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VALUATION OF FAMILY BUSINESS INTERESTS FOR ESTATE AND GIFT TAX PURPOSES MAY CHANGE UNDER PROPOSED IRS REGULATIONS

As soon as January 1, 2017, proposed IRS regulations which reduce or do away with valuation discounts may take effect. On August 2, the U.S. Treasury Department issued new proposed regulations under Internal Revenue Code Section 2704 in an effort to do away with the practice of allowing discounts in transfers of interests in family business and investment entities. **If the proposed regulations become final in their present form they will reduce or do away with valuation discounts for transfers by gift or sale of family-controlled entity interests to family members and for the interests retained by a senior family member at death.**

The final form and effective date of the regulations has not been determined, but the regulations could be effective as soon as January 1, 2017. Families who expect to make transfers of interests in family-controlled entities that assume the availability of valuation discounts should consider whether to complete those transfers before the proposed regulations become effective. **If you are concerned that these proposed changes may impact your planning, please contact us to review your situation.**

Who Should Contact Us Now? If you fall in one or more of the following categories, we suggest you contact us as soon as possible:

- You own a family business interest that will be subject to estate tax at your death.
- You have historically made regular gifts of discounted business interests to family members or to trusts for the benefit of family members.
- You are actively considering business succession planning that benefits your family.

We have never thought that the "tax tail should wag the dog," but this is a serious possible change and merits your immediate attention. Read on!

The Target of Proposed Regulations: Valuation Discounts. A common estate planning strategy has been to make gifts, sales, or transfers of partial interests in family investments or businesses such as partnerships or limited liability companies. The valuation of the interests transferred typically incorporates significant discounts on the fair market value of the property transferred. The discounts on value, depending on the assets held in the entity, have ranged from 15 to 40%, resulting in significant lower gift or estate tax liability. Typically tax is imposed based on the fair market value of the property being transferred. The fair market value of an interest is generally determined by appraisal and defined as the price at which the property would change hands between a hypothetical willing buyer and willing seller, neither being compelled to buy or sell. For a partial interest in an entity, appraisers discount the value by considering such factors as the lack of marketability of an interest or the lack of control over the entity owning the property. Family relationships among the owners have been disregarded in determining fair market value. In addition, restrictions on an owner’s power to liquidate a legal entity imposed by default state law could be considered in determining the discounted value.

In 1990 the Internal Revenue Code was amended by Congress to curb perceived abuses relating to transfers of interests in corporations and partnerships to family members. Section 2704 was one of those new laws. It also gave the IRS broad authority to issue regulations concerning voting or liquidation rights. Initial regulations were issued long ago, but no comprehensive and definitive guidance followed. After 1990 the IRS argued in court cases that Section 2704 and other sections precluded discounts being taken by taxpayers. The IRS lost a number of cases where the transfers were carefully documented and the values were carefully established. Now, decades later, the IRS has used its authority to issue the proposed regulations that, if enacted, will eliminate the use of most, or all, of the commonly used discounts in valuing interests in family-owned entities.

What are Regulations and How Do They Work? Regulations are issued administratively by federal agencies (in this case the Treasury / IRS) to provide added guidance or additional rules pertaining to laws passed by Congress. Before “proposed” regulations become final the Treasury must consider comments and hold a hearing about them. After a hearing, the regulations are made final, or amended, or withdrawn. Some proposed regulations are made final quickly, while others remain in their proposed form for years, making it more uncertain what the rules will be.

When Will the Regulations Be Effective? The hearing on the new Section 2704 regulations is currently scheduled for December 1 and the final regulations will not be effective until 30 days after they are issued. As a result, the earliest effective date of the regulations would be January 1, 2017. However, the proposed regulations also try to retroactively tax discounted lifetime transfers made before the date final regulations are issued if the person making the transfer dies within three years after the transfer (this kind of retroactivity has seldom passed muster with the courts).

The proposed regulations are very long and have received many negative comments, so it is possible final regulations will be delayed. However, most commentators we have talked to believe that there will be some significant and unfavorable change to the valuation process under the final regulations. We will continue to watch the developments concerning the proposed regulations.

The question is whether there is something that should be done before January 1, 2017 (the earliest effective date for final regulations). We suggest you contact us if you wish to use currently available valuation discounts for transfers of family controlled business or entities in your estate planning.

For further information or questions, please contact us.

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The Fine Print.