PCE | VALUATION

Disappearing Discounts

RUN, DON'T WALK. Go See your Estate Planner NOW!

On August 2nd, the Treasury issued proposed regulations that will drastically change estate planning. If you have, or anticipate having, a taxable estate, you should visit your estate planner as quickly as possible to determine the possible financial impact.

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Discounts Defined

For decades, one of the best techniques to transfer wealth between family members and to younger generations has depended on the ability to make transfers of non-control interests at less than the pro-rata value of the interest when considered on a control basis. This ability was based upon the definition of Fair Market Value (FMV). FMV allows the application of valuation discounts to reflect the value of the interest to an outside, unrelated purchaser. These “discounts” make it possible to transfer more interests of an entity without incurring gift tax by considering the real economic value of the interest in the marketplace.

New Twist on FMV

One of the lynch-pins of FMV is the idea that only the interest being transferred can be considered in determining the value of the interest. That is, valuation experts were to ignore who held the rest of the interests, even if those interests were held by the person receiving the interest considered in the valuation. So, if I owned 49% of an entity which was owned 51% by my father and he transferred 20% of his interest to me, the valuation of the transferred interest would be based on what a hypothetical buyer would pay for a 20% (non-controlling) interest, even though I would have control after the transaction. Accepted valuation theory based on evidence, shows that a hypothetical buyer would not pay the full pro-rata value (would apply a discount) for the minority interest because the buyer would have no control over the entity.

The newly proposed regulations would change the application of FMV for any intra-family transfer for a family group that had control of the entity before and after the transfer. While this might seem reasonable (especially in a transfer like the one described above), consider the following. Suppose that my father wished to transfer 20% to me, 20% to my sister, and 20% to my brother- none of us hold any interest before the contemplated transfer. Assume our interests are divergent. Under the existing regulations, these transfers would be subject to valuation discounts, as each transfer is of a non-controlling interest and family-member interests are not to be considered together. Under the newly proposed regulations, the new family attribution rules would combine all of the ownership of the entire family. If the interests in combination are sufficient to control the entity, no discounts will apply to the transferred interests. No matter how skilled a valuation expert is at analyzing these types of interests and how supportable the analysis, once the rules change, we will no longer be able to consider those attributes giving rise to discounts.

We disagree with this regulation change from the valuation perspective, because economic evidence shows that non-controlling interests require a discount to the control value of the interest. The changes effectively create a second definition of FMV. Together this potentially charges a tax on economic value that does not exist for the owner of the interest.

Plan Now

Whether or not we agree that this is a good policy it is coming. The proposed regulations could become final as soon as December of this year, and could be fully effective by January 1, 2017.