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Act Now! Regulations Limiting Valuation Discounts Anticipated by Fall

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The Internal Revenue Service and commentators recently made remarks strongly suggesting that the ability to take valuation discounts in connection with certain family transfers may be limited—soon. If you are considering this type of planning, now is the time to act.

One of the most powerful tools in an estate planner's toolbox is the ability to take valuation discounts for purposes of gift tax or estate tax calculations. Two of the most common discounts are for lack of control and lack of marketability. It is not uncommon for these discounts (in the aggregate) to range from 30% to 50%, the impact of which is illustrated by the following example:

- In 2013, Dad created a limited liability company ("LLC") and contributed $6 million of real estate and marketable securities to the LLC. In 2014, the LLC was appraised and, due to certain restrictions, the appraiser determined that it was appropriate to apply a 40% discount to a gift of a minority interest in the LLC. Dad then made a gift of 25% of his LLC units to each of his four children, with the value of each such gift being $900,000. At a transfer tax cost of only $3.6 million, Dad was able to get $6 million of value out of his estate without paying a gift tax and avoiding an estate tax on $2.4 million (a net tax savings under current rates of $960,000).

Section 2704(b) of the Internal Revenue Code (the "Code") requires that "applicable" restrictions be disregarded in determining the value of certain business interests transferred to family members. Exceptions to these restrictions currently make it possible to take discounts like those illustrated above.

Code section 2704(b)(4) gives the Treasury Department the power to issue regulations that further limit the ability to take valuation discounts. On May 10, 2015, Catherine V. Hughes, Department of the Treasury, Office of Tax Policy, spoke at the American Bar Association's Tax Section meeting. In her comments, Ms. Hughes indicated that the Treasury is going to issue a regulation limiting valuation discounts, as soon as late this summer or early this fall.

At this point, the content of the regulation is speculative only, although a number of commentators believe it will not apply to operating businesses. Instead, its anticipated focus is non-operating family entities, such as passive investment entities like the one illustrated in the example above.

Also unknown is the regulation's effective date. When regulations are issued, they typically are first issued in proposed form. Comments are invited for a period of time, and then the regulations are issued in final form. In most cases, regulations are not effective until issued in final form. However, it is possible for a regulation to be effective as of its proposed date. Regardless of which effective date applies (first "proposed" date, or final date), the regulation likely will apply to all transfers that occur after that date. In other words, it is very possible that there will be no grandfathering for family entities created before the effective date if the transfer occurs after the effective date.

If you are considering planning with valuation discounts or would like more information regarding valuation discounts, now is the time to contact your Reinhart attorney or a member of Reinhart's Trusts and Estates team to discuss how the regulation may affect you and your family.