Last call for family limited partnerships?

Valuing a publicly traded company is a fairly easy proposition. Every day, shares trade hands between willing buyers and willing sellers. The price of that trade, times the number of shares outstanding, provides the capitalized value of the company. For any shareholder's stake, the value of that interest is the number of shares held multiplied by the price.

Valuing privately held companies is far more difficult. The standard is, fundamentally, the same: What would a willing buyer pay, and what would a willing seller accept, if neither were under any requirement to buy or sell? Putting that standard into practice is very different, because there is no public market for the shares. In particular, with closely held firms the issue of control becomes paramount. If one stakeholder controls the enterprise, his or her share may command a premium, while the minority shareholders' interest will be discounted. The minority interest may get an additional discount if there are restrictions on selling it, as is usually the case.

These principles of tax law are nothing new. The new twist came in utilizing them in the context of a family limited partnership or, alternatively, a family-run limited liability company. These are legal entities used to manage family wealth, and also to move wealth to younger generations in a planned, controlled fashion. By employing discounts for illiquidity and lack of control, the transfer tax costs (gift taxes or estate taxes) could be significantly reduced. The IRS gets particularly unhappy when the new legal entity is essentially a repository for a portfolio of marketable securities. There are many sound nontax reasons for employing a family limited partnership to manage any kind of wealth, but the IRS believes that no one would go to the trouble for a portfolio of securities except to secure additional tax benefits.

Accordingly, the IRS has effectively declared war on family limited partnerships, by proposing a new set of regulations under Internal Revenue Code 2704, which deals with intra-family transfers. The proposal is detailed and abstruse, and it is not limited to securities portfolios. One new rule in particular stands out, one that is fairly easy to understand: the "deemed put." Regardless of what the actual terms are regarding an interest that is received by a family member, for purposes of determining value for estate or gift tax purposes the IRS will assume that the interest includes the right to sell a proportionate part of the underlying partnership within six months. If that rule becomes final, according to some observers, that will change the utility of family limited partnerships, because the minority and illiquidity discounts will be gone.

Will the rule become final? The scheduling suggests that the IRS hopes to put the finishing touches on the rule before the next President is sworn in. A public hearing will be held on December 1, and final regulations become effective 30 days after they are issued. Some observers believe that the proposed regulations go well beyond what the statute authorizes. Even if they do, finding a taxpayer to fund a challenge to them is problematic.

Should Hillary Clinton become the next President, the proposed regulations likely would be followed and then some—she advocates lowering the federal estate tax exempt amount and increasing the tax rate. On the other hand, Donald Trump has proposed the complete elimination of the federal estate and gift tax, which would render these new proposals moot.

(October 2016)