IS LESS MORE?

TRENDS IN UTILIZING VALUATION DISCOUNTS IN ESTATE PLANNING

By Jamie T. Katzen

Utilizing valuation discounts of closely held business interests to supercharge gift and/or sale transactions, and to mitigate estate and gift tax liability, is a popular strategy for many estate planning practitioners and a boon to taxpayers with taxable estates. However, the ability to discount the value of an asset and lower a taxpayer's estate and gift tax liability is also a thorn in the side of the IRS. Therefore, it comes as no surprise that the applicability and usage of valuation discounts has provided one of the most spirited legal battles over the past few decades.

Estate Planning Techniques Using Valuation Discounts

The most popular estate planning technique (and, accordingly, the most derided one from the IRS' perspective) is the implementation of the "Family" Limited Partnership (FLP). A litany of case law[1] has provided estate planners with a game plan for how to successfully employ FLPs.

By splitting the FLP's voting and control rights among its limited partners and general partners, the taxpayer is able to obtain a valuation discount for lack of control, lack of marketability and others that routinely reach the 30%-50% range. These deep discounts on FLPs often result in otherwise taxable estates largely avoiding the estate and gift tax regime, especially in the post-Tax Cuts and Jobs Act environment.

§2704 Proposed Regs. and Trump Administration

Unsurprisingly, after years of back and forth in the courts, in 2016 the U.S. Treasury Department issued §2704 proposed regulations (Prop. Reg. §§25.2701-8, 25.2704-4(b)(1)-(2)) that were intended to provide the IRS with a new arrow in its quiver to limit and possibly eliminate valuation discounts for family-owned business entities (including FLPs). Naturally, business owners and their legion of advisors were very concerned by these developments.

In September 2016, mounting political pressure resulted in a group of 41 U.S. senators sending a letter to the Secretary of the Treasury requesting that the proposed regulations be withdrawn[2].

However, with the change in executive administrations came a change in the Treasury's backing and motivation to fight this cause. In April 2017, President Donald Trump signed Executive Order 13789, which directed the Treasury to examine recent tax regulations to determine whether any of the regulatory projects:

- Imposed an undue financial burden on U.S. taxpayers;
- Added undue complexity to the federal tax laws; or
- Exceeded the statutory authority of the IRS.

President Trump went on to direct that "Treasury was to take 'appropriate steps' to delay or suspend the effective date of the identified regulations, and to modify or rescind the regulations, through notice and comment rulemaking."

On October 4, 2017, Treasury released a final report with recommendations intended to mitigate the burden imposed by legislation identified as either imposing an undue financial burden on taxpayers or adding excessive complexity to the tax system.[3] With respect to the final report, the Treasury issued a press release stating that the proposed regulations under Section 2704 would be withdrawn because they "... would have hurt family-owned and operated businesses by limiting valuation discounts. The regulations would have made it difficult and costly for families to transfer their businesses to the next generation."[4]

Eventually, on October 20, 2017, the IRS published a withdrawal notice, eliminating the possibility of the proposed regulations being issued in temporary or final form.

What's New with the IRS? – Anecdotal Developments

The abandonment of the 2704 proposed regulations is the most recent battle on this broader issue. Since the withdrawal notice was issued, estate planning practitioners have continued to plan utilizing FLPs in a "business as usual" manner, often taking advantage of the deep valuation discounts that they provide.

However, the IRS has not given up its position on valuation discounts in the context of family-owned/controlled businesses. Anecdotal evidence from the ground level shows that IRS examiners continue to assert that the depths of the discounts ordinarily taken by taxpayers are unreasonable. Under 706 audit, estates holding ownership in FLPs that contain a preponderance of marketable securities and cash are under attack, with IRS engineers routinely asserting that little to no discount should be taken, essentially disregarding the existence of the limited partnership structure.

Examiners also continue to assert that §2036 applies to estates that have fact patterns that may be low-hanging fruit. In one recent case, a taxpayer died within 45 days of the funding of the FLP. A collective valuation discount of 36% was asserted on the Form 706, which mitigated the Estate and Generations Skipping Transfer Tax liabilities by approximately $8 million. Under examination, the IRS has asserted that, in an echo of the *Estate of Strangi*[5], the FLP should be disregarded for tax purposes and no valuation discount should be applied. In an effort to force a settlement, the examiner also threatened to assert penalties for substantial underpayment of tax and substantial valuation understatement. Notwithstanding the IRS' position in this case, there was still an offer to settle the case if the taxpayer would accept a lowered valuation discount of 15% or less.

In another recent 706 examination, the decedent placed approximately $18 million in assets into an FLP and retained her house (which was unencumbered) and $1 million in cash in her individual name. She made no lifetime gifts of FLP interest. The IRS examiner argued, citing the *Estate of Paxton*[6], there is an "implied understanding" that distributions from the FLP would be required to maintain the decedent's standard of living, and therefore, the decedent retained possession or enjoyment of the assets under Section 2036.

Sometimes, the IRS examiners rely on no law or legal theory at all. In one recent case, the agent simply stated that the valuation discount of 43.6% on an FLP was too high and offered to settle the estate at a lowered discount of 35%.

The anecdotal evidence suggests that when the facts of a case provide the IRS with a reasonable 2036 argument, the mandate is to press the estate to lower the discount. Further, it appears that the IRS believes that they can chip away at the depth of valuation discounts by simply injecting the fear of a long audit and appeals process.

Business as Usual

Utilizing valuation discounts of family-controlled businesses in the context of estate planning is a tax-planning strategy that has not gone away. Rather, it appears that the motivation of taxpayers to employ FLPs and other techniques to leverage valuation discounts has only picked up in the Tax Cuts and Jobs Act era of $11.4 million (in 2019) Estate and Gift Tax exemptions. However, although being all but forced to abandon the §2704 proposed regulations, the IRS continues to fight, tooth-and-nail, valuation discounts used for estate and gift tax planning purposes.

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FOOTNOTES:

[1] See, e.g., Estate of Bongard, 124 T.C. 95 (2005); *Estate of Harper*, 83 T.C.M. (CCH) 1641, T.C. Memo. 2002-121; *Estate of Reichardt*, 114 T.C. 144, 114 T.C. No. 9 (2000).

[2] Lorenzo, "Senate GOP Urges Treasury to Abandon Estate Tax Rules," *BNA Daily Tax Report*, 189 DTR G-5 (September 29, 2016); letter reproduced in *BNA Daily Tax Report*, (September 30, 2016)

[3] See Executive Order 13789, 82 Fed. Reg. 19,317 (Apr. 26, 2017); Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Executive Order 13789 (Oct. 2, 2017), 82 Fed. Reg. 48,013 (Oct. 16, 2017).

[4] Available at https://www.treasury.gov/press-center/press-releases/Pages/sm0172.aspx.

[5] *Estate of Strangi v. Commissioner*, 293 F.3d 279

[6] *Estate of Paxton v. Commissioner*, 86 T.C. 785 (T.C. 1986)