LOEB & LOEB LLP

Trusts and Estates

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IRS Seeks to Limit Valuation Discounts for Family – Controlled Entities: Proposed Section 2704 Regulations

Many sophisticated estate planning techniques include gifts, sales, or other transfers to family members that incorporate significant discounts on the value of the property transferred. These discounts can range from 15 percent to 40 percent, or even higher. As a result, significant wealth can be transferred to the next generation at greatly discounted values. Some of these techniques include transfers of fractional interests in real property or business entities such as limited partnerships, limited liability companies, or closely held corporations. The size of the discount depends upon a number of factors, including the entity's organizational structure and provisions of the partnership or operating agreement and of state law that place restrictions on control of the entity and on marketability.

Standard for Determining Value of Interest. The standard for determining the value of a transferred interest for gift and estate tax purposes under the Internal Revenue Code is the fair market value of the interest at the time of the transfer. Fair market value is the price at which the property would change hands between a hypothetical willing buyer and willing seller, neither being under any compulsion to buy or sell. For example, what would a third party pay for a non-controlling interest in an entity with provisions that restrict voting rights and the ability to sell the interest to a third party? Until now, this standard disregarded family relationships in determining fair market value.

Internal Revenue Code Section 2704. Internal Revenue Code Section 2704 was enacted in 1990 to curb perceived abuses by taxpayers related to provisions in partnership or LLC operating agreements that artificially restricted the ability of a partner or member to force a liquidation of the entity. In these instances, Section 2704 provides that these restrictions are disregarded in valuing the interest being transferred to a family member so that no discount is allowed. Until now, this provision has not been used to disregard restrictions imposed by federal or state law or any commercially reasonable restrictions that would normally be used in an arm's-length business transaction, which has allowed taxpayers to take advantage of lack of control and lack of marketability discounts for intrafamily transfers of closely-held entities.

Challenges by IRS Routinely Disregarded by Courts. Over the years, the IRS has tried to expand the reach of Section 2704 beyond typical liquidation

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restrictions and has argued that many restrictions (including those currently resulting in discounts for lack of control and lack of marketability) should also be ignored for transfers between family members. In most properly structured transactions, the courts have rejected the arguments by the IRS and permitted the taxpayer to take appropriate discounts on the transfer to family members. Because courts were unwilling to accept the position of the IRS that these discounts should be ignored when the transfer was between family members, the IRS previously sought legislative assistance to revise Section 2704. To date, no legislative change has been forthcoming.

New Proposed Regulations Under Section 2704. Under Section 2704, the IRS was given broad authority to issue regulations to implement the statue's intent. On August 2nd, after much anticipation, the Treasury Department issued new proposed regulations under Section 2704. Mark Mazur, Treasury assistant secretary for tax policy, said in a statement that the proposed regulations would eliminate a practice "that certain taxpayers have long used to understate the fair market value of their assets for estate and gift tax purposes."

The proposed regulations, which attempt to significantly limit the ability to claim valuation discounts, appear to be broad and far-reaching and could be challenged in light of Section 2704's legislative history. Some commentators have questioned whether they are within the IRS's statutory authority. While the validity of the Section 2704 regulations may be challenged by taxpayers on the grounds that the regulations are an abuse of discretion by the IRS and beyond the scope of the type of restrictions prohibited by Section 2704, it will be some time before we see how the courts address this situation.

Before the proposed regulations are adopted as final, written comments can be submitted by interested parties and a public hearing is scheduled for December 1, 2016. The eventual final regulations, which could differ from the proposed regulations due to the commentary and other factors, will not be effective until after they become final. However, in light of the long history of the IRS challenging such valuation discounts, planning with family-controlled entities now becomes more problematic even before final regulations are issued. Taxpayers may want to consider completing transactions that could be affected before year end.

The details of the proposed regulations are important, but the bottom line is that they would appear to eliminate most if not substantially all valuation discounts for family-controlled entity interests, even including active businesses owned by a family. They do this, in part, by expanding the class of restrictions disregarded under Section 2704 to include those under the governing documents and even under state law (regardless of whether that restriction may be superseded by the governing documents).

But there are important exceptions. The proposed regulations do not apply to all entities depending on the level of family control and when and to what degree any unrelated parties acquired an interest in the entity. Another exception is a commercially reasonable restriction imposed by an unrelated person providing capital to the entity for the entity's trade or business.

Moreover, one should keep in mind that the estate tax benefit (at a taxpayer's death) of valuation discounts is often offset by an income tax cost due to the lower tax basis of the inherited property. Entity interests valued without discounts will obtain a higher "step up" in basis at death.

These new regulations are particularly important in the context of intra-family gifts and sales to effectively reduce the estate tax payable at a decedent's death. If you are interested in making such gifts and/or sales and believe that you would benefit from such valuation discounts, it is imperative that you act promptly.

Please contact us if you would like to discuss the implications of this important development for your estate planning.

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