POTENTIAL REGULATIONS MAY LIMIT VALUATION DISCOUNTS FOR FAMILY ENTITIES

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Over the years, many of our family clients have used limited partnerships or limited liability companies ("LLCs") to gift ownership interests to junior family members. Utilizing careful planning, discounts for lack of control (also known as "minority interests") and "lack of marketability" have enabled families to move value to succeeding generations on a discounted basis, thereby minimizing their gift or estate tax liabilities. The Internal Revenue Service has attacked these discounts as perceived abuses, but has had limited success when challenging properly planned entities.

When partnership or LLC units are gifted from one party to another, the gift is required to be reported on a gift tax return at its "fair market value". Fair market value is usually derived by taking the value of the underlying assets of the LLC and then discounting that value to account for various restrictions placed on the donee by the governing document of the entity. The IRS theory is that these restrictions are artificial since the family controls the entity, and has litigated these cases for many years with a heavy dependence on the facts and circumstances in each case. In recent years, President Obama has included proposals in the Administration's fiscal year budgets to restrict or eliminate valuation discounts on transfers of interests in family controlled entities. But without the support of Congress, no legislation has emerged.

However, the Treasury Department now believes it can bypass legislative action and implement regulations under Internal Revenue Code §2704 that will effectively limit the ability to utilize these discounts when transfers occur among family members. Given recent communications from Treasury officials, it is anticipated these new regulations will be issued this Fall, as early as mid-September.

Regulations of this nature are often issued first in "proposed" form, to seek comments and to make revisions prior to releasing "final" regulations. The effective date of these regulations could be as early as the date the proposed regulations are issued, or possibly the date the regulations are issued as final. Transactions completed before the effective date are likely to be

grandfathered, though it is very possible grandfathering will not be available for family entities created before the effective date if the transfer occurs after the effective date.

Once these regulations are issued, it will be interesting to see how narrow or broad the language is applied to family controlled entities in connection with an intra family transfer. Whether the new rules will only apply to passive holding companies or actual operating companies is a source of speculation. For example, if a family owns a furniture store and the parents want to transfer ownership interests to their children, discounts may possibly be allowed. If a family only owns marketable securities, real estate, or other passive investments, and wants to transfer ownership interests to their children, the discounts would be denied. On the flip side, given that federal estate tax exemptions are now over $10 million per married couple, the family may actually achieve income tax savings by not transferring the property during the parents' lifetime since property held at death receives a "step up" in basis which could result in significant capital gains tax savings for the children.

In any event, families whose financial and estate planning may be impacted by this expected development should consider whether prompt action must be undertaken.

As always, we appreciate your confidence in our planning, and welcome any questions about your individual situation.

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