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Valuation discounts for transfers in family businesses in jeopardy

The ability to take valuation discounts on the transfer of an interest in a family business for estate, gift and generation-skipping transfer tax purposes would be drastically limited under long-awaited proposed regulations from the Treasury Department.

The most impactful element of the proposal bars any significant discount for lack of control or lack of marketability associated with the transfer of an interest in a family-controlled entity.

If the regulations are finalized as written, the tax cost for transferring interests in such businesses will be substantially higher.

The rules would apply to family-controlled corporations, partnerships, limited liability companies (LLCs) and other similar entities.

Under current rules, transfers of interests in family businesses may be discounted due to lack of marketability and lack of control. The idea is that if you give a percentage of interest in your business to your child, it should be discounted because your child wouldn't be able to immediately sell his or her interest to someone else for the same amount. Discounts of this nature can yield significant tax savings.

For example, assume three siblings inherited an equal third of their parents' business and now one of them wishes to transfer her third to her children. Assume if the business was liquidated or sold, the value of her one-third interest would be worth $5 million.

If a combined 30 percent discount for lack of control and lack of

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marketability were applied to the business interest, then the value of the gift would be $3.5 million. If the regulations become final and eliminate discounts, then the value of the same gift would be $5 million. At a 40 percent gift and estate tax rate, the impact of the elimination of discounting on this family would be $600,000 in additional tax.

As a result of the proposed changes, if you've been thinking of doing such a transfer involving a family business for estate planning purposes, it's critical to consider doing it now, before the regulations become final.

What's the timing?

The proposed regulations were issued in early August and a public

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Remarriage is a reminder to revisit your estate plan

Approximately 40 percent of marriages these days are remarriages for at least one partner. When you remarry, there are all sorts of issues to consider related to your estate plan.

For older people, the main focus may be ensuring that their adult children or grandchildren have an inheritance. Without proper planning, a new spouse could receive assets that were originally intended for children and grandchildren.

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Here are some important elements to review in order to protect everyone's interests when you remarry:

► **Consider drafting a pre-nuptial or post-nuptial agreement.**

In most states, a spouse is entitled to a certain percentage (typically approximately a third) of the other spouse's assets at death even if the other spouse has provided differently in a will. If you don't want this to happen, the best way around it is for your spouse to waive this right in a pre-nuptial or post-nuptial agreement.

You can also use the agreement to specify how your assets will be divided when one of you dies.

Before you sign a pre-nuptial or post-nuptial agreement, have it reviewed by your own attorney to ensure it is legally valid and doesn't accidentally give up any important rights.

► **Check titling of your assets.**

Who gets your assets when you die depends on how they are titled, not on what you say in your will. If an asset is titled as a joint tenancy with rights of survivorship, tenancy by the entirety or community property with rights of survivorship, it will go automatically to the surviving owner. That means you have to retitle the assets if you don't want them to pass to the joint owner on the account.

► **Revise your beneficiary designations.**

When a person dies, many retirement accounts automatically pass to the person's spouse, unless the spouse has signed a waiver or disclaimer. This is true even if the person's will and pre-nuptial agreement state otherwise. Be sure you know where your retirement accounts will go if something happens to you. You should also review the beneficiary designations on life insurance policies, annuity contracts, and bank or brokerage accounts.

► **Update your power of attorney and health care directives.**

Make sure you update your power of attorney and other health care directives if you want to change who you list as your agent. Also, make clear who you want as your guardian to make it easier for your new spouse or another relative to care for you if you become ill.

► **Put certain assets into a trust.**

Many people who remarry provide in their will that certain of their assets will pass into a trust for the surviving spouse after they die. The trust will commonly pay income to the second spouse for the rest of his or her life, and when that spouse dies, the assets will go to the first spouse's children.

Oftentimes, such a trust is called a "Qualified Terminable Interest Property" trust, or QTIP. One advantage of a QTIP is that all the property in the trust is treated as having gone to your spouse for estate tax purposes, so there is no estate tax on the assets at the time of your death.

In the trust, your spouse will likely want investments that generate income, while your children will favor growing the principal. It's important to specify how the assets are to be invested. Otherwise, you risk having your spouse and your children arguing about it. A possible solution is to create a "unitrust" that will pay the spouse a percentage of the total assets each year — that way everyone benefits if the assets are appreciating.

One caveat to creating a QTIP trust is if your new spouse is significantly younger than you are and could possibly outlive your children. In that case, it might be better to protect your children's interest by buying a life insurance policy with your children (or a trust for them) as the beneficiary.

► **Consider buying long-term care insurance**.

If one spouse requires expensive nursing home care, the other spouse may be legally required to pay for it. And few things can drain a child's potential inheritance faster than paying for a step-parent's expensive medical care. Long-term care insurance is a great way to solve this problem before it happens.

Valuation discounts for transfers in family businesses in jeopardy

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hearing about them was scheduled for December 1. Generally, the rules go into effect on the day they are published in final form, although certain portions will be effective for transfers occurring 30 or more days after the date of publication.

While it's unclear exactly when that will be, the rules aren't expected to be finalized until sometime in 2017. Still, you should act soon and contact an estate planning lawyer if you want to take advantage of the discounts under current law before then.

Could the rules be retroactive?

Even if you make transfers now, though, there is one new rule in the proposal that might have a retroactive effect. The so-called "three-year rule" in the proposed regulations may prohibit certain discounts taken for transfers made within the three years before the transferor's date of death.

That rule would apply to transfers that result in the transferor losing a liquidation right. That means that if a transfer is made soon to take advantage of the current rules on discounts — or if the transfer has already been made — the discount might be lost if the final rules go into effect and the person who transfers the interest dies within three years.

The same rule would also apply to measure any gift component of a transfer that has been structured as a sale. Therefore, discounts on gift tax elements of such transfers could also be caught by the three-year rule.

Are there other significant changes?

The proposed regulations are lengthy and some of the applications are still unclear.

But it's important to be aware of one new section of the rules that could have a big impact. That is the creation of a new set of "disregarded restrictions."

These restrictions would be "disregarded" when valuing the transferred interest for estate or gift tax purposes in any family-controlled entity.

They include any provision that limits the ability of a holder of an interest in a family-controlled entity to compel liquidation or redemption.

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For valuation purposes, that means the new rule would assume that someone who holds an interest in a family-controlled entity has the right to liquidate or redeem the interest for its pro rata share of the net asset value in cash or other property payable within six months of exercise.

Under the rules, "disregarded restrictions" will be disregarded if they lapse after the transfer, or if the transferor or the transferor's family may remove or override them.

With respect to restrictions that will be ignored for valuation purposes, the new rules no longer focus on those that are more restrictive than the relevant state law rules, but instead will affect virtually any restriction that limits the ability to liquidate.

Through public comments and a hearing, the rules will continue to be debated and discussed before they become final. To understand the possible application to your family business, contact an estate planning lawyer.

Should you amend or rewrite your revocable trust?

It's important to review a revocable trust regularly to see if any amendments are needed, such as when something changes in your life or if the law changes.

There are two ways to go about it. You can either amend the existing trust to change a certain part of it or rewrite the whole trust, which is known as a restatement.

While you might expect that an amendment is easier and more cost-effective, that's not always the case.

Remember that your trust should provide instructions to your heirs about your wishes, so it has to be clear and comprehensive.

If you're making one or two simple changes, then amending is often sufficient. That's especially true if the changes don't interrelate.

However, if you've made a lot of changes over time, it might be time for a restatement to ensure that the trust clearly states your wishes and is set up to be administered properly.

In addition, a restatement can also reduce how much paperwork you need to give to third parties like banks and avoid beneficiaries learning about prior terms of the trust.

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Survivorship life insurance can be good vehicle for estate planning

Survivorship life insurance (also known as "second-to-die") can be an important vehicle to consider for estate planning in the right cases.

This type of insurance policy covers two lives and pays out the proceeds when the second insured dies.

One benefit is that the premium tends to be lower than it would be for two separate policies because the life expectancy is based on the two insureds' combined ages and the insurer has lower administrative costs.

As a result, these policies typically provide a much higher face value than you would obtain for an individual for the same premium cost. This sort of policy can be used for a married couple, though it can be used for any pair of people, such as a parent and child or even two business partners.

For planning purposes, when the life insurance pays out on the second death it can be used to cover any estate tax payments. It can also be a good option for a couple with a modest income that wants to ensure some amount of an inheritance for their children.

Often, an irrevocable life insurance trust is set up to buy the policy. That way, the trustee pays the premiums and manages the terms of the trust. You provide the funding as the grantor of the trust and can make gifts to the trust to pay the premiums. Using the trust as the owner keeps the death benefits paid from the policy out of the survivor's estate when he or she dies and retained in the trust for the benefit of the heirs.

Keep in mind that when the first spouse dies, the surviving spouse has to be able to afford to continue paying the premiums.

Also, if a couple has a survivorship policy and gets divorced, you may want to divide it in two if the carrier allows this, with each spouse owning half of the initial face value.

Deciding whether survivorship life insurance is a beneficial estate planning vehicle for you is complicated and should be evaluated on a case-by-case basis, with the advice of an attorney.