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Internal Revenue Service Releases Proposed Regulations Aimed at Reducing Valuation Discounts for Family Businesses and Family Controlled Entities

The Internal Revenue Service recently released proposed regulations under Section 2704 of the Internal Revenue Code that could significantly impact estate planning for clients who own interests in family businesses or family-controlled investment entities. The proposed regulations may result in reducing the availability of certain discounts when valuing interests in family-controlled entities for estate, gift and generation-skipping transfer tax purposes. Because the proposed regulations are not yet finalized, there may be opportunities available for clients who own interests in family entities to make gifts or sales to take advantage of the valuation discounts that have been and currently are available.

Under existing law, for transfer tax purposes, the value of an interest in a family-controlled entity may be significantly reduced due to the fact that the interest being transferred does not permit the transferee to control the entity, and therefore, he or she cannot derive an immediate economic benefit from his or her interest. The transferred interest may be subject to restrictions under the entity's governing document, the interest may be a minority interest or there may be other restrictions imposed under state law. This valuation discount is often referred to as a discount for "lack of control."

For decades, the IRS has been concerned that a lack of control discount for an interest in a family-controlled entity does not have economic substance. This has been the subject of seemingly endless litigation, and many of such cases have resulted in losses by the IRS. The IRS assumes that family members who control an entity can collude to remove any restrictions on the transferred interest, and that the restrictions often are used only to obtain a tax benefit. The proposed Section 2704 regulations will disregard any such restrictions when a transfer is made in the context of an entity controlled by the family. For valuation purposes, the proposed regulations will treat the transferee of any interest in a family-controlled entity as having a right to liquidate his or her interest for its net asset value in cash or other property, regardless of whether the transferee actually has any such rights after the transfer. This will have a significant effect on lack of control discounts because the transferee will be treated as having sufficient control to derive an immediate economic benefit from his or her interest in the entity. The proposed regulations would apply to any corporation, partnership or LLC in which members of the same family own fifty percent or more of the voting or capital interests.

Another component of the proposed regulations is intended to address the IRS's concern about "death bed" transfers of interests in family entities that have the effect of converting the dying transferor's controlling interest in an entity into a minority interest. At present, donors may give or sell an interest in an entity, leaving the donor herself with a non-controlling interest. At death, the non-controlling interest still held by the now deceased donor is subject to the valuation discount for lack of control. Under the proposed regulations, in addition to the disregarded restrictions rule described above, the IRS will impose a new "three-year" rule relating to such transfers. If a donor makes a transfer of an interest in a family-controlled entity within three years of his or her death, and the transfer resulted in the donor losing control and the ability to force the liquidation of the entity, then the value of that liquidation right will be included in the donor's gross estate at death. Essentially, the value of the liquidation right will be subject to federal estate tax even though no "actual" asset passes through the decedent's probate or non-probate estate. This legal fiction would create a number of technical tax and administrative problems.

The proposed regulations are not currently effective. It is not clear exactly when the regulations will be finalized, but as a general matter, they will apply prospectively—that is, after their effective date. The proposed regulations have drawn a significant amount of commentary and will be the subject of much discussion and debate over the next few months, including a hearing at the IRS on December 1, 2016; however, many commentators expect the regulations to be finalized some time in 2017. It is possible that the regulations could be effective sooner, shortly after the hearing, although this is unlikely. It is also unclear whether the three-year rule will apply to transfers made after the regulations are finalized, or whether they apply to any decedent who dies after the regulations are finalized who has made an applicable transfer within three years of death. Gifts made now, or gifts made recently, that implicate the lapse of a voting right or a liquidation right may get "caught" by the three-year rule.

If you are considering transferring interests in family-controlled entities, it is probably advantageous to do so before the proposed regulations are finalized to take advantage of the valuation discounts available now that will likely be adversely affected once the proposed regulations are finalized. Of course, given the proposed regulations and their potential impact, planning in this regard should be done deliberately and with mindful forethought. If you believe that gifts or sales of an interest in family-controlled entities might be appropriate for your family and your estate planning, please contact your lawyer at Heckscher, Teillon, Terrill & Sager, P.C. to schedule a call or meeting.