Proposed regulations could limit valuation discounts for family entities

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On August 4, 2016, the U.S. Treasury Department issued Proposed Code §2704 Regulations pertaining to the value of transfers of interests in family held entities. These proposed regulations affect transfers of ownership interests in corporations, partnerships, limited liability companies, and even some disregarded entities that are transferred to family members. The Proposed Regulations severely restrict the ability to discount the value of family owned entities and could become effective as soon as early 2017, leaving a small amount of time to thoughtfully make gifts and transfers of interests prior to year-end.

Background

Typically, ownership interests in family businesses are subject to restrictive language, making it difficult for independent third parties to be involved. The overall ownership in the business remains in the family, and protects the family business from creditors and future ex-spouses. The restrictive language also means the ownership interest is worth less money, because the ownership interest cannot be sold like a traditional stock on the NYSE (who wants to invest with someone else's family, and be unable to make decisions?). The restriction lowers the value due to discounts such as minority interest, lack of control, and lack of marketability. This offers an attractive way to transfer assets to the next generation because less lifetime gift tax exemption (currently $5.45 million) is used. The Proposed Regulations will reduce the leveraging of these transfers.

Applicable restrictions

Code §2704 (b) disregards "applicable restrictions." Prior to the Proposed Regulations, applicable restrictions were ones that limit the ability to liquidate and either lapse (disappear) after the transfer or can be removed by the transferor or the transferor's family. However, federal and state law restrictions were exempt. Now, the Proposed Regulations disregard any restriction that is greater than what is imposed by state law. This virtually eliminates the discounts, resulting in a higher value for the entity. The higher value will create a larger gift or transfer on death, and thus the imposition of more estate tax.

Lapsed (disappearing) rights

The other main provision is Code §2704 (a) which states that if there is a lapse of a voting or liquidation right in an entity and the owner's family holds the control both before and after the lapse then the value of the lapse is treated as a gift. The Proposed Regulations further state that if an interest is transferred, and the owner dies within three years, then the owner's estate will include the difference in value as though the interest lapsed on death. For example, if an owner gives 33 shares of non-voting stock to each of the owner's three children, and retains one voting share, there will be a discount for the non-voting shares. However, if the owner dies within three years, the owner's estate will include the difference in value between the non-voting shares and voting share.

Control

The Proposed Regulations also define "control" to include holding at least 50% of either the capital or profits interest, or owning any equity with the ability to cause a liquidation. Attribution of ownership rules are applied, so it's not just the individual's interest, but also those interests owned by the entire family, including those owned indirectly, such as in trust or other entities.

Effective date

There is currently a 90 day comment period on the Proposed Regulations, and a hearing will occur on December 1, 2016. If the Final Regulations are issued (after the hearing) most of the provisions will then be effective 30 days later. Until then, the current Regulations apply. This provides a unique opportunity between now and year end to complete transfers to family members.

Is this Really the End?

Of course not. It just means more thought needs to go into business succession planning. For example, Code §2704 only applies to entities. If an individual wants to give fractional ownership in real estate, a discount will be available. There are also upsides to the new §2704 regulations. For persons who are not likely to owe estate tax (estates larger than $5.45 million or twice that for married couples), there is potential for increasing basis in ownership interests transferred upon death, because discounts will not be allowed, i.e., the persons inheriting the interests in the entity will owe less capital gains tax when the entity sold.

As more unfolds, stay tuned to find out some of the ways that families can transfer assets from one generation to the next in the most tax efficient manner. If you have any questions, please contact Katherine E. Wensink or any member of our Tax and Benefits Department.

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