THE ESTATE PLANNER

January/February 2017

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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.

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.

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."

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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WHEN A VALID POWER OF ATTORNEY IS REJECTED

We recently had an issue with a bank refusing to accept a durable power of attorney prepared for a client by our firm. In 2015, the client properly executed the durable power of attorney designating her two daughters to serve as co-agents with the express authority to conduct banking transactions. The client is now physically incapacitated. When the client's daughters presented the durable power of attorney to the bank, the bank refused to accept it.

Now what?

A power of attorney is a legal document delegating authority from one person to another. The maker of a power of attorney (the "principal") grants an agent or agents the right to act on the principal's behalf. The Florida Power of Attorney Act (the "Act"), effective as of October 1, 2011, significantly changed powers of attorney in Florida. The Act provides protection to principals and clear guidance to agents as to their rights and responsibilities under a power of attorney. A power of attorney signed after October 1, 2011 is effective as soon as the principal signs it.

A power of attorney terminates upon the incapacity or death of the principal. However, there is a special type of power of attorney, known as a *durable power of attorney*, which remains effective following a principal's incapacity. A durable power of attorney generally alleviates the need for a court-appointed guardian to act for an incapacitated principal.

Under the Act, a third party is required to accept or reject a power of attorney within a reasonable time. For banks and financial institutions, four business days is presumed to be a reasonable time to accept or reject an agent's authority if the power of attorney contains the specific authorization to conduct banking or investment transactions. While it is reasonable for a third party to have time to consult with a lawyer or an internal legal department, any delay exceeding a brief period of time may be unreasonable.

A third party that in good faith accepts a power of attorney may rely on it and seek to enforce any obligation created by the agent on the principal's behalf. Under the Act, there are limited circumstances in which a third party may reject a power of attorney and the reason for its rejection must be set forth in writing. Some reasons for which a power of attorney may be rejected include the third party's notice that the power of attorney or the agent's authority is invalid, void, suspended, or terminated; the third party is not obligated to engage in business with the principal in the same circumstances; or the third person knows that there is an allegation of abuse by the agent and an investigation is pending. A third party that improperly rejects a power of attorney is subject to a court order mandating acceptance and to liability for damages including reasonable attorney's fees and costs.

In the case of our client's daughters who were seeking to exercise their rights under a valid durable power of attorney, the bank ultimately accepted it once our firm explained the provisions of the Act to the bank officer.

If your power of attorney is ever rejected, please call our office. A third party may not understand the implications of refusing to accept an otherwise properly executed and valid power of attorney. If your power of attorney was executed prior to October 1, 2011, it remains valid but is not eligible for the expedited review period required for banks and financial institutions described above. In this case, it would be prudent to contact our office to have a new durable power of attorney prepared and executed pursuant to the Florida Power of Attorney Act.