Valuation Discounts for Transfers of Interests in Family Entities May Be Severely Curtailed – You May Want To Act Now

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On August 2, 2016, the Treasury Department and the Internal Revenue Service (the "IRS") issued proposed regulations under section 2704 (the "Proposed Regulations") of the Internal Revenue Code of 1986, as amended (the "Code"), in an effort to limit otherwise available valuation discounts of interests in various entities for transfer tax purposes (i.e., gift taxes, estate taxes and generation-skipping transfer taxes). The Proposed Regulations are not final, and they may not affect any transfers that occur prior to the date the regulations are published in final form, so there is still a window of opportunity for planning using the current valuation rules.

Background and Current Law

The most successful estate planning techniques pass significant value from one generation to the next by freezing or establishing an appreciating asset's value and shifting the asset's growth to a younger generation. For clients with interests in closely held corporations or partnerships (a "Family Entity"), this often can be accomplished by transferring an interest in that Family Entity to a child or grandchild or, more commonly, to a trust or trusts for children and/or future generations (i.e., a dynasty trust).

Historically, individuals' interests in Family Entities are subject to valuation discounts when a noncontrolling, minority interest is transferred. Discounts for lack of marketability and lack of control can account for the reduced value of an interest transferred because of the restrictions placed on an individual's right to vote, or the ability to transfer or liquidate his or her interest in the Family Entity, among others.

Section 2704 of the Code is designed to eliminate perceived abuses by taxpayers in artificially reducing the transfer tax cost of intra-family transfers of interests in Family Entities through the use of valuation discounts. Through careful navigation of the rules under section 2704, however, clients have been able to transfer interests in Family Entities to family members or dynasty trusts on a discounted basis; these discounts typically range between twenty and forty percent, thereby lowering the transfer tax cost of such transfers.

As a result of these valuation discounts, practitioners are able to achieve greater transfer tax savings for their clients and transfer more wealth down generational lines by using common estate freeze techniques. With the release of the Proposed Regulations, however, Treasury has sought to further limit the availability of valuation discounts in connection with intra-family transfers of interests in Family Entities using such techniques.

Proposed Regulations

The Proposed Regulations would significantly amend the current regulations under section 2704. This would, in turn, drastically affect the ability of individuals to benefit from valuation discounts when transferring interests in Family Entities to a younger generation. Below are a few examples of the changes the Proposed Regulations seek to make to the current landscape under section 2704, thereby eliminating common ways to achieve valuation discounts under current law.

The scope of restrictions on an owner's ability to liquidate his or her interest in an entity that will be disregarded for valuation purposes under section 2704 would be expanded so that any restriction will be disregarded, unless it is less restrictive than a *mandatory* restriction under state law that cannot be removed or overridden. Thus, individuals with Family Entities in jurisdictions that have enacted statutes with harsh but optional restrictions may no longer benefit from valuation discounts when transferring interests in those businesses to family members.

Pursuant to Treasury's broad authority under section 2704(b)(4) to disregard "other restrictions," the Proposed Regulations also seek to impose an additional class of "disregarded restrictions" for valuation purposes. The new class of disregarded restrictions applies if the restriction on an interest holder's right to liquidate his or her interest in a Family Entity will lapse after a transfer, or if the transferor and his or her family can remove the restriction after the transfer.

Critically, under the current rules, the limitations of section 2704 only apply to partnerships and corporations. The Proposed Regulations expand the class of entities covered under section 2704 and its regulations to include limited liability companies ("LLCs"), S corporations and other business entities or arrangements.

Additionally, the Proposed Regulations intend to prevent individuals from giving nominal interests to nonfamily members, such as charities, in order to avoid certain restrictions from being disregarded for valuation purposes, unless the interest owned by the nonfamily member is "economically substantial and long-standing." To accomplish this, the Proposed Regulations provide a bright-line test to determine whether the interest of a nonfamily member will be recognized for purposes of calculating a valuation discount.

It is important to note that restrictions created on or before October 8, 1990 will not be subject to the

Proposed Regulations, so any amendments concerning such restrictions should be carefully considered to ensure available valuation discounts are utilized properly. Also, generally speaking, the new regulations will only apply to transfers in Family Entities made after the regulations are published as final regulations. If you would like to transfer an interest in a Family Entity or discuss the implications of the Proposed Regulations on your planning, please contact us immediately, as time may be running out on your ability to achieve significant transfer tax savings through the use of valuation discounts.

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