Nevada Senate Bill 3501

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National Association of Certified Valuators and Analysts

Restrictions on Distributions and Impact on DLOM…Who Else Will Follow?

In 2009 Nevada Senate Bill 350 was passed into law. This law authorized the creation of two new business entities: the Restricted LLC and Restricted LP. The bill also allowed for the conversion of existing entities into one of the above types. In this article, Eric J. Barr provides an overview of these two entities and raises questions regarding why someone might want to form such an entity and whether the IRS will respect the statutory restrictions given that under IRC 2704, the government retains the right to disregard certain rights and restrictions.

State laws impact the rights of owners of pass through entities (PTEs). Certain states have a large body of applicable case law that provides clarity as to how the courts will interpret the statutory language; other states do not have a large body of relevant case law. Further, while other states have laws that provide for greater protection of minority interests, others have laws that provide for greater protection of controlling interests. The valuation analyst needs to be aware of applicable state limitations on the rights of PTE owners that may impact value.

Nevada Senate Bill 350, enacted during 2009, is an example of a state law that restricts the rights of PTE ownership interests.[2] Significantly greater valuation discounts would appear to be available to owners of restricted LLCs and restricted limited partnerships subject to Nevada Senate Bill 350. However, it is uncertain if such increased discounts for lack of control and lack of marketability would be sustained by the courts if challenged by the IRS, as there is no case law yet.

Nevada Senate Bill 350 created two new types of business entities: (1) a restricted limited liability company (Restricted LLC) and (2) a restricted limited partnership (Restricted LP). Restricted LLCs and Restricted LPs are collectively referred to herein as Restricted PTEs. Restricted PTEs are Nevada LLCs and Nevada limited partnerships that agree to be restricted entities by indicating their restricted nature on their certificate of partnership or certificate of formation, as applicable. This election can be made for new LLCs or new limited partnerships or for existing LLCs or existing limited partnerships that are converting to a

Restricted PTE.

Unless otherwise stated in the certificate of partnership or certificate of formation, the Restricted PTE cannot make any distributions to their owners for ten years from their date of formation. Thus, by operation of the partnership/members' agreement and consistent with Nevada state law, a PTE could be restricted from making any distributions, including income tax reimbursement distributions, for up to ten years. The length of time selected can be any period but not greater than ten years. If the agreement is silent on the length of time, ten years is the default provision under Nevada state law if the statute is cited within the certificate of formation.

So, why would anyone want to set up a limited partnership (or LLC) that restricts distributions for ten years? Internal Revenue Code Section 2704(b), *Treatment of Certain Lapsing Rights and Restrictions, Certain Restrictions on Liquidation Disregarded*, currently states that when valuing a limited partnership interest for gift or estate tax purposes, the liquidation restrictions in the operating agreement will be disregarded if the person transferring the interest in the partnership to a family member and the transferor and members of the transferor's family control the entity immediately before the transfer. The transferred partnership [or member] interest will be valued without considering any applicable restrictions. Since the restrictions in the partnership agreement will be ignored, there will be no valuation discounts. However, under section 2704(b) (3) (B), restrictions imposed under state…laws are not considered applicable restrictions. This exception acknowledges that restrictions imposed by state law cannot be ignored. Therefore, the limited partnership [member] arrangement will be a factor in determining estate and gift valuation discounts and can help reduce [gift, estate, and generation-skipping transfer] taxes.[3]

Restricted PTEs under Nevada Senate Bill 350 provide wealth-management protection as well as asset protection. This law protects debtor assets by making it more difficult for a creditor to demand that the Restricted PTE make distributions.

Nevada Senate Bill 350 does not include a residency requirement. Accordingly, family limited partnerships and family LLCs from all over the country can presumably take advantage of this law.

An owner of a Restricted PTE has an ownership interest that has less value than an ownership interest in an identical entity that does not impose limits on distributions. The longer the distribution limitation is in effect, the greater the discounts for lack of control and lack of marketability. The magnitude of these discounts will be impacted by the nature and risk inherent within the assets held by the Restricted PTE and by the expected income tax cost associated with holding the ownership interest during the distribution limitation period, among other factors.

As of the writing of this text, no other state has adopted a law similar to that of Nevada Senate Law 350. Presumably, state legislators are waiting to see how the IRS responds. If the IRS respects this law and permits the larger discounts, other states will likely follow.

[1] Barr, Eric J. *Valuing Pass Through Entities*. Hoboken: John Wiley & Sons, 2014. Reprinted with permission.

[2] S.B. 350 (Nev. 2009).

[3] *Neveda [sic] Senate Bill 350*, RINA, http://www.rina.com/resource-library/articles/nevada-senate-bill-350/ (last visited Mar. 11, 2014) (emphasis in original).

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