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Are Minority and Marketability Discounts Going Away?

In the world of estate and gift taxes, valuation discounts applied to family limited partnership interests have long been a point of contention between taxpayers, their advisors and the IRS. The IRS recognizes that the value of an interest in a privately-held corporation or partnership may be less than the owner's pro rata share of the entity's assets. However, by proposing to disallow certain valuation discounts, numerous IRS challenges in the courts have attempted to break the back of family limited partnerships as an effective means of reducing estate and gift taxes for wealthy individuals. The outcomes of various court cases have created uncertainty for the estate planning community and valuation professionals. Previous legislative proposals, including those made by the Treasury Department in 1984 and by the Fiscal Year 2000 Administration Budget Proposal, have attempted to greatly limit the use of minority and marketability discounts. In the last few months, valuation discounts and their applicability have once again caught the attention of the United States Congress, with the Joint Committee on Taxation addressing the issue in the January 27, 2005 release of *Options to Improve Tax Compliance and Reform Tax Expenditures*.

In its proposal, the Joint Committee on Taxation seeks to limit the use of valuation discounts such as minority discounts, marketability discounts, fragmentation discounts, and investment company discounts applicable to interests in closely-held corporations, limited liability companies, family limited partnerships, or other similar interests in business or investment entities or assets. Further, the proposal attempts to address the "disappearing wealth" phenomenon in which "manufactured discounts," which do not reflect an actual negative economic impact upon value, erode wealth from the transfer tax base. It also attempts to reduce the use of complicated holding structures that serve only to shelter value from full taxation. The proposal of the Committee has two parts—aggregation rules and look-through rules, which are intended to restrict the ability to claim minority and marketability discounts in situations where the discounts do not accurately reflect the value of the property interests transferred.

Aggregation Rules. The basic aggregation rule disallows a minority discount when the transferor holds a controlling interest in the entity or property just before the transfer. Hence, the value for estate and gift tax purposes is the pro rata share of the fair market value of the entire interest owned by the transferor just before the transfer. Conversely, if the transferor

holds a minority interest prior to transfer, a minority discount may be appropriate and allowed. However, the transferee aggregation rule provides that, if the transferred asset or interest is part of a controlling interest in the hands of the donee or heir, the value for estate and gift tax purposes is the pro rata share of the fair market value of the entire interest in the entity owned by the *donee or heir* after taking into account the gift or bequest. The transferee aggregation rule, thus, virtually eliminates the minority discount in certain cases.

Look-Through Rule. If the interest being valued represents a controlling interest by the transferor or by the donee or heir (after transfer), the look-through rule then applies. Under the look-through rule, if at least one-third of the entity's assets are marketable assets (cash, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. Treasury obligations and bonds, foreign treasury obligations, corporate bonds, precious metals or commodities, or publicly-traded securities), the value of the transferred interest for estate and gift tax purposes is the sum of the net value of the entity's marketable assets allocable to the transferred interest and the value of the transferor's interest in the entity attributable to nonmarketable assets. As a result of the look-through rule, a marketability discount is not allowed for the marketable assets in the entity. In addition, no minority discount is allowed, since the interest must represent a controlling interest in order for the look-through rule to apply; therefore, the aggregation rule would already have applied.

Though the proposal made by the Joint Committee on Taxation would severely restrict the use of minority and marketability discounts applicable to certain estate planning techniques, the proposal does not totally eliminate valuation discounts. In its proposal, the Joint Committee on Taxation indicates the following:

> *The proposal does not eliminate minority and marketability discounts in other contexts in which facts generally support those discounts. If, for example, neither the transferor nor the transferee owns a controlling interest in an entity, the estate and gift tax value of an interest in that entity may be determined by taking into account the lack of control. Similarly, where an entity's value primarily is attributable to nonmarketable assets, the estate and gift tax value of an interest in that entity may reflect that illiquidity.*

It is unclear at this time whether Congress will create legislation that restricts the use of minority and marketability discounts for valuations of family limited partnership interests for estate and gift tax purposes. Though the issue has arisen in the past but failed, the current federal deficit may prompt lawmakers to close more perceived loopholes or areas of abuse in the tax code, in an effort to recoup some of the estimated $400 million per year in lost tax revenues attributable to the current application of valuation discounts. However, powerful lobbying efforts by individuals and organizations with vested interests in estate planning may derail any legislation that would have an adverse impact upon valuation discounts applicable to family limited partnership interests. For now, it is advisable to stay apprised of how the issue plays out in the Congress.