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IRS could shake up special valuation rules in coming weeks

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One of the most powerful tools in estate tax planning is the ability to "discount" the value of an interest in a closely held entity by the (i) lack of marketability and (ii) lack of control. Those combined discounts can each be as much as 35 percent, depending upon the type of entity and the type of assets.

Assume Mom and Dad have a garment business that the appraiser values at $10 million. Mom and Dad wish to give 20 percent of the stock to an irrevocable trust for their children. The appraiser determines that the stock is subject to a 25 percent discount for lack of control and a 30 percent discount for lack of marketability (the stock does not trade on an established exchange). The value of the gift is, therefore: $10 million *x* 20 percent (the percentage of stock being given) *x* 75 percent (to reflect the 25 percent control discount) *x* 70 percent (to reflect the 30 percent marketability discount) = $1.05 million, which is a combined 47.5 percent discount.

The discounts help both in saving the parents' lifetime exclusion ($5.45 million per parent) and in reducing the value of the stock later included in the surviving parent's estate. Assume Mom and Dad use up their lifetime exclusions on other transfers and Dad dies first. His half of the community property interest in the stock, 40 percent, will go into a marital trust for Mom's benefit. When Mom later dies her taxable estate includes both the marital trust's 40 percent and her own 40 percent of the stock. However, both 40 percent shares will be entitled to be discounted in the same way as the 20 percent gift to the children's trust. Assuming, many years later, the discount is still the same 47.5 percent, the remaining 80 percent is only worth $10 million *x* 80 percent *x* 52.5 percent = $4.2 million. In other words, an initial gift of 20 percent reduced the asset's value by 58 percent, providing a tremendous reduction in estate tax.

Chapter 14, the "Special Valuation Rules," was added to the Internal Revenue Code back in 1990. It was aimed at preventing estate tax reduction through the use of "freezes" and other arrangements that reduce the value of the taxable estate or gifts without reducing the economic benefit of the transferred assets. In addition to the tools on the face of the statute, Section 2704(b)(4) provided the IRS with broad authority to issue regulations: "The ... regulations [may] 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 for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee." Congress' grant of authority to the IRS is so broad that it is doubtful that any regulation would be struck down as invalid, especially in light of the U.S. Supreme Court's decision in *Mayo Foundation for Medical Education & Research v. U.S.*, 131 S. Ct. 704 (2011).

On May 7, Melissa Liquerman, IRS branch chief in the Office of the Chief Counsel, told an ABA gathering that final regulations relating to these rules could be released within the next six to eight weeks. That means that by July 7 we may see regulations which address valuation adjustments for family-owned businesses and other entities, such as family limited partnerships and family LLCs.

Some have speculated that the regulations might exempt operating businesses. So our example of a gift of a 20 percent interest in the family "S" corporation that operates a garment business might not be affected. However, the gift of a 20 percent interest in a family limited partnership or LLC that holds $10 million in apartment buildings would lose the discount.

The situation we are now in is reminiscent of the situation at the end of 2012, when the fear was that the estate tax exclusion would be reduced from $5 million to $1 million. At that time, lawyers and taxpayers rushed to do planning to use up each taxpayer's then-$5 million lifetime transfer tax exclusion. Of course, the reduction never occurred, and the $5 million exclusion became "permanent" and has been increased by changed in the cost of living. This time appears to be different because the change will not be made by Congress, which is changeable, but by the IRS, which is implacable. The end of valuation discounts in at least some situations seems certain to occur, as the IRS has been discussing this - and warning us about this - now for years.

What should wealthy taxpayers do? For liquid assets, investment real estate and other non-operating assets, establish the family limited partnership now. Then consider the best way to transfer significant interests in those entities to an irrevocable trust for the children. The best way might be the way that uses the least amount of lifetime exclusion, or the way that keeps all of the income going to the parents, or that transfers the most amount of the wealth, or the way that accomplishes all of the above.

Of course there is no certainty as to the effective date of regulations which have not yet been issued. They might be prospectively effective, which will give additional time to engage in planning. However, transactions completed before the effective date will almost certainly be "grandfathered" as the U.S. and California constitutions both have contracts clauses. Article I, Section 10, clause 1 of the U.S. Constitution states "No State shall ... pass any ... Law impairing the Obligation of Contracts." See also Article 1, Section 9 of the California Constitution.

Even if the regulations eliminate discounts, that will not be the end of estate tax planning. We will still be able to argue about the value of the assets, e.g., the investment real estate and the closely held businesses. We will still have structures, such as GRATs (grantor retained annuity trusts), SCINs (self-cancelling installment notes), Private Annuities and QPRTs (qualified personal residence trusts), that have discounts inherent in them. However, it will put more pressure on experienced counsel to be thoughtful with planning.

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