Message from the Chair

The Taxation Committee has been active and growing and now has more than 1,000 members. Over the past year, we have organized presentations and panel discussions and meetings via webinar and at the ABA meetings in the US and abroad. We have also recently filled the following new positions:

Vice Chair: Imke Gerdes  
Content Committee Liaison: Richard S. Barnes  
Director, International Coordinating Committee: Marc Levey  
Section of Taxation Liaisons: Joanne Rocks  
Membership Committee Liaison: Thomas D. Sykes

We have covered a wide range of content at our recent meetings in Montreal and Boston, including US-Canada cross border employment tax issues, distressed company sales, tax considerations in domestic and international M&A transactions and the state aid controversy.

We have a panel discussion planned for Friday, April 7 from 10:30 am - noon at the ABA Spring Meeting in New Orleans. In cooperation with the Intellectual Property and International Business Law committees, the Taxation Committee will host a panel discussion on Intellectual Property and Transfer Pricing - a hot button issue in many tax audits these days. The panel members will be IP lawyers, economists, state and federal tax lawyers, as well as transfer pricing specialists. This combination usually warrants a lively discussion. I hope to see you there. It will be a perfect opportunity to get to know each other and the members of this and other committees. Also, New Orleans in April is always worth a trip.

In addition to the live panels at the upcoming Spring meeting, the Section is always looking for interesting topics for webinars. Please contact me if you or someone in your firm would like to participate in a presentation or webinar.

Finally, I would like to let you know that the Section has assigned Raul Escatel, a Business Law Fellow, to the Taxation Committee. The Business Law Fellows Committee helps underrepresented groups, such as young lawyers, lawyers of color, lawyers with disabilities and LGBT lawyers, participate in the Section. If you would like to participate in the Committee and be a mentor to Raul, please let me know at rroyse@royselaw.com.

Roger Royse  
Chair, Taxation Committee

Message from the Editor

Much has happened since we published our last issue in September. Not only do we have a new President, but we are also in a period of transition with Treasury Department tax staffing. In addition, the Fall was a very active period for IRS and Treasury as they worked overtime to complete projects that had been underway for some time.
Phyllis Epstein, Epstein Shapiro & Epstein PC, Philadelphia, PA

In this issue, we have a mix of old and new. While much attention continues to focus on federal tax implications of Section 385 debt/equity regulations, we are pleased to offer an expert's look at the state and local tax (SALT) implications of these rules, which are likely to have quite a sting. We also have articles discussing practical aspects of the Section 2704 regulations on valuation discounts in estate planning; providing an update on employment tax liability where disregarded entities are used; and considering recent Treasury regulations restricting tax planning involving allocation of partnership liabilities.

As we head into an active period for Congress and the Administration in the tax area, we offer a high level outline of House Republican and Trump tax reform proposals (undoubtedly more on this in our Spring issue). We also have an important report on changes in the way the IRS Appeals process is handled, something that affects many of our clients. And finally, "It's Time for Your Buy-Sell Checkup," a topic that speaks for itself and comes up commonly in most business lawyers' practice.

As always, we'd love to hear from you: How do you like the content, suggestions for our next issue(s), and of course, content submissions.

Michael Kliegman
Editor

Feature Articles

Valuation Discounts After the Proposed Code § 2704 Regulations
By Jeramie J. Fortenberry

On August 4, 2016, the Treasury Department issued long-awaited Proposed Regulations (Proposed Regulations) on valuation discounts for family-owned businesses under Internal Revenue Code (Code) § 2704. The stated purpose of the Proposed Regulations is to clarify the application of Code § 2704 and curb transfer tax valuation discounts used by family-owned businesses.

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A Comparison of Trump and House GOP Tax Reform Proposals
By William B. Sherman, David Scott Sloan, Kathleen M. Nilles, and Daniel L. Janovitz

With Republicans in control of the U.S. Senate, the U.S. House of Representatives and the White House starting in 2017, the federal government is now better positioned to move forward on comprehensive tax reform, with anticipated legislation that restructures both the individual and business income tax provisions of the Internal Revenue Code. It is expected that upcoming tax reform efforts will build on the principles set forth in the House Republicans' "A Better Way" proposal, released by House Speaker Paul Ryan (R-Wis.) in June 2016, as well as the tax proposals advanced by President-Elect Donald Trump during the course of his campaign. Trump's original tax plan was proposed in September 2015, and his revised tax plan was proposed in September 2016.

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State and Local Tax Implications of Final Section 385 Debt Equity Regulations
By Peter L. Faber

The US Department of the Treasury has just released final regulations under Section 385 of the Internal Revenue Code dealing with the circumstances under which related company debt will be classified as equity for income tax purposes.
Regulations under this provision had been proposed in April 2016. The proposed regulations caused considerable consternation in the corporate taxpayer community. Although Section 385, which was enacted in the Tax Reform Act of 1969, arguably was intended merely to require Treasury to list factors that would be taken into account in determining when purported debt should be reclassified as equity, the proposed regulations prescribed absolute rules, not just factors. If a debt instrument failed to meet the requirements of the proposed regulations, in many cases it was automatically reclassified as equity regardless of whether it would have been respected as debt under the well-accepted rules that had been laid down in dozens of federal court cases.

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Employment Tax Liability and Disregarded Entities
By Jennifer L. Villier

If there was ever any doubt, the U.S. Tax Court has recently clarified that the sole member of a single member LLC can, in certain circumstances, be held liable for the employment tax liability of the entity. In Heber E. Costello, LLC and Costello v. Comm’r, T.C. Memo. 2016-184 (Sept. 29, 2016), Scott Costello, the sole member of Heber E. Costello, LLC, a Louisiana LLC, disputed his responsibility for the unpaid employment taxes of the LLC. Costello contended that the LLC should be treated as a corporation since (1) it resulted from a reorganization under Code §368(a)(1)(F), and (2) he filed corporate tax returns (Form 1120) for the LLC, which he claimed constituted a valid election for the LLC to be taxed as a corporation.

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It's Time for Your Buy-Sell Checkup!
By James M. McCarten

Shareholders, Partners and/or LLC members of any closely-held or family-held company should check the buy-sell formula contained in their Shareholder Agreement (sometimes called a Buy-Sell Agreement), Partnership Agreement or Operating Agreement to make sure that the formula still works for all of the owners following the release last August by the IRS of proposed regulations under Code §2704.

Read more....

Changes in IRS Appeals Could Create Difficulties for Taxpayers
By Robert J. Kovacev, Lisa M. Zarlenga, Cameron Arterton, Caitlin Tharp

Recent changes within the IRS Office of Appeals (Appeals) have resulted in clarifications and modifications to IRS Appeals policy. Other proposed changes could cause delays and make the process more difficult for taxpayers. This article examines these changes and their potential impact on the resolution of taxpayer cases.

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New Treasury Regulations Curtail Planning Opportunities for Partnership Structures
By Steven E. Clemens, Daniel M. Dunn, Steven J. Lorch and Michael J. Rufkahr

The U.S. Treasury Department and the Internal Revenue Service issued final and temporary regulations (the "2016 Regulations") on October 5, 2016 addressing the partnership disguised sale and debt allocation rules. The 2016 Regulations limit or, in some cases, eliminate taxpayers’ ability to achieve tax deferral in certain partnership structures where deferral previously was available.

Read more....
Valuation Discounts After the Proposed Code § 2704 Regulations

Jeramie J. Fortenberry, J.D., LL.M.
Executive Editor, WealthCounsel® LLC

January 16, 2017

On August 4, 2016, the Treasury Department issued long-awaited Proposed Regulations (Proposed Regulations) on valuation discounts for family-owned businesses under Internal Revenue Code (Code) § 2704. The stated purpose of the Proposed Regulations is to clarify the application of Code § 2704 and curb transfer tax valuation discounts used by family-owned businesses. The Proposed Regulations:

- Apply to limited liability companies (LLCs) and address what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership, or limited partnership;
- Restrict “deathbed transfers” that result in the lapse of a liquidation right and clarify the treatment of a transfer that creates an assignee interest;
- Refine the definition of the term Applicable Restriction by eliminating the comparison to state law liquidation limitations; and
- Add a new section to address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interests held by persons who are not members of the family.

Although the Internal Revenue Service has stated that it did not intend the Proposed Regulations to eliminate valuation discounts for family-owned business interests, many tax practitioners believe that the Proposed Regulations do just that. This article analyzes the Proposed Regulations in light of prior law and discusses the status of the Proposed Regulations in the current legislative environment.

Clarifications About LLCs and Other Entities That Are Not Corporations or Partnerships

When the current Code § 2704 regulations were issued, corporations and partnerships were the dominant forms of business. Since then, the check-the-box regulations have been promulgated, allowing a business entity’s tax status to differ from its classification under local law. LLCs have also become increasingly popular, overtaking corporations and partnerships as the go-to entity choice for small businesses. These new developments were not contemplated by the existing regulations.

The Proposed Regulations address these changes in two ways. First, they clarify that Code § 2704 applies not only to corporations and partnerships, but also to LLCs and other business arrangements. The Proposed Regulations also clarify that Code § 2704 applies regardless of how the entity is classified for other federal tax purposes and regardless of whether the entity is a disregarded entity.

Second, the Proposed Regulations specify how to determine control of LLCs and other entities that are not corporations or partnerships. Control of an LLC or other entity that is not a corporation or partnership means either (a) holding at least 50 percent of either the capital or profits interests of the business or (b) holding any equity interest with the ability to cause full or partial liquidation.

Restriction on Deathbed Transfers that Result in Lapse of Liquidation Rights and Clarification of Treatment of Assignee Interests

Code § 2704(a) was enacted in response to a Tax Court ruling that liquidation rights that lapse at death were excluded from the decedent’s gross estate. Code § 2704(a) was intended to apply to transfers of
interests in family-owned businesses to family members under circumstances that prevent individual transferees from liquidating or controlling the entity, but allow the transferees to act together to liquidate or control the entity. In this scenario, the transferor’s ability to liquidate or control the entity would not pass to any of the individual transferees. Instead, the transferees would each have interests that, when viewed at the individual transferee level, carried no voting control or liquidation rights. The value of the interests transferred to the transferees could be reduced by lack of control or minority discounts, thereby allowing the business to pass to the transferees at a lower tax cost.

Code § 2704(a) prevents this result by applying special rules to value lapsing rights in closely-held businesses. Under these rules, a lapse of rights in a family-controlled business is treated as a transfer by the individual holding the right immediately before it lapses. If the rights lapse during a person’s lifetime, the lapse is treated as a taxable gift. If the lapse occurs at death, the gross estate of the deceased taxpayer includes the value of the lapsing rights. The transfer tax value of the lapsed rights equals the difference between the value of the interests held by the person before the lapse (including the lapsed right) and the value of the interest after the lapse (excluding the lapsed right).iv

Assume that Father and Daughter own controlling interests in a corporation. If Father’s stock has voting rights that lapse on Father’s death, Code § 2704(a)(1) would include the value of the lapsed rights in Father’s estate. If Father’s stock has voting rights that lapse before Father’s death, Father will be treated as having made a taxable gift on the date of the lapse. Either way, the lapse of the voting rights is a taxable transfer for federal gift and estate tax purposes.

Code § 2704(a) applies to both voting and liquidation rights. The Treasury Regulations define liquidation right as follows:

Liquidation right means a right or ability to compel the entity to acquire all or a portion of the holder’s equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity.v

For federal transfer tax purposes, a liquidation right lapses when it is restricted or eliminated.vi But the regulations contain an important exception: A transfer of an interest that results in the lapse of a liquidation right is not treated as a taxable lapse if the rights with respect to the transferred interest are not restricted or eliminated.vii This exception allows taxpayers to transfer liquidation rights during lifetime without having the liquidation rights treated as a taxable gift, as long as the rights with respect to the transferred interest are not restricted or eliminated.

The IRS believes that the exception for transfers of interests with lapsing liquidation rights should not apply to deathbed transfers. Specifically, the IRS believes that deathbed transfers create a disparity between the economic effect of the transfer and the tax effect of the transfer. These transfers have minimal economic effects on the value of the interest, but result in a transfer tax value that is lower than the value of the interest both before and after the decedent’s death.

To address this disparity, the Proposed Regulations apply a three-year rule to transfers of interests that are subject to lapsing liquidation rights. If a taxpayer transfers an interest with a lapsing liquidation right within three years of the taxpayer’s death, the liquidation rights are considered to lapse at the taxpayer’s death and the value of the lapsed rights are included in the taxpayer’s gross estate.viii If a deceased taxpayer makes a gift to a family member that creates a minority interest and the gift occurs within three years of death, the value of the gift will not be discounted to reflect the minority interest.
The new three-year rule under Code § 2704(a) is overshadowed by the more drastic changes to the Proposed Regulations under Code § 2704(b). As discussed below, the Proposed Regulations under Code § 2704(b) create new categories of Disregarded Restrictions that reduce—and perhaps eliminate—minority interest and marketability discounts for transfers to family members, regardless of whether those interests are transferred within three years of the decedent’s death. Because of the broad reach of the Proposed Regulations under Code § 2704(b), the three-year rule under Code § 2704(a) may have little practical effect.

The Proposed Regulations also clarify the treatment of transfers that create an assignee interest. Under state law, an assignee is a person who receives an interest but is not admitted as a partner or member. An assignee may receive items of income and loss, but has no rights to participate in management. Because of this loss of management control, transferring an interest from a partner to an assignee eliminates significant rights and powers associated with the interest.

Under the Proposed Regulations, if a transfer results in the restriction or elimination of any of the rights or powers associated with the interest, the transfer is treated as a lapse under Code § 2704(a).xix As a result, a transfer of an interest to an assignee may be treated as a lapse of liquidation rights associated with the interest and thus be treated as a taxable gift.

Changes to Treasury Regulations Regarding Liquidation Restrictions Under Code § 2704(b)

The valuation of an owner’s interest in a business may depend on the owner’s power to force liquidation of the business. Without the ability to force a liquidation, the owner has no means to obtain his or her pro rata portion of the underlying business assets. In these circumstances, the owner cannot realize the full value of his or her interest without cooperation of the other business owners.

Any reasonable buyer of the owner’s interest in the business would consider the lack of ability to force a liquidation to be a detriment. All else being equal, a reasonable buyer would pay less for a business interest without liquidation rights than it would for an interest with liquidation rights. In recognition of this, the value of interests that do not include liquidation rights have historically been discounted to reflect the marketplace realities.

Taxpayers have long benefited from valuation discounts associated with lack of liquidation rights. One common strategy involves creating artificial restrictions that limit liquidation of the business. When the business owner dies, the value of the interest is discounted to reflect the fact that a buyer would take the inability to compel liquidation into account in determining a purchase price. These discounts allow the business owner to transfer assets at a lower transfer tax value and thereby save estate and gift taxes.

Code § 2704(b) was enacted to curb the use of discounts to reduce transfer tax value in the family-owned business context. It applies when:

- the transferor and her family hold at least 50 percent, by vote or value, of equity\( \text{ }^x \) in the entity;
- there is a transfer of a business interest to (or for the benefit of) a member of the transferor’s family; and
- immediately before the transfer, the transferor and members of the transferor’s family hold control of the entity.\( \text{ }^{xi} \)

If Code § 2704(b) applies, any Applicable Restriction (defined below) is disregarded for purposes of determining the value of the transferred interest for transfer tax purposes.\( \text{ }^{xii} \) If an Applicable Restriction
is disregarded, it is not taken into account in determining valuation discounts. Stated differently, the disregarding of an Applicable Restriction will prevent the taxpayer from using the restriction as a basis for transferring the interest at a lower tax cost.

Because the identification of a restriction as an Applicable Restriction can cause loss of tax savings, much depends on whether a given restriction qualifies as an Applicable Restriction under Code § 2704. Code § 2704(b)(2) defines Applicable Restriction to mean any restriction that effectively limits the ability of the business to liquidate, provided that the restriction lapses after the transfer or can be removed by the transferor’s family after the transfer.\textsuperscript{xiii} Significantly, Code § 2704(b)(3)(b) excludes from the definition of Applicable Restriction “any restriction imposed, or required to be imposed, by any Federal or State law.”

The current Treasury Regulations went beyond the explicit language of the statute to exclude not only state law restrictions, but also any “limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction.”\textsuperscript{xiv} Under the current regulations, restrictions that are no more restrictive than those that would apply under state law are not Applicable Restrictions under Code § 2704(b) and thus do not adversely affect valuation discounts.

The restrictions defined in Code § 2704 are not exhaustive. Code § 2704(b)(4) allows the Treasury to issue regulations that disregard other types of restrictions for tax purposes if the restrictions reduce the transfer tax value without reducing the actual value to the transferee. This significant grant of discretion gives the Treasury expansive authority to promulgate regulations to identify restrictions that are not explicitly covered by Code § 2704(b) but should be disregarded for valuation purposes.\textsuperscript{xv}

The IRS believes that the current regulations do not fulfill the intended purposes of Code § 2704(b). The Summary of the Proposed Regulations identifies several reasons for this deficiency. First, courts have applied the current regulations to restrictions on the ability to liquidate the entire entity, not to restrictions on the ability to liquidate a transferred interest in the entity.\textsuperscript{xvi} Because of this interpretation, a restriction on the ability to liquidate an individual interest is not considered to be an Applicable Restriction under the current regulations.

Second, the current regulations provide that a restriction on liquidation is not an Applicable Restriction if it is no more restrictive than restrictions imposed by state law.\textsuperscript{xvii} Since the enactment of Code § 2704(b), many states have revised their limited partnership acts to allow liquidation only with the unanimous vote of the partners (unless provided otherwise in the partnership agreement) and to eliminate the statutory default provision that allowed limited partners to liquidate their limited partnership interests. Most state partnership and LLC statutes now prohibit withdrawal from the partnership unless the partnership agreement provides otherwise.

Because of these broad state law restrictions, most provisions in partnership and operating agreements that restrict liquidation are no more restrictive than those that apply under state law. As a result, most restrictions in partnership and operating agreements are not Applicable Restrictions under Code § 2704(b) and thus do not adversely affect valuation discounts.

Third, the IRS recognizes a common strategy of transferring partnership interests to assignees instead of partners. Under state law, assignees are typically allocated items of partnership income, gain, and loss, but do not have the controlling rights of a partner. This allows taxpayers to argue that an assignee’s inability to cause the partnership to liquidate his or her interest is no more restrictive than state law and thus should not be considered an Applicable Restriction.
Fourth, some taxpayers avoid the application of Code § 2704(b) by transferring a nominal interest in a business to a nonfamily member (including a charity or employee) and requiring all owners to approve liquidation. This creates a situation where liquidation restrictions cannot be removed by the transferor’s family after the transfer and arguably removes the restriction from the definition of Applicable Restriction.xviii

The IRS believes that the combined effect of these developments has eviscerated Code § 2704(b).

Changes to the Definition of Applicable Restriction to Eliminate Comparison to the Liquidation Limitations of State Law

As stated above, the Treasury Regulations go beyond the language of the statute regarding federal or state law restrictions. Where the statute disregards any restrictions required by state or federal law, the current Treasury Regulations disregard any limitation on the ability to liquidate the entity that is more restrictive than state law limitations. The Proposed Regulations take a narrower approach by removing the exception that limits the definition of Applicable Restriction to limitations that are more restrictive than state law restrictions.xix The IRS believes this exception contradicts the intent of Code § 2704(b) to the extent that it allows the transferor and family members to avoid any statutory rule.

The Proposed Regulations also provide that an Applicable Restriction includes both a restriction imposed under the governing documents and a restriction imposed under local law, regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise.xx This regulation is intended to ensure that a restriction that is not imposed or required to be imposed by federal or state law is disregarded without regard to its source.

The Proposed Regulations also define the terms “federal” and “state” for purposes of determining whether a restriction is “imposed, or required to be imposed, by any Federal or State law” under Code § 2704(b)(3)(B). The terms “federal” and “state” refer only to the United States or any state (including the District of Columbia), but do not include any other jurisdiction.

The Proposed Regulations also clarify which restrictions will be considered to be “imposed, or required to be imposed” under state or federal law. A restriction is imposed or required to be imposed by law if the restriction cannot be removed or overridden and it is mandated by the applicable law, must be included in the governing documents, or is otherwise made mandatory.

Even restrictions that may not be removed or overridden may be Applicable Restrictions in two circumstances. Both involve situations where the statute is mandatory, but other statutes may be used that would effectively make the mandatory statute elective. The two situations are:

1. When state law is limited in its application to a narrow class of entities like family-controlled entities that would otherwise be subject to Code § 2704; and
2. When state law imposes a mandatory restriction but provides an optional provision or alternative statute for the creation and governance of the same type of entity and the optional provision or alternative statute does not mandate the restriction.

If an Applicable Restriction is disregarded, the fair market value of the transferred interest is determined under general valuation principles as if the restriction does not exist (i.e., as if the governing documents and the local law are silent on the question).

New Disregarded Restrictions on Transfers of Individual Interests

The most devastating change introduced by the Proposed Regulations is the introduction of a new category of Disregarded Restrictions. The Proposed Regulations close valuation loopholes by creating
new restrictions are disregarded for transfer tax purposes in the family-owned business context.\textsuperscript{xxi} Section 25.2704-3(b)(1) of the Proposed Regulations creates four categories of Disregarded Restrictions (\textit{Disregarded Restrictions}): 

1. Provisions that limit or permit the limitation of the holder’s ability to compel liquidation or redemption of the interest.
2. Provisions that limit or permit the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than minimum value.\textsuperscript{xxii}
3. Provisions that defer or permit the deferral of the payment of the full liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder’s intent to have the holder’s interest liquidated or redeemed.
4. Provisions that authorize or permit the payment of any portion of the full liquidation or redemption proceeds in any manner other than in cash or property.\textsuperscript{xxiii}

These restrictions are in addition to the Applicable Restrictions and are evaluated at the individual interest level. The inquiry is not whether the individual can cause a liquidation of the entity, but whether the individual can redeem or liquidate his or her interest in the entity.\textsuperscript{xxiv} For each of the four categories, the restriction will be disregarded if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor’s family, either alone or collectively.\textsuperscript{xxv}

Many practitioners believe that the practical effect of the new categories Disregarded Restrictions is to create a fictional put right for all interests in the family-owned business context unless a mandatory state law precludes the put right. This is illustrated by Example 1 of § 25.2704-3 of the Proposed Regulations, which posits a scenario where a parent with a 98-percent interest in a limited partnership makes gifts of 33 percent limited partnership interests to her two children. In the example, the partnership agreement prohibits withdrawal of a limited partner prior to dissolution of the partnership on June 30, 2066, and requires all partners to approve amendment of the partnership agreement. The example concludes:

\textit{By prohibiting the withdrawal of a limited partner, the partnership agreement imposes a restriction on the ability of a partner to liquidate the partner’s interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor’s family, acting collectively, by agreeing to amend the partnership agreement. Therefore, … the restriction on a limited partner’s ability to liquidate that partner’s interest is disregarded in determining the value of each transferred interest.}

In other words, the restriction on withdrawal of a limited partner is disregarded and all partners are treated as if each partner could liquidate his or her interest. Each partner is treated as though he or she has the right to be redeemed for full value. This would reduce—and perhaps eliminate—any minority or marketability discount.

Effect of Insubstantial Ownership by Nonfamily Members
The IRS also believes that the grant of an insubstantial interest in the entity to a nonfamily member should \textit{not} preclude the application of Code § 2704(b). The IRS believes that transfers to nonfamily owners in these circumstances creates a “friendly” environment that does not actually prevent the family from removing the liquidation restriction.
In determining whether the transferor or the transferor’s family can remove a restriction included in this new class of Disregarded Restrictions, any interest in the entity held by a nonfamily member is disregarded if, at the time of the transfer, the interest:

- has been held less than three years before the date of the transfer;
- constitutes less than 10 percent of the value of all of the equity interests;
- when combined with the interests of other nonfamily members, constitutes less than 20 percent of the value of all of the equity interests; or
- lacks a right to “put” the interest to the entity and receive a minimum value.\textsuperscript{xxvi}

If an interest is disregarded, the determination of whether the family can remove the restriction will be made assuming that the remaining interests are the sole interests in the entity.\textsuperscript{xxvii}

If a restriction is disregarded, the fair market value of the interest in the entity is determined assuming that the Disregarded Restriction did not exist, either in the governing documents or applicable law. Fair market value is determined under general valuation principles, including any appropriate discounts or premiums.\textsuperscript{xxviii}

The Public Hearing and Later Developments
The Proposed Regulations were published on August 4 and followed by a 90-day comment period. After the 90-day comment period, a public hearing was held on December 1. This public hearing was a precursor to the Treasury’s adoption of the Proposed Regulations as final. Because it was a last chance for practitioners to comment on controversial and perhaps overbroad regulations, the estate planning community anxiously awaited the December 1 hearing in hopes that some of the open issues would be clarified.

At the hearing, many commentators expressed their concern that the new categories of Disregarded Restrictions effectively treat all family-owned interests as though the owner could require the entity to redeem the interest for cash or equivalent property within a six-month period at a value equal to the interest’s pro rata share of the entity’s assets. By disregarding all non-mandatory restrictions to the contrary, the Proposed Regulations can be interpreted to create a deemed mandatory put right for all interests in family-controlled businesses.

Commentators were also concerned that the new three-year rule could trigger a retroactive application of the Proposed Regulations. Because the Proposed Regulations treat the lapse of a liquidation or voting right as occurring on the transferor’s death, the Proposed Regulations could affect valuation of interests that are transferred before the effective date of the Proposed Regulations.

The December 1 hearing lasted almost six hours. Although several IRS representatives were on the panel, most of the official discussion came from Catherine Hughes, Attorney-Advisor in the Treasury Department’s Office of Tax Policy. Ms. Hughes has made unofficial comments about the Proposed Regulations at the recent Notre Dame Tax and Estate Planning Institute. Many attendees hoped that she would state the Treasury’s official position on key issues or at least indicate the next steps that Treasury intends to take to address practitioners’ concerns.

At the hearing (and, more recently, at the 2017 Heckerling Institute on Estate Planning), Ms. Hughes made a few comments that, although not authoritative, may provide some indication of the Treasury’s intent in adopting the Proposed Regulations. First, in response to practitioner concerns about the deemed put right that is arguably created by the new category of Disregarded Restrictions, Ms. Hughes stated unequivocally that it was not the Treasury’s intent to create a deemed put right. This statement
echoes her prior statements at private events, but does little to clarify how the Proposed Regulations should be interpreted if they do not create a deemed put right. A plain reading of the Proposed Regulations could support a Tax Court determination of a deemed put right, notwithstanding Ms. Hughes’s statements to the contrary.

Second, Ms. Hughes stated that the Proposed Regulations would be clarified to address the ambiguity around the retroactive application of the three-year rule for transfers of business interests that are subject to lapsing liquidation rights. Ms. Hughes stated that the three-year rule would not cause retroactive application of the new Proposed Regulations to these transfers.

Beyond these two minor clarifications, though, neither the IRS nor the Treasury provided any meaningful feedback. They left unaddressed many concerns regarding the Treasury’s novel redefinition of fair market value and the control and family attribution rules. They also gave no response to commentators’ requests to exempt operating businesses from the application of the Proposed Regulations. And, although all but one of the 37 commentators requested that the Proposed Regulations be withdrawn and reconsidered, the IRS did not indicate their intentions regarding when—or even whether—the Proposed Regulations would be finalized. The lack of clarification on these important open issues provided little reassurance to planners concerned about the application of the Proposed Regulations.

Although Ms. Hughes provided verbal assurance that Treasury did not intend to create a deemed put right, her comments did little to identify what, exactly, the Treasury did intend when it created the new category of Disregarded Restrictions. And, as one commentator noted, the issue is not only what the Treasury may have intended, but also how a court may read the Proposed Regulations. Although there is now at least some indication that the Treasury is willing to amend the Proposed Regulations to address the retroactive application of the three-year rule for transfers of interests with lapsing liquidation rights, we do not know how or whether the Treasury intends to clarify the remaining open issues.

The Proposed Regulations are also overshadowed by the recent election of Donald J. Trump as President of the United States and the Republican majority in both houses of Congress. Both President-elect Trump and Republicans in the House of Representatives have pledged to repeal the current federal estate tax. If the estate tax is repealed, the Proposed Regulations would presumably become irrelevant. Given the open issues that the IRS and Treasury have not addressed and the possibility of estate tax repeal in the early months of the Trump presidency, the future of the Proposed Regulations is uncertain.

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ii Prop. Reg. § 25.2701-2. For purposes of determining control, under the attribution rules of existing § 25.2701-6, an individual, the individual’s estate, and members of the individual’s family are treated as holding interests held indirectly through a corporation, partnership, trust, or other entity.
iv I.R.C. § 2704(a)(2).
vi Treas. Reg. § 25.2704-1(c)(1).
vii Id.
viii Prop. Reg. § 25.2704-1(c)(1). (“The lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor’s death is treated as a lapse occurring on the transferor’s date of death, includible in the gross estate pursuant to § 2704(a).”).
x I.R.C. § 2704(c)(1); § 2701(b)(2).
xi I.R.C. § 2704(b)(1).
xii Id.
xiii I.R.C. § 2704(b)(2).
xv See Kerr v. Commissioner, 113 T.C. 449 (1999), aff’d 292 F.3d 490 (5th Cir. 2002).
xvi Id. at 473.
xvii Treas. Reg. § 2704-2(b).
xviii See I.R.C. § 2704(b)(2).
x  Id.
x  xiii Prop. Reg. § 25.2704-3(b).
x  xviii Prop. Reg. § 25.2704-3(b)(1)(ii) provides: “The term minimum value means the interest’s share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under Code §§ 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under Code § 2053 if those obligations instead were claims against an estate.”
x  xxiii Prop. Reg. § 25.2704-3(b)(1)(iii) provides that the term “property” does not include a note or other obligation issued directly or indirectly by the entity, other holders of an interest in the entity, or persons related to either. There is an exception for notes of an entity engaged in an active trade or business in some circumstances.
x  xxiv Prop. Reg. § 25.2704-3(b)(1)(i) (“The term disregarded restriction means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity ....”).
x  xxv Prop. Reg. § 25.2704-3(b)(1).
x  xxviii Prop. Reg. § 25.2704-3(f).
A Comparison of Trump and House GOP Tax Reform Proposals

November 29, 2016

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David Scott Sloan
Kathleen M. Nilles
Daniel L. Janovitz

HIGHLIGHTS:
» With Republicans in control of the U.S. Senate, the U.S. House of Representatives and the White House starting in 2017, the federal government is now better positioned to move forward on comprehensive tax reform.

» It is expected that upcoming tax reform efforts will build on the principles set forth in the House Republicans' "A Better Way" proposal, as well as the tax proposals advanced by President-Elect Donald Trump during the course of his campaign.

With Republicans in control of the U.S. Senate, the U.S. House of Representatives and the White House starting in 2017, the federal government is now better positioned to move forward on comprehensive tax reform, with anticipated legislation that restructures both the individual and business income tax provisions of the Internal Revenue Code. It is expected that upcoming tax reform efforts will build on the principles set forth in the House Republicans' "A Better Way" proposal, released by House Speaker Paul Ryan (R-Wis.) in June 2016, as well as the tax proposals advanced by President-Elect Donald Trump during the course of his campaign. Trump's original tax plan was proposed in September 2015, and his revised tax plan was proposed in September 2016.

Below is a comparison of the House GOP plan and the Trump plan. While there are many differences in the extent of tax relief promoted by each plan (with Trump's being by far the more generous), there are many similarities on key issues, including significant cuts in both individual and business tax rates, repeal of the estate tax and efforts to position U.S. businesses to compete on a more level playing field internationally. Of course, there are many details still to be completed, and many House Republicans have made it clear that they have no intention of passing huge tax cuts that would worsen the growing federal deficit. For the most part, however, details about any offsetting tax revenue raisers that may be imbedded in tax reform have yet to be worked out or disclosed.

It is important to note that any House-passed tax reform may need to be negotiated with the Senate, led by Minority Leader Charles Schumer (D-N.Y.) and Senate Committee on Finance Chairman Orrin Hatch (R-Utah). The Democrats' priorities differ significantly in focus from the Republican proposals, and it is likely that the Democrats' strong minority will, under Senate rules, make them key players in developing any tax reform legislation that can pass the Senate. Additionally, Hatch and his staff have been working for months on a comprehensive "corporate integration" tax plan aimed at eliminating the double taxation of income earned by corporations, but the plan has not yet been released. Such a plan may be substantially different than the House GOP or Trump plans.
<table>
<thead>
<tr>
<th>Tax Reform Proposal</th>
<th>Trump Plan</th>
<th>House GOP Plan</th>
</tr>
</thead>
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<tr>
<td><strong>Individual Tax Rates</strong></td>
<td>Three brackets: 12 percent, 25 percent, 33 percent, Eliminate head-of-household status</td>
<td>Three brackets: 12 percent, 25 percent, 33 percent</td>
</tr>
<tr>
<td><strong>Capital Gains and Qualified Dividends Rates</strong></td>
<td>0 percent if in 12 percent bracket, 15 percent if in 25 percent bracket, 20 percent if in 33 percent bracket</td>
<td>50 percent exclusion for all investment income (dividends, capital gains and interest)</td>
</tr>
<tr>
<td><strong>Personal Exemption</strong></td>
<td>Replaced with above-the-line deduction for child care and elder care expenses, as well as tax-deferred Dependent Care Savings Accounts</td>
<td>Replaced with increased dependent credit and expanded child tax credit</td>
</tr>
<tr>
<td><strong>Standard Deduction</strong></td>
<td>$15,000 for single filers, $30,000 for joint filers</td>
<td>$12,000 for single filers without children, $18,000 for single filers with children, $24,000 for joint filers</td>
</tr>
<tr>
<td><strong>Itemized Deductions</strong></td>
<td>Capped at $100,000 for single filers and $200,000 for joint filers</td>
<td>Silent</td>
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<tr>
<td><strong>Exclusion of Investment Income on Life Insurance Contracts</strong></td>
<td>Repeal*</td>
<td>Silent</td>
</tr>
<tr>
<td><strong>Alternative Minimum Tax (AMT)</strong></td>
<td>Repeal</td>
<td>Repeal</td>
</tr>
<tr>
<td><strong>Marriage Penalty</strong></td>
<td>Repeal</td>
<td>Repeal</td>
</tr>
<tr>
<td><strong>Home Mortgage Interest Deduction</strong></td>
<td>Retain*</td>
<td>Retain</td>
</tr>
<tr>
<td><strong>Carried Interest</strong></td>
<td>Taxed as ordinary income</td>
<td>Reasonable compensation will be paid or treated as paid by pass-through entities to owner-operators Entity can deduct the income and owners must include it in income</td>
</tr>
<tr>
<td><strong>Corporate Tax Rate</strong></td>
<td>15 percent</td>
<td>20 percent</td>
</tr>
<tr>
<td>Section 199 Gross Production Activities</td>
<td>Silent</td>
<td>Repeal</td>
</tr>
<tr>
<td>----------------------------------------</td>
<td>--------</td>
<td>--------</td>
</tr>
<tr>
<td>Business Tax Credits</td>
<td>Largely repeal, but retain the research and development credit and business tax credit for on-site child care</td>
<td>Largely repeal special-interest credits and deductions, but retain the research and development credit</td>
</tr>
<tr>
<td>Taxation of International Income</td>
<td>Silent</td>
<td>Territorial system based on consumption</td>
</tr>
<tr>
<td>Earnings of Foreign Subsidiaries</td>
<td>One-time 10 percent deemed repatriation tax on cash held abroad that represents earnings of foreign subsidiaries of U.S. companies payable over 10 years Future earnings of foreign subsidiaries of U.S. corporations are taxable as earned</td>
<td>One-time deemed repatriation tax on earnings of foreign subsidiaries of U.S. companies of 8.75 percent to the extent held in cash or cash equivalent and 3.5 percent otherwise, payable over eight years</td>
</tr>
</tbody>
</table>

**Depreciation**
- If election is made, immediate deduction of capital expenditures by manufacturers
- Interest on debt used to acquire such assets would not be deductible
- Immediate deduction of capital expenditures

**Business Tax Rate**
- Income from S corporations, partnerships, disregarded entities and sole proprietorships would be taxed at 15 percent
- Income from S corporations, partnerships, disregarded entities and sole proprietorships would be taxed at 25 percent

**Interest Deduction**
- "Reasonable cap" on the deductibility of business interest expenses*
- Limited to interest income
- Excess interest expense carries over to following years
- Exceptions to be developed for financial businesses (e.g., banks, insurers, etc.)

**Net Operating Losses**
- Silent
- Unlimited carryforward
- Carryforwards will be increased by interest factor
- Income that may be offset in any year limited to 90 percent of income
- Eliminates carryback
<table>
<thead>
<tr>
<th>Dividends from Foreign Subsidiaries</th>
<th>Silent</th>
<th>Excluded from income of U.S. parent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subpart F Income</td>
<td>Silent</td>
<td>Largely repeal</td>
</tr>
<tr>
<td>Gift Tax</td>
<td>Repeal*</td>
<td>Silent</td>
</tr>
<tr>
<td>GST</td>
<td>Repeal*</td>
<td>Repeal</td>
</tr>
<tr>
<td>Estate Tax</td>
<td>Repeal</td>
<td>Repeal</td>
</tr>
<tr>
<td>Step-Up in Basis at Death</td>
<td>Only to extent total appreciation does not exceed $10 million</td>
<td>Silent</td>
</tr>
</tbody>
</table>

*Denotes an item that was part of Trump's original tax plan but not mentioned in his revised tax plan

Information contained in this alert is for the general education and knowledge of our readers. It is not designed to be, and should not be used as, the sole source of information when analyzing and resolving a legal problem. Moreover, the laws of each jurisdiction are different and are constantly changing. If you have specific questions regarding a particular fact situation, we urge you to consult competent legal counsel.

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State and Local Tax Implications of Final Section 385 Debt Equity Regulations

By: Peter L. Faber, McDermott Will & Emery LLP

The US Department of the Treasury has just released final regulations under Section 385 of the Internal Revenue Code dealing with the circumstances under which related company debt will be classified as equity for income tax purposes. Regulations under this provision had been proposed in April 2016. The proposed regulations caused considerable consternation in the corporate taxpayer community. Although Section 385, which was enacted in the Tax Reform Act of 1969, arguably was intended merely to require Treasury to list factors that would be taken into account in determining when purported debt should be reclassified as equity, the proposed regulations prescribed absolute rules, not just factors. If a debt instrument failed to meet the requirements of the proposed regulations, in many cases it was automatically reclassified as equity regardless of whether it would have been respected as debt under the well-accepted rules that had been laid down in dozens of federal court cases.

Treasury’s principal concern was preventing US corporations from diverting income to foreign affiliates by deducting interest on loans to them from the affiliates. This was, in turn, an offshoot of Treasury’s concern about inversions, under which US corporations moved abroad, by merger or otherwise, in manners that reduced their federal tax liability.

Although designed to address an international tax issue (one that has been of concern to foreign governments as well as to Treasury), the proposed regulations were not limited to the diversion of income offshore and applied to purely domestic transactions as well. They had implications for state and local taxation, although obviously Treasury had not focused on this aspect of the situation.

Final Regulations

The final regulations, like the proposed regulations, set forth certain rules under which debt will automatically be reclassified as equity or will be presumed to be equity. Satisfying the rules of the final regulations does not mean that a particular debt instrument gets a free pass and will necessarily be respected as debt for income tax purposes. It only means that the debt will not automatically be reclassified as equity under the regulations. The debt still must pass the traditional tests that have been laid down in the federal case law. For example, although the final regulations except from their scope debt issued by certain regulated financial corporations and insurance companies, that debt will still have to pass muster under the criteria specified in the federal case law.

The final regulations apply only to debt issued to related corporations. The universe that is subject to these rules is defined as the “expanded group” of corporations, which generally tracks the definition of “affiliated group” in Internal Revenue Code Section 1504(a), dealing with eligibility to file consolidated federal returns. The definition of “expanded group” is modified by excluding S corporations, non-controlled regulated investment companies and non-controlled real estate investment trusts. A major change from the proposed regulations is that foreign issuers of debt are excluded from the definition.
The proposed regulations contained detailed documentation rules that had to be followed in order for an instrument to be respected as debt. These rules applied only to large corporate groups. They applied only if the stock of any expanded group member was publicly traded, the expanded group had total assets exceeding $100 million, or the expanded group had total annual revenue that exceeded $50 million.

The final regulations retain the documentation rules, but with some significant changes. Non-compliance with respect to a debt instrument generally results in it being treated as equity, but non-compliance results only in a rebuttable presumption that the debt is equity if the taxpayer can show that it is otherwise “highly compliant” with the documentation rules. High compliance is based on some mathematical tests. The taxpayer can overcome the presumption by demonstrating that the instrument should be treated as debt under the traditional common law rules.

Among the documentation requirements is an analysis of the issuer’s ability to repay the debt in accordance with its terms. This means that corporations will have to produce and maintain studies showing that the issuer’s financial circumstances and prospects justified a reasonable expectation that the debt would be repaid. Although obviously banks and other professional lenders do this as a matter of course with respect to loans made to customers in the ordinary course of business, they do not do so with respect to related party debt, and regular business corporations typically do not do this with respect to inter-company debt. They will have to change their practices.

Fortunately for taxpayers, the effective date of the documentation rules has been delayed. The rules will only apply to debt instruments issued after December 31, 2017. This will give corporations time to develop systems to comply with the new rules.

Among the most controversial rules of the proposed regulations were the funding rules. These generally provided that debt issued in connection with a distribution, in exchange for the stock of a member of the expanded group, or as “boot” in an internal asset reorganization, was automatically reclassified as equity if it was issued within three years before or after the transaction. Many commenters criticized the concept of the funding rule and, in particular, its application to all transactions within a six-year period. The final regulations retain the basic concept, but they soften it in a number of respects.

The proposed regulations contained an exception for certain transactions that occurred in the ordinary course of business. These were designed primarily to apply to routine purchases of goods and services within the expanded group that were not paid for immediately but were funded by inter-company debt.

The final regulations expand the scope of the ordinary course exemption to include traditional cash pooling arrangements and short-term debt instruments. Under the final regulations, the funding rule does not apply to “qualified short-term debt instruments,” which are defined to include short-term funding arrangements, ordinary course loans, interest-free loans and cash pool arrangements.
The proposed regulations provided that the amount of transactions subject to the funding rules was reduced by the amount of the issuer’s current-year earnings and profits. The current year limitation was criticized for a number of reasons, including that it was typically impossible to determine them before the end of the year, and that it would create an artificial incentive to “use” current-year earnings and profits by making premature distributions. The final regulations expand the earnings and profits limitation to include accumulated earnings and profits, but only those accumulated in taxable years ending after April 4, 2016 (the date when the proposed regulations were issued).

In a major change, the final regulations except from their requirements debt issued by certain regulated entities, such as insurance companies or financial institutions. Covered debt instruments do not include instruments issued by regulated insurance companies that are subject to risk-based capital requirements under state law. The preamble states that the regulatory requirements mitigate the risk that tax-avoidance transactions would be done. The exception is limited to insurance companies that engage in regular issuances of insurance to unrelated persons. Captive insurance companies are not included in the exception. Further, the exception does not apply to members of an expanded group that includes an insurance company, that are not themselves insurance companies. The same principles apply to debt issued by regulated financial institutions, including those with specific regulatory or capital requirements, such as bank holding companies, members of the Federal Reserve System, registered broker-dealers, companies subject to a determination by the Financial Stability Oversight Council, and Federal Home Loan banks.

Instruments issued by regulated insurance companies and financial institutions are treated as meeting the documentation rules if they contain terms that satisfy regulatory requirements.

The proposed regulations treated members of a consolidated return group as a single corporation, which in effect meant that debt instruments issued by one consolidated return group member to another were not subject to the rules. This general concept has been retained, with slight modifications. Under the final regulations, members of a consolidated group are treated as one corporation, but only for purposes of the general and funding rules. With respect to the documentation rules, the final regulations do not treat the members as a single corporation, but provide that obligations between consolidated group members are not subject to the documentation rules. As a practical matter, this may not be a significant change. An important point to remember is that the exception for intra-group debt does not apply to debt issued to related corporations that do not join in the consolidated return.

SALT Implications

A basic issue that will be of concern to SALT practitioners is whether, and the extent to which, the principles of the final regulations will apply for state and local tax purposes. State statutes typically base state taxable income on federal taxable income with changes to reflect differences between federal and state tax policies. Will states that generally conform to the Internal Revenue Code be required to adopt the final regulations or their principles? Although the final regulations have been adopted pursuant to a statutory mandate, they are not part of the Internal Revenue Code. While regulations adopted pursuant to a statutory authorization are entitled to greater deference than normal interpretative regulations, they are not part of the law and are subject to
judicial review. Even provisions of the consolidated return regulations, where it is clear that Congress has delegated rule-making authority to Treasury, have been declared invalid by the courts on occasion. (See, e.g., American Standard, Inc. v. United States., 602 F.2d 256 (Cl. Ct. 1979)). State revenue departments have made it clear that they believe that they are not bound by IRS determinations or interpretations of other Code provisions. In fact, most states do not automatically conform to the consolidated return regulations, even though, as indicated above, they represent an express delegation of rule-making authority by Congress to Treasury. Some state revenue departments follow the consolidated return regulations with respect to corporations filing combined returns, but most do not address the issue.

We believe that the states will not be required to adopt the final regulations or their principles and will be free to reject them entirely, to accept parts of them and not others, and to modify them as applied to their own laws. Some revenue department officials disagree, however, and believe that the states will be required to adopt the regulations.

Even if state revenue departments do not consider themselves to be bound by the terms of the final regulations, they may look to them for guidance, and it can be expected that the final regulations will be a factor in state and local tax audits. We have had cases in which state auditors agreed to be bound by the results of an IRS audit of a debt-equity issue, even though this meant keeping the statute of limitations open only for that issue. Further, relying on federal regulations would be an easy way for state revenue departments to avoid having to make their own detailed examinations of the many factors that the courts have taken into account in making debt-equity determinations. It would be prudent to meet the requirements of the final regulations, even with respect to debt that is not literally subject to those regulations (for example, because the companies are too small or because they are filing consolidated federal income tax returns).

One option open to the states would be to adopt comparable regulations that conform to the basic principles of the final regulations but that part company with them with respect to certain details. For example, comparable state regulations might have lower thresholds for the size of affected corporations or debt or have no thresholds at all. A state revenue department could also retain the minimum size threshold concept but reduce the thresholds so as to apply the state’s regulations to more corporations.

A fundamental question is whether state revenue departments will apply the regulations or their principles to corporations that are not subject to the federal regulations because they are members of a federal consolidated return group but file separate state returns. This is a common situation because many corporations that file consolidated federal returns are not engaged in a common unitary business and, hence, file separate returns in one or more states. It is possible that a state revenue department could assert that the principles of the federal regulations should apply for state tax purposes in those situations even though the federal regulations do not apply. Presumably, the potential for tax avoidance that Treasury has concluded is present when related corporations file separate federal returns would be present for state purposes in those situations. In some states, this is required by statute. For example, the Louisiana and Maryland statutes specifically provide that corporations that file consolidated federal income tax returns must be

Conversely, some corporations file state combined returns even though they file separate federal returns. For example, in New York State, two corporations can file combined returns even though the stock of both corporations is owned by an individual. These corporations could not file consolidated federal returns because a federal consolidated return group must have a common corporate parent. Further, in New York, combined returns can be required or permitted if the common ownership exceeds 50 percent, whereas the federal common ownership level is 80 percent. In those situations, could taxpayers argue that, even though the federal regulations literally apply and require a certain debt instrument to be treated as equity, a similar determination should not be made for state purposes because they are filing combined state returns and if the same filing profile had existed for federal purposes the regulations would not have applied? Such an argument would be strengthened if the state adopted the federal rules on elimination in intra-group transactions under the federal consolidated return regulations.

The exception for distributions from earnings and profits could be applied differently for state and local tax purposes than for federal tax purposes because state and local earnings and profits are not necessarily the same as federal earnings and profits. If state revenue departments apply this rule, will they apply it to federal earnings and profits or to state earnings and profits? The right approach would seem to be to use state earnings and profits as the measure, even though that could result in an instrument being treated differently for federal and state purposes.

Another implication of the regulations is that corporations that pay franchise taxes based on the amount of their capital and not on the amount of their net income may find that their capital-based taxes increase if debt is reclassified as equity.

As indicated above, the final regulations exclude debt issued by S corporations from their scope. How will the states treat corporations that are S corporations for federal income tax purposes but that are C corporations for state income tax purposes? In New York State, a federal S corporation must elect to be treated as an S corporation for state tax purposes. If it fails to do so, it will be treated as a C corporation. Under the New York City general corporation tax, S corporations are necessarily treated as C corporations. Unlike the New York State rules, the New York City rules do not give corporations a choice. The New York tax authorities will have to decide how they are going to treat these entities.

Conclusion

The proposed regulations were controversial and gave rise to much criticism. Indeed, many members of Congress attacked the concept. Nevertheless, Treasury has issued the regulations in final form, and they are now part of the tax landscape. State and local tax practitioners, both in-house and in professional firms, will have to address the regulations’ implications and, more importantly, will have to make their business and federal tax colleagues aware that these regulations have state and local tax consequences that must be taken into account.
If there was ever any doubt, the U.S. Tax Court has recently clarified that the sole member of a single member LLC can, in certain circumstances, be held liable for the employment tax liability of the entity. In *Heber E. Costello, LLC and Costello v. Comm’r*, T.C. Memo. 2016-184 (Sept. 29, 2016), Scott Costello, the sole member of Heber E. Costello, LLC, a Louisiana LLC, disputed his responsibility for the unpaid employment taxes of the LLC. Costello contended that the LLC should be treated as a corporation since (1) it resulted from a reorganization under Code §368(a)(1)(F), and (2) he filed corporate tax returns (Form 1120) for the LLC, which he claimed constituted a valid election for the LLC to be taxed as a corporation.

Costello became the sole owner of the LLC’s predecessor, Heber E. Costello, Inc. (the “Corporation”), after his father’s death. His father had been the sole shareholder of the Corporation. Costello formed the LLC on December 31, 2003 and merged it with the Corporation, with the LLC as the surviving entity. Costello never filed a Form 8832 to make an entity classification election for the LLC. Costello filed Forms 1120 on behalf of the LLC using the Corporation’s employer identification number. Costello filed the appropriate employment tax forms for the LLC but did not pay the tax due for tax years 2006, 2007 or 2008.\(^1\)

The Court first considered Costello’s claim that the LLC is actually a corporation. The Court referred to the check the box regulations\(^2\) that provide that an eligible entity with a single owner, such as the LLC, may elect to be classified as an association by filing Form 8832. If that entity does not file an election, then it will be disregarded as an entity separate from its owner. The LLC never filed Form 8832 and therefore, it is disregarded as a separate entity from Costello. Costello argued that there are other methods of electing corporate classification, such as by reorganizing under Code §368(a)(1)(F) or by filing corporate tax returns, but he was not able to provide any legal support for these claims and the Court rejected them. According to the Court, “an eligible entity may not elect its entity classification by filing any particular tax return it wishes.” As such, the LLC was not a corporation.

The Court next considered Costello’s claim that he is not personally liable for the LLC’s unpaid taxes. Since the employment taxes at issue related to wages paid before January 1, 2009, Treasury Regulations § 301.7701-2(a) (former regulations) applied. Under the former regulations, a disregarded entity is treated as a disregarded entity. In other words, the sole member of the disregarded entity and the disregarded entity itself are treated as a single taxpayer. As a result, the sole owner (here, Costello) is personally liable for the employment taxes of the disregarded entity (the LLC).

The former regulations were amended in 2007\(^3\) to provide that, for employment tax purposes with respect to wages paid on or after January 1, 2009, a disregarded entity is treated

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\(^1\) Procedural history has been omitted for the sake of brevity.

\(^2\) 26 C.F.R. 301.7701-3

\(^3\) See T.D. 9356, 2007-2 C.B. 675
as a separate entity (e.g., a corporation). A disregarded entity continues to be treated as
disregarded for other Federal tax purposes. Under the final regulations, the sole owner of a
disregarded entity that is treated as a sole proprietorship continues to be treated as self-
employed, and not as an employee of the disregarded entity.

While it should go without saying, a business owner should intentionally choose its
structure and tax status and accept the related tax and governance implications. Inadvertently
forming the wrong entity could have costly consequences. In this case, it seems that Costello
believed he formed a corporation and treated the entity as a corporation, but failed to check
the box by filing Form 8832. As a result, he was personally liable for the entity’s unpaid
employment tax liability of approximately $200,000. Attorneys should impress upon clients the
importance of making timely filings — tax or otherwise — and ensure that clients fully
understand the implications of selecting a particular form of business entity.
IT'S TIME FOR YOUR
BUY-SELL CHECKUP!

By James M. McCarten

Shareholders, Partners and/or LLC members of any closely-held or family-held company should check the buy-sell formula contained in their Shareholder Agreement (sometimes called a Buy-Sell Agreement), Partnership Agreement or Operating Agreement to make sure that the formula still works for all of the owners following the release last August by the IRS of proposed regulations under Code §2704.

By now, most owners of interests in family-controlled businesses have heard of or read about the regulations proposed by the IRS last August specifically designed to reduce, if not completely eliminate, minority interest and lack of marketability discounts when a single family controls 50% or more of the ownership of the company. While there have been numerous articles and blogs explaining how interests in a family-controlled business must be valued once these regulations are finalized, few of those articles have provided much detail on when, where or how closely-held business owners should start planning with respect to these proposed rules and what documents need to be reviewed.

Even with November’s election results and the likelihood of tax reform, my suggestion for answering the "when, where, how and what" questions are pretty consistent. When should family-controlled companies seek advice on the impact of these rules? Before the proposed regulations become final. Obtaining advice soon becomes even more imperative if a family member has been discussing the possibility of making a transfer of interests in the family business sometime in the near future (for example, sometime in the next 3 to 5 years). Why review now? Because odds are that it makes much more sense tax-wise to transfer the interests before final regulations are published than to wait and make the transfer later.

A brief note about the potential impact of tax reform on these proposed regulations. The Republican members of the House Ways and Means Committee have called for the repeal of the estate and gift taxes as we know them (The Better Way Blueprint on Tax Reform), but have not indicated whether the Congressional majority will endorse President Trump's call to replace it with a capital gain tax (an idea similar to the "limited step-up" in basis concept passed and then repealed in the 1990's). The question we should be focused on, though, is whether the new Administration will withdraw the proposed regulations or focus their efforts on tax reform, which under the President's proposal will incorporate some sort of date-of-death value calculation, and then deal with these issues. There is also the potential that estate/gift tax reform could be delayed into next year to avoid having the controversial public policy fight when many members of both parties seem to agree that some amount of income tax reform is necessary. So, for now, the proposed regulations have to be part of the conversation we have with our clients.

So, what documents need to be reviewed during those discussions? Any buy-sell provisions as well as the company's organizational documents, which then need to be compared
against applicable state law and any state law default restrictions on transfers (the reason for this comparison is discussed later in this article). Where questions relate to obtaining a careful review of buy-sell provisions; will they be respected by the IRS for valuation purposes? If not, the family should know whether any restrictions on liquidation or redemption exist and whether such restrictions constitute applicable restrictions under the proposed regulations. Further, if restrictions are binding for state law purposes, but not federal transfer tax purposes, has control of the company been inadvertently transferred out of the family because of tax costs? Finally, business owners should know the potential difference in tax value between the formula in the buy-sell and the value as could be determined under the proposed regulations.

If your client's business is a family business, whether their buy-sell agreement relies on the term fair market value ("fmv"), the phrase fair market value as finally determined for estate tax purposes or any other formula to set the agreed price when a transfer is made, it's time to have them bring their agreement in for a checkup. Both tax and non-tax issues need to be addressed and decisions made, and the window of opportunity for making such choices could be a relatively short one. I strongly advise that now is the time for a buy-sell formula checkup.

BUY-SELL PROVISIONS: An Overview. For many years now, one of the important business reasons that attorneys and CPAs alike have recommended the use of buy-sell arrangements to business clients is to make sure that the amount received by a deceased owner's heirs is not significantly less than the amount taxable in the owner's estate. Historically, even following the 1990 enactment of Chapter 14 and Code §2703(b) (which specifically exempts bona fide business arrangements comparable to agreements entered into by unrelated parties from being treated as disregarded restrictions), the phrases fair market value and fair market value as finally determined for estate tax purposes have often been treated by tax practitioners as rough equivalents of each other for purposes of drafting buy-sell provisions. No matter which term is found in the buy-sell, when Farmer Ed passes away holding a 35% interest in an LLC owning rental properties, both Ed's family and his partners, whether family members or unrelated individuals, would know, more or less, what to expect financially and what to expect from a transfer tax perspective because of the buy-sell. Ed's partners would know they were going to pay Ed's heirs the fmv of his interest, and Ed's heirs would expect to receive an amount equal to the interest's fmv (they would also know how much might be financed). More importantly, Ed's heirs could also reasonably expect the amount received from Ed's partners would be the same amount required to be reported on Ed's estate tax return. Using either of the above terms in a buy-sell thus allowed the family to determine, with relative certainty, the amount of any transfer taxes that might be due whether Ed gifted his interest or passed away holding his interest.

One of the reasons this practice has continued to be favored by tax practitioners and their family business clients is because of the surprisingly narrow interpretations adopted by the IRS in its first set of regulations under Code §2704 with respect to when lapses in liquidation/redemption rights, lapses in voting rights and the family's imposition of applicable restrictions would be ignored for transfer tax purposes (thus impacting the transfer tax value). The original regulations and subsequent changes by numerous states in the "default" provisions of their business statutes governing the rights associated with becoming a shareholder in a corporation, a partner or limited partner in a partnership or a member in an LLC made lawyers comfortable in "doubling down" and providing in a buy-sell that the value of an interest in a
family business would be its \textit{fmv} provided that violations of then current regulations under Code §2704 did not occur (so that no changes to \textit{fmv} would be required).

Further encouraging the use of \textit{fmv} in buy-sell agreements was the fact that the original Chapter 14 regulations differentiated between the valuation effects of lapses in certain rights, the imposition of applicable restrictions and the binding nature of buy-sell agreements which meet certain requirements. Treas. Reg. §25.2704-2(b)(4)(iii) still provides that any buy-sell agreement meeting the requirements of Code §2703(b) is not an \textit{applicable restriction}. However, many of the types of rights covered by Code §2704 and its regulations are often included as restrictions in buy-sell agreements. Because the original 2704 regulations focused on the rights associated with the interest transferred, not the bundle of rights originally held by the transferor, and because the original regulations respected state law with respect to voting rights limitations and liquidation rights limitations arising out of default statutes, \textit{fmv} would often be the valuation result, even after working through Code §2704's rules.

However, with the 2704 regulations proposed in August, the IRS now has a reason to more aggressively pursue the question of whether a buy-sell agreement qualifies for the Code §2703(b) safe harbor. Presumably, if the buy-sell does not qualify for that safe harbor, then any restriction on use, liquidation and/or redemption will be taken into account for valuation purposes under Code §2703(a) and/or Code §2704.

So what are the requirements set forth in the 2703 regulations for a buy-sell agreement to meet the safe harbor test? There are three (3) and each of them must be independently satisfied in order for the safe harbor to apply. One requirement is that the taxpayers must affirmatively prove that the buy-sell was comparable to similar arrangements entered into by persons in arm's-length transactions at the time the buy-sell was created. According to the regulations, a buy-sell restriction which conforms with the \textit{general business practice} of unrelated parties in the same business will be treated as \textit{comparable}. On the other hand, merely showing isolated examples does not meet the general business practice standard; while not expressly stated this way, in order to protect a buy-sell agreement, the taxpayer must demonstrate that it followed a general business practice in its industry when setting the buy-sell formula. The two other §2703(b) tests with respect to which the taxpayer will bear the burden of proof are (i) that the buy-sell is not a device to accomplish intra-family transfers for less than full and adequate consideration, and (ii) that the buy-sell is a bona fide business arrangement. Fail any of these three (3) tests and the rules under Code §2703(a) and/or Code §2704's proposed regulations will apply to the restrictions.

Now that the IRS has proposed revised §2704 regulations setting forth a new set of rules for determining whether liquidation, redemption and voting rights have been lost when transferring business interest to family as well as imposing a minimum value standard, the traditional approach of just assuming that the use of \textit{fmv} in a buy-sell is sufficient to protect how interests in the business are to be valued for estate tax purposes is unlikely to control when applied to family-controlled businesses. These new 2704 regulations finally provide the IRS with a reason to look more closely at buy-sell agreements and whether they withstand scrutiny under Code §2703(b) and its regulations.
WHAT THE PROPOSED REGULATIONS DO: First, They Reject Valuation Discounts When Voting or Liquidation Rights Are Lost. The proposed regulations require practitioners and business owners to fundamentally re-focus the starting point of traditional valuation from the value of what the owner actually conveyed to a transferee (determined in a vacuum, so that gifts made to others around the same time are not considered or combined), to a starting point that takes into account the cumulative impact of all transfers of a business entity conveyed during any tax year (e.g., whether voting or liquidation rights were lost by the transferor due to the cumulative impact of gifts made). Fortunately, only losses of voting control or the right to force a liquidation which occur within three (3) years of the transferor's death are subject to inclusion in the transferor's estate under the proposed regulations.

An example from the proposed regulations provides an easily understood illustration of how the IRS anticipates that its new intra-family transfer valuation rules will operate. In that example, a parent owns 84% of the stock of a business. The by-laws require a vote of 70% in order to liquidate. When parent transfers 42% of the stock (e.g., 50% of parent's total ownership) equally between his/her three (3) children in the same tax year, each child receives 14% of the company's stock. As a result of the gifts, no single child has received a sufficient number of shares to constitute voting control. Neither has any child received an adequate number of shares to be able to cause the company to liquidate. Therefore, each child has only received an interest in the business which does not hold the two factors that when missing give rise to minority interest and lack of marketability discounts. Also note that prior to making the gifts to the three (3) children, parent held both voting control and the right to force a liquidation of the company. Prop. Treas. Reg. §25.2704-1(f), Example 4.

Before these new regulations, the focus under generally applicable valuation principals would be on the value of what the transferee received, and because each share of stock received by parent's children still carried the right to vote, no lapse of any voting or liquidation right occurred. Treas. Reg. §25.2704-1(c) (the current version). In other words, no right associated with the stock transferred to each child was eliminated or restricted when the gift was made, so no valuation adjustment was required under Code §2704 and the transfer tax value of each gift was the fmv of the business interest transferred to each child. Treas. Reg. §25.2704-1(f), Example 4 (current version).

In what feels like a complete 180° shift in policy, the proposed regulations force us to focus on the value of everything the parent has directly or indirectly given up, what was collectively conveyed away -- in the above example, in addition to having conveyed a number of shares equal to 52% of the company, parent, because of the cumulative number of shares transferred, also transferred away both voting control of the company and the right to unilaterally force its liquidation. Prop. Treas. Reg. §25.2704-1(f), Example 4. Another way to conceptualize the impact of the proposed regulations on parent is to understand that his/her estate will effectively be treated as if parent died still holding 84% of the business. Thankfully, this specific adjustment to traditional tax valuation methodology is only required if parent dies within three (3) years of conveying the stock to his/her children.

WHAT THE PROPOSED REGULATIONS DO: The Number and Types of Restrictions on Liquidation/Redemption to be Disregarded Are Being Increased. According to its legislative history, the original purpose behind Code §2704(b) was to ensure
that any limitation on the right to liquidate which is more restrictive than state law, whether imposed by the family or caused by the transfer of a business interest to a family member, is to be disregarded when valuing the asset for estate/gift tax determinations. The August proposed regulations expand the types of restrictions to be disregarded beyond those covered in the original regulations by focusing on whether the transferee's ability to compel the liquidation or redemption of the interest received for cash or property within 6 months and receive the business interest's minimum value has somehow been limited by family action, actions which can include the family's original choice of law and/or original choice of the statute under which the entity was formed. These rules directly attack the valuation impact of so-called default rules which apply under state corporate/partnership/LLC statutes, provided the owners had the right to elect under those statutes to provide otherwise in the organizational documents.

The effect of how such other restrictions are now to be treated is perhaps best exemplified by the proposed regulation which will govern the value of a transfer to someone treated as an assignee under state law and/or the organizational documents. If a transferee is a mere assignee, the proposed regulations provide that no discount is to be allowed for estate/gift tax purposes. The transfer is to be treated as if the interest received still has all the voting, liquidation and/or other rights associated with it in the hands of the transferor.

While the proposed regulation addressing assignees is specific to that term, any other restriction which adversely impacts the ability of the transferee of an interest in a family-controlled business to compel the liquidation or redemption of that interest is treated in the same fashion; the restriction is ignored for transfer tax purposes. Said just a little differently, if the family could have chosen a structure when first organizing the business which provided subsequent transferees with the right to put the business interest to the business or to the other owners upon 6 months' notice and receive minimum value, any restriction on the right to liquidate that interest up to and including the total lack of the ability to do so is to be ignored for transfer tax purposes. As noted earlier, these proposed regulations are the Service's response to default provisions in state laws added since Chapter 14 was first enacted which have the effect of allowing business owners to allegedly receive overly favorable transfer tax valuations even though the members/partners/owners could have chosen a different structure when first organizing the entity.

So what is this put value that must be met under the proposed regulations; what is the interest's minimum value? This new valuation standard for family-controlled entities is defined as the interest's pro-rata share of the net value of the entity; a definition which sounds very much like, but may not be exactly equal to the fair value of the interest under state law. Further confusing the valuation calculation is that the net value of the entity is defined as starting with the net fmv of the entity's assets, and then deducting the entity's liabilities, but only those liabilities "that would be deductible for federal estate tax purposes." So, will all liabilities on the entity's financial balance sheet be treated as reducing the value of the company for tax purposes? That is an issue that needs to be clarified when the final regulations are issued.

WHEN IS A COMPANY FAMILY-CONTROLLED? If these proposed regulations are adopted in the same form as published in August, whether an entity is family-controlled will be determined under rules which look to the percentage of ownership of the company held by an individual, his/her spouse, any ancestor or lineal descendant of such individual, any brother or
sister of the individual and any spouse of an ancestor, a lineal descendant, or a sibling. If the ownership of the extended family equals or exceeds 50% of the total interests in the company, the company is *family-controlled*. Further complicating the analysis, attribution rules with respect to certain types of entities also apply under Treas. Reg. §25.2701-6. So, pick the individual making a transfer or deemed transfer and if 50% of the company is controlled by such transferor and his/her family, the company is *family-controlled* and these new valuation rules apply.

The proposed regulations then provide even more complexity with respect to determining whether the family members could remove a restriction on liquidation or redemption so that the restriction is disregarded for estate/gift tax purposes. To combat a practice which the IRS has long characterized as abusive, the use of transfers to or ownership by unrelated "straw" owners to allegedly create a legal obstacle to the family being able to, in fact, control the removal of a restriction, the proposed regulations provide that ownership in a family-controlled business by a third-party is to be disregarded unless (i) the interest has been held by the non-family member for at least three (3) years prior to the family transfer at issue, (ii) on the date of the family conveyance being valued, the interest held by the third-party constitutes at least 10% of the equity interests of the business, (iii) on the date of the family transfer, the total equity held by non-family members is at least 20% of the value of all equity interests of the company, and (iv) each non-family owner must have the clear and unequivocal right to have that business interest liquidated/redeemed within 6 months following notice for cash and/or other property at a value that is at least equal to the *minimum value* of the interest (determined as described above). Thus, both taxpayers and tax advisors must carefully analyze the identity of each and every owner of a corporation, partnership or LLC in order to properly draft or advise on any buy-sell arrangement or any transfer of an interest if looking to use non-family ownership to block the application of these proposed 2704 rules.

There is yet one more unexpected requirement which these *put rights* must meet in order to overcome the presumptions of the proposed regulations. Specifically, the amount due when the *put right* is exercised must be paid in cash or property, and the proposed regulations expressly state that a promissory note issued by the entity, its owners or any person related to the business or its owners will not qualify as property for this purpose. Fortunately, a safe harbor for certain promissory notes exists which requires: (i) that such note be issued by an entity engaged in an active trade or business (e.g., is the real estate business at issue an active business or a passive one?), (ii) that the note be adequately secured, (iii) that the note require periodic payments on a non-deferred basis, (iv) that the note require that market interest be paid, and (v) that the note has a *fmv* on the date of liquidation equal to the amount due (a present value calculation). This is the first time that *market rate interest* as opposed to the usual *applicable federal rate* has been imposed by the IRS for a related-party transaction.

**BACK TO BUY-SELL FORMULAS.** With all these valuation changes, is setting the buy-out price at the *fmv* of the interest or its *fmv as finally determined for estate tax purposes* still a reliable default rule? Unfortunately, it now appears to depend; are all of the parties to the agreement unrelated so that the entity is *not* a family-controlled business? If so, and assuming that none of the parties intends to own more than 50% of the new entity, *fmv* appears to still be a viable choice for setting the interest's value. Of course, if the parties are unrelated, the buy-sell formula can be whatever the owners negotiate between themselves. However, remember the
example from the proposed regulations examined earlier? Presumably, the 16% of the company not owned by parent was owned by an unrelated individual or individuals and when the stock was transferred, the rules under the proposed regulations applied. So, should the choice of fmva or its cousin, fmva as finally determined for estate tax purposes, be advised as the formula for a buy-sell agreement, especially if a majority owner knows or expects that he/she ultimately intends to convey interests in the business to his/her family? Probably not, unless the practitioner is also comfortable advising the client that the agreement will qualify for the Code §2703(b) safe harbor. Finally, what about an entity which is already clearly family-controlled; does fmva as a default buy-sell value make sense? Maybe not; there is uncertainty here too.

The uncertainty of whether the buy-sell for a family-controlled business will control the valuation of an interest in the business is whether the arrangement meets the safe harbor requirements under Code §2703(b) discussed earlier: is the buy-sell a bona fide business arrangement, is it a device to transfer property to the family at less than full consideration and is it comparable to similar arrangements between unrelated parties at arm's-length? See, e.g., Holman v. Comm'r, 601 F.3d 763 (8th Cir. 2010), aff'g, 130 T.C. 170 (2008) (where the Courts found the arrangement failed the first two prongs of the 2703(b) safe harbor, but were fairly liberal in their approach to allowing the taxpayers to prove comparability through expert testimony), and Est. of Amlie v. Comm'r, T.C. Memo 2006-76.

While less of a problem for operating businesses than entities holding investment-type assets, the analysis under Code §2703(b) will be fact specific and subject to uncertainty until the issue has been raised by the IRS. Still, there are certain factors which can be reviewed by practitioners in order to know whether the buy-sell has a fighting chance of being upheld or whether it is more vulnerable to attack by the IRS than other such agreements. For any industry or investment do comparable terms include a fmva buy-out or the use of some other valuation method? How do you know? With the downside being the probable application of the proposed regulations, taxpayers should check and try to determine if Code §2703(b) might provide protection on the choice of how interests in a family-controlled business are to be valued when transferred.

In any event, if the buy-sell does not meet the requirements for safe harbor treatment, the new 2704 proposed regulations (along with Code §2703(a)) will clearly prevent the term fmva as finally determined for estate/gift tax purposes from being a clear and unambiguous description of how the value of an interest in a family-controlled business is to be determined for estate/gift tax purposes. So, what about the enforceability of a buy-out provision relying on that term? Consider first that fmva implies that all generally applicable valuation principles, including discounts for minority interests and/or lack of marketability, are to be applied. Yet those discounts are the very targets which these new regulations were designed to eliminate or reduce. Neither does fmva as a definition of value become any clearer by adding the clause as finally determined for estate tax purposes. A mere modifier, that clause should not be interpreted to somehow inherently incorporate the adjustments to generally applicable valuation principles required under the proposed regulations. Given these considerations, it seems clear that two individuals, much less different courts and/or different lawyers, would be unlikely to interpret the phrase fair market value as finally determined for estate tax purposes in the same fashion once the proposed 2704 regulations have become final.
Imagine for a second, the potential for dispute when the second spouse of a recently deceased family member is told by the deceased's family that she must accept the *fmv* of a minority interest as the redemption price. Is that spouse likely to agree that the term *fmv* is without ambiguity as to the amount which the spouse, the spousal trust and/or that spouse's children are supposed to receive, especially after being informed by the tax advisor that the value to be used for estate tax purposes is more likely the interest's fair value or perhaps its minimum value because the IRS has applied the proposed regulations rather than the buy-sell formula?

Tax advisors, business lawyers and clients must also be conscious of the potential that an ownership structure which would not currently be treated as family-controlled can easily become so, thereby also making transfers of interests in the business subject to the new regulations if intra-family transfers occur at some point in the future (as in the example with "parent" discussed earlier). Should attorneys therefore consider drafting buy-sell agreements so that when these new regulations control the method for determining the value of a family-controlled business interest, that valuation method will also control the amount due the owner's heirs if the interest is to be purchased? Alternatively, is there a reason to use the term minimum value as defined in these new regulations in buy-sell agreements for non-family owners?

**THE SECOND SPOUSE BUY-OUT PROBLEM.** Let's look at a practical application of these new rules when a buy-sell agreement is in place. Phil is the family patriarch and started an operating business (e.g., not a passive business), eventually transferring 30% of the Company to each of his three (3) sons in 1995. Under these facts, there is little room for debate that the business will be a family-controlled business and that the proposed regulations could apply. Joel, one of Phil's sons, passes away after the proposed regulations become final at a time when the Company's enterprise value is $33 million. The buy-sell provision contained in the Company's Operating Agreement states that the agreed price for any member's ownership interest will be the fair market value of the interest as finally determined for estate tax purposes. If the family cannot successfully prove that a *fmv* buy-out is comparable to other buy-sell arrangements in their industry (or is unsuccessful in its position that the buy-sell is a bona fide agreement or that it is not a device), Joel's family is likely to be forced to use the proposed regulations and treat the value of Joel's interest as being $10 million for estate tax purposes (e.g., the ownership interest's fair value). What happens then if Joel's brothers insist that the terms of the buy-sell be enforced so that Joel's family is only entitled to $6.5 million ($10 million less a 35% discount based on the interest being a minority interest and that lack of marketability applies because no liquidation and/or redemption rights exist)? If we assume the value of Joel's interest in this family-controlled business is fully includable in his taxable estate, the estate will pay 40% on $5 million (approximately) after using Joel's exemption amount. That results in the net cash received by Joel's family being $4.5 million (instead of $8 million net received if the estate tax value were used as the starting point). Is that the result Joel would, if he could, testify he had agreed to and anticipated before these regulations were proposed? Is there any doubt that family relationships are likely to deteriorate if the position initially expressed by Joel's brothers is enforced against his family? Is that a result which Phil, the family patriarch, will support? Isn't litigation a strong possibility?

**CONCLUSION.** All of the issues and questions raised in this discussion arise solely because the IRS has, in issuing these proposed regulations, effectively decoupled the transfer tax value of family-controlled businesses from the value which would be determined under generally
applicable valuation principals. The result is that closely-held businesses which are, and even those which might later become, *family-controlled businesses* should carefully consider taking advantage of the window of opportunity provided in the proposed regulations (e.g., that they do not become effective until issued in final) to make transfers this year. Family-controlled businesses should also determine whether the formula used in the company's buy-sell will have the proper financial and tax impacts on the family once the proposed regulations are finalized; those family-controlled businesses without buy-sell agreements should decide what steps the family ought to take to protect the family and the business, should a buy-sell be considered and, if so, what formula should be imposed? These are just some of the questions which should be resolved by the family before/if these proposed regulations become final in 2017.
Changes in IRS Appeals Could Create Difficulties for Taxpayers

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Recent changes within the IRS Office of Appeals (Appeals) have resulted in clarifications and modifications to IRS Appeals policy. Other proposed changes could cause delays and make the process more difficult for taxpayers. This article examines these changes and their potential impact on the resolution of taxpayer cases.

The IRS has made several changes to the Internal Revenue Manual (IRM) regarding Appeals conference procedures, IRM 8.6.1. These changes became effective at the beginning of October. Under one of these new procedures, most Appeals conferences will be conducted telephonically as opposed to in person, as was common previously. A taxpayer may still request an in-person conference, but the request must be approved by the Appeals team manager. The IRM provides that in-person conferences should be limited to certain situations, such as when there are substantial books and records to be reviewed that cannot be referenced easily. The apparent purpose of the change was to address concerns that requests for in-person conferences sometimes were intended to get the case reassigned to a field employee who may be less-skilled or more taxpayer-favorable. As a result, however, what was once an important and standard part of the Appeals process will be relegated to a phone call.

Rob Kovacev, a partner in Steptoe’s Washington office commented: “the success of the Appeals process in resolving many controversies rested on the fact that a taxpayer could have a face-to-face discussion with the decision maker to explain its position and negotiate a settlement. These proposed changes weaken those advantages and may well force taxpayers to litigate cases that could have been resolved under the old Appeals rules.”

In addition, the updates to IRM 8.6.1.4.4 now allow Appeals to invite IRS Chief Counsel and/or Compliance (which includes Examination, Collections, and Accounts Management) to the Appeals conference. Appeals is intended as a review of the assessment of Compliance, and allowing Compliance to be present during the Appeals conference could upset the dynamic of the discussion between the taxpayer and Appeals. The IRM does note that even if Compliance and IRS Chief Counsel may be present for the conference, the existing prohibition against ex parte communications must not be violated. Thus, to the same extent as before, Appeals still may not communicate with IRS Chief Counsel or Compliance without the taxpayer also being present.

IRS Appeals announced that it reorganized its structure to rebalance after decreases in staffing. Appeals’ staffing decreased nearly 21% between fiscal years 2012 and 2015. The two geographic field operations -- one specialty operation and one campus operation -- have been replaced with three newly created functions: one for collection, one for examination, and one for specialized examination programs and referrals. The Collection Appeals function resolves
cases involving collection due process, offer in compromise, trust fund recovery penalties, jeopardy levies, and Collection Appeals Program (CAP) cases. The Examination Appeals function resolves general docketed and non-docketed cases generated from the IRS examination functions. The Specialized Examination Programs and Referrals function resolves a variety of specialized programs such as international issues, tax computations, innocent spouse, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and penalty appeals. A fourth function, Case and Operations Support Function, covers all support operations.

As another update, the IRS clarified appeals policies relating to docketed cases. In recent years, Appeals has initiated independence projects to ensure that its policies and practices are consistent with its mission. The Appeals Judicial Approach and Culture (AJAC) project began in 2012 and resulted in a series of policy clarifications primarily for non-docketed cases. The latest policy changes result from the Docketed Examination Assistance (DEA) project, which was initiated to ensure that Examination cases docketed in the US Tax Court receive consistent treatment. The fact sheet states that these changes are to clarify that IRS Compliance functions are the finders of fact and Appeals does not take investigative actions. For example, Appeals will retain jurisdiction of docketed cases when a taxpayer submits new information or raises a new issue that merits investigation but will request fact-finding assistance from Examination. If Examination does not provide assistance, Appeals will attempt to settle cases based on factual hazards.

While these changes may alter the dynamics of the Appeals process, in potentially problematic ways for taxpayers, the IRS appears to still be considering a further change that could have even worse impacts on the Appeals process. Recently, the IRS had been widely reported to be considering a change to IRS Appeals’ settlement procedure to shift authority to settle cases away from Appeals Team Case Leaders (ATCLs) to their managers. This move was considered in response to a report issued last year by the Treasury Inspector General for Tax Administration suggesting that some penalty appeals settlements did not comply with Appeals’ criteria. While this move is aimed at ensuring that Appeals’ decisions are adequately supported, it raised concerns among practitioners. The move would take away the decision-making ability from the person most familiar with the facts of the case. In addition, a move to require all settlements to be decided by one of about a half-dozen Appeals managers nationwide could create a backlog and divert taxpayers out of the Appeals process and into litigation.

In response to these widespread practitioner concerns, IRS Appeals Chief Kirsten Wielobob has informally clarified that settlement authority would remain with the ATCLs. However, she indicated that Appeals will revise its procedures to require that a manager review a case and propose any changes prior to the ATCL finalizing the settlement. While it is reassuring that the ATCLs retain the ultimate settlement authority, this new pre-decisional manager review may raise some of the same concerns about interference with the ATCLs’ decision-making, as well as about creating a backlog in the Appeals process. It remains to be seen whether this new process will solve the intended problems or just create new ones.

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New Treasury Regulations Curtail Planning Opportunities for Partnership Structures

Written by Steven E. Clemens, Daniel M. Dunn, Steven J. Lorch and Michael J. Rufkahr

The U.S. Treasury Department and the Internal Revenue Service issued final and temporary regulations (the “2016 Regulations”) on October 5, 2016 addressing the partnership disguised sale and debt allocation rules. The 2016 Regulations limit or, in some cases, eliminate taxpayers’ ability to achieve tax deferral in certain partnership structures where deferral previously was available.

Background: Allocation of Partnership Debt

Section 752 of the Internal Revenue Code of 1986, as amended (the “Code”), provides that partnership debt allocable to a partner gives rise to a deemed cash contribution by that partner to the partnership. This deemed contribution increases the partner’s basis in the partnership interest (referred to as a partner’s “outside basis”). A partner’s outside basis impacts the partner’s ability to receive cash distributions without gain recognition and to utilize loss allocations, among other things. The Section 752 regulations (the “Debt Allocation Rules”) allocate partnership debt to the extent a partner (or related person) bears the economic risk of loss with respect to the debt. For instance, a partner typically would be allocated the full amount of a partnership debt to the extent the partner provides a full guarantee of the debt, unless the facts and circumstances indicate a plan to circumvent or avoid the guarantee obligation. A more complex regime applies to the allocation of nonrecourse debt (that is, debt for which no partner bears the economic risk of loss).

Bottom Dollar Guarantees No Longer Recognized Under Debt Allocation Rules

Previously, under a common bottom dollar guarantee structure, a partner could include the guaranteed amount in the partner’s allocable share of the partnership debt (and therefore outside basis), even if the partner were not obligated to make payment unless the lender failed to recover an agreed-upon minimum amount. As a result, a partner could potentially receive a debt allocation equal to the guaranteed amount despite being exposed to a relatively low degree of economic risk.

In response, the 2016 Regulations require that “bottom dollar payment obligations" be ignored for purposes of determining a partner’s debt allocation and therefore outside basis. The 2016 Regulations generally define a bottom dollar payment obligation as any guarantee other than one where the partner (or a related person) would be liable for the full amount of the partner’s payment obligation if any amount of the guaranteed partnership obligation were not otherwise satisfied. There is a notable exception for guarantees where another person is obligated to reimburse the partner (or a related person) for a portion of the guaranteed amount, provided that the partner (or related person) still remains liable for at least ninety percent (90%) of the initial payment obligation. The 2016 Regulations also require partnerships to disclose bottom dollar payment obligations and, if applicable, details concerning an arrangement for which the above exception applies.

The 2016 Regulations could impact structures where bottom dollar guarantees are used, which are particularly prevalent in the real estate industry. For instance, without sufficient outside basis, a partner contributing appreciated real estate assets to a partnership might be required to recognize taxable gain if the assets are leveraged and the debt is allocated away to other partners. Alternatively, admission of a new partner could cause an allocation of debt away from current partners, thereby triggering a deemed distribution (and gain) to the current partners; a bottom dollar guarantee can no longer shield this gain and prevent this result. Also, even in the absence of immediate tax risk, a contributing partner’s low outside basis may limit the extent to which the partner can take valuable depreciation and amortization deductions generated by the partnership.
Attack on the Leveraged Distribution: Pro Rata Allocation of Debt Required in Disguised Sale Context

Current law provides that a partner may contribute appreciated property to a partnership without immediate tax (that is, on a tax-deferred basis) and, separately, a partner may receive a distribution of cash tax-free to the extent of outside basis. However, pursuant to Section 707(a) of the Code and the regulations thereunder (the "Disguised Sale Rules"), a contribution by and contemporaneous distribution to the same partner may be treated as a taxable sale if the partnership would not have made the distribution but for the initial contribution. In the case of nonsimultaneous transactions, a distribution generally will cause taxable sale treatment if it occurs within two years of the initial contribution.

One exception to disguised sale treatment is the so-called “debt-financed transfer” rule, which overrides the Disguised Sale Rules when a contributing partner receives proceeds from a third-party borrowing, but only to the extent the borrowing is allocated to the partner under the Debt Allocation Rules. Under current law, partners seeking tax deferral under the debt-financed transfer exception could therefore guarantee the borrowing or, instead, rely on an allocation under the “significant item of income” provision, which provides that a debt allocation will be respected if reasonably consistent with a significant item of partnership income or gain.

The 2016 Regulations put harsh limitations on partners’ ability to defer tax under the debt-financed transfer rule. These regulations require that, solely for purposes of the Disguised Sale Rules, all partnership debt must be treated as nonrecourse and therefore must be allocated in accordance with the partners’ share of partnership profits. Notwithstanding the provision that all debt be treated as nonrecourse, a partner cannot include partnership debt for which another partner bears the economic risk of loss. As a result, in the context of a disguised sale, which could include the acquisition of a business operated in partnership form (including certain joint ventures), and rollovers of partnership assets and interests, a debt allocation no longer can be made based on whether that partner provides a guarantee or a significant item of income or gain.

Effective Dates

The 2016 Regulations addressing bottom dollar guarantees are effective for liabilities incurred on or after October 5, 2016 (except in the case of a liability incurred pursuant to a written binding agreement entered into before that date). Pursuant to a transition rule, a partner may apply the previous Debt Allocation Rules for seven years if and to the extent the partner’s share of partnership debt exceeds the partner’s outside basis (without respect to partnership debt) on October 5, 2016. The 2016 Regulations addressing debt-financed transfers will apply to any transaction pursuant to which all transfers occur on or after January 3, 2017.

Footnotes

1) References to “partnerships” herein are intended to include all entities, including limited liability companies, that are classified as partnerships for U.S. federal income tax purposes.