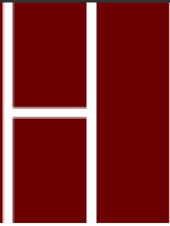

TAX ALERT 2015

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POTENTIAL LIMITATIONS ON FAMILY VALUATION DISCOUNTS

I. Overview

Family-controlled entities, such as Family Limited Liability Companies and Family Limited Partnerships, are the cornerstone vehicles of high-end advanced planning. These entities provide a tax effective method of transferring property to intended beneficiaries, customarily utilizing grantor retained annuity trusts ("GRATs") or generation-skipping/dynasty trusts. Essentially, a member or partner can transfer, either by sale or gift, non-voting, non-marketable membership or partnership interests to beneficiaries (or trusts for their benefit) and claim a valuation discount due to the restrictions that apply to the transferred interest. However, the Internal Revenue Service ("IRS") may soon restrict the use of valuation discounts by promulgating new regulations under Internal Revenue Code (the "Code") Section 2704. **ACTION: If you are considering making a discounted gift or sale, consider accelerating your plans in order to avoid any potential diminution of the applicable discounts.**

II. Valuation Discounts

Under the Code, the standard for determining the value of the transfer is the fair market value of the interest at the time of transfer (i.e. what a willing buyer and willing seller would agree to). Currently, this standard disregards family relationships (i.e. no attribution of interests owned by family members) in determining fair market value. Valuation discounts are a significant component of advanced estate planning and are currently available when transferring interests in a family-controlled entity to intended beneficiaries. In this context, two typical valuation discounts are recognized by the IRS: (1) the Minority Interest Discount; and (2) the Discount for Lack of Marketability. The Minority Interest Discount is applied due to the restrictions on control of the entity (i.e. non-voting, non-managing or minority interests). The Discount for Lack of Marketability is applied due to restrictions on marketability (i.e. sale of non-controlling interest in an entity with provisions that restrict the ability to sell the interest to a third party or the lack of a recognized market).

These two discounts can range from 15 percent to 40 percent, or higher, and together can produce significant tax savings by allowing a transfer of interest for less than the pro rata value. For example, if the value of a 100 percent interest of a family-controlled entity is $10 million and a 10 percent interest is transferred, the $1 million undiscounted value can be transferred for $600,000 (assuming a 40 percent discount) because it is presumed to have less value due to control and liquidity limitations. In fact, that is the reality; no buyer would pay full price for interests that cannot be transferred or hypothecated, have no vote and are illiquid.

III. Code Section 2704

Code Section 2704(b)(3) gives the IRS broad authorization to issue regulations providing for restrictions that can be disregarded in determining the value of a transfer to a family member, if such restriction has the effect of reducing the value of the transferred interest but does not ultimately reduce the value of such interest to the transferee. For several years, the Department of Treasury, in its annual General Explanations of the Administration's Fiscal Year Revenue Proposals (also known as the "Green Book"), has issued a statutory proposal to Code Section 2704 that would

restrict the use of discounting by creating an additional category of restrictions that would be disregarded in valuing an interest in a family-controlled entity. Congress has summarily rejected these Obama Administration proposals. The Code Section 2704 legislative proposals indicate that transferred interests would be valued by substituting for "disregarded restrictions" certain assumptions to be specified in the regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in the regulation. The proposed disregarded restrictions would apply to a transfer to a family member if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Undoubtedly, any such regulations will be aggressively challenged by taxpayers.

IV. Conclusion

While the exact specifics and effective date of the proposed regulations are unclear, it now appears, based on comments made by the Department of Treasury, that the IRS may issue these regulations as soon as mid-September of this year, with the worst case scenario being that the regulations take effect immediately upon release. On the other hand, such regulations may come out later this year or early next year. Accordingly, if you are considering this type of advanced estate planning transaction, please contact us before there are any changes in the law that may significantly restrict discounts, because the regulations may be effective immediately upon issuance.

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