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Treasury Department Issues Proposed Regulations That Will Dramatically Reduce Valuation Discounts

On Aug. 2, 2016, the Treasury Department issued proposed regulations under Section 2704 of the Internal Revenue Code that, if finalized in their present form, would substantially alter the valuation of transfers of interests in family-controlled entities (including corporations, partnerships, and LLCs) for estate, gift and generation-skipping transfer tax purposes.

Decades of established law require that transfers of property, including non-controlling interests in family-controlled entities, must be valued without regard to the identity of the transferee. Thus, a gift of a minority interest in a family business is currently valued at its fair market value between an arms-length purchaser and seller, taking into account any applicable discounts for lack of control and lack of marketability. The proposed regulations would ignore, for tax purposes, restrictions on a minority owner’s ability to withdraw from an entity, if the entity is controlled by the family. As a result, the availability of minority interest discounts in estate planning would be severely impaired if the proposed regulations are finalized as drafted.

A hearing on the proposed regulations is scheduled for Dec. 1, 2016, and the regulations presumably will be finalized and become effective sometime thereafter. Clients wishing to take advantage of the valuation principles applicable under current law to transfers of interests in family-controlled entities to or for the benefit of their families need to take prompt action.

Current Law

Generally, Section 2704 applies to transfers of interests in family-controlled entities if the transferor and the transferor's family own 50 percent or more of an entity by vote or value or if any of them holds an interest in a partnership as a general partner. Broad family attribution rules apply to determine ownership by the family members. If an individual transfers an interest in a family-controlled entity to or in trust for the individual's family, Section 2704 generally operates to limit the availability of valuation discounts for purposes of estate, gift, and generation skipping transfer tax (collectively, transfer tax) purposes by ignoring so-called "applicable restrictions." An applicable restriction is one that limits the ability of an owner to cause the entity to liquidate, in whole or in part, if (1) the restriction lapses at any time following the transfer, or (2) the transferor or members of the transferor's family can remove the restriction immediately after the transfer.

Section 2704(a) has been interpreted to apply only to restrictions on the ability to liquidate the entity itself, in whole or in part. Section 2704(b) does not currently limit the availability of valuation discounts resulting from restrictions on withdrawal imposed by an entity's governing document, provided the restrictions are no greater than the limitations on withdrawal that would be applicable to the minority owner under default state law. Because the laws of most states do not, by default, permit a minority owner to "put" (that is, demand payment for) his or her interest to the entity and obtain the minority owner's share of net asset value, valuation discounts for lack of control are currently applicable to transfers of minority interests in family-controlled entities even if made to or for the benefit of family members.

Valuation discounts may substantially reduce the tax cost of transferring wealth to members of the transferor's family. Under current law, even if 100 percent of a family-controlled entity is gifted to family members, if each family member receives a minority interest, each interest will be valued independent of the whole, as if made to a stranger, resulting in a significant reduction in the tax cost of planning with family entities. It should be noted that for estate tax purposes, no such discount is permitted if the decedent owned a majority interest, even if only minority interests are bequeathed to separate individuals.

Summary of Proposed Regulations

Internal Revenue Code Section 2704(b)(4) authorizes the Treasury Department to issue so-called legislative regulations. This means that the Treasury Department may issue regulations that establish other restrictions, in addition to the restriction on liquidation, that will not be taken into account for purposes of valuing interests in family-controlled entities for transfer tax purposes. The proposed regulations are issued under that authority.

The proposed regulations are long and technical, and constitute a broad attempt to eliminate or significantly curtail the applicability of valuation discounts to transfers of minority interests in family-controlled entities. The following are the key points of the proposed regulations:

- > Under current law, the lapse of an applicable restriction results in a deemed transfer of the value attributable to the lapse. Thus, if an owner's ability to liquidate an entity lapses upon his or her death, the reduction in value resulting from the lapse of the liquidation right is itself a transfer subject to transfer tax. Taxpayers sought to avoid the application of this rule by reducing a controlling interest in an entity to a non-controlling one shortly before death. The proposed regulations modify the definition of an applicable restriction to aggregate transfers made within three years of death with transfers at death for purposes of determining if a taxable lapse of a restriction on liquidation has occurred.
- > The regulations create a new category of restrictions that will not be given effect for valuation purposes called a "disregarded restriction." The measure of whether a restriction is more restrictive than state law is determined based upon whether the state law restriction is one that is mandatory and not merely a default rule. No state law is likely to prohibit the creation of an entity in which a minority interest holder has the right to withdraw. Moreover, state law will not be deemed to contain such a

prohibition if the entity could have been formed under another state law without such a restriction. Therefore, default state law will no longer determine whether a restriction will be given effect for valuation purposes. A disregarded restriction includes one that:

- > Limits the ability of the holder of the interest to liquidate the interest,
 - > Limits the liquidation proceeds to any amount that is less than the proportionate net asset value attributable to the interest,
 - > Defers the payment of the liquidation proceeds for more than six months, and
 - > Permits the payment of the liquidation proceeds in any manner other than cash or other property (which generally does not include a promissory note issued by the entity or other owners of the entity).
- > The proposed regulations also require that the interest of a non-family member will be disregarded unless:
- > The aggregate interests of non-family members is at least 20 percent,
 - > Each non-family member interest is at least 10 percent,
 - > The interest of each non-family member has been held for at least three years, and
 - > Each non-family member has a put right in exchange for a proportionate share of net asset value.

Importantly, the proposed regulations do not distinguish between entities that own passive investments (such as a portfolio of marketable securities or passive real estate interests) and active investments (such as an operating family business), except that an active business may be able to fund the “put” right with a note. Therefore, entities with operating family businesses will be subject to the same valuation rules as entities with only passive investments.

Basic Effect of the Regulations

If the regulations become final in the form described above, the basic effect of the regulations will be to require an interest in a family-controlled entity transferred to a family member during life or at death to be valued for transfer tax purposes at the net value of the entity (the value of the assets held by the entity, reduced by the liabilities of the entity) multiplied by the percentage interest in the entity that is being transferred, without the application of a lack of control discount.

Effective Date of Final Regulations

The proposed regulations provide that the effective date for most of the new rules will be 30 days after the regulations become final. The Treasury Department has set a hearing date of Dec. 1, 2016 to hear comments on the proposed regulations. Proposed regulations are subject to change by the Treasury Department in response to comments it receives. Whether these proposed regulations will be changed in material respects and the time required to implement any changes are matters of conjecture. As final regulations could be issued shortly after the hearing date, individuals and their planners should anticipate that the regulations will become effective in early 2017.

Potential Challenges to the Validity of the Proposed Regulations

If the proposed regulations become final, there will likely be challenges to the validity of the regulations asserting that the Treasury Department exceeded the scope of its authority and the intent of the statute. However, such challenges will likely result in lengthy court proceedings, and, ultimately, may not be successful. Therefore, we believe it is prudent to plan on the basis that valuation discounts under current law will be adversely affected when the proposed regulations are finalized.

Planning Prior to the Effective Date of the Final Regulations

Individuals and families with existing family-controlled entities should consider implementing transfers of interests in the family-controlled entities as soon as possible and prior to the effective date of the regulations if they wish to take advantage of the valuation discounts available under the current rules. Effective estate planning to reduce transfer taxes under current law would include outright gifts of minority interests in the family-controlled entities to family members or trusts for family members, or sales of interests in the family-controlled entities to family members or trusts for family members.

Planning After the Effective Date of the Regulations

If final regulations are issued in substantially the form of the proposed regulations, valuation discounts applicable to a transfer of an interest in a family-controlled entity will be reduced and, in some cases, eliminated. Therefore, individuals will need to actively attend to their estate plans over the course of their lifetimes, and particularly during their most active years of wealth accumulation, in order to accomplish the most tax efficient transfer of wealth to their intended beneficiaries.

For example, suppose an individual has \$5,000,000 of gift tax exemption available. Under current law, the individual might make a gift of a minority interest in an entity worth \$5,000,000 by transferring an interest in the entity with a net asset value of \$6,666,667 to which a 25 percent valuation discount is applicable. If the assets of the entity grow on an after-tax basis at an annual rate of 5 percent, the net asset value of the interest in the entity would be worth approximately \$10,860,000 at the end of 10 years. On the other hand, if no valuation discount were available, only an interest with a net asset value of \$5,000,000 could be given, in which case it would take approximately 16 years for the net asset value of the interest in the entity to be worth the same amount as the discounted interest after 10 years.

Many estate planning techniques that are currently being used will continue to be effective to transfer interests in family-controlled entities. For example, arrangements that will shift the post-transfer appreciation of transferred assets outside of the transferor's taxable estate will continue to be effective even without valuation discounts. These techniques include outright gifts to individuals or trusts for their benefit, grantor retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs), and sales of assets to "grantor trusts." The techniques involving gifts or sales to trusts can also be structured with additional gift and estate tax benefits by permitting the transferor (rather than the trust) to pay the income tax on trust assets, thereby permitting the transferor to effectively make tax-free gifts to the trust equal to the income tax paid by the transferor.

These arrangements can achieve significant tax savings, but planning should be undertaken sooner rather than later, as the reduction in transfer taxes that results by eliminating future growth requires time between the date of transfer and a possible transfer tax event.

Your GT Team Is Ready To Assist

The issuance of the proposed regulations signals the most significant potential change in the valuation principles applicable to transfers of family-controlled entities in recent times, overturning decades of established law. Your GT Team is ready to assist you in determining how these changes might affect you and your family, and what actions you should consider taking to maximize the after-tax benefits of your wealth transfer planning.

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