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## THE END OF VALUATION DISCOUNTS FOR FAMILY-OWNED ENTITIES

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The IRS has issued proposed new rules related to Internal Revenue Code Section 2704 that affect taxpayers' ability to take valuation discounts on interests in family-owned entities such as family limited partnerships ("FLPs"). Please be aware of the far-reaching impact of these new regulations:

- 1) The opportunity to do "squeeze" planning will go away once the proposed regulations become effective. With current valuation discounts, the value of an FLP holding assets worth \$100 might be squeezed down to just \$65. When you gift the FLP interests, you only use up \$65 of your lifetime exemption. If you instead sell your FLP interests to your children, the promissory note that you'll receive in return will be for \$65, immediately removing \$35 from your estate.
- 2) Clients that have engaged in "squeeze" planning but have not completed the second step of moving the FLP interests out of their estates (out of their names) have not locked in the discounted value. Continuing with the scenario above, if you die with the FLP interests still in your estate, the value of those interests for estate tax purposes will be at or near the full \$100. To lock in the discounted \$65 value before your death, you must gift or sell the FLP interests out of your estate before these proposed regulations become final. An ideal option is to transfer the FLP interests to a 678 Trust so that you can retain access to the assets.

### Background

Many clients create FLPs and limited liability companies (LLCs) to hold and transfer family wealth because a greater amount of wealth can be transferred to the next generation at a lower estate and gift tax cost. This structure is used because certain valuation discounts are often applicable when calculating the value of these transferred interests when the interests are in a closely-held entity (including both operating businesses and investment entities) and are transferred to a family member.

Because of restrictions placed on the interest owner by the entity's governing documents, the discounts most often applicable to these intra-family transfers are for Lack of Control and Lack of Marketability. Assuming the entity's governing documents restrict the interest owner from managing the entity, the Lack of Control discount is applicable. The Lack of Marketability discount is applicable when the interest owner is restricted from selling or transferring the interest. Together, these discounts can reduce the value of the transferred interest by 35% or more.

Under IRC Section 2704, these restrictions must be disregarded when determining the value of the transferred interest. However, prior to the date the new regulations become effective, most intra-family transfers fall within exceptions which allow the discounts to still be applied.

## **Proposed Regulations**

In an effort to curtail the use of valuation discounts, the IRS released new proposed regulations under IRC Section 2704 on August 2, 2016. These proposed regulations provide significant, veritably insurmountable, requirements which must be met to qualify for a valuation discount. Gifting interests in a family-owned entity to the next generation for a discounted value will effectively be eliminated.

### **Window Remains for Locking In Discounts**

The proposed regulations are not yet effective. The IRS has requested comments on the proposed regulations, and a public hearing is scheduled for December 1, 2016. This provides a window for clients to undertake planning before the regulations become effective. Clients considering the use of a family entity for estate planning may wish to accelerate those plans and complete the transfers before December.

Additionally, clients who have created an FLP but still own FLP interests in their name will want to lock in the discount before December. For example, many clients have created FLPs but still own a majority of the limited partnership interests. However, in order to take advantage of the potential discounts for these entities, the clients need to transfer the interests to family members or trusts for family members prior to the proposed regulations becoming effective.

### **Non-Tax Reasons Remain for Using these Entities**

While potential discounts are a motivating factor for many clients, there are many other benefits to the use of FLPs. In addition to discounts, FLPs provide a system for the management of diverse assets, an efficient means of gifting assets and most importantly—creditor protection. While the focus of planning for many clients is tax reduction, taxes only present one of many risks to a family's wealth. In this regard, planning to protect assets from creditors, divorces and lawsuits can be just as crucial as planning for tax savings! FLPs will continue to be a valuable tool even in a world without valuation discounts.

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