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The End of Valuation Discounts?

In a recent American Bar Association meeting, a Senior Treasury Department Official indicated that the IRS may issue proposed Regulations as early as this fall that would drastically restrict or eliminate valuation discounts for transfers of interests in Family Limited Partnerships ("FLPs"), Family Limited Liability Companies ("FLLCs") and other family entities. In order to understand the magnitude of this news, it is important to understand what valuation discounts are and how important they have been to strategic estate planning for high-net-worth families.

Valuation Discounts in General

One of the most popular estate planning techniques for transferring assets to future generations is the use of FLPs or FLLCs. There are many reasons that these entities are used, from centralized management of assets, to asset protection, marketing and branding. These entities can also help facilitate the transfer of financial wealth to subsequent generations while allowing the current generation to maintain control until appropriate. One of the greatest ancillary benefits to using these entities to make transfers is the availability of valuation discounts on the fair market value of the company interest.

Typically, when an FLP or LLC interest is transferred (by gift, sale or bequest) the IRS uses the fair market value ("FMV") of that interest to determine the amount of transfer tax that will be owed. FMV is generally defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a knowledge of facts surrounding the transaction. The fair market value of an FLP or LLC interest is determined from a number of factors, including the recipient's ability or inability to control the business after receiving the interest and their ability to sell the interest to others (liquidity factor). These two factors give rise to the two primary valuation discounts of *lack of control* and *lack of marketability*.

Lack of Control

The reason for the *lack of control* discount is fairly intuitive. If an individual is contemplating the purchase of a minority interest in a business and will have no control over management of the business, the amount and timing of distributions, whether to liquidate, merge or sell assets, he or she will value that interest less than if it included the ability to make such decisions. The *lack of control* discount simply recognizes this reality.

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Lack of Marketability

The *lack of marketability* discount also makes a lot of sense. If you purchase an interest in an asset that is not readily sold and converted to cash, that asset is not worth as much and you, as a buyer, will expect a commensurate discount for that lack of liquidity.

Amount of Discount

The value of the discounts for *lack of control* and *lack of marketability* vary, as they should, depending on the particular facts and circumstances of the parties. For example, a 49% minority interest has more ability to control the business than does a 10% interest holder and the discount percentage will be adjusted accordingly. The actual combined discount percentage is typically in the range of 25% to 45%. Because it is a facts and circumstances determination, it is important to have an expert value the property and determine the amount of the discounts. However, even if a conservative combined discount of 25% were used there would still be enormous tax savings.

For example, if a senior family member decided to place $10,000,000 worth of assets into an FLLC and then transferred 90% of the FLLC units (nonvoting units subject to transfer restrictions) equally to each of his three children, taking only a 25% combined discount for *lack of control* and *lack or marketability*, he could transfer that 90% interest, valued at $9,000,000, for a gift tax value of $6,750,000, saving him or her $900,000 in gift tax ($2,250,000 * 40%). If the senior family member had not used his federal gift tax exemption (currently $5.43 million) then he or she could have made the entire transfer with discounts and only incurred $528,000 in gift tax. Without the discount, the senior family member would have incurred $1,428,000 in gift tax.

The amount of the discount can also vary based upon the type of assets the company owns. An FLLC comprised of $10,000,000 in cash is deemed to be a more liquid type of entity as opposed to an FLLC that has multiple assets classes such as real property, stocks, bonds and other marketable securities. Often times, in the family setting, the FLLC may own assets that are even less marketable and therefore harder to sell, like a family owned business, etc. The less liquid an underlying asset owned in the FLLC is, typically the larger overall discount on the FMV of the company interest.

Planning Considerations

As you can see, the tax savings using these discounts is phenomenal. For this reason, the IRS has been fighting these discounts for years. In early years the IRS was victorious in showing that a family had implemented this type of structure only for the purposes of avoiding taxes, which is not considered a valid business purpose. Planners therefore got wise and have structured the use of FLLCs properly and the IRS has been losing in court on their challenges against discounts. As a result, there has been a push to actually legislate or regulate against a person's ability to accurately value the interest of their company if the valuation is to support planning in a family context.

Very recently, in an American Bar Association Tax Section meeting, Cathy Hughes, from the Department of Treasury's Office of Tax Policy, hinted that proposed regulations may be released this fall (possibly as early as September 2015) that drastically reduce or eliminate the valuation discounts for FLPs, FLLCs and other family businesses. These "hints" are never taken lightly by the planning community and cause us some concern about the potential loss of this useful and reasonable tool.

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Families who are thinking of transferring assets by way of an FLP, FLLC or other family business should take care to make such transfers prior to the release of these new regulations.

If you have any questions or would like to discuss potential planning opportunities, please contact us at info@yorkhowell.com

York Howell & Guymon is a boutique law firm focused on estate planning, asset protection, business planning, and real property. York Howell & Guymon has estate planning attorneys licensed to practice in Alaska, Arizona, California, Idaho, Nevada, Texas, Utah, Washington and Wyoming.

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