

August 30, 2016

Proposed Treasury Regulations Will Limit Valuation Discounts For Family-Controlled Entities

On August 4, 2016, the Internal Revenue Service published proposed regulations, which to the extent implemented, would reduce significantly or eliminate the valuation discounts now used to value interests in family-controlled entities, including corporations, partnerships and limited liability companies. As a result, transfers of such interests would result in larger amounts being subject to gift or estate tax.

Background

Under current law, when a non-controlling interest in a family-controlled entity is gifted or sold for estate planning purposes, or included as part of a decedent's estate, the value for gift or estate tax purposes is the fair market value on the date of gift or death, taking into account discounts that typically apply to such interests, namely, discounts for lack of control and lack of marketability. Such discounts can reduce the value of the gift or bequest from the pro rata share of the underlying assets in the company by 35 percent or more.

Under the proposed regulations, the discounts used in valuing such interests would be reduced substantially or eliminated so that the value would be more or less equal to the value of the pro rata share of the underlying assets, without reduction for lack of control or lack of marketability.

Persons Who May Be Affected by the Proposed Regulations

Individuals who own an interest in a family-controlled entity, and whose net worth exceeds, or may exceed after application of the proposed regulations, the federal estate tax exemption (currently, \$5,450,000) or the state estate tax exemption (currently, \$4,187,500 in New York State) may be affected by the regulations, and may see the value of the interest increase for estate and gift tax purposes. As a result, such persons soon may be subject to higher federal and state estate and gift taxes.

Example

Assume that an individual owns a 100 percent interest in a family business having a value of \$7,000,000, and wants to transfer 90 percent to two children – 45 percent each. Assume further that the individual is unmarried and has made no prior taxable gifts, so that the individual has \$5,450,000 of unused gift tax exemption that may be used to shelter any gifts from federal gift tax. Under current law, the value of the 45 percent interest to be transferred to each child would be discounted to reflect lack of control and lack of marketability, which might reduce the gift tax value of such interest by 35 percent or more from the pro rata share of the underlying assets. Thus, each share might be valued at \$2,047,500, which is 35 percent less than the pro rata share of the underlying assets ($35\% \times (45\% \times \$7,000,000)$). As a result, there would be no gift tax payable on such transfers because the combined value of the two 45 percent interests for gift tax purposes would be \$4,095,000 ($2 \times \$2,047,500$), which is less than the unused federal gift tax exemption of \$5,450,000.

Now assume that the same transfer takes place after the proposed regulations have been finalized. Under the proposed regulations, the valuation discounts would be eliminated. Thus, the gift tax value of each share would be based on the pro rata share of the underlying assets, with no discount; here, \$3,150,000 ($45\% \times \$7,000,000$). As a result, the combined value for gift tax purposes would be \$6,300,000 ($2 \times \$3,150,000$) and there would be federal gift tax payable of approximately \$340,000.

Effective Date of Proposed Regulations

The proposed regulations will become effective after final regulations are issued, some time after a public hearing on December 1, 2016. The exact date when the proposed regulations will become effective is not known. However, the earliest date that the most significant provisions will become effective is December 31, 2016.

Steps to Be Taken to Avoid or Minimize the Impact of the Proposed Regulations

While the exact provisions of the new regulations will not be known until final regulations are issued, it is likely that the tax benefits now available for transfers of minority interests in family-controlled entities will be negatively affected. By taking steps now, one may be able to "lock in" the tax benefits before the proposed regulations go into effect.

If you or a family member owns an interest in a family-controlled entity, it is important to consider whether to make any transfers to family members and to make such transfers prior to the effective date of the proposed regulations. After the effective date, such transfers may become more expensive.