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EDITORS' FEATURE

VALUATION PLANNING

Nevada Jumps Ahead With New “Restricted” Entities

Nevada has recently passed legislation that will permit the creation of “restricted” limited liability companies and limited partnerships. Such entities will provide greater opportunities for achieving valuation discounts when transferring interests in these entities. For the practitioner’s viewpoint on this new legislation, we contacted attorney Steven J. Oshins. Mr. Oshins is a member of the Law Offices of Oshins & Associates, LLC, Las Vegas, Nevada (www.oshins.com), a nationally recognized firm specializing in estate planning and asset protection. Mr. Oshins wrote the Nevada law allowing restricted entities and has previously worked with the legislature to amend Nevada law to allow 365-year dynasty trusts and to make the charging order the exclusive remedy of a judgment creditor of an LLC or LP.

CCH: Before discussing the new Nevada law changes, could you give our readers a better understanding of how we got to this point, particularly with respect to the significance of the special valuation rules in Chapter 14 of the Code?

Mr. Oshins: In the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) Congress added four new code sections (2701—2704), collectively known as the special valuation rules. These rules were enacted to combat what the government perceived as abuses in transfer tax avoidance that could be achieved through transfers of property from senior to younger family members, while the senior family members retained certain interests in the transferred property. Because, prior to the special valuation rules, the transfer tax value of the property transferred was the full value minus any retained interest, large tax savings could be gained by overvaluing the retained interest. The four code sections are aimed at different transfer valuation situations. Code Sec. 2701 is concerned with valuing transfers of interests in corporations and partnerships, while Code Sec. 2702 deals with transfers of interests in trusts. Code Sec. 2703 looks at the valuation of property that is subject to various rights and restrictions, such as an option or other right to acquire property at less than fair market value. Finally, Code Sec. 2704 addresses the valuation of certain lapsing rights and restrictions.

CCH: In general, how do these provisions operate?

Mr. Oshins: With the basic overall constraint that these provisions govern transfers among family members, the rules generally treat the transfer of an interest in property from one family member to another as if the ordinary precepts governing valuation do not apply.

CCH: More specifically, what are the parameters of Code Sec. 2704?

Mr. Oshins: Code Sec. 2704 was enacted in reaction to the result in *D. Harrison Est.*, 52 TCM 1306, CCH Dec. 43,609(M), TC Memo.1987-8, in which the decedent contributed assets worth approximately \$59 million to a partnership with his two sons. The terms of the partnership permitted the decedent to liquidate his interest at any time during his lifetime and recover his capital investment, but this right lapsed upon his death. The lapse was held to have reduced the value of the decedent’s interest at death by about \$26 million. Code Sec. 2704 seeks to include in a decedent’s gross estate the value of lapsing rights and liquidation rights in corporations and partnerships controlled by the decedent and members of the decedent’s family. Under Code Sec. 2704, the lapse is disregarded in valuing the interest for estate and gift tax purposes.

There are two main parts to Code Sec. 2704. Pursuant to Code Sec. 2704(a), an individual’s gross estate (or lifetime taxable gifts) will include the value of any lapsed voting or liquidation right held by the person in a corporation or partnership, provided the entity was controlled by the person and members of the person’s family both before and after the lapse. Rights subject to the rule include those relating to liquidation, voting, puts and calls, redemptions and conversion. Technically, the statute states that the value of the lapsed right is the value of all the interests in the entity held by the person immediately before the lapse over the value after the lapse. For purposes of the statute, “family members” include a spouse, brothers and sisters (and their spouses), and ancestors and lineal descendants (and their spouses) of the individual.

Most relevant to our interview is the second part—Code Sec. 2704(b). According to Code Sec. 2704(b), the value of any “applicable restriction” limiting the liquidation of a corporation or partnership is ignored in valuing the person’s interest for estate and gift tax purposes, provided

the person and the person's family controlled the entity both before and after the transfer and the restriction either lapses after the transfer or can be removed at any time by the person or members of the person's family, either acting together or separately. Among the restrictions that are excluded from the operation of this rule are commercially reasonable restrictions in connection with financing or those required under state or federal law.

CCH: Could you provide details on the exception provided in Code Sec. 2704(b)(3)(B)?

Mr. Oshins: Code Sec. 2704(b)(3)(B) says that any restriction that is imposed, or required to be imposed, by federal or state law is not considered an applicable restriction and, thus, would not be disregarded in valuing the transferred interest. Pursuant to Reg. §25.2704-2(b), an applicable restriction is a limitation on the ability to liquidate

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an entity "... 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." In other words, choice of state law is critical with respect to whether the restriction contained in the agreement governing the entity will be considered an applicable restriction for purposes of Code Sec. 2704(b). Accordingly, a provision on liquidation that is no more restrictive than the corresponding state law default provision should not be deemed to be an applicable restriction. Taxpayers have found this to be a winning argument before the Tax Court, as evidenced by the decisions in *B. Kerr*, 113 TC 450, CCH Dec. 53,667, aff'd CA-5, 2002-1 USTC ¶60,440 and *I. Knight*, 115 TC 506, CCH Dec. 54,136 (both cases involving Texas law), as well as *M. Harper Est.*, 79 TCM 2232, CCH Dec. 53,939(M), TC Memo. 2000-202, involving California law, although in a subsequent decision (83 TCM 1641, CCH Dec. 54,745(M), TC Memo. 2002-1210), the estate in *Harper* lost on another issue.

Nevada Ups the Ante

CCH: Since the enactment of Code Sec. 2704, states have amended or added to their statutes what could best be described as taxpayer-friendly provisions to fit within the Code Sec. 2704(b)(3) exception for restrictions

imposed under state law. Could you describe what the recent Nevada law adds to this exception?

Mr. Oshins: You might say the new Nevada provisions (NRS 86.161 for LLCs and NRS 87A.235 and NRS 88.450 for limited partnerships) serve to turbo charge the Code Sec. 2704(b)(3) exception. In a nutshell, the new law creates a significant difference between a "restricted" LLC or LP created under Nevada law in comparison to an LLC or LP formed elsewhere. This difference stems from a default lock-in of 10 years for the entity's underlying assets. This difference should provide a measurably higher ceiling for valuations involving a Nevada restricted LLC or LP than is currently available in any other state.

CCH: Do the statutes provide any flexibility?

Mr. Oshins: Yes, the statutes provide a very high level of flexibility in that they create a much higher ceiling for valuation discounts than the statutes in any other state, but the estate planner may determine that some lesser period—five years, three years, etc.—may be more appropriate. There are a myriad of possibilities presented, plus the restrictions imposed could be lifted by amending the LLC's articles of organization or the partnership's certificate of limited partnership, except that doing so before the gift tax statute of limitations has run risks there being a determination by the IRS that the amendment was prearranged.

CCH: When is the new law effective?

Mr. Oshins: It was signed by the Governor on May 29 and will be effective October 1, 2009.

CCH: In practical terms, do you have any estimate of the range of valuation discounts that could result from the transfer of an interest in a Nevada restricted LLC or restricted LP?

Mr. Oshins: Obviously, every situation is different and a qualified appraiser would have to provide his or her professional evaluation of the facts and circumstances surrounding a particular valuation. However, I posed a number of hypothetical scenarios to two different appraisers describing varying applications of the statute including those employing a 10-year, five-year, and one-year restriction on member/partner distributions as well as scenarios in which the restriction was tied to an income or growth target or to federal or state income taxes. As might be expected, the appraisers suggested that the hypothetical involving the 10-year restriction would provide the greatest discounts (10 to 35 percent) over and above any discounts obtained without the new law provision.

CCH: Were there any problems encountered in getting the new law passed?

Mr. Oshins: Interestingly, it passed through the Nevada Senate 20 to 0 and the Nevada Assembly 42 to 0. I was very surprised that it passed so easily given that it was the first major change from the Uniform Laws in any state. I was expecting the academics to question why a state should create such a drastic change from the uniformity that many people desire. I believe that it passed unanimously because it was just one of many modifications in a large legislative bill sponsored by the Business Law Section of the State Bar of Nevada. The committee members of the Business Law Section were kind enough to sponsor my language in their bill so that I wouldn't have to use a stand-alone bill. I purposely did it this way because I don't think it would have passed had it been in its own stand-alone bill since that would have caused additional scrutiny. I learned this strategy in the 2005 Nevada legislative session when my rule against perpetuities bill was reduced from 1,000 years to 365 years after significant negotiations. Conversely, my charging order language was easily passed in both the 2001 and 2003 legislative sessions when it was part of larger bills with multiple items.

Looking to the Future

CCH: Among the revenue raising proposals for the 2010 fiscal year put forth by the Obama Administration in the

recently issued "Green Book" is one that would appear to be aimed at tightening Code Sec. 2704(b). What is your reaction to that proposal and its potential impact on the Nevada statute, as well as on valuations in general?

Mr. Oshins: On its face the proposal is troubling and, if passed, could certainly serve to blunt not only the Nevada statute but other state law provisions on the treatment of restrictions as well. In effect, the proposal would disregard restrictions imposed under state law unless they conform with standards contained in regulations to be issued by the Treasury. The proposal would seem to be antithetical to the long established concept of a willing buyer and a willing seller in that it ignores real restrictions on business interests.

I would remind your readers that as far back as the mid-90s, the Clinton Administration had proposed law changes that would have severely limited valuation discounts with respect to family limited partnerships and LLCs. Those proposals proved controversial and were never seriously considered by Congress. I would not be surprised to see an intense lobbying effort against such a provision even now. However, particularly with the government seeking greater revenues to finance health care reform and other initiatives, it is certainly possible that, at some point in the near future, we will see major changes to the existing valuation rules.