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Discounts of family entity interests threatened

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In 2011, the lifetime transfer tax (estate, gift and generation skipping transfer tax) exclusion was set at $5 million. As a result, less than 1 percent of the families in the country will be impacted by the estate tax. The $5 million figure is adjusted for changes in the cost of living, so it has steadily risen steadily to $5.12 million in 2012; $5.25 million in 2013; $5.34 million in 2014; and now $5.43 million in 2015.

For those few families for whom estate tax planning is important, it often takes advantage of valuation adjustments for gifts of interests in closely held entities. The two most common adjustments are the: (i) DLOM - discount for lack of marketability (the family entity does not trade on the New York stock exchange); and (ii) DLOC - discount for lack of control (a limited partner does not, by definition, control the entity).

Here is a simple example: Mom and Dad own $10 million of income-producing real property. They transfer it to a family limited partnership. They transfer a 20 percent limited partnership interest to an irrevocable trust for the benefit of their children. The combined discounts for lack of marketability and lack of control applicable to a gift of this type of limited partnership would likely be, at this time, 40 percent. That means that the gift would be valued as follows: $10 million *x* 20 percent (the gift percentage) *x* 60 percent (the obverse of the discount) = $1.2 million. In other words, the valuation adjustments save the parents $800,000 of their $5.43 million per parent lifetime transfer tax exclusion.

The more important benefit of the valuation adjustments occurs upon the surviving parent's death. Assume that 80 percent of the limited partnership interests are included in the surviving parent's taxable estate. What would be the value? $10 million *x* 80 percent *x* 60 percent = $4.8 million. In other words, the discounts reduced the $10 million asset to a taxable asset of only $6 million, saving ($4 million *x* 40 percent =) $1.6 million in estate tax.

These discounts are such an important tool in estate and gift tax planning that there are specific questions on the federal estate tax return (IRS Form 706) designed to find out if valuation adjustments were used.

The Obama administration has proposed to restrict or eliminate the valuation discount for transfers of interests in family controlled entities. However, that proposal was omitted from its 2014 and 2015 budget proposals. In response, the Treasury Department announced at a May meeting of the American Bar Association Section of Taxation that it will attempt to accomplish much the same result through regulations.

Internal Revenue Code Section 2704(b) provides that if there is a transfer of 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 control the entity, any "applicable restrictions" shall be disregarded in valuing the transferred interest. "Applicable restriction" is defined; however, what makes the statute so attractive to the IRS is the authority given by Section 2704(b)(4) to the secretary of the Treasury to promulgate regulations that provide that "other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family 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."

As a result of the announcement, law and accounting firms and financial advisors have issued warnings to their clients to act now if they wish to accomplish estate tax planning before the end of the year. That is because the IRS could issue regulations at any time. Also, the regulations could be effective when finalized retroactive to the date of the proposed regulation.

Some families will benefit from a regulation which disallows discounts in certain situations: for instance, those where no estate tax is due who will benefit from a stepped-up basis at death to the assets' undiscounted value.

The advice to engage in estate tax planning as far in advance as possible is always good advice. The possibility of regulations eliminating or restricting valuation discounts makes this advice even more important.

The most powerful tool in estate tax planning is not valuation, but leverage. As that great estate tax lawyer Archimedes once said, "Give me a lever and a place to stand and I will move the earth." A grantor retained annuity trust is just one example of how planners can move millions of dollars of actual value to the next generation while using only a portion of the parents' lifetime exclusion. Assume the parents have an apartment building worth $40 million generating 4 percent per year. If the parents transfer the building to an irrevocable trust and retain the right to the 4 percent for 24 years, they can transfer the building to their children without paying a gift tax. The results with this structure are even more impressive with a closely held S corporation.

It is always helpful to do estate tax planning as far in advance as possible. However, even if the laws change and people delay, there are still ways to get to an attractive result.

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