Last Call for Valuation Discounts?

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Earlier this month, the IRS announced a proposal that would eliminate a tax planning strategy relating to discounts on transfers of interests in Family Limited Partnerships and other family owned entities. By way of background, Family Limited Partnerships (FLPs) are legal entities designed to help pass down wealth to future generations by allowing the General Partner (typically a parent) to transfer interest in the FLP to one or more Limited Partners (typically children) over time. FLPs can hold a variety of assets ranging from concentrated stock positions to privately owned family business to real estate portfolios. Since the Limited Partners often have no control over the FLP and cannot readily sell their interests, valuation discounts may be applied for gift tax purposes.

The concept of valuation discounts has been around for decades. In fact, in 1990, Congress passed an act under Section 2704 of the Internal Revenue Code that was actually meant to address the perceived abuse of these discounts among family owned entities. As tax law has evolved, however, the act became less effective and a number of discounts still exist that are frequently used by financial advisors, accountants and attorneys alike.

For example, assume a couple holds $20 million of assets and would like to use some of their combined lifetime gift exemption of $10.9 million to transfer 20% of these assets to each of their two children. If done outright or through a trust, the gift would be valued at $4 million per child. If, however, the assets were first placed into an FLP and then transferred to their children, a valuation discount of say 30% might be applied to the transfers due to the lack of control and marketability associated with the children's ownership interests. This would reduce the value of each child's gift from $4 million to $2.8 million for tax purposes – at least for now.

The U.S. Treasury Department is looking to close this so-called loophole by prohibiting the use of valuation discounts going forward, particularly for closely held businesses. There has been chatter around this for some time but just recently it was formally announced that the proposed regulations will be put forth in a public hearing scheduled for December 1st. Should the law pass, some of the changes could take effect as soon as early next year.

What does this mean? As the title states, we could be facing a "last call" of sorts to take advantage of the current valuation discount laws. It is worth considering another round of wealth transfer planning before year-end if you have used (or have considered using) FLPs as a conduit since any action taken today will be grandfathered in under the existing law. Please speak with your Client Advisor about how these proposed regulations may impact your estate plan and potential planning strategies to consider over the coming months.

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