Last Chance to Make Gifts Using Discounted Valuations?

Proposed regulations widely anticipated to be released by the Internal Revenue Service in late summer or early fall may significantly curtail the availability of valuation discounts when transferring interests in family controlled entities (such as family limited partnerships and limited liability companies) to family members.

Background

Under current law, valuation discounts allow taxpayers to transfer minority interests in family entities to family members at a significantly reduced transfer tax cost. For example, a discount of 25% would permit a family patriarch to transfer a 20% interest in a family controlled entity owning a $30 million pool of marketable securities to his daughter at a reduced gift tax value of $4.5 million, rather than $6 million, thereby reducing the value of the gift below the gift tax exemption of $5.43 million. Some clients have also funded similar limited partnerships but have gifted only the voting control (without gifting significant equity) in the hope that the value of their retained interest will be similarly discounted for estate tax purposes at their death. For example, Bob and Mary Smith each own a 49.5% limited partner interest in the Smith Partnership LP and their son owns the 1% general partner interest. Since Bob and Mary, individually have no voting control, they are deemed to own a non-marketable, non-controlling interest which, under present law, would be valued at a discount when they die.

Government's View

In an effort to stem perceived abuses in valuation discounts for transfers of interests in family entities, Section 2704 of the Internal Revenue Code was enacted in 1990. Section 2704 provides that if an interest in a family controlled entity is transferred to a family member any "applicable restriction" is disregarded in valuing the transferred interest. An "applicable restriction" is a restriction that limits the ability of the entity to liquidate and the restriction lapses after the transfer but excludes "any restriction imposed, or required to be imposed, by any Federal or State law." Because "applicable restriction" does not include any restriction imposed by federal or state law, the applicability of Section 2704 to partnership and LLC transfers has been limited as a number of states have revised their laws in a taxpayer friendly manner.

For a number of years the Obama Administration proposed statutory changes to restrict or eliminate such valuation discounts on transfers of interests in family-controlled entities. However, in 2014 and 2015 the Section 2704 statutory proposal was absent from the Administration's budget proposal. The speculation is that this reflects the Treasury Department's intention to bypass statutory change by issuing regulations adding an additional category of restrictions that may be disregarded in determining the value of interests in family controlled entities transferred to family members. Cathy Hughes, from the Treasury's Office of Tax Policy, noted, in addressing the American Bar Association's Tax Section that proposed regulations under Section 2704 might be

issued prior to the Tax Section's September meeting. It is not clear at this time whether such regulations, when issued, will be prospective or retroactive.

Section 2704 provides that the Secretary of the Treasury may provide, in regulations, that other restrictions shall be disregarded in determining the value of a transfer to a family member, if such restriction has the effect of reducing the value of the transferred interest but does not ultimately reduce the value of such interest to the transferee.

Immediate Action Recommended

Given the likelihood of imminent issuance of proposed regulations that would eliminate the valuation discounts, it would be prudent for anyone considering transferring interests in family entities to act as soon as possible. If you are interested in learning how such discounts can be utilized in your estate planning please contact one of the members of our estate planning team.

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Moses & Singer LLP
The Chrysler Building
405 Lexington Avenue
New York, NY 10174-1299
Tel: 212.554.7800, Fax: 212.554.7700

2200 Fletcher Avenue
Fort Lee, NJ 07024
Tel: 201.363.1210, Fax: 201.363.9210
Abraham Y. Skoff, Esq.
Managing Attorney for New Jersey

10 Cuttermill Road – Suite 201
Great Neck, NY 11021
Tel: 516.498.8828, Fax: 516.498.8810
James Alterbaum, Esq.
Managing Attorney for Long Island

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