IRS Proposed Regulations Would Impose Major Restrictions on Valuation Discount Planning

Last month, the IRS issued proposed regulations under section 2704 of the Internal Revenue Code that would permanently change estate planning for families that own a controlling interest in a privately held entity. If adopted, the proposed regulations would restrict or eliminate available valuation discounts, thus directly increasing the tax associated with certain transfers.

Valuation discounts are an important tool in estate planning. The two main discounts are for lack of control (also referred to as minority interest) and lack of marketability. In order to take advantage of these discounts, many families create family limited partnerships (FLPs) and limited liability companies (LLCs) to hold and transfer family assets for estate planning purposes. In some cases, discounts of 40% or more have been allowed for transfer tax purposes on gifts and bequests of interests in such FLPs and LLCs.

The IRS has consistently challenged the use of valuation discounts but has been mostly unsuccessful in its challenges. So, on August 2, 2016, the IRS issued proposed regulations which would significantly limit, or possibly eliminate, valuation discounts. The proposed regulations will not take effect until they are issued as final regulations (or soon thereafter), and a hearing on the proposed regulations and public comments to them is scheduled for December 1, 2016. **Most importantly, there may be a brief window of opportunity for families to take estate planning steps to take advantage of the valuation discounts prior to the imposition of new regulations.**

National Law Review put together a brief review of the major categories of the proposed regulation, as described below. Additionally, Clifton Larson Allen has written the following articles, which you may find useful: IRS New Attacks on Valuation Discounts and Examples of New Proposed IRS Rules on Valuations.

Major Categories of the Proposed Regulations

Applicable Restrictions Redefined: Present law targets valuation abuses with respect to liquidation rights. Thus in valuing a transfer of an interest in a controlled entity, "applicable restrictions" are disregarded. Under current regulations, applicable restrictions are those that are more restrictive than state law. The proposed regulations expand the definition of an applicable restriction, such that even state law defaults would be "applicable restrictions" – unless the law provided that they could not be modified, which is rare in practice.

Disregarded Restrictions: Perhaps the most noteworthy section of the proposed regulations is the introduction of a class of "disregarded restrictions." Like applicable restrictions, disregarded restrictions would be ignored in valuing an interest in an entity for estate and gift tax purposes. A disregarded restriction includes:

1. Any restriction or limitation on the ability of the holder to liquidate or have his or her interest redeemed;
2. Any restriction limiting the amount received by the holder to less than a minimum value, defined as a pro rata share of the entity value reduced by certain outstanding obligations;
3. Any provision permitting deferral of redemption proceeds for more than six months; and
4. Any provision that permits repayment in anything other than cash or property. Notably, a promissory note is not considered "property" unless the entity is engaged in an active trade or business, the proceeds are not attributable to passive assets, the note is adequately secured and the note is issued at a market interest rate.

The Three Year Rule: This rule is intended to capture deathbed transfers. If a transfer made within three years of death results in the lapse of a voting or liquidation right, the transferor's gross estate will be increased by the value of that lost liquidation right. This effectively creates a phantom asset in the estate – it will be taxed, but the tax must be paid from other assets of the estate.

Who is Affected?

The proposed regulations will primarily impact individuals that exceed the $5.43 million estate tax exemption (nearly $11 million for couples). That said, anyone with an interest in a family controlled entity may be affected. Roughly speaking, an entity is controlled if family members collectively own greater than 50 percent of the entity. In a complex set of rules, interests held in trust are attributed to the grantors and beneficiaries of the trust.

For purposes of determining control, the proposed regulations would ignore interests held by nonfamily unless:

1. The interest has been held by the nonfamily member for at least three years;
2. The interest is at least a 10 percent equity interest;
3. Nonfamily members in the aggregate hold at least 20 percent of the equity of the entity; and
4. Each nonfamily has the right to put his or her interests to the company and receive a share of the underlying value.

The stated purpose of this provision is to limit taxpayers' ability to give "insignificant" interests to nonfamily members in order to escape being subject to the rules.

When Would the Regulations Take Effect?
At this point, the regulations are in proposed format. Comments are due by November 2, 2016 and the IRS has scheduled a public hearing on December 1, 2016. While the exact timing is uncertain, the proposed regulations could not take effect before December of this year.

It is possible that comments submitted to the IRS will result in modifications and clarifications, which can take time, but the IRS has indicated that this is a high priority. It is possible that regulations would be finalized and effective in early 2017.

Strategy Moving Forward
The Family Business Estate Tax Coalition (FBETC) is coordinating the submission of comments to the regulatory docket from a broad and diverse range of stakeholders: The goal will be an overwhelming number of comments evidencing that the proposed regulations (i) represent a step backward from the bi-partisan, permanent estate tax relief enacted in 2012, (ii) will have immediate, negative economic impacts on the family business community and reduce the level of family business job creation, (iii) are wholly inconsistent with establish legal precedent, and (iv) unfairly discriminate against the unique structures of family held businesses.

Coordinate a federal legislative response to repeal, or limit the scope of, the regulations once finalized: Although the grant of regulatory authority under Section 2704(b) is broad, the legislative history expressly provided that Section 2704 would not affect minority and other similar valuation discounts. The need to clarify congressional intent could thus provide the basis of a legislative response, which might include: (i) additional correspondence from the Hill asking for clarifications and opposing the rule, (ii) legislation to repeal the rule, and (iii) hearings, speeches and other communications making clear the intent of Congress when it adopted Section 2704.

Coordinate a challenge to the legal validity of the proposed regulations: Ultimately, a court will need to determine whether the regulations are consistent with the underlying statute and to what extent legislative history is relevant and controlling.