On August 2, 2016, the IRS issued proposed regulations under Section 2704 of the Internal Revenue Code that would effectively eliminate an important gifting strategy that families with large estates frequently use to minimize transfer taxes. These new regulations are not yet effective, but could become so, either as drafted or in part, by the end of 2016.

IRS Plans to Eliminate Valuation Discounts for Gifting

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On August 2, 2016, the IRS issued proposed regulations under Section 2704 of the Internal Revenue Code that would effectively eliminate an important gifting strategy that families with large estates frequently use to minimize transfer taxes. These new regulations are not yet effective, but could become so, either as drafted or in part, by the end of 2016. Between now and then, there is a window of opportunity in which to take action.

Background

Taxpayers are currently allowed a lifetime exemption of $5.45m (indexed for inflation) for gift, estate and generation skipping transfer tax purposes. If they give less than this amount to their heirs during lifetime and at death, then no federal transfer taxes are due. Taxpayers with significantly larger estates will owe transfer taxes on the excess unless they can reduce their estate accordingly.

One strategy that such taxpayers have used to minimize these taxes is to take advantage of valuation discount planning to reduce the value of gifts to family members for transfer tax purposes. Valuation discounts are most frequently created by establishing entities such as partnerships or LLCs to hold investments and businesses, and then transferring fractional interests in these entities to heirs. These fractional interests are often restricted in many ways. The owner of the fractional interest frequently cannot liquidate their interest, nor can they control the investments of the entity. Because of these restrictions, case law has developed allowing taxpayers to take discounts for transfer tax purposes to reflect the restrictions.

As an example, assume a parent has created a partnership worth $10,000,000, and gives his child a 40% limited partnership interest nominally worth $4,000,000. The partnership will liquidate in 2066 unless all of the partners unanimously agree to an earlier liquidation. Under current rules, the limited partnership interest could be discounted for transfer tax purposes, perhaps to $3,000,000 (this value is hypothetical; the exact discount and resulting gift value must be determined by a

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valuation expert). The discount takes into consideration the fact that in a willing seller / willing buyer scenario, a buyer would pay less than $4,000,000 for a 40% interest in a $10,000,000 partnership where they can't liquidate their interest or control the investments.

Impact of the Proposed Regulations

The proposed regulations would disregard restrictions on transferability, essentially treating the gift recipient as if he or she had the right to redeem their interest in the entity for its full fractional value. This could have the effect of practically, if not entirely, eliminating the minority and marketability discounts. The opportunity to make a $4,000,000 gift using just $3,000,000 of lifetime exemption would be gone.

Window of Opportunity

The IRS is seeking comments from the public regarding the proposed regulations and has scheduled a hearing for December 1, 2016. After the hearing, the IRS will incorporate any final revisions and issue the final regulations which will take effect 30 days after release. They will not, in other words, have retroactive effect there is still time to act. Please contact us if you would like us to help you determine whether you may be able to take advantage of existing strategies prior to the proposed regulations taking effect.