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## Proposed IRS regs will eliminate important valuation discounts

**Bruce Givner** is a partner at *Givner & Kaye* in Los Angeles. He can be reached at [bruce@givnerkaye.com](mailto:bruce@givnerkaye.com).



**Owen Kaye** is a partner at *Givner & Kaye* in Los Angeles. He can be reached at [owen@givnerkaye.com](mailto:owen@givnerkaye.com).



On Aug. 2, the Internal Revenue Service issued proposed regulations that will eliminate two important valuation discounts for estate and gift tax purposes for transfers of interests in family controlled entities. These rules will apply if the entity passively holds liquid assets or if it income producing real property. Most surprising, these rules apply even if the entity is an active business, e.g., an auto dealership. The mechanism for eliminating these discounts is simple: Each owner is deemed to have a put or liquidation right to receive a pro rata share of the underlying assets. That rights sweeps away any discount for lack of

marketability or control that, in the current environment, often leads to a 40 percent discount. The regulations would become effective in early 2017.

In effect, the proposed regulations argue that, in a family controlled entity, the discounts are unreal: One family member would not enforce the restrictions against another family member. However, the law, as manifested by the IRS's own regulations, insists on a hypothetical "willing buyer - willing seller": "The value of the property is the price at which [it] would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Treas. Reg. Section 25.2512-1. The courts have consistently rebuffed IRS attempts to use family attribution to overcome the hypothetical "willing buyer - willing seller" standard: "[The IRS] persists in attempting to have the Court consider the identify of a related transferee ... in determining fair market value, a position that has repeatedly been rejected in favor of assuming a hypothetical unrelated buyer." *Mooneyham v. Commissioner*, T.C. Memo 1991-178.

Due to these proposed regulations, there is great pressure on older taxpayers to engage in estate tax planning, in the final months of 2016, while the discounts for lack of marketability and lack of control are clearly still available. This is an example of the problem of waiting. Assume Mom and Dad, ages 55 and 60, own stocks and bonds worth \$10 million which generate \$300,000 of free cash flow per year. Also assume that they have used their entire \$5.45 million per person lifetime transfer tax exclusion. They can contribute the liquid assets to a family limited partnership, and it is almost certain that the combined discounts for lack of marketability and lack of control will be 30 percent. In other words, the limited partnership units will have an aggregate \$7 million value. \$300,000 of cash flow on a \$7 million value is 4.3 percent. Coincidentally, the annuity required for two people ages 55 and 60 is 4.2 percent. That means Mom and Dad can sell all the limited partnership units to a children's trust, generate no capital gains tax on the sale, incur no gift tax, retain all of the cash flow, and immediately achieve a zero estate tax as to those assets. A phenomenal result. If the proposed regulations go into effect, the \$10 million of liquid assets will be worth \$10 million, whether or not they are contributed to a limited partnership, so Mom and Dad will have to pay gift tax on \$3 million to achieve a similar result.

Note: There is less pressure if Mom and Dad own an apartment building because the proposed regulations do not eliminate the discounts for tenancy in common interests. However, most families owning real estate own it through limited partnerships and limited liability companies, and changing the ownership to tenancies in common will present practical and legal difficulties that motivate them to do their planning now.

There is a significant argument that the regulations are invalid. Why? They are authorized by Internal Revenue Code Section 2704(b)(4) which provides "The Secretary [of the Treasury] may by regulations provide that ... restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for [estate and gift tax ] purposes ... but does not ultimately reduce the value...to the transferee." Contrary to the motive behind the proposed regulations, the provisions of the partnership agreement, operating agreement or stock purchase agreement that cause the discounts for lack of marketability and lack of control in fact "ultimately reduce the value ... to the transferee."

Last Thursday, Rep. Jim Sensenbrenner (R-Wis.) introduced H.R. 6042 entitled "Nullifying Proposed Restrictions on Liquidations of Estate, Gift, GST Tax Interests." It is short: "Regulations proposed for purposes of Section 2704 of the Internal Revenue Code ... relating to restrictions on liquidation of an interest with respect to estate, gift and generation-skipping transfer taxes, published on August 4, 2016 (81 Fed. Reg. 51413), and any substantially similar regulations ... shall have no force or effect."

Will the bill become law? It is too soon to tell. Many members of Congress would prefer to focus their attention on impeaching IRS Commissioner John Koskinen and repealing the estate tax. The latter would eliminate the problem completely. More likely, in the short-term, the IRS will be influenced, by the Sensenbrenner bill, to soften the final regulations.

However, the conservative approach for taxpayers with estates likely to be subject to the estate tax, meaning estates over \$11 million, is to explore their planning options now. There are two elements that immediately get the estate to zero: using the lifetime exclusion (\$5.45 million per person) and a private annuity. There are structures that have significant leverage built into them, e.g., a qualified personal residence trust and a grantor retained annuity trust. And there are techniques which can allow the heirs to significantly discount the value of the assets even after the parents are dead, e.g., testamentary charitable lead annuity trusts. An ounce of planning is worth a ton of tax.

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