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Frequent **LISI** contributors **Steve Oshins, Esq., AEP (Distinguished)** and **Bob Keebler, CPA/PFS, MST, AEP (Distinguished), CGMA,** recently gave a joint teleseminar for **Ultimate Estate Planner, Inc.** discussing the IRC 2704 Proposed Treasury Regulations and their effect on estate planning. Here they summarize some of the planning ideas presented in that presentation.

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Steve authors three different annual state rankings charts and one state income tax chart:

- The Annual Domestic Asset Protection Trust State Rankings Chart
- The Annual Dynasty Trust State Rankings Chart
- The Annual Trust Decanting State Rankings Chart
- The Annual Non-Grantor Trust State Income Tax Chart

Robert S. Keebler, **CPA/PFS, MST, AEP (Distinguished), CGMA** is a partner with **Keebler & Associates, LLP** and was inducted into the NAEPC Estate Planning Hall of Fame® in 2007. He has been named by CPA Magazine as one of the *Top 100 Most Influential Practitioners in the United States* and one of the *Top 40 Tax Advisors to Know During a Recession*. His practice includes family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. Mr. Keebler frequently represents clients before the National Office of the Internal Revenue Service (IRS) in the private letter ruling process and in estate, gift and income tax examinations and appeals. In the past 20 years, he has received over 200 favorable private letter rulings including several key rulings of "first impression." Bob is a frequent speaker for legal, accounting, insurance and financial planning groups throughout the United States on advanced IRA distribution strategies, estate planning and trust administration including presentations at the Heckerling Institute, the Notre Dame Institute and the AICPA's Advanced Estate Planning Conference, Personal Financial Planning Conference and Tax Strategies for the High Income Individual Conference. Bob may be reached at 920-593-1701 or at Robert.keebler@keeblerandassociates.com His firm's web site is http://www.keeblerandassociates.com

Listen to Steve and Bob's recent **LISI** podcast on the Private Decanting technique at this link to learn how to decant an irrevocable trust without having to give notice to the beneficiaries.

Now, here is Steve and Bob's commentary:

EXECUTIVE SUMMARY:

The Ultimate Estate Planner, Inc. was the first national organization to host a national presentation on the new IRC Sec. 2704 Proposed Treasury Regulations which were released Tuesday, August 2, 2016. This was likely the most heavilyattended teleseminar in the Ultimate Estate Planner, Inc.'s history, given the importance of the subject matter. To register or learn more about the upcoming dates and times, simply click this link: The New Section 2704 Regs: Planning Traps and Opportunities.

That presentation summarized the current IRC Sec. 2704 rules as well as the new Proposed Regulations and how they would change the rules if issued as Final Regulations. Since this will likely be the most discussed topic in the estate planning profession for some time, this newsletter will only briefly describe the basic changes and instead will focus on how to plan around the changes should they become final as currently drafted (or with only minimal changes), which is likely.

In the Ultimate Estate Planner presentation, we introduced certain planning ideas that we believe will become the primary planning strategies for most estate planners, assuming the Final Regulations match or closely match the Proposed Regulations.

COMMENT:

The Basic IRC Sec. 2704 Rules

IRC Sec. 2704(a) generally provides that, if there is a lapse of any voting or liquidation right in a corporation or a partnership and the individual holding such right immediately before the lapse and members of such individual's family hold, before and after the lapse, control of the entity, such lapse is treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate, whichever is applicable. The amount of the transfer is the fair market value of all interests held by the individual immediately before the lapse, determined as if the voting and liquidation rights were non-lapsing, over the fair market value of such interests after the lapse.

IRC Sec. 2704(b) generally provides that if a transferor transfers an interest in a corporation or partnership to or for the benefit of a member of the transferor's family, and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any "applicable restriction" is disregarded in valuing the transferred interest. An "applicable restriction" is a restriction that effectively limits the ability of the entity to liquidate that is more restrictive than applicable state law.

The Proposed Treasury Regulations

The Proposed Regulations essentially take away nearly all valuation discounts for interfamily transfers of entities controlled by the transferor and transferor's family.

Among other changes, the key problem for estate planners is that the Proposed Regulations take away nearly all discounts by disregarding the interests held by non-family members:

> 1. That have been held for less than three years before the date of the transfer;
>
> 2. That constitute less than 10% of the value of all of the entity interests;
>
> 3. That when combined with the interests of other non-family members constitute less than 20% of the value of all of the equity interests; or
>
> 4. That lack a right to put the interest to the entity and receive a minimum value (computed on a pro rata basis).

In actual practice, these requirements can almost never be satisfied. Therefore, there should be, and probably will be, a "mad rush" to do advanced estate planning prior to finalization of the Final Regulations. It will be like 2012 all over again (where the fear of the $5 million exemption dropping back down to $1 million provided estate planners with the most challenging few months in history). During this window of opportunity there are many concerns, including:

1. Choice of trust situs;
2. Gifting and selling minority positions;
3. Obtaining sustainable valuations;
4. Creating time between steps of complex transactions; and
5. Utilizing *Wandry* or other protective strategies.

There will be a public hearing on the Proposed Regulations on December 1, 2016. Most of the Final Regulations won't be effective until the Final Regulations are issued, with a portion effective 30 days later.

So how will we plan after the Final Regulations are issued? This newsletter will focus exclusively on Sec. 2704(b) rather than Sec. 2704(a) since the only change to Sec. 2704(a) would be to add a three-year rule.

Creative Estate Tax Planning Post-Final Regulations

If the proposed regulations are issued as final regulations as currently drafted, this will not spell the end of advanced estate planning. Below are some of the planning ideas that we expect will be used.

1. Create a Promissory Note

Make a gift to an Intentionally Defective Grantor Trust ("IDGT"), followed by an installment sale to the IDGT. The installment sale may have no discount (i.e., for example, simply an installment sale of a brokerage account) or may have a small discount (i.e., an installment sale of an interest in an LLC, LP or corporation that has a tiny discount due to 2704 Final Regulations).

Now the clever part…Take the promissory note and gift it to a Grantor Retained Annuity Trust ("GRAT"). Because a promissory note is entitled to a large valuation discount and isn't limited by IRC Sec. 2704(b), we are creating a substantial discounting opportunity by simply creating a discountable asset that is not subject to IRC Sec. 2704(b). Discounts for promissory notes are often greater than discounts for business interests anyway, so arguably we should have been doing this instead of what most of us generally do.

Alternatively, contribute the promissory note and other assets to an LLC that is taxed as a disregarded entity and then transfer LLC membership interests to the GRAT. The internal discount on the note is what will make this option work well. We believe that the promissory note strategy described herein will become the standard advanced technique used by sophisticated planners.

Note that there may be cash flow issues that will need to be fully thought through during the planning phase. If the promissory note uses the lowest AFR available, then the GRAT won't be able to make its annuity payments without making the term of years too long. Therefore, to avoid this problem, make sure the promissory note is payable interest-only with the right of prepayment of principal without penalty. As long as the assets gifted and sold to the IDGT are very liquid and/or throw off a lot of cash flow, the trustee of the IDGT can prepay principal on the promissory note so that the GRAT term can be condensed and the trustee of the GRAT can make its annuity payments to the settlor. Also consider an increasing annuity GRAT (with each subsequent annuity payment up to 120% of the prior year's annuity payment) in a situation where cash is tight during the early years, but where there is an anticipated liquidity event sometime in the future.

Note further that the installment sale could be to a self-settled trust where the settlor retains lifetime and testamentary powers of appointment and a lifetime veto power of distributions so that (unlike the installment sale to an IDGT described above) the creation of the promissory note doesn't involve a trust that makes the seed money gift a completed transfer for gift tax purposes. The installment sale to the incomplete gift trust is designed to change non-discountable assets into a promissory note that can then be gifted to a GRAT as described above.

2. Transfer Undivided Interests in Real Estate

Make gifts and installment sales of undivided interests in real estate. Whether it's an undivided 1% interest or an undivided 99% interest in real estate, it is discounted to reflect the rights that the other owner(s) have in the property. Our new focus will be to look for these opportunities since IRC Sec. 2704(b) doesn't affect real estate held outright.

3. Discount Internal Assets Rather than Focusing on External Business Entity Discounts

Focus on creating discounts on the internal assets in the business entity rather than discounts on the interests in the entity. In the past, planners often haven't focused on discounts within the entity given that the discounts would be at the entity level and the appraiser can only "double-dip" on the discount a tiny bit. Therefore, we will create LLCs and transfer discountable promissory notes and undivided interests in real estate to the LLC before making gifts of LLC interests.
For example, an LLC might own a large promissory note or an undivided 99% interest in an office building.

4. The Friendly Ex-Spouse or Current Unmarried Couple

Many clients are still very friendly with their ex-spouse and also share the same children and therefore have a common interest in maximizing wealth to those children. There are also many couples who are as good as married, but never actually tied the knot. In either case, these situations provide potential opportunities to work around the proposed new rules by meeting the non-family exceptions.

5. Strategic Divorce

This term is normally associated with an attempt to avoid a creditor by divorcing and giving the non-debtor spouse the majority of the assets. However, the new IRC Sec. 2704(b) rules may entice certain married couples to strategically divorce in order to become nonfamily members so they can work around the Sec. 2704(b) rules. For example, two spouses can divorce and divide the entity so they each own a 50% interest. If each of them gives away a 0.5% interest to a family friend, then both of them will be left with 49.5% interests (which are below the 50% control test that applies for Sec. 2704(b) purposes.

6. Self-Cancelling Installment Sale ("SCIN") and Tax Burn

This is currently a widely-used technique, but it might become more popular (for healthy clients) if these regulations become final. A SCIN is just like a regular promissory note except that there is an additional provision that waives the balance of all remaining principal and income that would otherwise be owed were it a regular note if the seller dies before the end of the term of years of the note. With less ability to obtain valuation discounts, except using some of the strategies such as those described herein, there will be a greater focus on planning to reduce the estate tax by selling assets to an IDGT for a SCIN.

Thus, the SCIN solves much of the estate tax problem through the end of the term of years (but not after). Since the settlor of the IDGT is responsible for payment of all income taxes on income earned by the IDGT, the "tax burn" magnifies the estate reduction by "burning" the settlor's estate through that term of years and beyond. This doesn't necessarily solve the problem, but it buys time and significantly reduces the estate.

7. Private Annuity and Tax Burn

Just like the SCIN transaction, a Private Annuity is also a bet-to-die technique. Generally, a Private Annuity is a stream of payments for the rest of the seller's life. Unlike a SCIN, a Private Annuity generally pays for life, whereas a SCIN stops at the end of the term of years of the note. [Note: A Private Annuity can be drafted for a term that is a term of years.]

Unlike a SCIN, a Private Annuity is subject to the exhaustion test which effectively limits the dollar amount that can be sold to the IDGT. Therefore, this won't work well for the ultra-large estate, but it may become more widely used for taxable estates that are not so large that the amounts are small relative to the estate. When combined with the tax burn, the results are magnified.

8. Reverse Freeze and Tax Burn

A regular freeze transaction involves a gift of common shares and the retention of preferred shares which have a preference right on income. There are strict rules under IRC Sec. 2701 that have to be followed to use a regular freeze transaction.

However, IRC Sec. 2701 does not affect a reverse freeze. A reverse freeze involves a gift of preferred shares and the retention of common shares. Therefore, a person can transfer the preferred shares to an IDGT either by gift or by installment sale, or both, thereby shifting most or all of the income to the IDGT. Since the settlor of the IDGT is responsible for payment of all income owned by the IDGT, the “tax burn” is magnified, thereby “burning” the settlor’s estate. This takes some time, but can be hedged with life insurance and/or the use of a Self-Cancelling Installment Note, both of which hedge “bet-to-live” transactions that require time to make a significant positive impact.

Summary

The Proposed Regulations will likely become Final Regulations either as currently written or with slight modifications. Planners therefore have a window of opportunity to encourage their clients to take advantage of the current rules before they are adversely changed. Therefore, there should be a mad rush to do the planning this year just as there was a mad rush in 2012 when the fiscal cliff was approaching.

This newsletter introduces certain planning ideas that can be used if and when the rules change. We believe that the installment note strategies and other ideas that are discussed in this newsletter will become commonplace among advanced estate planners.

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We look forward to seeing and hearing the continued dialogue on this subject so that planners are ready to modify their strategies once the Final Regulations are issued.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Steve Oshins

Bob Keebler

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IRC Sec. 2704 Proposed Regulations