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Latest Challenge by IRS to Family Valuation Discounts

Overview. Many sophisticated estate planning techniques include gifts, sales or other transfers to family members that incorporate significant discounts on the value of the property transferred. These discounts can range from 15 percent to 40 percent, or higher. As a result, significant wealth can be transferred to the next generation at greatly discounted values. Some of these techniques include transfers of fractional interests in real property or business entities such as limited partnerships, limited liability companies or closely held corporations. The amount of the discount depends upon a number of factors, including details of the organizational structure or provisions contained in the partnership agreement or operating agreement that place restrictions on control of the entity (*i.e.*, non-voting or non-managing or minority interests) and on marketability (*i.e.*, sales to third parties).

Standard for Determining Value of Interest. The standard for determining the value of the transfer under Chapter 14 of the Internal Revenue Code is the fair market value of the interest at the time of the transfer. Fair market value is the price at which the property would change hands between a hypothetical willing buyer and willing seller, neither being under any compulsion to buy or sell. For example, what would a third party pay for a non-controlling interest in an

entity with provisions that restrict voting rights and the ability to sell the interest to a third party? This standard disregards family relationships (*i.e.*, no attribution of interests owned by family members) in determining FMV.

IRC Section 2704. IRC Section 2704 was enacted in 1990 to curb perceived abuses by taxpayers in the context of provisions in partnership or LLC agreements that restricted the ability of a partner or member to force a liquidation of the entity. In these instances, 2704 provides that these restrictions are disregarded in valuing the interest being transferred to a family member (*i.e.*, no discount allowed). This does not include discounts for restrictions imposed by federal or state law or any commercially reasonable restrictions that would normally be used in an arm's-length business transaction (*e.g.*, lack of control and lack of marketability discounts).

Challenges by IRS Routinely Disregarded by Courts. Over the years, the IRS has tried to expand the reach of 2704 beyond liquidation restrictions and argued that all restrictions (including those currently resulting in discounts for lack of control and lack of marketability) should also be ignored for

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transfers between family members. In most properly structured transactions, the courts have rejected the arguments by the IRS and permitted the taxpayer to take appropriate discounts on the transfer to family members. Because courts were unwilling to accept the position of the IRS that these discounts should be ignored when the transfer was between family members, the IRS in 2009 sought legislative assistance to revise Section 2704. To date, no legislative change has been forthcoming.

New Proposed Regulations Under 2704. Under Section 2704, the IRS was given broad authority to issue regulations to implement the intent of 2704. The IRS and Treasury Department have indicated new proposed regulations under 2704 are in the works. Cathy Hughes of the Treasury indicated in May that five trust and estate regulation projects were underway and that she expected certain proposed regulations would be released by September of this year. Many practitioners assumed this meant the 2704 regulations would be released by September and have encouraged clients to accelerate gifts prior to enactment. We believe Hughes may have been misquoted. While Hughes was noncommittal as to when the 2704 regulations would be completed, she listed the order in which the five projects would be completed; the 2704 regulations were last. Two of the five regulation projects have been completed. The remaining three projects, including the last one involving 2704, may not be completed until the end of the year or early next year. That being said, ***if you are considering making transfers involving discounts, we recommend you contact us so that we can assist you in completing such transfers sooner rather than later.***

Conclusion. When released, the new IRC Section 2704 regulations will likely have a chilling effect on a taxpayer's appetite to take discounts on transfers to family members. While the validity of the 2704 regulations may be challenged by taxpayers on the grounds that the regulations are an abuse of discretion by the IRS and beyond the scope of the type of restrictions prohibited by 2704, it remains to be seen how the courts will deal with this situation.

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