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Should Proposed Regulation Changes Affect Your Year-End Planning?

Helpful tax planning tips and what wealthy families need to know about the proposed tax regulations before completing their year-end planning.

While there are no major changes to 2016 tax rates and contribution limits, long-anticipated major proposed regulations under Internal Revenue Code Section 2704 (Proposed Regulations), released on August 2, 2016, would make significant and far-reaching changes to the valuation of interests in many family-controlled entities with respect to estate, gift, and generation-skipping transfer taxes.

To help navigate these proposed regulations, Jeff Bezanson of Fidelity Family Office Services talked with Joe Comeau, Managing Director of Andersen Tax, and Allan Zachariah, Co-Chief Executive Officer of Pathstone Federal Street, to understand how the Proposed Regulations may affect you.

Jeff: Can you provide some background on valuation discounts and what tax planning strategies are at risk for wealthy families with the Proposed Regulations?

Joe: Section 2704 was enacted in 1990 as a part of Chapter 14. The goal in particular was to limit discounts for certain family partnership or LLC interests that are transferred to family members and to attack several perceived loopholes in the estate and gift tax laws.

Since then, a valuation discount has been available to families who make intrafamily gifts. For example, in the case of a family limited partnership or a family business, interests in the entity may be gifted subject to certain restrictions on transfer or liquidation.

The Proposed Regulations attack, with artificial rules, what Congress and the judicial system have consistently blessed: valuing closely held enterprises fairly by taking into account market realities for equity that is not publicly traded.

Today, transfers of equity stakes in those entities may take into account objective valuations that consider the impact of lack of liquidity, control, and marketability. The Proposed Regulations largely eliminate the well-settled, objective methodology and replace it with a brand-new artificial construct. The proposed rules make a halfhearted attempt to protect operating family businesses, but the new rules cast a wide net nonetheless.

Allan: If the Proposed Regulations go into effect as written, they will have a dramatic impact on estate planning for owners of family-controlled entities. Most significantly, these rules prohibit any meaningful discount for lack of control or lack of marketability in connection with the transfer of an interest in a family-controlled entity, even if the entity operates a business.

Jeff: What are valuation discounts?

Allan: If a transferred asset represents a minority interest in a business, then a reduction in the value of the asset is typically allowed, known as the "Minority Discount."

A reduction in the value of an asset transferred is commonly allowed if the asset transferred has an inherent lack of marketability, such as a house, a farm, or collectible items. The interest in a closely held business or partnership interests might also be short of marketability as they are often more difficult to sell than other interests, such as a bank certificate of deposit (CD) or marketable securities.

Jeff: What is the timing around the Proposed Regulations?

Joe: The rules are currently proposed. A hearing on the proposed limitations will be held on December 1, 2016.

Since the Proposed Regulations are being pushed by the current administration, they likely must become final by the time the new president comes in. If not, the new administration will have a say. If they agree, the regulations could become effective in 2017. If they do not agree, they will likely get pulled, and we are back to the drawing board.

Allan: It is unlikely that the Proposed Regulations will become effective before the end of 2016. There is also some question whether the Proposed Regulations exceed the regulatory authority of the Treasury Department under § 2704, but that issue will not be resolved until a court considers the regulations long after they have been finalized.

Jeff: Will the Proposed Regulations apply only to transfers that occur after the effective date?

Joe: The Proposed Regulations apply only to lapses and transfers occurring on or after the date the proposed regulations are published as final regulations. The one exception is that the new rule on disregard restrictions applies only to transfers occurring 30 or more days after the date the Proposed Regulations are published as final regulations.

A new "three-year rule" might apply, however, to transfers made before the effective date if the transferor dies after the effective date but within three years of making the initial transfer.

Many families are scrambling to make equity transfers before year end in order to make use of the current law that allows valuation discounts.

Jeff: What is the value to families considering accelerating gifts via a family limited partnership (FLP) or limited liability company (LLC) before the Proposed Regulation effective date?

Joe: Ranges of discounts are quite wide, as the amounts are a function of the kind of asset being transferred and the circumstances of that asset. Discounts of a few percentage points to 50% are possible under today's law.[1]

Any family that is considering taking advantage of valuation discounts on intrafamily gifts should consider making those gifts before December 1.

Allan: Families that have previously made gifts or sales of existing FLP or LLC interests and have been considering additional ones should act before the effective date of the final regulations to ensure the more favorable valuation discounts. Of course, they should consult their tax advisor, who is most familiar with their situation.

Jeff: If a family wishes to gift and chooses to establish an FLP or LLC, what types of assets can be gifted, and what would be examples of the potential discounts?

Allan: There are many non-tax/economic reasons for families to put assets in to a family FLP or LLC. Economies of scale, asset protection, ease of administration, etc. The gift or sale is usually in the interest of the FLP or LLC. Any potential discounts will be driven by the nature of the underlying assets in the entity and the operating agreement of the entity.

An LLP of marketable securities would generally have less discount than one holding an operating company.

Jeff: If a family has used their lifetime gift exemption, could there be any additional value in further funding an FLP or LLC?

Joe: Of course a client who has no more lifetime exemption has no more room for error on gift values. Gifts or transactions involving discounts for them will mean they should consider whether they can stomach a lower discount or a fight in the event of an IRS audit. Since gifts are typically irrevocable, this could be an important consideration.

Allan: Clients that have used their lifetime exemption can still utilize various techniques to "freeze" the value of assets in their estate via a sale or by utilizing a Grantor Retained Annuity Trust (GRAT). I prefer a sale for nonmarketable assets such as interests in closely held family entities and a GRAT for concentrated interests in public securities.

Jeff: Despite the Proposed Regulations eliminating most valuation discounts, what are the benefits to families when using FLPs and LLCs?

Joe: FLPs or LLCs should be a core element of any family's plans. They provide significant benefits in productivity and confidentiality as well as superior financial controls. Even if the government eliminates proper discounts, families should continue to use these tools for their other benefits.

Allan: Some of the benefits include:

- Allowing continued centralized management of assets after the parent dies or becomes incompetent
- Allowing the older generation to shift management responsibilities to the younger generation

- Possibly reducing family fights concerning management of assets, since management may be centralized in general partner or manager
- Protecting assets from claims of creditors of the partners/members
- Better returns for partners since they are investing a larger amount, instead of each partner investing separately
- Opportunity to train younger generations in managing and preserving family assets for future generations
- Limited partners with no say in the investment or operation of the entity, and no say in distributions to the partners
- Possibility to limit the transferability of the partnership interest — keeping out undesired owners, such as ex-spouses
- Ability to allow the parent to retain control of the management of the assets (but see below for IRS problems)
- Limited liability for debts of the entity (except for the general partner)
- Allowing gifts of interests in property without having to actually separate ownership — gift of a limited partnership interest rather than an undivided interest in the underlying asset
- Amendable
- Avoiding ancillary probate proceedings on out-of-state real property

Year-End Planning: Tips and Reminders

Jeff: As 2016 comes to an end, can you share any additional timely and relevant planning ideas you are talking with wealthy families about?

Joe: At this time of year we spend a lot of time with clients, helping them think through the proper tactics for minimizing the drag that tax cost has on their lives. Here are the core items that most should consider:

- Tax-loss harvesting should be a year-round discipline. As long as it is done without adding investment risk, it can be a great tool to minimize current taxable gains.
- Tax-efficient charitable giving is a must. Too many people are so busy that they just write checks. But when they understand how to take that single deduction and transform it into a double deduction with appreciated stock, they become converts. There are several easy ways to use appreciated stock, even when you like to make relatively small gifts, too.
- People should be looking carefully at whether their otherwise deductible expenses are really giving them a tax break. The AMT and deduction limits often eliminate or reduce the tax subsidy deductions that they were supposed to preserve. Investment expenses, especially in this environment of reduced returns but still high cost, are very often completely nondeductible unless proper planning is done.

Allan: I like asset freezes. In this continued low-interest-rate environment, the ability to freeze the value of an asset in a client's estate and transfer all of the appreciation to the next generation is very powerful. GRATs and sales to Intentionally Defective Grantor Trusts are wonderful planning ideas within this concept.

Jeff: We thank you, Allan and Joe, for your insights and planning perspectives. We encourage clients or prospective clients to speak with their tax or estate professional to understand which strategies are appropriate for them. If clients would like an introduction to a professional, we are happy to help.

Additional planning topics clients can contemplate before year-end are listed below. Although each tax move in and of itself can seem nominal, in aggregate and over time, particularly across multiple family members, together they can make a meaningful difference.

- Contribute to a tax-advantaged retirement plan
- Qualified Charitable Distributions: Remains at $100,000
- Minimum Required Distributions
- Annual Gift Tax Exclusion: Remains at $14,000
- Give appreciated securities rather than cash,[2] and consider donating complex assets
- Six tax-saving tips to complete by year-end
- Year-end strategies for charitable giving
- Understanding estate and gift tax rules
- 2016 Ordinary income and short-term capital gains tax rates

At Fidelity Family Office Services, we provide custody, brokerage, investments, and reporting services to single family offices, wealthy families, and the advisors that support them. We are not a fit for everyone, so we spend a great deal of time getting to know family offices and how we would best serve their needs. It is important that our clients are a good fit for our offering and our culture.

Joseph Comeau

Managing Director, Andersen Tax

Joe Comeau is the Office Managing Director of Andersen Tax's Boston office as well as the current national Client Group Leader for the Private Client Services practice. He has over 30 years of experience in serving the financial, tax, investment, and estate-planning needs of high-net-worth individuals and their families.

Joe has spent his entire career in New England and has a strong connection with the technology, venture-capital, and financial communities there. His experience includes working with companies from small startups to Fortune 500 multinationals. He has extensive experience in bringing valuable business perspective to families and entrepreneurs who may be faced with new opportunities and unfamiliar financial decisions. As a member of a large family of his own, Joe has firsthand experience with family dynamics, which helps him appreciate many of the nonfinancial issues that challenge his clients as they consider their financial options. Joe's insightful, businesslike approach helps him provide his clients creative, practical, and understandable ways to achieve their family financial objectives.

Before joining Andersen Tax, Joe was a Tax Partner at Arthur Andersen, where he worked with successful entrepreneurs, their families, and their businesses.

Allan Zachariah

Co-Chief Executive Officer, Pathstone Federal Street

As Co-CEO of Pathstone Federal Street, Allan J. Zachariah supervises a highly experienced, multidisciplinary team of specialists that delivers comprehensive family office solutions to high-net-worth individuals and families. Allan, a partner, is also a member of the firm's Executive Committee and Board of Governors.

Prior to Pathstone Federal Street, Allan was an Executive Managing Director of Pathstone Family Office. In 2000, as a Managing Director of Harris myCFO, he opened the Atlanta office of myCFO and led the office through a period of significant growth, increasing assets under advisement to more than $1 billion during his tenure. He also assisted in the opening of the Northeast office of Harris myCFO in 2006 and became Co-Managing Director of East Coast operations in 2007.

Allan has over 34 years of professional experience designing sophisticated wealth-transfer strategies for family businesses and high-net-worth individuals, and is a frequent speaker on wealth-transfer techniques and family office issues.

Allan has also served as a partner and National Director of Estate Planning for Grant Thornton LLP and as a partner and member of the National Estate and Gift Planning Team at BDO Seidman, both in Atlanta. He began his career as an accountant with the Louisville, Kentucky, office of Arthur Andersen developing the office's Family Wealth Practice and the Real Estate Service Group for Kentucky and Southern Ohio.

Allan earned his bachelor's degree in accounting from the University of Kentucky. He is a member of the American Institute of CPAs, the Georgia Society of CPAs, and the Board of Governors for the Buckhead Club. He is also a member of the National Board of Governors of the American Jewish Committee and the Advisory Board to the University of Kentucky Von Allmen School of Accountancy.

For more information, please contact your relationship team, call **866.273.2130,** or visit **familyoffice.fidelity.com**.

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[1]Consult a qualified appraiser when considering taking valuation discounts, as penalties may apply to discounts deemed to be too excessive. Be sure to document discounts taken and file all required gift tax returns.

[2]Charitable contributions of capital gains property held for more than one year are usually deductible at fair market value. Deductions for capital gains property held for one year or less are usually limited to cost basis. For contributions to public charities, deductions for cash donations are usually limited to 50% of adjusted gross income (AGI), while donations of securities with long-term appreciation are usually limited to 30% of AGI. Additional limitations and reductions may apply, especially to taxpayers in higher tax brackets. Excess charitable deductions can generally be carried forward for up to five years. Consult a tax professional regarding your specific tax situation.

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200 Seaport Boulevard, Boston, MA 02210

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