

Publication

07/30/2018

Client Alert: IRS Proposes Regulations That Would Eliminate Most Valuation Discounts for Transfers of Interests in Family Entities

The Internal Revenue Service (IRS) released regulations on August 2, 2016 that would limit the use of discounts when valuing interests in family entities for estate, gift and generation-skipping transfer tax purposes. If enacted in their current form, the regulations will curb the use of “minority,” “lack of marketability” and “lack of control” discounts, thereby increasing the value of any interests transferred or owned at death. The IRS anticipates applying the new rules to transfers occurring 30 days after the regulations are finalized and may finalize the regulations in early 2017. Although we anticipate that taxpayers will challenge the validity of the regulations, the best time for planning and action is now, before the regulations are finalized.

Overview of Proposed Regulations

The proposed regulations would limit the use of valuation discounts for transfer tax purposes for intra-family transfers of interests in family-controlled limited partnerships and other “closely-held” entities. Under current law, the lapse of a voting or liquidation right (i.e., the removal of a right to vote or liquidate an interest) in a controlled closely-held family entity is treated as a transfer by the individual who owns or dies with the lapsing right. In addition, “Applicable Restrictions” that would otherwise reduce the value of a transferred

CLIENT SERVICES

Private Wealth
Family Office Services
Intergenerational Wealth
Estate and Gift Tax Reduction

RELATED PEOPLE

Eric M. McLimore
Lawrence I. Richman
Martin H. Tish

interest are disregarded if an interest in a controlled closely-held entity is transferred to or for a member of the transferor's family, and the family controls the entity both before and after the transfer. However, the legislative history and the prior regulations establish important exceptions, including respecting restrictions on transferability, withdrawal and liquidation which were no more restrictive than under state law.

Under the proposed regulations, the definition of "control" is clarified and enhanced, and a "bright line" rule is established under which any "lapse" within three years of death (and the accompanying reduction in value of the transferred interest) is disregarded. Further, the proposed regulations create a new class of "disregarded restrictions" that apply in the case of transfers to family members without regard to state law. Specifically, restrictions that a transferor, or his or her family, can override and insubstantial interests held by non-family members will be disregarded in most circumstances. In other words, the Code will assume that individuals receiving transferred interests are able to liquidate the interests, which effectively will eliminate valuation discounts based on minority, lack of marketability or lack of control.

Inevitable Challenges to the Validity of the Regulations

The regulations have been proposed under a grant of statutory authority in Section 2704(b)(4) to issue regulations if both (i) the restriction reduces the value of the transferred interest for transfer tax purposes and (ii) does not reduce the ultimate value of the transferred interest held by the transferee. Although the grant of regulatory authority is broad, the legislative history of Section 2704(b) expressly provided that Section 2704 would not affect minority and other similar valuation discounts.



We anticipate a challenge to the validity of the proposed regulations if enacted as written because the impact of the proposed regulations is inconsistent with the legislative history. Ultimately, a court will have to determine whether the proposed regulations are consistent with the statute and the extent to which the legislative history is relevant.

Plan Ahead

The use of valuation discounts is an important and valuable aspect of planning techniques to minimize gift, estate and generation-skipping transfer taxes. The regulations restricting valuation discounts and imposing a three-year look-back for lapses in liquidation rights will apply prospectively, and could become law within the year. Therefore, time is of the essence for individuals and family offices to evaluate their holdings in closely-held family corporations, LLCs and partnerships. Owners and managers of such interests should contact Neal, Gerber & Eisenberg before the regulations become finalized to discuss the impact that the proposed regulations will have on their wealth and tax planning.