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Client Alert

Proposed Treasury Regulations Would Drastically Curtail Valuation Discounts for Transfers of Interests in Family Controlled Entities

August 17, 2016 – Sophisticated estate plans often include gifts, sales or other transfers to family members which incorporate discounts on the value of the property transferred. These "valuation discounts" can range from ten to forty percent (and sometimes even higher). On August 2, 2016, the Treasury Department and the Internal Revenue Service ("IRS") issued proposed regulations under Section 2704 of the Internal Revenue Code ("Code") which, if finalized in their current form, would severely limit the ability to use valuation discounts (the "Proposed Regulations"). A hearing on the Proposed Regulations is scheduled for December 1, 2016, and we believe that the new restrictions will not be applicable until sometime in 2017, when regulations are anticipated to be issued in final form. Therefore, there is still a window of opportunity to plan using the current valuation rules.

Background

Wealthy families often use family limited partnerships, closely held corporations and limited liability corporations (hereinafter, each referred to as a "family controlled entity" or, collectively, as "family controlled entities") to (1) control and manage family assets, (2) limit liability and (3) provide creditor protection. A successful estate planning technique is to shift any appreciation in a family controlled entity to younger generations; this is often accomplished by transferring an interest in a family controlled entity to a descendant or to a trust for the benefit of a descendant. Under current law, when a parent or grandparent transfers a non-controlling, minority interest in a family controlled entity to a descendant, a valuation discount can be applied to reduce the value of the property transferred for transfer tax purposes. Valuation discounts are most commonly claimed based on (1) the lack of marketability of the interest transferred and (2) the lack of control vis-à-vis the family controlled entity represented by the interest transferred. The IRS has attacked the use of such valuation discounts for years with mixed results.

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Code Section 2704

Section 2704 of the Code was enacted in 1990 to curb perceived taxpayer abuses associated with the valuation discounts claimed in connection with intra-family transfers of interests in family controlled entities. Specifically, Section 2704 provides that restrictions in an operating agreement for a family controlled entity that artificially restrict the ability of a partner/member to force a liquidation of the entity are disregard in valuing any interest in the entity being transferred to a family member – in other words, no discount is allowed. However, Section 2704 has not been used to disregard restrictions imposed by federal or state law or restrictions that are commercially reasonable (such that they would be utilized in an arm's length transaction). Thus, by carefully structuring transactions and navigating the nuances of Section 2704, taxpayers and planners have up until now been able to effectuate intra-family transfers of interests in family controlled entities utilizing valuation discounts.

The Proposed Regulations

The provisions of Code Section 2704 give the Treasury Department and the IRS broad authority to promulgate regulations effectuating the statute's intent. After years of anticipation, the Proposed Regulations were issued on August 2, 2016. The Proposed Regulations are lengthy, dense and detailed, but the bottom line is that, if enacted in their current form, the Proposed Regulations would appear to eliminate most, if not all, of the valuations discounts utilized in intra-family transfers of interests in family controlled entities, even with respect to interests in entities that are active businesses controlled by a family. The Proposed Regulations accomplish this, in part, by vastly expanding the class of restrictions that are disregarded under Section 2704. While there are some important exceptions for certain family controlled entities, the Proposed Regulations would drastically limit the use of valuation discounts in connection with an intra-family transfer of an interest in a family controlled entity.

Before the Proposed Regulations can become final, written comments can be submitted to the Treasury Department and IRS, and a public hearing is scheduled for December 1, 2016. Many commentators have already questioned whether the Proposed Regulations exceed the statutory authority of the Treasury Department and the IRS. While the timing and the exact content of the final regulations is uncertain, there may be a limited window available to take advantage of valuation discounts for transfers of family controlled entities. Clients contemplating such a transaction should contact us to discuss before the changes to the law become final.

If you require any additional information about the Proposed Regulations, please contact:

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