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IRS rules may eliminate all valuation discounts

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On Aug. 2, the Internal Revenue Service issued proposed regulations restricting valuation discounts in estate and gift tax planning. The proposed rules are so broad that it may take a decade of litigation to determine if they are valid.

Let's start with an example. Assume Mom and Dad, ages 75 and 80, have an estate so large it will, without planning, be subject to the 40 percent estate tax. They own an apartment building worth $10 million which generates $500,000 per year in cash flow. Current planning would call for them to contribute the building to a family limited partnership. The business appraiser might value the partnership interests as follows: $10 million *x* 80 percent, to allow for a 20 percent discount for lack of marketability, equals $8 million. Then $8 million *x* 75 percent, to allow for a 25 percent discount for lack of control, equals $6 million. In other words, the aggregate discounted value of the limited partnership units would be 40 percent less than the underlying assets' value. So Mom and Dad can sell the limited partnership units to a children's trust for a private annuity. Once the sale closes, their estate tax as to that asset would be zero. That is because the annuity rate at their ages is 8.3 percent and $500,000 of cash flow divided by the $6 million discounted value = 8.3 percent.

If the proposed regulations become final there may be no reason to hire a business appraiser. Why? Because there may be no discount for lack of (i) control or (ii) marketability. Therefore, to transfer the building to the children's trust free of estate tax Mom and Dad must first use $4 million of their lifetime transfer tax exclusion to give 40 percent of the limited partnership interests to the children's trust, and then sell the remaining 60 percent to the children's trust for the private annuity. That is fine if Mom and Dad have $4 million of exclusion available for that purpose.

How will the regulations eliminate the discounts? They require each limited partner to have the ability to (i) compel the partnership's liquidation or (ii) force a redemption of the partner's interest based on a pro rata (non-discounted) share of the underlying assets. Of course, the IRS cannot require a partnership agreement to give each limited partner those rights. What the IRS (apparently) can do is require that the limited partner's interest be valued as if it had those rights.

Could a taxpayer avoid this regulation's impact by, instead of using a partnership or LLC, own the property with the children's trust as tenants in common? Perhaps. However, the IRS may try to characterize the tenancy in common as a partnership.

The regulations may help in some situations. For example, in estates not subject to estate tax, these rules will ensure a higher value and, therefore, a higher income tax basis for the heirs. Also, the rules do not apply to charitable transfers. Finally, although they apply to transfers to a spouse, that should not create an estate tax problem.

The proposed regulations will not become final until early 2017. Therefore, taxpayers for whom the valuation discounts are important must get their planning done in the next four or so months. Which taxpayers are most likely to be affected? People in their 80s or older. People who are going to live at least 18 months but not to their life expectancy. People with "platinum" properties. A "platinum" property is one with cash flow which is a small percentage of the fair market value. This, of course, depends upon the taxpayer's age. For example, the annuity rate for a 65-year-old is 6.6 percent. If the 65-year-old owns a building worth $50 million which generates $500,000 (1 percent) per year, that person needs the valuation discounts for estate tax planning.

What will we do after the regulations become final? Here are some preliminary thoughts. First, we must pay more attention to the underlying assets' appraisal. The client might think that the apartment building is worth $10 million. However, appraisers A, B and C might opine that it is worth $10 million, $9.5 million and $9 million, respectively, since valuation is, at least in part, an art form. The taxpayer is entitled to pick the lowest non-laughable value. The attorney must hire the appraisers so that the reports not used will remain confidential as part of the attorney's work-product.

Second, clients must do their planning at younger ages. Assume Mom and Dad are 60 and 65 with the same $10 million apartment building generating $500,000 per year. Their annuity rate is 4.8 percent. So if they are spending the $500,000 per year, a sale to a children's trust for a private annuity means there is no estate tax as to that asset and their estate will not grow from "excess" cash flow.

Third, estate tax planning structures that have discounts inherent in them will be more important. For example, a qualified personal resident trust (QPRT) has two discounts, neither of which will be affected by the proposed regulations. One discount is the time value of money and the other is based on mortality. Assume Mom and Dad, ages 60 and 65, have a principal residence with $5 million of equity. They each establish a QPRT for their one-half community property interest which will last until their respective age 85. Assuming they survive to age 85 they will have made that asset disappear from their taxable estate while using less than $1.5 million of their lifetime transfer tax exclusion. That is an effective discount of 70 percent!

The new regulations may well eliminate valuation discounts for family entities. However, we will still be able to eliminate estate taxes for most clients with thoughtful, timely planning.

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