Proposed Rules Would Limit Valuation Discounts for Family Controlled Entities

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On August 2, 2016, the Internal Revenue Service proposed regulations that would severely limit valuation discounts for lack of marketability and lack of control that taxpayers have historically applied for federal gift, estate and generation-skipping transfer tax purposes when transferring interests in family controlled entities. Taxpayers who want to take advantage of traditional discounts must do so before the proposed regulations are finalized, which may be as early as December.

In a Nutshell

Under existing tax rules, when a minority interest in a partnership, corporation, LLC, or other entity is transferred, the interest is valued at what a willing buyer would pay a willing seller. In general, a purchaser of a non-controlling interest will pay something less than a pro rata share of the value of the entire entity because the interest holder cannot control the entity and normally cannot force the entity to "cash out" the interest. In addition, there is generally no active market for non-controlling interests. Accordingly, tax rules have historically recognized that discounts for lack of control and lack of marketability apply when valuing non-controlling interests in such entities.

The tax rules have, until now, disregarded some value-reducing restrictions applicable to a non-controlling interest holder in a family owned business, but, with careful planning, the impact of these rules could be minimized. However, under the proposed regulations it appears that nearly all limitations on an owner's ability to liquidate or control the entity would effectively be ignored in situations where the entity is family controlled. The effect of the proposed regulations would be to increase the gift or estate tax cost of transferring many interests in closely-held businesses within the family by lifetime gift or at death.

Some Specific Changes

The proposed regulations make a number of changes to the existing rules under section 2704 of the Internal Revenue Code. Some of the more important changes are as follows:

- **New 3-Year Rule for Certain Gifts:** If a family business owner makes a gift that causes the owner to lose the ability to liquidate or control the entity (such as by going from a majority to a minority owner), the donor now must live at least three years from the date of the gift to avoid the value of the lost control or liquidation right from being added to the donor's estate as a phantom asset subject to estate tax. This rule would have the effect of discouraging deathbed transfers.
- **Ignoring Restrictions on the Ability to Liquidate the Entity:** Under the new rule, the only restrictions on liquidation that will be considered for gift and estate tax valuation

purposes are those that are mandatory under state law. This would eliminate virtually all restrictions because state laws generally do not contain such mandatory restrictions.

- **Disregarded Restrictions on an Individual Owner's Ability to Cash Out:** The proposed regulations introduce a series of new "disregarded restrictions," which address an individual owner's inability to liquidate his or her own interest (as opposed to the entity as a whole). The new rules essentially require a presumption that the owner may convert the interest to cash at virtually any time.
- **Non-Family Members:** The proposed regulations would apply to transfers of entity interests that are "controlled" by the transferor or the transferor's family. The presence of non-family member owners may prevent the family from holding control. However, under the proposed rules, non-family owners will count when measuring family control only if they meet certain thresholds in terms of the amount of equity held and the length of their holdings, and if they also have a right to cash out their interests without restriction.

Looking Ahead

The regulations are proposed, and are not yet effective. They are unlikely to become effective until after a public hearing scheduled for December 1, 2016 in Washington, DC.

If the proposed regulations do become final, they will have the effect of increasing the net worth of many family business owners on paper by eliminating several of the valuation discounts that previously applied. Consequently, the tax cost of transferring many interests in family entities will increase. While the new regulations will likely reduce the impact of certain estate planning techniques that take advantage of valuation discounts, other planning techniques to ensure liquidity to pay estate taxes and to qualify for deferred estate tax payments are likely to become increasingly attractive to owners of family businesses.

It should be noted that the proposed regulations will not actually eliminate voting or liquidation restrictions from an entity's governing documents. While ignored for tax purposes, those restrictions will continue to govern the day-to-day relationship of the owners.

What to Do

Until at least December 1, 2016, there remains an opportunity for individuals to transfer non-controlling interests in family controlled entities (by gift or sale) subject to restrictions that support the application of valuation discounts. In addition, taxpayers should revisit prior assumptions about estate taxes and the disposition of their estates based on the elimination of valuation discounts in their specific circumstances.

In the near term, individuals who wish to take advantage of this planning opportunity should contact their Goulston & Storrs attorney or any member of the Private Client & Trust or Tax Group.

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