

PROPOSED REGULATIONS MAY SUBSTANTIALLY REDUCE THE AVAILABILITY OF VALUATION DISCOUNTS FOR INTERFAMILY TRANSFERS OF BUSINESS INTERESTS

Estate Planning Alert
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On August 2, 2016, the Treasury Department published Proposed Regulations to Chapter 14 of the Internal Revenue Code which, if adopted, may substantially reduce the availability of valuation discounts for inter-family transfers of family business interests. At present, the Proposed Regulations are just that – proposed – giving clients a potentially narrow window to implement strategies that can reduce their estate, gift, and generation-skipping transfer tax exposure.

Presently, taxpayers can transfer interests in a closely-held business to family members (generally members of a lower generation) at a discounted value. This is traditionally accomplished by giving the recipient a non-voting, minority (i.e., less than 50%) interest and restricting his or her ability to dispose of that interest (usually accomplished by including transfer restrictions in the business' governance documents). These discounts, which can total upwards of 40%, are designed to reflect the economic reality that a third party would not pay \$1 for a 1% interest in a \$100 family business because: (1) as a minority owner, the third party cannot control business decisions; and (2) due to transfer and liquidation restrictions, and the small market for selling closely-held business interests, the third party cannot easily sell or otherwise liquidate the business interest.

The Proposed Regulations would change this landscape. Under the Proposed Regulations, certain restrictions on an owner's liquidation and redemption rights in a family-controlled entity are disregarded if the transferor, members of the transferor's family, or an entity holding interests for such persons, can remove or override those restrictions. In other words, if the entity is family-controlled and members of the transferor's family and certain attributed entities (acting together if necessary) can remove the liquidation and redemption restrictions by amending the applicable business governance documents, any restriction contained in those documents is disregarded for valuation purposes. By disregarding these restrictions, the Proposed Regulations may substantially reduce the availability of discounts applicable to transfers of interests in family-controlled entities. Although the full impact of the Proposed Regulations on an appraiser's determination of discount valuation is

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uncertain at this time, if the Proposed Regulations are enacted, clients will likely pay a greater transfer tax cost for giving away fractional interests in a closely-held family business.

Fortunately, there is still time to act. The Proposed Regulations must undergo a 90-day comment period, and the Treasury Department is holding a public hearing on December 1, 2016. It is likely that the Treasury will receive substantial comments, as some practitioners believe the Proposed Regulations are contrary to prior judicial determinations (which have upheld discounts in the inter-family context) and exceed the Treasury's authority under the Code. Any final Regulations issued after this comment period will not be effective for 30 days after those final Regulations are published (which will not be before 2017).