The FLP Valuation Discounts and What It Means for You

(The Claws Come Back Out

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On August 2, 2016, after years of unanswered requests to combat both the lack-ofmarketability and lack-of-control valuation discounts for family businesses by the IRS and the Treasury to Congress, the Treasury proposed new Section 25.2704 regulations. The Treasury hopes these regulations will close loopholes in the valuation discounts that apply to family businesses. IRC Section 2704 was passed in 1990 in an attempt to curb aggressive valuation discounts but in the years since, the courts and state law have largely made those statutes an ineffective tool against valuation discounts. The annual gift tax exclusion amount is that amount taxpayers can gift annually without being taxed. The Act did not impact the annual gift tax exclusion amount. However, the IRS announced that the annual gift tax exclusion amount increased in 2018 from $14,000 to $15,000 per recipient due to inflation.

The proposed regulations will implement three major changes. First, a bright line rule will be used regarding transfers within three years of death. If transfers within three years of death result in a lapse of a liquidation right in the transferor, inclusion in the transferor's gross estate for federal estate tax purposes will occur. This three year look back rule is similar to the one set out in IRC Section 2036 with one major exception, there does not seem to be an exception for transfers for adequate and full consideration in money or money's worth made within three years of the transferor's death. The value of the transfer will be determined under Section 2704(a) (2) as the excess of the value of all interests in the entity held by the transferor immediately before the lapse over the value of the interest immediately after the lapse. The Act increased the amount of cash contributions to charities that a taxpayer may deduct from 50% to 60% of the taxpayer's contribution base (generally equivalent to adjusted gross income), for contributions made after 2017 and before 2026.

Second, the proposed regulations will result in a shift away from looking only at restrictions that are "more restrictive" than available state law for valuation purposes. This means that, state imposed "applicable restrictions" on an individual's ability to liquidate an entity will no longer be excepted if the ability to liquidate can be subsequently changed by family members. In other words, under the proposed regulation, the IRS will ignore all restrictions except mandatory restrictions when determining value. Therefore, families can no longer agree to implement stricter restrictions with the option of waiving them at a later date, nor can discounts be obtained by splintering the ownership into smaller pieces if the family as a whole still clearly maintains full control.

The third set of rules under the proposed regulations implement new "disregarded regulations" which are more restrictive than the "applicable restrictions" where a family continues to retain control after the transfer. The disregarded restrictions, as proposed by the regulations impose a limitation on the recipient's ability to redeem or liquidate a business interest and limits the payments due to the recipient on liquidation or redemption, where said restrictions or limitations lapse or may be removed by the controlling family after the transfer. Unlike the applicable restrictions, disregarded restrictions make no reference to the limits created by state law. These disregarded restrictions make no reference to the limits created by state law. These disregarded restrictions include anything that:

a) limits the interest holder's ability to liquidate the interest; b) defers the liquidation payment proceeds more than 6 months; (c) permits liquidation proceeds to be paid in any manner other than cash or other property; and (d) limits the liquidation proceeds to any amount less than a "minimum value" (the fair market value of the entity, reduced by any of the entity's outstanding obligations).

Further, these regulations would expand from only including corporations and traditional partnerships to including LLCs and other "arrangements that are business entities." These regulations will end most FLP valuation discounts but will not affect transfers made before their effective date. Further, in determining the basis for valuing the business under Section 2704, the proposed regulations would use the business' asset values, not the business as an operating business. Therefore, families or individuals who face estate tax exposure (over the $5.45 million exemption amount, for individuals) should consider establishing a family business, if one is not already established, and transferring shares of said business to take advantage of the minority and marketability discounts before the proposed regulations take effect. This does not apply to the three year look back rule as proposed. Although an individual still risks having assets getting pulled back into his or her gross estate if the transfer occurred within three years of his or her death, those assets will be subject to the value as determined by the then applicable marketability and minority discounts if made before the regulation becomes effective, plus there is an added benefit of gifting assets during life, the appreciation is out of your estate.

In conclusion, it would be advisable for individuals who face estate tax exposure to seriously consider the potential impact of the proposed regulations. Action should be taken during the public comment period which runs through November 2, 2016, which will be followed by a public hearing on December 1, 2016. It is likely that we will see final regulations at some time in 2017. Once final, families will be facing higher valuation and therefore more estate and gift taxes.

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