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FAMILY ENTITY VALUATION DISCOUNTS: GOING, GOING, GONE?

An effective estate planning strategy may very soon be removed from the tool kits of trusts and estates practitioners. By mid-September the Internal Revenue Service is expected to release proposed regulations limiting valuation discounts of interests in family entities.

Current Law and Practice

Section 2704(b) of the Internal Revenue Code, enacted in 1990 to curtail perceived abuses in the valuation of transfers of interests in family-owned entities for estate and gift tax purposes, provides that certain restrictions on liquidating an entity (an important factor in determining the value of an interest in an entity) are disregarded in intra-family transfers for valuation purposes when the transferor and members of the transferor's family together hold a majority interest and the restriction lapses or can be removed by the family after the transfer.

However, because restrictions that are imposed by Federal or state law are excluded from 2704(b) treatment (i.e., are not disregarded for valuation purposes), many states have eviscerated § 2704(b)'s applicability by setting very restrictive default rules. For example, unless a limited liability company agreement otherwise provides, New York law requires the consent of a majority of each class of members for the dissolution of a limited liability company. Delaware law requires the consent of two-thirds of the members and New Jersey requires the consent of all members.

Thus, under current law, the estate and gift tax valuation of non-controlling interests in family limited liability companies or partnerships may yield substantial discounts for lack of control and/or marketability. Such discounts, in turn, commensurately reduce the transfer tax impact of a gift or sale, or transfer at death, of such interests.

Anticipated Proposed Regulations

Section 2704 authorizes regulations providing for additional restrictions that are to be disregarded for valuation purposes when interests in family entities are transferred between family members. The IRS began signaling the possibility of such

regulations as early as 2003, and recent public remarks by an attorney advisor for the Treasury Department's Office of Tax Policy suggest that the IRS is preparing to move forward with a regulatory proposal at this time.

When asked about the outlines of the anticipated proposed regulations, the IRS official pointed to the Obama Administration's § 2704 legislative proposal included in its 2013 budget "Greenbook," which provides for the following:

- The creation of an additional category of "disregarded restrictions" for purposes of valuing an interest in a family-controlled entity transferred to a family member, to which the exception for Federal and state default rules would not apply.
- Included in the class of disregarded restrictions would be (1) restrictions on a holder's liquidation rights that are more restrictive than a standard to be identified in regulations and (2) limitations on a transferee's ability to be admitted as a full partner or to hold an equity interest in the entity.
- The treatment of certain non-family members (including charities) holding interests in the family entity as family members for purposes of determining whether the transferor and the transferor's "family" may remove restrictions post-transfer.
- A safe harbor pursuant to which taxpayers could draft the governing documents of a family-controlled entity to avoid application of the expanded § 2704.

Statutes and case law have already limited somewhat valuation discounts in family entities that have no purpose other than to temporarily depress value at the time of a transfer to family members. The anticipated regulations, however, would apply even where the restrictions giving rise to the discounts have legitimate family or business purposes. Presumably, the regulations would not apply to transfers of interests in entities that the transferor and the transferor's family do not control.

While the 2013 Greenbook called for prospective application of the proposal, proposed regulations, if adopted, could apply retroactively to the date they were proposed.

Effect on Intra-Family Transfers of Family Entity Interests

In the event that § 2704 regulations are proposed and ultimately adopted as outlined above, intra-family transfers of family entity interests will become less effective estate planning tools because the value of transferred interests for gift and estate tax purposes will be larger, thus requiring the transferor to incur a heftier tax or to utilize a larger portion of his or her exemption. Given the imminent timing of the anticipated regulations, those considering such transfers may wish to implement them soon.

We are available to advise our clients in determining what the potential changes to the regulations mean for their particular situation, or to discuss any other estate planning matter.