Client Update (July 2015) Treasury Department may Limit Discounting

Newsflash: Treasury Department Contemplating Regulations to Limit Discounts for Interests in Family-Owned Entities

A client once observed that there is no lower form of economic investment than being a minority owner of a closely-held business. Minority owners, absent some form of agreement such as a shareholders agreement or partnership agreement, do not have the ability to control the business operations, and cannot monetize their investment at will. Moreover, it is very difficult to sell minority interests in a closely-held business to a third party because the buyer too will be handcuffed in its ability to control when and how to ultimately cash out (in addition to being subject to the management whims of others). Because of this "lack of control" and "lack of marketability", minority interests are generally valued at a discount compared to what the owner's pro rata share of the liquidation value of the entity might be absent such discounts.

Estate planners have long used this concept in facilitating planning for clients. By way of example, a family might create a limited partnership, with children investing $100,000 for a 1% general partner interest, and parents investing $9,900,000 for a 99% limited partner interest. Upon the death of the parents, or in connection with lifetime gifting, the limited partner interest would be worth less than $9,900,000, because of the discounts for lack of control and lack of marketability. Depending on the underlying assets, it is not unusual to see those discounts range from 20% to 35% (bringing the value in our example above to as low as $6,450,000). With a 40% federal estate tax rate, that savings in valuation translates to very significant estate and gift tax benefits.

One can imagine that the entire discounting process does not appeal to the IRS. Various means of challenging discounts have been used. It is important that clients follow the formalities of entities like limited partnerships, and the failure to do so can result in the loss of discounts (if the client won't treat the partnership properly, why should the IRS?). The tax law was modified in 1990 to provide that certain types of planning with closely-held family entities would have special valuation rules. But that legislation didn't prevent discounting. For many years, proposals have been floated by the administrations to eliminate discounting in family settings.

The rumor is now rampant that the Treasury Department is prepared to take things into their own hands by issuing Regulations that would affect the ability to claim discounts in family-controlled entities. Although this has been widely reported in both the general and tax presses, we are faced with the following unknowns:

- we don't know when these Regulations might be issued, although the rumor is sometime this year
- we don't know what the Regulations might cover - for example, will they apply equally to a securities-only family limited partnership as to an operating business that is owned by related persons?
- we don't know how the Regulations will be applied - will they affect prior transactions involving family entities? or only prospective transactions?

As a result of the potential for the issuance of Regulations governing discounts for closely-held family entity interests, now could be the ideal time to consider this planning. If you have any questions, please do not hesitate to contact us.