North American Management
Financial Planning Note

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Valuation Discounts and Family Partnerships – The Window is Closing

Many high net worth families use family limited partnerships (FLPs) as a valuable tool in their estate plans. By gifting property and/or business interests to an FLP, senior family members are able to keep assets in the family while in turn removing significant assets from their taxable estates at below market valuations.

With newly proposed IRS regulations, the demise of favorable valuation treatment for these types of gifts looks inevitable.

The Current Rules

Currently when a senior family member wants to pass on his or her business interest or large investment pool to the next generation of family members, creating an FLP offers a tax-efficient solution. By structuring the FLP with general and limited partner interests, two types of valuation discounts can be created.

Lack of Control Discount: When a family member receives a portion of the family business that represents less than majority ownership, that gift can be valued at less than fair market value. Why? Because the recipient lacks the ability to control managerial decisions. Further, instead of reducing the giver's estate tax exemption by the full market value of that portion of the company, only the discounted market value counts towards the lifetime exemption. Effectively, the company is being passed along to the next generation at a discount and the senior family member is saving on future estate taxes.

Lack of Marketability Discount: In addition to the lack of control new minority owners will have, there may also be restrictions put on their ability to sell their interests. A barrier to liquidation of partial interests can create an additional "lack of marketability" discount.

Proposed Changes

Although the IRS attempted to crack down on family discounts as far back as 1990, tax court cases and state laws have hampered its ability to enforce the rules of IRC Section 2704. Until now. With the introduction of new regulations under Section 2704, the use of valuation discounts will likely be very restricted going forward.

Imposition of 3-Year Lookback Period**:** To eliminate deathbed transfers of family interests in order to reduce a majority ownership to minority (and therefore receive a minority discount valuation for estate tax purposes), the IRS will no longer allow any discounting on the shares remaining in the estate if the transfer was less than three years before death. Simply put, it is no longer viable to reduce a majority interest in a family business to a minority interest when the majority owner is at or near death.

Disregarded Restrictions**:** Under current law, an heir can claim a lack of marketability discount if there is a restriction on the sale of his or her minority interest. Under the new rules, this discount would be eliminated if the heir or the family has the ability to remove such restriction after the transfer. There are a few exceptions, especially when non-family members are also owners, but for most FLPs, this ability to remove restrictions by the family effectively negates the lack of control and marketability discounts.

What to Do Now

If you have been considering creating an FLP, a family limited liability company (family LLC), or a similar entity (which are now also covered under these new regulations), the time to do so is now. These proposed regulations are currently in the Public Comment period, and there will be a Public Hearing on December 1, 2016. After that, the IRS will consider the comments before issuing the final rules, which will then be in effect thirty days after issuance. So it is likely some or all of these new restrictions to discounting gifts will take place in early 2017.

The new rules would only apply to transfers made after the effective date, which means families have a few months left to accelerate gifts of family business shares that can still be subject to market and control discounts. Note however, as they are written now, the new rules will require a three-year lookback period for any deaths that occur after the effective date. This would only affect the valuation of the estate, not the value of the gifted assets.

Of course, gifting shares of a family business now or in the future may remain a valuable way to get future appreciation out of one's estate, even if the valuation discounts are no longer applicable.

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