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Transferring the Family Business Is About to Get More Costly

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On August 2, 2016, the IRS released long-awaited proposed regulations under Section 2704 of the Internal Revenue Code. Once finalized, these proposed regulations will significantly limit the use of valuation discounts that are typically applied with regard to transfers of interests in many family-controlled entities for gift, estate and generation-skipping transfer tax purposes.

"Minority interest," "lack of marketability" and "lack of control" discounts can be applied under current law to the valuation of interests in family-controlled entities that are transferred to family members. Such discounting provides for estate and gift tax savings by reducing the value of the transferred interests. However, these new regulations, once enacted, will greatly reduce—if not entirely eliminate—the applicability of these various discounts, resulting in higher asset values (and higher gift and estate taxes).

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By way of background, in 1990, the Congress enacted special provisions to the Internal Revenue Code that were designed to limit what it perceived to be abusive valuation practices for the transfer of interests between family members in various family-owned corporations and partnerships. These new proposed regulations increase the scope of existing law—and significantly curb the use of discounts when valuing minority ownership interests in a family business when those are transferred to family members (whether by gift, sale or bequest). These proposed regulations would severely restrict the ability of a taxpayer to make leveraged (*i.e.*, discounted) gifts and will likely increase estate taxes on interests in a family-controlled entity that a taxpayer may own at death. To accomplish this goal, the proposed regulations allow the IRS to ignore restrictions on transfer or liquidation under governing documents for valuation purposes, even if they are permissible under state law.

Taken in their entirety, these proposed regulations pose a significant obstacle to the application of estate planning techniques that would be designed to transfer family businesses and other similar entities using customary methods of valuation.

However, all is not lost. First, we anticipate strong challenges to the validity of the proposed regulations if they are enacted in their current form—as they run contrary to a well-detailed legislative history. Ultimately, the validity of these proposed regulations may be settled in court, which will likely be a long battle that will play out in several stages over many years.

Second, and most important, these proposed regulations are not current law. The IRS and the Treasury Department have invited public comments regarding these regulations and will hold a public hearing in December 2016. Sometime after that hearing, the proposed regulations will be finalized and become law.

Until the proposed regulations are enacted, a narrow window of opportunity exists to employ estate planning strategies that make use of currently available valuation discounts. Because this opportunity will likely disappear soon, the time to plan is now.