A Closer Look

The IRS Takes Aim at Valuation Discounts: What It Means and What You Should Do

BESSEMER TRUST

Mark R. Parthemer
Senior Fiduciary Counsel

In Brief

- **Recently proposed tax regulations could negatively impact estate planning, particularly for high-net-worth families. If finalized in their current form, they could severely limit — or eliminate — the ability to use two common valuation discounts.**
- **It is unclear when the proposed regulations will become effective or even what the specifics of the final regulations will be, but whatever happens, the fair expectation is that the rules will likely be less favorable than they are today.**
- **Clients considering a transaction that might engender a valuation discount should consider completing the transaction before these changes take effect.**

The U.S. Treasury Department has revealed its long-awaited proposed changes addressing valuation discounts. If finalized in their current form, the proposed regulations could have a major negative impact on estate tax planning, particularly for high-net-worth families, by reducing or eliminating the ability to use two common valuation discounts.

More specifically, the proposed regulations could reduce or potentially eliminate the use of minority-interest and marketability discounts for interests in family-controlled entities being transferred among family members. These new rules would apply whether the entity owns an operating business, an investment account, or other assets.

While this announcement is arguably the biggest estate tax planning event from the IRS in years, it doesn't come as much of a surprise — the Treasury has been signaling its intent to make these changes for more than 12 years.

Right now, the regulations are only proposed and thus not yet effective. They were written so that some of them would become effective immediately when finalized, and the rest 30 days later. But when they might become finalized is unknown. It could be as early as December 31, 2016 (but more likely would be later than that).

Not only do we not know when the rules might become finalized; we also do not know what the final rules will be. The Treasury Department is now receiving comments on the proposed regulations from taxpayers and advisors, followed by a public hearing on December 1, 2016. When that process is complete, the Treasury Department will consider the comments and, at some point thereafter (but no earlier than December 31), most likely issue final regulations that will trigger the effective date of the new limitations. Often, this process can take 18 months or longer, but there is speculation among practitioners that the IRS has "fast tracked" these rules.

As a result, there is uncertainty not only regarding the length of this process, but also the specifics of the final regulations themselves. They could be similar to the proposed regulations, or only slightly modified. Even if there are material changes, the fair expectation is that the final regulations will be less favorable than the current environment for high-net-worth families seeking valuation discounts for gift, estate, and generation-skipping tax (GST) planning. This creates a window of opportunity between now and December 31 (or until the rules are finalized).

Following is an explanation of some of the more critical concepts, a summary of the proposed regulations, a suggestion on what clients should do, and answers to some of the most common questions we are hearing from clients.

Family Businesses, Estate Freezes, and Valuation Discounts

Before exploring the specifics of the proposed regulations, we need to explain what is meant by the various terms and techniques associated with them.

When discussing family-owned businesses, for instance, the term includes much more than the typical company that sells products or services. It also includes investment entities — such as private family-controlled businesses, including family limited partnerships (FLPs) and family limited liability companies (LLCs) — that hold various investments. If you're imagining a classic portfolio of stocks, bonds, and possibly alternative investments, that's exactly right. At Bessemer Trust, many of our clients form partnerships using their investment portfolios for a variety of important planning reasons.

Such partnerships often play a central role when it comes to wealth transfer and estate planning, providing structure for family governance, prudent investing, and desired restrictions on who can be a participant.

They can also provide efficiency for estate tax planning. There are three common benefits:

1. The use of a technique known as an estate "freeze," where the assets are either passed through the tax system at their current value, or frozen in the hands of the senior generation at their current value, so that younger generations receive any future appreciation without exposure to gift, estate, or GST tax.
2. If interests in the entity are transferred to a grantor trust (an income tax concept), earnings on the investments can be taxed to the senior generation. This results in 100% of earnings being available for their children undiminished by income taxes *and* also causes a "burn" by enabling yet-to-be-estate-taxed assets of the senior generation to be used to pay the income tax on the trust's income. This is a big benefit to the younger generation since the value of the income tax paid is not treated as a taxable gift.
3. Finally, the interests that are sold or given are often non-voting or minority interests that are subject to transfer restrictions. These restrictions position the interests to receive a **discounted valuation** for tax purposes. The amount of the discount is based on the nature of the assets, restrictions, and rights; however, it is not uncommon for the range to be somewhere between 25% and 40%.

With a goal of minimizing the amount of estate tax owed down the line, the math is simple: the smaller the estate, the lower the estate taxes.

The freeze may be accomplished by forming a business entity (such as an LLC or FLP), or restructuring an existing one, to provide a 1% voting share and 99% non-voting shares. A senior family member often initially retains the 1% voting interest, while giving or selling the non-voting interests to junior family members — or trusts for them. Eventually, the voting interests also are transferred, but even until then, the vast majority of growth in value of the assets in the entity goes to the interests held by the junior family members. This shifting of the benefit of the growth circumvents taxation in the senior family member's estate.

Not only does this reduce the taxable estate of the senior family member, but it can also allow for a **valuation discount** on the transfer — meaning lower taxes on the transfer of the shares.

Here's how it works. Families draft partnership agreements or other organizational documents that include terms that place certain restrictions on the ownership of the interests (shares). When these restricted interests are then given to junior family members, these restrictions reduce the appraised value of the transferred shares for tax purposes. (The value of the actual assets held within the underlying LLC or FLP does not change.)

What are those restrictions? Often, they are provisions added to agreements that severely limit transferability and control, including a lack of voting rights. Alternatively, they may be restrictions that apply under local law unless overridden in the governing documents.

The transferability restriction refers to situations where the junior family members are not permitted to sell or transfer their partnership shares without the consent of all other partners. This means they are far less marketable than, say, shares of stock in a publicly traded company, which results in a valuation discount.

The lack-of-control discount applies because, absent voting rights, junior family members have no control over the partnership's management issues (investments, distributions, etc.). They simply don't have a say.

Because such shares are non-voting minority interests with no say or control over the operations (including distributions of profits), the appraised value of these shares is typically lower as a consequence of these restrictions. After all, would it make sense to pay full value for a 10% interest in a business that (a) could not be resold or converted into cash, and (b) does not have voting rights on management issues (including declaring dividends or making distributions)?

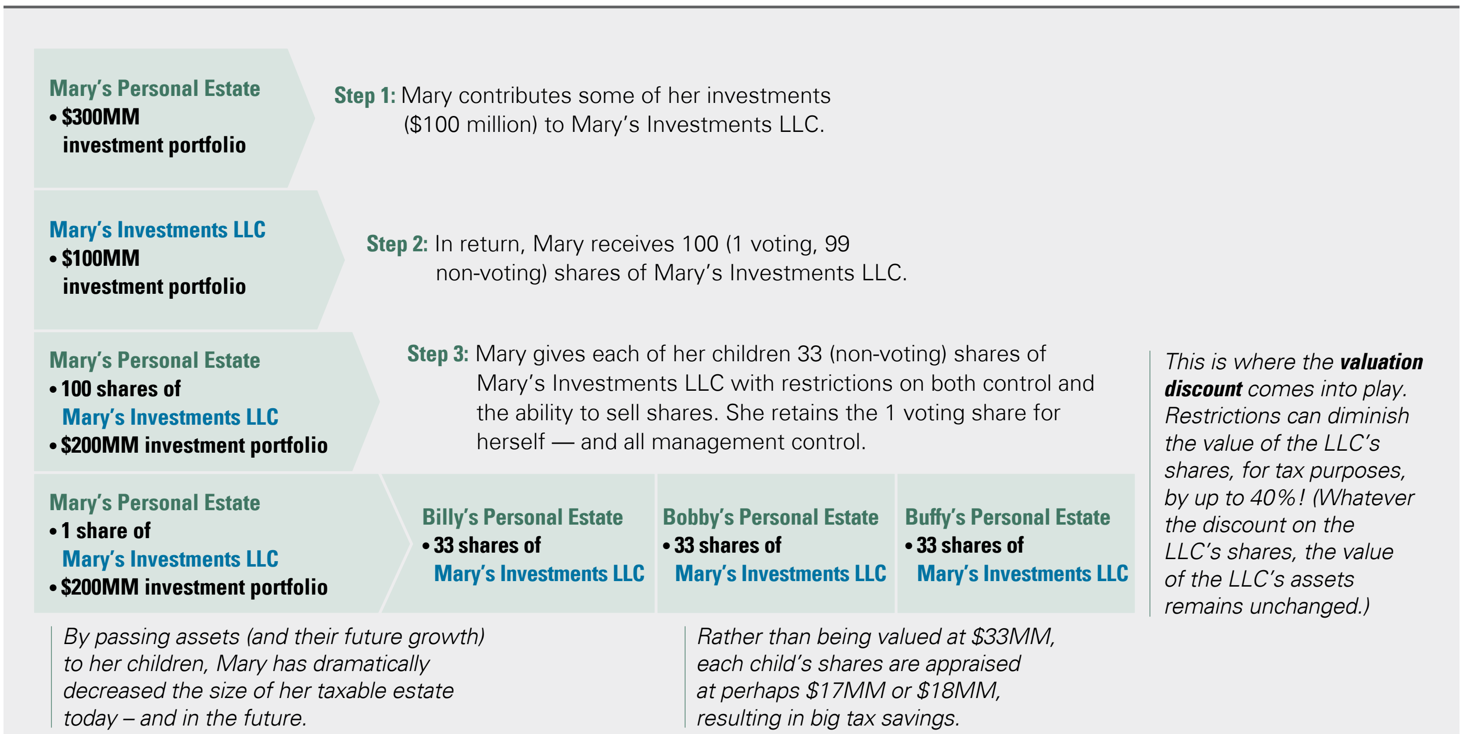
These valuation discounts, and the resultant tax savings, can be substantial, often ranging from 25% to 40%. And although forming a partnership and transferring ownership can itself be expensive — including legal, appraisal, and other fees — those costs are often negligible when compared to the tax savings that can be achieved.

Using other estate planning strategies along with this structure — such as sales to grantor trusts — can result in additional tax savings, perhaps dramatically so over longer time horizons.

Enter Section 2704

As late as the 1980s, several court cases had ruled favorably for families, permitting discounts to be recognized even when transferring interests in businesses to other family members.

The Freeze and the Valuation Discount: How It Works Today



Source: Bessemer Trust

However, the IRS began to scrutinize these partnership structures, particularly those that appeared to have been established solely to avoid taxes. Legislation to address them was just a matter of time.

In 1990, Congress enacted Internal Revenue Code Section 2704 to limit valuation discounts on FLPs and LLCs being transferred to family members.

Specifically, Section 2704 attempted to eliminate the application of any restrictions that 1) limit the ability of the new owners to liquidate the entity (this is commonly known as the lack-of-marketability discount), and 2) lapse or can be removed, unilaterally, by the family after the transfer occurs. (This law did not directly impact the lack-of-control, or minority interest, discount.)

But Section 2704 never achieved its intended results. In fact, it failed miserably. Why? The new law included an exception for any restrictions required by federal or state law. And many state legislatures, in response to Section 2704, updated their partnership and LLC statutes to include default limitations — restrictions on the rights of limited partners or LLC members to withdraw from the entity or to make transfers that would apply even if the governing documents were silent.

The upshot? These default state law rules fell within Section 2704's exception, and the rule's applicability to partnership and LLC transfers was dramatically reduced.

Family business owners have, as a result, continued to claim valuation discounts on transfers of partnership interests to their family members — valuation discounts that would, in the absence of the state-law exception, be limited under Section 2704.

Not surprisingly, beginning in 2003, various regulatory (issued by Treasury) and legislative (to be enacted by Congress) proposals designed to curtail what the IRS perceived as an end run around the law were discussed or proposed, but none was ever adopted. During this period, the IRS has continued to challenge valuation discounts in court, with sporadic success.

But now the Treasury Department has decided to issue new proposed regulations on its own — the first in a two-step process to reinvigorate Section 2704.

What Are the Proposed Changes?

- **Expanded application**: The scope of restrictions on an owner's ability to liquidate his or her interest in an entity will be disregarded for valuation purposes unless it is less restrictive than a *mandatory* restriction under state law that cannot be removed or overridden. Thus, state law default and optional restrictions may no longer justify a valuation discount when transferring interests among family members.

- **Expanded scope**: The current rules only apply to partnerships and corporations. The proposed regulations expand the class of entities covered under Section 2704 and its regulations to include limited liability companies, S corporations, and other business entities or arrangements.

- **New disregarded restrictions**: The proposed regulations also seek to impose an additional class of "disregarded restrictions" for valuation purposes. The new class of disregarded restrictions applies if the restriction on an interest holder's right to liquidate his or her interest in a family entity will lapse after a transfer, or if the transferor and his or her family can remove the restriction after the transfer.

- **Small non-family interests to be ignored**: The proposed regulations intend to prevent individuals from giving nominal interests to non-family members, such as charities, in order to avoid the requirement under Section 2704 that the family, acting alone, can remove a liquidation restriction that would otherwise support a valuation discount. To accomplish this, the proposed regulations provide a bright-line ownership test to determine whether the interest of a non-family member will be recognized for purposes of calculating a valuation discount (in particular, whether the family can remove a restriction).

- **(Very) old transfers still protected**: It is important to note that restrictions created on or before October 8, 1990 (when Section 2704 was enacted), will not be subject to the proposed regulations, so any amendments concerning such restrictions should be carefully considered to ensure available valuation discounts are utilized properly. Also, generally speaking, the new regulations will only apply to transfers in family entities made after the regulations are published as final regulations.

- **(Slightly) old transfers and the three-year "clawback" of discounts to formerly controlling interests retained by transferors**: The proposed regulations would include in an estate a "phantom asset" equal to the discount previously reported for transfers within three years of death, where the interest transferred caused a "lapse" of voting or liquidation rights. This three-year "clawback" may even apply to transfers made before the regulations are finalized, if the transferor dies within three years of making the transfer.
- **Uncertainty**: The proposed regulations are complex, and the degree to which they will impact valuation discounts remains unclear. The new rules could end up having little impact, or they could end up virtually eliminating some valuation discounts.

The (Often) Long and Uncertain Journey from Proposed to Final Regulations

It's important to remember that absolutely nothing changes immediately as a result of the Treasury's announcement. These are still only proposed regulations. That said, however, they reflect the government's perspective and must be taken seriously.

Not surprisingly, there has been significant activity within the estate planning community over the past few weeks, analyzing the proposed regulations and the authority of Treasury to issue them.

When Congress adopted Section 2704 in 1990, it granted Treasury authority to issue regulations to provide guidance and "rules of the road" as to the law. This is not unusual in tax law. Thus, Treasury likely has authority to issue relevant regulations, but it is still possible, if not likely, that an aggrieved taxpayer will lodge a legal attack arguing that the scope of the final regulations exceeds Treasury's authority.

In fact, in 2015, before the new regulations had been formally proposed, the Treasury Department provided indications regarding their likely content, and many planners were critical of the then-described approach. In fact, Chicago attorney Richard Dees published a 29-page "letter" to the IRS. He carefully analyzed at length potential legal concerns regarding any changes to the valuation discount rules and argued that the new regulations would likely be declared invalid if finalized. Treasury delayed releasing its rules until now, and the proposal in 2016 is markedly different than what was hinted at in 2015. This illustrates the complexity of the regulatory and legislative process, and perhaps the kind of pushback Treasury is likely to receive.

If challenged in court, it could be several years before appeals are exhausted. As an example, it took 10 years before a court ruling invalidated a small part of the regulations for a similar law, Section 2702. However, the regulations may still be the law of the land while a final determination is pending.

So What Should You Do?

Even though we don't know exactly what the final regulations will say, when they'll become effective, or whether they'll survive almost-certain litigation, it's probably safe to assume that obtaining valuation discounts on family business transfers will be more difficult in the future than it is today.

That means if you're considering a transaction that might engender a valuation discount, it may be that the sooner you complete it, the better.

It's worth mentioning that, even under current regulations, the business purpose for a non-operating family entity is critical. That means finding real reasons — beyond the desire for a tax break — for creating a partnership or limited liability company to hold publicly traded securities, for example. If the IRS believes it to be obvious that the only reason for creating it was to take advantage of valuation discounts, the IRS is more likely to challenge its validity.

Thankfully, there are legitimate — and worthwhile — non-tax reasons for creating a family entity structure. For instance, providing the younger generation with access to investments (such as private equity or hedge funds) they wouldn't qualify to have access to without the pooled family investment fund may be a valid reason. Other examples practitioners suggest include the desire to transfer the business to the younger generation without giving up management control and the means to simplify a family's investment structures by consolidating ownership.

Appropriate reasons for creating an entity and transferring ownership will remain as valid and valuable as ever, no matter the changes to the tax code.

The bottom line is that the law has never been written in stone, and estate planning has never been a "set it and forget it" enterprise. Regulatory change — often unfavorable — is the rule. Here at Bessemer, we've been adapting our approaches to the shifting tax rules for more than a century. Whatever the new regulations turn out to be, we will — as always — adjust our planning strategies accordingly to achieve the most favorable results possible for our clients.

Frequently Asked Questions

What are these valuation discounts?

The proposed regulations involve two common valuation discounts: minority interest and lack of marketability.

Let's assume you own a family business valued at $100 million. If you decided to give 25% of the business to your child, it has been long acknowledged that it's not considered a *$25 million gift*. After all, 25% is a minority interest, and it would be difficult for your child to market those shares and turn them into cash. So, for tax purposes, the value of that gift can be discounted. The combined discounts may be in the 25%–40% range (depending on factors such as the type of assets and extent of restrictions). So, in this situation, the gift may be valued at $17–$18 million, resulting in big tax savings.

Does the discount apply only to operating businesses?

No. Let's say, instead of a family business, you put $100 million of publicly traded stocks into a family limited partnership. If you were to take one fourth of the partnership, representing $25 million of the portfolio, and give it to your child, the value once again may be able to be discounted for tax reasons. Again, that 25% transfer may be considered as though it's worth only $17–$18 million.

Does the IRS like these discounts?

Both of these valuation discounts have been around for decades, but that does not mean the IRS is happy about them. In fact, Congress enacted Internal Revenue Code Section 2704 in 1990 to limit these very discounts for transfers among family members. But estate planners have found ways around that law.

That's the backdrop to these new IRS-proposed rules, which are designed to reduce — or potentially eliminate — these two valuation discounts.

So what should I do?

Before answering that, it's important to stress that it is unknown *when* the regulations will become final. In fact, we don't even know *what* the final regulations will say.

But we do know three things:

1. They may become final as early as December 31, with part of the rules effective immediately, and the balance 30 days later.
2. The current proposals could be the final version of the law.
3. Once effective, a grace period for additional planning under the current rules will probably not exist.

So, if you have been contemplating using a valuation discount in your estate plan in the next few years, consider this a call to action. Talk with your advisors, especially your estate planning attorney, right away.

As always, your Bessemer team is available to answer your questions and discuss how the recent proposals might affect you and your family.

Our Recent Insights

Proposed Tax-Code Changes Target Valuation Discounts — Wealth Planning Insights (August 2016)

Liquidity Alternatives for Family Businesses — A Closer Look (June 2016)

Making a Difference: A Donor's Guide to Major Gifts — A Closer Look (April 2016)

Engaging the Next Generation Through Philanthropy — A Closer Look (March 2016)

Family Meetings — An Important Strategy for Preserving Wealth — A Closer Look (March 2016)

Tax Extender Legislation — A Positive Step on the PATH to Tax Reform? — A Closer Look (January 2016)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 100 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

This material is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation, or needs of individual clients. This material is based upon information from various sources that Bessemer Trust believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy of completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

ATLANTA • BOSTON • CHICAGO • DALLAS • DENVER • GRAND CAYMAN • GREENWICH
HOUSTON • LONDON • LOS ANGELES • MIAMI • NAPLES • NEW YORK • PALM BEACH • SAN FRANCISCO
SEATTLE • WASHINGTON, D.C. • WILMINGTON • WOODBRIDGE

Visit us at bessemer.com

© 2016 Bessemer Trust Company, N.A. All rights reserved.