Internal Revenue Service Aims To Curtail Valuation Discounts in Family Controlled Businesses

By: Stephen Wilchins, Esq., Imelda Monaghan, Esq., and Rebecca MacGregor, Esq.

Overview

The Treasury recently issued Proposed Regulations under Section 2704 of the Internal Revenue Code that may dramatically impact your estate planning by eliminating business valuation discounts, such as minority interest discounts and lack of marketability discounts, on transfers of family controlled businesses. When enacted, these Proposed Regulations will have a substantial impact on wealth transfer techniques often used by taxpayers to reduce the impact of the estate, gift and generation-skipping transfer taxes ("transfer tax"). Any individual with a family controlled business should immediately consult with us to discuss how the Proposed Regulations may apply to their specific situation.

Effective Date

A public hearing on the Proposed Regulations will be held on December 1, 2016. The final regulations will become effective on or after the date that the Treasury decision is published in the Federal Register. We anticipate that Taxpayers will have until the end of 2016 to move forward on transfer tax planning to take advantage of valuation discounts. Once the Proposed Regulations are effective, the ability to claim valuation discounts may be reduced or eliminated.

Background

Many families with significant wealth hold a portion of their assets in a common business entity, with one or more family members holding ownership interests in that business entity. When a Taxpayer gives ownership interests in these entities to their children, the gift tax value of such an interest is often reduced by a "minority interest" discount and/or a "lack of marketability" discount. These discounts to the entity's underlying net asset value reflect a minority owner's limited ability to control the entity and/or monetize the investment through liquidation, redemption, transfer or sale. The discounts vary but are in the general range of 25% – 35% of the asset values. The IRS has long been concerned that, in the family context, these valuation discounts artificially depress the value of the gift (and therefore the transfer tax owed) while not meaningfully restricting the ownership rights. The Proposed Regulations are designed to curtail or eliminate these valuation discounts.

For example, assume a Taxpayer owns 100% of an LLC which is valued at $10 million, and he gifts a 40% interest in the LLC to a Trust for his children. Since the Trust cannot force a liquidation of its interest, and the Trustees may be restricted in transferring the LLC interest, a valuation expert may determine that the 40% interest is not worth $4 million. Because there are minority interest discounts and lack of marketability discounts available, a qualified valuation expert may determine that a discount of 30% is applicable. Therefore, the value of the gift (for transfer tax purposes) is $2,800,000, resulting in a reduction in value of $1,200,000 from a net asset valuation of $4,000,000.

Highlights of Proposed Regulations

The Proposed Regulations are very broad in scope. If the Proposed Regulations are adopted in their proposed form, most restrictions that have historically justified business valuation discounts will be ignored. As a result, it would become more expensive from a transfer tax perspective to transfer these interests to family members. Here are some highlights to be concerned about:

- **Deathbed Transfers**: The Proposed Regulations apply a bright-line test imposing a three year rule to transfers of interests where a voting right or liquidation right lapses. For example, if a Taxpayer makes a gift to a family member that creates a minority interest to that family member and the Taxpayer dies within three years from the gift, the value of the gift may not be reduced for the minority interest discount. This three year rule is applicable only if the Taxpayer and members of his family control the entity. (See also Family Attribution below discussing family control).

- **Applicable Restrictions**: Taxpayers have long used the inability of a Taxpayer to access the underlying assets of an entity or to force the liquidation of an entity in order to benefit from valuation discounts. Under the Proposed Regulations, restrictions that limit a Taxpayer's ability to compel liquidation of his interest will be ignored if the restrictions may be removed by the Taxpayer or his family. The holder's interest would be valued as if the holder had a full liquidation right. Since the lack of a right to liquidate drives minority discounts (and to a certain extent, marketability discounts), the availability of such discounts may be completely eliminated for transfers of family held interests to family members.

- **Effect of State Law:** Taxpayers have used the restrictions imposed by state law to claim valuation discount on the business interest that is being transferred. These Proposed Regulations now provide that if there is a state law restriction which may be overridden or removed by the entity's governing documents, then such restriction may not be utilized to discount the value of the business interest.

- **Disregarded Restrictions**: The most dramatic change is that the Proposed Regulations define new restrictions that should be disregarded for transfer tax valuation purposes. The Disregarded Restrictions focus on whether an individual may liquidate or redeem his or her interest in the entity. Disregarded Restrictions include any one or more of the restrictions that: (i) limit the ability of owner to liquidate his interest in the entity; (ii) limit the liquidation proceeds to an amount that is less than a minimum value; (iii) permit the deferral of the payment of the liquidation proceeds for more than six months; <u>or</u> (iv) permit the payment of the liquidation proceeds in any manner other than in cash or property. These restrictions will be disregarded if the restriction either lapses after the transfer, or if the transferor, or the transferor and his family (without regard to certain interests held by nonfamily members) may remove or override the restriction.

- **Control**: The Section 2701 of the Code provides that the term "control" means the holding of at least 50 percent (by vote or value) of the stock of the corporation, or the holding of at least 50 percent of the capital or profits interests in the partnership (including an LLC), or in the case of a limited partnership, the holding of any interest as a general partner.

- **Family Attribution**: The application of the Proposed Regulations cannot be avoided by transferring a nominal interest in the entity to a non-family member (such as a charity or employee). The Proposed Regulations apply a bright line test where entity interests held by non-family members will be disregarded unless all of the following are met: (i) the interest has been held by the non-family member for at least three years before the transfer; (ii) the interest constitutes at least 10% of the value of the equity interest (or capital and profits of a partnership or LLC); (iii) the total equity interest held by the non-family members constitutes at least 20% of the value of all of the equity interest in the entity; and (iv) each non-family member (as an owner) has a put right.

- **Operating Business:** The Proposed Regulations do not differentiate between operating businesses and investment entities.

Recommendation

The Treasury's desire to curtail the use of business valuation discounts has been in existence for quite some time. The issuance of the Proposed Regulations is a major step in accomplishing these objectives. There is currently a window of opportunity before the Proposed Regulations are finalized to plan using valuation discounts for family businesses. This is the time to act while the window of opportunity exists.

To review the alternatives and the estate and gift tax planning strategies that may be appropriate for you and your family, please contact Wilchins Cosentino Friend LLP for more information.