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DARKENING CLOUD FOR DISCOUNTS MAY HAVE A SILVER LINING

Opportunity to Transfer Wealth at Historically Depressed Values Before Congress Moves to Restrict Family Entity Discounts

Absent Congressional action, the estate and gift tax is set to expire in 2010. Even before the current fiscal crisis, however, it seemed improbable that Congress would have allowed the tax to “sunset,” and a severe recession makes that even less likely now. We anticipate that Congress will debate the future of the estate and gift tax in the next weeks and months; indeed legislation has already been introduced in the House of Representatives to extend the 2009 estate tax exclusion amount of \$3,500,000 and to freeze the current maximum estate tax rate of 45 percent.

The real story may be in the other ways Congress and the IRS will try to find additional revenue in the estate and gift taxation system. The same legislation that proposes to continue the current rates and exemption — H.R. 436 — also seeks to curtail a standard technique of estate tax planning: discounting the value of interests in family-controlled non-business entities upon transfer to another family member. This approach is often effectuated in a family limited partnership, or FLP, sometimes structured as a limited liability company with essentially the same tax effect.

The IRS has been fighting FLP discounting for decades, with some success against taxpayers who have not included the appropriate provisions in their partnership agreements or who fail to respect the existence of the entity, but well-crafted, diligently-managed partnerships can see discounts approaching 50 percent on the value of the assets held by the entity. The discount arises from two main concepts: *lack of marketability* (a third-party buyer of family partnership interest would be hard to find) and *lack of control* (once found that buyer wouldn't pay the pro-rata value of the underlying assets without the right to “cash out” or otherwise control his interest in those assets).

Though both represent economic realities — the market for FLP interests is indeed very thin — the IRS views FLPs as a self-induced scheme for transferring assets to family members at less than their fair market value, ultimately avoiding the gift or estate tax that would be payable without the entity wrapper. With epic deficits looming, the IRS may have more success in convincing Congress to close what it has long considered a loophole. H.R. 436 proposes to do exactly that.

Although some of the provisions of H.R. 436 are less than clear, and will surely be refined if the bill moves forward, it attempts to make an exception for interests in an active trade or business, which apparently would still be discountable. With this distinction, discounts would remain available on FLP interests in an operating family business, but not on interests in investment assets. The core estate tax planning technique of “freezing” the value of an asset by gift or sale to another family member would not be affected by the proposed legislation; any future appreciation would still be transferred to the donee and out of the donor's taxable estate.

HRO believes that the confluence of depressed asset values and favorable existing law on entity discounting may prove a rare opportunity to transfer family property to another generation at deeply reduced values. This assumes that asset values will ultimately appreciate and that Congress will extend the estate tax at or near 2009 levels. It also assumes that any attempt to limit entity discounting will not be made retroactive to a date prior to passage. H.R. 436 sets the date of enactment as its effective date, although tax laws are sometimes dated back to an earlier start, a practice that has been sanctioned by the U.S. Supreme Court in certain cases.

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The combined power of freezing asset values at historic lows and discounting the interests in those assets works best in estates having:

- A current or expected value in excess of the 2009 estate tax exemption, \$3,500,000 for an individual or \$7,000,000 for a married couple.
- Investment assets that are likely to appreciate significantly in coming years, including illiquid assets such as non-income producing real estate, which generally yields the highest discounts, and liquid assets such as marketable securities.
- Substantial unused lifetime gift tax exemption (\$1,000,000 for an individual or \$2,000,000 for a married couple).

Given that any limitation on discounting is very likely to curtail discounts on all transfers made after enactment, **HRO believes this may be an excellent time to use all or a substantial portion of your lifetime gift credits, as well as annual exclusion gifts, which have increased to \$13,000 from each donor to each donee in 2009.** If you have used your gift tax exemption or want to leverage the opportunity further, consider the sale of interests to children or grandchildren at the same discounted price with the same opportunity to transfer value out of your taxable estate. The purchase can be paid over time with interest tied to the “applicable federal rates,” which are currently at historically low levels (less than 1 percent for obligations of three years or less).

This opportunity applies to new and existing FLPs. HRO strongly encourages you to review your situation in light of proposed law and to contact us if we can assist you in analyzing or effectuating a discounted transfer.

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