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Estate Tax Planning
Foulston Siefkin Issue Alert

# Bill in Congress to Eliminate Minority Interest Discounts in Intra-Family Transfers


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A Bill (**HR 436**) was introduced in the United States House of Representatives by Congressman Earl Pomeroy (D-ND) on January 9th that should sound a very loud alarm for estate planners and their clients who have large estates that could be subject to federal estate taxation. The Bill would make permanent the current $3.5 million federal estate tax applicable exclusion amount, which increased from $2.0 million, effective January 1st of this year. Absent Congressional action this year such as included in the provisions of this Bill, the federal estate tax under current law would be repealed for one year in 2010 and then revert back to a $1.0 million applicable exclusion amount in 2011 and subsequent years. The move to keep the applicable exclusion amount at $3.5 million beyond 2009 had been expected by a substantial percentage of estate planners for the last few years and is supported by President Obama. There was-and is-virtually no chance of repeal of the federal estate tax now or in the foreseeable future.

What was probably not anticipated by most estate planners was another portion of the Bill, which would eliminate lack of marketability and minority interest discounts when valuing interests for gift and estate tax purposes in entities such as corporations, limited liability companies (LLCs) and family limited partnerships (FLPs) in circumstances where the majority of the voting interests are collectively held by family members. Currently, the use of these devices can achieve substantial discounts (from approximately 25%-70% of the otherwise taxable estate values, depending upon the circumstances), greatly reducing both gift and estate taxation for estates that otherwise likely would be over the federal estate tax applicable exclusion amount upon the owner's death. An individual who does not currently have assets in such an entity may create such an entity to hold assets in order to achieve such discounts, and for perhaps non-tax benefits such as asset protection, consolidated management, etc.

Although this discount elimination provision may not necessarily be retained in this Bill, or pass Congress in this Bill or a subsequent Bill, its inclusion in this Bill is extremely important from two perspectives. First, there can be no question but that the concept it embodies will be clearly in the minds of legislators considering any proposed estate tax legislation this year. Secondly, it confirms what our firm's estate planning practitioners have anticipated was a very real possibility following the Democrats gaining increased control of both Houses of Congress, as well as the Presidency, in last November's elections, and the subsequent appointment of Lawrence Summers by President Obama as head of the White House's National Economic Council. When Lawrence Summers served as Secretary of the Treasury during the last 18 months of the Clinton administration from 1999-2001, one of the proposed Treasury changes to the Internal Revenue Code was the same discount elimination provision contained in the subject Bill, i.e., the abolition of such discounts for federal estate tax purposes when the decedent and other members of the decedent's family collectively held voting control of an entity. In sum, the Treasury during the Clinton administration proposed to eliminate this favorable gift and estate tax benefit.

Almost without question, a substantial reason the proposed legislation was not given to serious legislative consideration during the Clinton administration was that Congress at that time was controlled by Republicans, many of whom favored the elimination of the estate tax. This is not a political comment or the taking of a position on the merits of the issue, simply part of the on-going professional process of realistically assessing the political situation in order to anticipate the likelihood of the passage of tax legislation which could affect our clients and their individual planning. Because of this current sea change in the political climate and the introduction of Congressman Pomeroy's Bill, it is now much more plausible

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that any legislation to extend the current estate tax applicable exclusion amount, some form of which is highly likely to pass, might include the foregoing Treasury proposal of the Clinton administration.

Congressman Pomeroy's Bill would become effective upon date of its enactment into law. Prior legislative proposals designed to "cut off" a perceived unfair tax benefit often have made the legislation effective prior to the date of its enactment. Once a Bill designed to eliminate a certain tax benefit has been introduced, making it effective prior to the date of enactment precludes tax planners and their clients from legally taking advantage of a soon to be eliminated tax benefit prior to the legislation's subsequent enactment into law. Notwithstanding the Bill's prospective effect, it is important to note that a "retroactive" bill having the same provision might still be introduced.

Due to the foregoing circumstances, business and farm owners, as well as others with substantial estates, may have a very short window of opportunity indeed to take advantage of this substantial estate tax benefit. As estate tax valuations are made with respect to the law in effect at time of death, it is axiomatic that any such estate tax discounts which are legislatively eliminated during a person's lifetime will not be available at the time of such person's death. The only way to ensure their availability in this current political and legislative climate is to take advantage of their availability during lifetime by either gifting entity interests to other family members (e.g., children), either outright or in trust, or selling such interests to family members or to a trust created for family members (e.g., a trust for spouse and children) prior to the time such discounts are eliminated. Because any such gift or sale transaction will have closed prior to the legal elimination of the discounts, the value of the property being gifted or sold (and thus eliminated from the transferor's estate) for gift tax purposes will be determined at such substantially discounted values.

If the entity interest is sold at its value for gift tax purposes after giving effect to then available lack of marketability and minority discounts, there would be no taxable gift on the sale. Taxable gifts beyond the annual gift tax exclusion (currently $13,000 per donee of a donor per year) are limited to a cumulative value of $1.0 million before substantial gift taxes are imposed. Selling the entity interests avoids gift taxation on amounts that otherwise might exceed such exemption. Selling the entity interests to a certain type of irrevocable trust (termed a "grantor trust") created for family members would also eliminate any potential capital gain on the sale, as well as any interest income on any installment or balloon note given in exchange for the sale. For this and asset protection reasons, sales to such trusts are often preferred.

In addition to the very significant risk of marketability and minority discounts on entity interests being legislatively eliminated in a family setting in the very near future, there are two other unique current conditions which are highly advantageous to further limiting estate taxation through the use of such gift/sale techniques. First, the values of most capital assets are at a historic low due to the current financial crisis. This not only reduces their value for gift or sale purposes in determining gift tax consequences, but following the closing of the transaction all subsequent appreciation and income on the property will be removed from the donor's or seller's taxable estate. Secondly, the interest that would be required on a promissory note under an installment sale of an entity interest to family members or to trusts for family members are also at historic lows (e.g., 1.65% currently on a nine year note), thus reducing the amount of interest, which along with the principal on the note, that is includible in the seller's estate for federal estate tax purposes.

In short, any person who has an estate that is large enough to be possibly subject to federal estate taxation should at least consider taking advantage of this benefit and the currently favorable gift/sale climate **NOW**! It is unlikely we will see such a beneficial gift/sale climate for limiting estate taxation for decades to come.

## For Further Information

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