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IRS Issues Proposed Regulations Limiting Valuation Discounts

POSTED:

Aug 10, 2016

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After much anticipation, the Internal Revenue Service (the "IRS") issued proposed regulations on August 2, 2016, limiting the ability to take valuation discounts in connection with certain intra-family asset transfers.

Prior to the proposed regulations, the ability to take valuation discounts for purposes of gift or estate tax calculations was one of the most powerful tools in an estate planner's toolbox. Two of the most common discounts were for lack of control and lack of marketability. It was 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 2014, Dad created a limited liability company (the "LLC") and contributed $6 million of real estate and marketable securities to the LLC. In 2015, 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 gift tax and avoiding 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. In the past, exceptions to these restrictions made 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.

The proposed regulations substantially limit or eliminate the ability to take these discounts in the family context. This is accomplished through a multifaceted approach, including an expansion of the list of disregarded restrictions and a narrowing of the exceptions. In addition, liquidation restrictions will be ignored in determining the value of transferred interests unless the restrictions are required by federal or state law.

A hearing on the proposed regulations is scheduled for December 1, 2016.

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Between now and November 2, 2016, members of the public may submit comments on the proposed regulations to the IRS. Commentators are expecting a great deal of pushback against the proposed regulations, including a discussion of whether the Treasury Department has overstepped its rulemaking authority in issuing these regulations. The regulations will become effective 30 days after they are published as final regulations. It is anticipated that the earliest the regulations will become final is 2017.

Despite this delayed effective date, clients should be wary of rushing to complete transactions and taking positions that are inconsistent with the proposed regulations. Although the regulations have not been finalized, transactions that fall within their scope are likely to catch the attention of the IRS.

If you are considering planning with valuation discounts, now is the time to contact your Reinhart attorney or a member of Reinhart's Trusts and Estates team to discuss how these regulations may affect your planning.