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Re: New IRS Regulations Spell the Demise of Valuation Discounts

Dear Clients, Friends and Colleagues:

The "Federal Discount Window" (that is, the IRS discount for intra-family gifting) will be closing soon.

Last November, we reported to you on the then prospect that the Treasury Department (i.e., the IRS) was going to promulgate regulations to reduce and curtail the viability of valuation discounts that have become standard fare in estate planning. For decades, estate planners have used valuation discounts when clients gift interests in family limited partnerships, limited liability companies or S corporations (let's call them "Family Entities") to the next generation. Pursuant to the valuation discount, the value of the interest gifted to the next generation, for gift tax purposes, is discounted such that the value of the gift is less than the value of the pro rata share of the donee's interest in the Family Entity. The valuation discount has been particularly beneficial to high net worth individuals in connection with their gifting to the next generation.

Generally speaking, in a Family Entity, assets are contributed by the senior generation, and gifts of entity interests (which are subject to transfer restrictions and no voting rights) are made to the next generation. The gifting of such interests is eligible for a valuation discount because the gifted interests have no "control" or influence over the management of the

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entity.[1] As a result, the "value" of the gift received by the next generation was "greater" than the value reportable to the IRS.

It took the IRS approximately a year to promulgate proposed regulations which have a very broad blunderbuss scope.

The newly proposed regulations (promulgated on August 2, 2016) will, in effect, eliminate valuation discounts that reflect that a "limited owner" (i.e., limited partner, in the case of a limited partnership, a class B nonvoting member, in the case of a limited liability company, or a Class B nonvoting stockholder, in the case of an S corporation) receives limited rights as to management of the Family Entity. While these discounts are grounded in economic reality and give fair economic effect to illiquidity, lack of control, and minority discount reflective of the lesser value associated with these types of interests, they will be outlawed by the new regulations.

The earliest possible date that these proposed regulations will become final is December 31, 2016. More likely the regulations will go into effect next year. Furthermore, it is likely that there will be litigation brought by heavy donors of Family Entities, based on the regulations exceeding the scope of the IRS authority under Internal Revenue Code Section 2704.

On the topic of effective date, in our opinion, the new regulations have a "claw back" if the decedent dies within three years of making a gift which has been made with certain types of valuation discounts. This claw back of three years (similar claw backs exist in other estate tax Code Sections) seems, in the case of a person dying during the next three years, to pull back into his or her taxable estate the amount of the discount even though taken in respect of a transfer made prior to the regulations becoming effective. Hence, in this situation, the proposed regulations will have a retroactive effect.

What you should do: If you have engaged in gifting or are thinking about it, you should plan on effecting the gifting between now and year-end.

Counterpoint: Now, having reviewed the pending demise of the valuation discount, let's also focus on the fact that, in many cases, a discount is not advantageous; indeed, it is a disadvantage. Given the $5.4 million "permanent" [reminder: "permanent" in a legislator's

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[1] By way of background, current law generally allows taxpayers to transfer minority interests in family controlled entities to the next generation at a reduced value after giving effect to certain valuation discounts. Section 2704 of the Internal Revenue Code generally provides that if an interest in a family-controlled entity is transferred to family members, discounts reflecting certain types of restrictions are disregarded in valuing the transferred interest. Nevertheless, a time honored, non-controversial "fact based" technique (not previously outlawed by Section 2704) were discounts reflecting lack of marketability (i.e., the limited owner cannot compel the purchase of his interest), lack of control (i.e. the limited owner cannot influence management of the Family Entity), and illiquidity (i.e., the limited owner has no exit scenario where he or she can monetize the investment without the consent of the senior generation).

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lexicon means until Congress decides to change it] estate and gift tax exemption amount, many taxpayers need not be concerned about the loss of the discount.[2] Thus, you must be mindful of the "inversion" of the prior rules of taxation, namely, in many cases, discounting is contraindicated because the goal should be to increase the donee's "cost basis" of property which means using a high (non-discounted) value. For example, where a surviving spouse receives assets from her spouse or a taxpayer's total assets are less than the $5.4 million "permanent estate tax exemption amount", one should be more interested in increasing the inherited "stepped-up" basis in order to lower the next generation's capital gain tax exposure, in which case, a valuation discount is a disadvantage. If a person is not exposed to estate tax, then the last thing he or she wants is to use a valuation discount. In such cases, the goal should be to have the highest possible asset value which translates into the next generation's having a higher cost basis for his or her inherited ownership interest in the Family Entity.

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A note to New Jersey residents: New Jersey residents are in a special category. Discounts may be helpful in connection with minimizing your exposure to New Jersey estate tax because, as we write this, New Jersey has yet to increase its estate tax exemption from $675,000. Over the past year, there have been a number of promises to do so, but none have been fulfilled despite much banter.

Ironically, the New Jersey estate tax is based on the federal estate tax as it was in effect for the year 2001. Consequently, in our opinion, the pending demise of valuation discounts for gifting of limited owner interests in Family Entities ought not apply to New Jersey taxpayers. Lastly, note that New Jersey does <u>not</u> have a gift tax; it only has an estate tax.

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The bottom line: These new rules are not user friendly, but at the same time, they are not necessarily a bad thing for many taxpayers.

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[2] If you are sitting back and not worried because you are a taxpayer with an asset base below $5.4 million (couples $10.8 million), you will be concerned if Hillary Clinton is elected and sweeps Congress. The Democratic proposals include reduction of the estate tax exemption to $3.5 million, a cap of $1 million on lifetime use of exemption, and an increase in the estate tax rate to 45%, plus other proposals. Donald Trump says he will eliminate estate and gift taxes. Stay tuned on this front.

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