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"TAX TIPS: Treasury could curtail discounting practices"

Carl Grassi for Crain's Cleveland Business

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Estate planning attorneys have been using discounting techniques as an important part of wealth transfer planning for many years.

Recently, there have been indications that regulations will be issued soon by the Treasury Department that will significantly curtail this practice.

While the higher federal estate tax exemptions put in place several years ago have lessened the need for discounting for most people, those with taxable estates over the exemption amounts should consider whether action needs to be taken soon to take advantage of the current law.

Generally speaking, discounting involves the use of planning techniques that facilitate an estate and/or wealth transfer plan that makes assets less valuable for gift and estate tax purposes.

Discounting in its simplest form is often times achieved by transferring the assets to an entity (such as a limited partnership) that imposes restrictions on the ability of the owners to convert the assets into cash. Gifts of an interest in the limited partnership would be valued at less than the underlying assets in the partnership because there would be significant restrictions.

For example, typically, there is no way to convert the partnership interest to cash and no way to control the investment decisions or the decision to sell the assets.

The actual value of the gift would be determined by an appraiser, but even a modest discount from the fair market value of the underlying assets could save a considerable amount of gift and/or estate taxes.

The IRS has, over the years, fought this type of planning, especially where the assets consisted of marketable securities. There have been many cases in tax court where the IRS has challenged this type of discounting strategy, and it has had some success. Most of the taxpayer losses have been in situations where the partnership or LLC was not set up properly or the gifting was not executed properly.

There has been a fair amount of press this summer on the IRS plan to curtail this planning technique in a more formal and permanent way. Treasury already has been given broad authority to issue regulations limiting situations where discounts can be taken. Existing regulations provide that an “applicable restriction” is ignored when determining the value of an asset. An “applicable restriction” is one that limits the ability of a corporation or partnership to liquidate, if the restriction lapses or could be changed in the future by family members. A limit provided under state or federal law is not considered an applicable restriction, so these types of restrictions are permitted and can provide the basis for a discount on the value of an interest.

For example, under Delaware law, the general partners and two-thirds of the limited partners of a partnership have to agree to dissolve the partnership. While a valuation expert could take this restriction into account when valuing an interest in the partnership, he could not take into account a provision in the partnership agreement that required unanimous consent to liquidate, because this is more restrictive that what is provided by Delaware law. The new regulations could provide additional “applicable restrictions” that would be ignored for purposes of valuing an interest, reducing or eliminating the benefit of discounting.

All indications are that these regulations may be released soon. While most practitioners feel that an outright prohibition on marketability discounts would be beyond the power of the Treasury, there may be some room for Treasury to scale back the use of this technique.

The scope of the changes is unclear. Some practitioners feel, for instance, that the regulations may be focused on situations such as the one described above, where marketable securities are put into an LLC or partnership, if the primary purpose of the transfer is to generate a discount. Operating businesses might be left out of the new rules. The timing of the effective date of the regulations is also a question. Although these regulations would likely be issued as proposed regulations, these types of regulations are oftentimes made effective as of the date of initial publication, meaning there would be little or no advance notice that the changes were coming.

Regardless of whether regulations are imminent, it is perhaps time to review your estate plan and determine whether discounting could be a part of your overall wealth transfer plan. If so, the plan should probably be put in place as soon as possible because this wealth transfer planning technique that may not be available much longer.

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