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Estate Planning Red Flag
Your trust owns S corporation stock

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IRS targeting FLPs

Proposed regs endanger valuation discounts for family-controlled entities

In August 2016, the IRS released its long-anticipated proposed regulations limiting the ability of family limited partnerships (FLPs) and other family-controlled entities to take advantage of valuation discounts. If the regulations are finalized as proposed, they'll make it difficult, if not impossible, for these entities to use certain lapsing rights and liquidation restrictions to "devalue" interests for gift and estate tax purposes.

The new rules won't take effect until the IRS publishes final regulations (or, for some provisions, 30 days after publication). Final regulations are expected sometime in 2017. In the meantime, families that own this type of entity or are contemplating establishing one should evaluate the potential impact of the rules on their estate planning strategies.

Background

The IRS has long been concerned with the use of lapsing voting or liquidation rights to depress the value of interests in family-controlled entities. For example, in a 1987 Tax Court case — *Estate of Harrison v. Commissioner* — a father and his two sons each held general partner interests in a limited partnership and the father held all of the limited partnership interests. General partners had the right to liquidate the partnership, but that right lapsed at death.

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After the father's death, the IRS valued his limited partnership interest for estate tax purposes at nearly $60 million, the value he would have received had he liquidated the partnership immediately prior to his death. The U.S. Tax Court, however, accepted the estate's argument that the father's right to liquidate the partnership lapsed at his death and, therefore, couldn't be taken into account in valuing his interest. Absent the right to liquidate, the court found, the father's limited partnership interest was worth only $33 million.

In 1990, in response to *Harrison* and similar cases, Congress added Section 2704 to the Internal Revenue Code. That section was designed to limit

Alternative estate planning strategies

After the IRS's proposed regulations limiting the ability of family limited partnerships (FLPs) and other family-controlled entities to take advantage of valuation discounts are finalized, families may want to explore alternative strategies for transferring wealth in a tax-efficient manner. A few examples:

- Transfer undivided interests in real estate, which are entitled to valuation discounts and aren't subject to Section 2704.
- Transfer "discountable" assets, such as promissory notes or undivided interests in real estate, to an FLP or LLC. The proposed regulations will affect only the value of interests in the entity, not the value of the underlying assets.
- Transfer interests in a family-controlled entity to a friendly ex-spouse or unmarried life partner. If the interests are substantial enough and held for at least three years, you'll avoid the new rules and qualify for valuation discounts.
- Consider tax-reduction techniques that don't involve establishing a family-controlled entity, such as installment sales to intentionally defective grantor trusts.

valuation discounts in family-controlled corporations and partnerships in two ways:

1. Sec. 2704(a) generally provides that the lapse of a voting or liquidation right is treated as a taxable transfer of an amount equal to the difference between the fair market values of the holder's aggregate interests before and after the lapse.
2. Sec. 2704(b) generally provides that, when valuing an interest transferred within the family, "applicable restrictions" should be disregarded. An applicable restriction is one that effectively limits the entity's ability to liquidate, and either lapses after the transfer or can be removed by the family.

Despite the enactment of Sec. 2704, family-controlled entities continued to find ways to take advantage of valuation discounts. The proposed regulations are intended to close these "loopholes."

How the proposed regulations work

The proposed regs contain a number of provisions designed to expand the reach of Sec. 2704. For starters, they clarify that Sec. 2704 applies not only to corporations and partnerships, as currently drafted, but also to limited liability companies (LLCs) and other entities and business arrangements. Other provisions include:

The three-year rule. Under current rules, if a holder of an interest in a family-controlled entity transfers a minority interest to a family member and, in so doing, loses liquidation rights or voting control, the transfer, by itself, doesn't cause a "lapse" of voting and liquidation rights. So long as the transferor's interest retains voting rights, the family can still take advantage of minority interest and lack-of-control discounts.

The proposed regulations would eliminate these discounts for "deathbed" transfers, defined as those made within three years before the transferor's death.

Disregarded restrictions. Currently, Sec. 2704(b) applies only to restrictions on the ability to liquidate the entire entity. The proposed regulations would expand it to cover restrictions on the ability to liquidate one's individual interest. There's some ambiguity, however, as to whether disregarding such restrictions eliminates or merely reduces valuation discounts.

Unrelated third parties. Currently, families can avoid Sec. 2704 by transferring a nominal interest in the entity to an unrelated third party, such as a charity. If unanimous consent is required to liquidate the entity, this strategy eliminates the family's ability to remove an applicable restriction. Under the proposed regulations, these interests would not be considered in determining whether a family can remove a restriction, unless they're fairly substantial and have been held for at least three years.

State law exception. Sec. 2704 contains an exception for restrictions "imposed, or required to be imposed, by any federal or state law." Under current rules, family-controlled entities in states with strict "default" liquidation restrictions can avoid Sec. 2704, and continue to enjoy valuation discounts by adopting restrictions that are consistent with those default restrictions. The proposed regulations would disallow this strategy if the entity has the power to override the state restrictions. In other words, valuation discounts would be available only if the state-imposed restrictions are *mandatory*.

What should you do now?

These and other changes would substantially reduce or eliminate valuation discounts for intrafamily transfers. The final regulations won't apply to transfers completed before their effective date, however, so families contemplating such transfers should act quickly. After the regulations take effect, consult with your estate planning advisor to consider other strategies for reducing gift and estate taxes.

3 reasons you should continue making lifetime gifts

Now that the gift and estate tax exemption has reached $5.49 million (for 2017), it may seem that gifting assets to loved ones is less important than it was in previous years. However, lifetime gifts continue to provide significant benefits, whether your estate is taxable or not.

Why make gifts?

Let's examine three reasons why making gifts remains an important part of estate planning:

1. Lifetime gifts reduce estate taxes. If your estate exceeds the exemption amount — or you believe it will in the future — regular lifetime gifts can substantially reduce your estate tax bill. Assume that your estate is worth $7.49 million. If you were to die this year, your estate tax liability would be $800,000 (40% × $2 million). You can reduce the size of your taxable estate by starting a gifting program.

The annual gift tax exclusion allows you to give away up to $14,000 per recipient ($28,000 if you "split" gifts with your spouse) tax-free. In addition, direct payments of tuition or medical expenses on behalf of your loved ones are excluded. Let's say you're married with four children and eight

But that doesn't mean lawmakers can't reduce the amount in the future, exposing your wealth to gift and estate taxes overnight. A program of regular annual exclusion gifts and direct payments of tuition and medical expenses can provide some insurance against future changes to the tax laws.

grandchildren, and that at any given time over the next six years four of your grandchildren are in college. You and your spouse give each child and grandchild $28,000 per year and make direct tuition payments of $20,000 per year for the grandchildren in college. In six years, you'll have reduced your taxable estate by nearly $2.5 million.

Taxable gifts — that is, gifts beyond the annual exemption amount — can also reduce your estate tax liability by removing future appreciation from your taxable estate. You may be better off paying gift tax on an asset's current value rather than estate tax on its appreciated value down the road. When gifting appreciable assets, however, be sure to consider the potential income tax implications. Property transferred at death receives a "stepped-up basis" equal to its date-of-death fair market value, which means the recipient can turn around and sell the property free of capital gains taxes. Property transferred during life retains *your* tax basis, so it's important to weigh the estate tax savings against the potential income tax costs.

2. Tax laws aren't permanent. Even if your estate is within the exemption amount, it pays to make regular gifts. The 2012 tax law made the $5 million exemption (indexed for inflation) "permanent."

3. Gifts provide nontax benefits. Tax planning aside, there are many other reasons to make lifetime gifts. Perhaps you want the chance to see your children or grandchildren enjoy your wealth. Or perhaps you wish to use gifting to shape your family members' behavior — by providing gifts to those who attend college, for example. If you own a business, gifts of interests in the business may be a key component of your ownership and management succession plan.

If your estate exceeds the exemption amount — or you believe it will in the future — regular lifetime gifts can substantially reduce your estate tax bill.

A win-win proposition

Regardless of the amount of your wealth, consider a program of regular lifetime giving. If your estate is large enough to be taxable — or if Congress reduces the exemption in the future — gifting can soften the blow of estate taxes. And even if estate taxes never become a concern, gifting provides significant nontax benefits for loved ones.

Is a noncharitable purpose trust right for you?

There are two trust types that don't require one or more human beneficiaries: charitable trusts and noncharitable purpose (NCP) trusts. A charitable trust is the more common of the two, but an NCP trust could also be a formidable tool to help achieve your estate planning goals.

Defining an NCP trust

Historically, trusts were required to have human beneficiaries. Why? Because, for a trust to be valid, there must be someone to enforce it. Charitable trusts were the exception: The attorney general of the relevant jurisdiction was authorized to enforce the trust in the public interest.

Over the years, however, many U.S. states and a number of foreign jurisdictions have enacted legislation (including provisions of the Uniform Probate Code and the Uniform Trust Code) that authorizes NCP trusts.

These trusts may be used to achieve a variety of purposes, such as caring for a pet or other animal (including its offspring); maintaining a gravesite and providing for graveside religious ceremonies (often referred to as "honorary" trusts); maintaining art collections, antiques, automobiles, jewelry or other personal property; and funding or otherwise sustaining a family business.

A trust may be an NCP trust even if the grantor's children or other heirs will ultimately receive trust property as "remaindermen." Suppose, for example, that you create an NCP trust to maintain and exhibit your art collection. After a specified time period — let's say 20 years — the trust terminates and the collection is distributed to your children. The fact that your children will receive the art once the trust has fulfilled its purpose doesn't change its character as an NCP trust. Nor does it render the trust valid or enforceable absent an applicable NCP trust statute.

To be valid, an NCP trust must meet certain requirements. Most important, it must 1) have a purpose that's certain, reasonable and attainable, 2) not violate public policy, and 3) be capable of enforcement. Typically, an NCP trust is enforced by a designated "enforcer" — someone whose job it is to ensure that the trust's purpose is fulfilled and who has the authority to bring a court action — and/or a "trust protector," who's empowered to modify the trust when its purpose has been achieved or is no longer relevant.

Choosing the right jurisdiction

The permitted uses of NCP trusts, as well as their duration, vary significantly from state to state, as do the powers of a trust protector or enforcer. Some states, for example, allow only pet trusts, honorary trusts or both. Other states authorize NCP trusts for most purposes, so long as they don't violate public policy. Most states limit an NCP trust's duration to a term of 21 years, although some permit longer terms or even "dynasty" NCP trusts of unlimited duration.

Twenty-one years may not be sufficient for certain purposes, such as supporting a family business or caring for horses or other animals whose life expectancies exceed 21 years.

Offshore NCP trusts tend to offer greater planning flexibility, but they also involve greater cost and strict reporting requirements.

It's also important to remember that NCP trusts raise a variety of income, estate, gift and generation-skipping transfer tax issues.

Don't try this at home

A full discussion of the tax implications is beyond the scope of this article, but it's important to consult your tax advisor to get an idea of the potential tax liabilities associated with NCP trusts. Your advisor can also help you choose the right jurisdiction and design the trust so that it meets your needs and is enforceable.

ESTATE PLANNING RED FLAG

Your trust owns S corporation stock

S corporations must comply with several strict requirements or risk losing their tax-advantaged status. Among other things, they can have no more than 100 shareholders, can have no more than one class of stock and are permitted to have only certain types of shareholders.

In an estate planning context, it's critical that any trusts that own S corporation stock — or receive such stock through operation of your estate plan — be eligible shareholders. Eligible trusts include:

- Grantor trusts, provided they have one "deemed owner" who's a U.S. citizen or resident and meet certain other requirements. Not all grantor trusts are eligible, including some that contain common tax-planning features. Also, when the grantor dies, the trust remains eligible for two years, after which it must distribute the stock to an eligible shareholder or qualify as a qualified subchapter S trust (QSST) or an electing small business trust (ESBT).
- Testamentary trusts — that is, trusts established by your will. These trusts are eligible S corporation shareholders for up to two years after the transfer and then must either distribute the stock to an eligible shareholder or qualify as a QSST or ESBT.
- QSSTs. These trusts must meet several requirements, including distributing all current income to a single beneficiary who's a U.S. citizen or resident, and filing an election with the IRS. They cannot be used to benefit multiple beneficiaries or to accumulate income, although in effect there can be multiple beneficiaries if they're treated as each owning a separate share of the trust. A QSST's income is taxed at the beneficiary's tax rate.
- ESBTs. A trust qualifies as an ESBT if 1) all of its beneficiaries or "potential current beneficiaries" would be eligible shareholders if they held the stock directly, 2) no beneficiary purchases its interest and 3) the trustee files an election with the IRS.

If you have any S corporation stock held in a trust, be sure to review its terms carefully to avoid inadvertently disqualifying the S corporation.

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Carlin Comments
The Love-Letter Will (Part 1)
By Angela G. Carlin

In the *Estate of Eric Anthony Hand*, the Butler County, Ohio, appellate court on October 24, 2016, in 2016-Ohio-7437, upheld the decision of the probate court denying the application of his widow and appellant therein, Natalie Hand ("Natalie"), to admit to probate the purported will of her late husband, Eric ("Eric"). The parties were married in April 2014. Eric died on September 7, 2014. He was survived by Natalie and four minor children from a previous marriage. Eric's former wife was Shannon ("Shannon") who is the minor children's mother. In searching for a will, the appellant discovered, in a box of love letters she received from Eric over the years, a three-page handwritten letter dated January 23, 2014 (the "Love Letter Will"). Unlike the other love letters, decedent Eric signed this letter with his full name. It consisted of three paragraphs (the first two paragraphs professed his love for appellant) and a post-scriptum not relevant to the case. The last paragraph read as follows:

> As my last will and testament, I appoint you the primary beneficiary of all I have and all I have worked for. With the complete trust that you will look after the children, my business interests and all other things that I have put together over the years and not let anyone try to deprive you of those things.
>
> I love you eternally,
> ERIC ANTHONY HAND
> s/ Eric Anthony Hand

Subsequently, appellant discovered in decedent's office a draft titled "the Last Will and Testament of Eric Anthony Hand," which decedent had prepared though LegalZoom.com, an online digital forms company. This draft, which was unsigned, left 52% of decedent's estate to appellant and 48% of his estate to his children. The record indicates that decedent paid LegalZoom and prepared such will draft the day before he wrote the Love Letter Will. The appellant first sought to admit the Love Letter Will as a lost, spoliated, or destroyed will, which was objected to by Shannon on behalf of her minor children. The probate court ordered appellant to file an application to admit the original of the Love Letter Will to probate which appellant did and thereupon the probate court issued an interlocutory order refusing admission and ordered a hearing, which was held in October 2015. At the hearing, two friends of the appellant testified that they saw decedent sign the Love Letter Will at his home on January 23, 2014. However, it was established that one friend was in Indiana on that date and did not arrive at decedent's home until the next day. Then both women changed their testimony and asserted they witnessed decedent sign the Love Letter Will on a different date in January 2014. Both women had different recollections where decedent signed such will in which room in his house, and, importantly, neither witness signed such will as a witness, nor had either woman remembered such will when decedent died.

Appellant testified that decedent signed the Love Letter Will, gave it to her and told her "what it was," she then put such document in the same box as other love letters. Later that evening decedent told appellant that he was going to prepare a LegalZoom document, and that when decedent called appellant and one of the two friends into the room, "he explained to us that this was his will and he would get it legally done at a later date." On January 21, 2016, the probate court denied to admit decedent's Love Letter Will to probate.