. However, **minimizing or eliminating valuation discounts for FLPs concentrated in marketable securities and investments appears to be a primary goal**, based on the IRS's continuous challenges to use of these FLPs in family wealth transfer planning.[1]

POTENTIAL IMPACT

- Valuation discounts for interests in FLPs, particularly those holding marketable securities, will likely be severely restricted. This could reduce the use of FLPs in transfer tax planning and/or their ability to support life insurance acquisitions, to the extent that the projected economics of a proposed technique rely on the discounts.

- The larger value for many of these transactions will be found in the long-term planning benefits of using grantor trusts. The resulting growth within the trust can often become a more valuable feature than an initial valuation discount.

- FLPs also will still provide many practical benefits for the long-term management of family wealth, particularly as family governance, creditor protection, and wealth consolidation mechanisms.

TAKE-AWAY

To take advantage of possible "grandfathering" for transactions completed before the effective date of any proposed regulations, individuals already engaged in transfer planning with FLPs should complete the process in a timely manner, while those seeking to rely on existing laws should begin planning immediately.

NOTES

[1] To name just a few of the cases the IRS has litigated in recent years, see *Knight v. Commissioner,* 115 T.C. 506 (2000), *Dailey v. Commissioner,* T.C. Memo 2001-263 (2001)*, Strangi v. Commissioner,* T.C. Memo 2003-145 (2003); *Holman v. Commissioner,* 130 T.C. 170 (2008), affd without discussion of this issue 601 F.3d 763 (8th Cir. 2010); *Keller et al v. U.S.,* 104 AFTR 2d 2009-6015 (DC TX 2009), affd (CA5 2012) 110 AFTR 2d 2012-6061.

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