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Are Valuation Discounts Almost a Thing of the Past?

Ideas and Considerations for Passing Wealth to the Next Generation Before the IRS Makes a Change

One of the biggest questions that our clients frequently ask us is "How can we pass on our family's wealth to our children, and minimize the portion that is lost to estate and gift taxes?" At First Long Island Investors, we have worked with many clients and their outside professionals to answer that question, and we have developed different and creative ways to reduce the estate tax burden so that more wealth is passed on to the next generation. Valuation discounts, one of many estate planning strategies that we have successfully implemented for clients are being threatened by proposed new government regulations. Now is the time to consider if this strategy is right for you and to take action before year-end.

Many wealthy taxpayers have contributed real estate or a family business into a family controlled entity (e.g. a family limited partnership), and have taken advantage of these available (and legal) discounts, to reduce the gift tax value of the interests in the entities that have been transferred to the next generation. The valuation discounts are based on the lack of control and illiquidity of interests in these family controlled entities, which are caused by restrictions that are built into the shareholder or partnership agreements.

Here is an example of how discounts can translate into real tax savings. A husband and wife have a $15 million estate which includes $5 million of real estate. The couple contributes the real estate to a family limited partnership ("FLP") and then gifts a 40% limited partnership interest to each of their two children, retaining a 19% limited partnership interest and a 1% general partnership interest for themselves. Since a limited partner cannot force the FLP to sell its interest in the real estate or even make any cash distributions to partners, the minority limited partnership interests in the FLP holding a non-controlling interest in the real estate are each worth less and should be valued accordingly. The 80% of limited partnership interests transferred to the children might be appraised, net of discounts, at $2.4 million, even though they hold real estate with an underlying value before discounts of $4 million. The discount has reduced the taxable estate by $1.6 million from this one transaction. This translates to approximately $640,000 of federal estate tax savings, not to mention the state tax benefits that may also be derived, if they live in New York or any other state that imposes an estate tax.

The IRS is working to prevent taxpayers from utilizing valuation discounts like these in the near future and has proposed regulations which would limit the ability of taxpayers to use valuation discounts on transferred interests in closely held family entities. Not all proposed regulations get adopted, but if these do get adopted they will be effective for all transfers made 30 or more days after the regulations are finalized.

The earliest that these new regulations could go into effect is December 31, 2016, so the time to take action is now. If you are considering making a gift of this type (utilizing a family entity and taking a discount), then you should try to get it done by December 31st. There are several steps to this process:

- First you would need to determine if you are subject to gift or estate taxes, so that you would benefit from any available valuation discounts. Typically, clients who expect to pay any gift or estate tax (all individuals with assets over $5.45 million or married couples with assets over $10.9 million (*under current law*), or anyone who has already made large (million dollar plus)

lifetime gifts) would be a candidate for this type of gift.

- Second, you would need to be comfortable making a lifetime transfer of a portion of your wealth to your children (i.e. – you can live without the income that the gifted assets generate). This can be done in trust if you prefer not to make an unrestricted gift.

- Third, you would need to be able to contribute real estate or a family business to a family entity (if you haven't already done so) and gift a portion of it to your children. You can also contribute marketable securities to this entity, but it is best if the entity does not contain only marketable securities. This gift can be discounted for tax reporting purposes, and that is the benefit of this structure.

Investors who meet the above criteria, should talk with their wealth management, legal and accounting professionals in evaluating this tax saving estate planning strategy.