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August 12, 2016

FAMILY ENTITY VALUATION DISCOUNTS WILL SOON BE GONE

In our client alert of June 2015, we wrote about the possibility that the IRS might release proposed regulations severely curtailing the use of valuation discounts in closely-held family entities when interests in such entities are transferred to (or for the benefit of) other family members. Last week, the IRS did just that. As early as January 1, 2017, the estate tax planning advantages reaped from such discounts may be effectively eliminated.

Current Law and Practice

Current Section 2704 of the Internal Revenue Code provides in part that, for valuation purposes, certain restrictions on an interest in an entity are disregarded in intra-family transfers when the transferor and his or her family together hold a majority interest and the restriction either lapses on transfer or can be removed by the family after the transfer. Until now, there were several exceptions to this rule, including, for example, that the rule did not apply to restrictions found in state law. This effectively still allowed many control and transfer restrictions to reduce the value of such interests for gift and estate tax purposes.

Proposed Regulations

The proposed regulations essentially expand the application of the statute and restrict the exceptions to it. The salient changes to current law include the following:

- A state law restriction on the holder of an interest in a family entity will generally be taken into account for valuation purposes only if it is mandated by law and cannot be overridden in the entity's governing documents.

- The proposed regulations provide for 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 <u>not</u> apply. Included among the newly disregarded restrictions would be (1) limitations on a holder's ability to liquidate the interest and (2) limits on the amount, character and timing of

payment of liquidation proceeds. To some extent, all of these restrictions are customary terms in a business entity.

- The lapse of voting or liquidation rights upon the transfer of an interest to a mere assignee (as opposed to a partner or shareholder) will be treated as a taxable gift.
- The proposed regulations also treat (in some cases) certain non-family members (including charities) holding interests in a family entity as family members for purposes of determining whether the transferor and the transferor's "family" can eliminate restrictions post-transfer.

Effect on Estate Tax Planning

A public hearing on these proposed regulations has been scheduled for December 1, 2016. In the event that they are ultimately adopted as outlined above, valuation discounts for lack of control and marketability will be sharply limited or eliminated with respect to family entities. Accordingly, intra-family transfers of interests in such entities will be more expensive from a gift and estate tax standpoint because the value of such interests will be greater, thus requiring the use of a larger portion of exemption, a heftier gift tax and/or, if the transfer is structured as a sale, a higher purchase price.

While the proposed regulations curtail the gift and estate tax benefits from the standpoint of the initial valuation, the transfer of such interests will still be advantageous to the extent that they appreciate in value after the transfer, because the growth will not be subject to further gift or estate taxes to the transferor.

Given the likely imminent adoption of the proposed regulations, we urge clients considering such transfers 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.