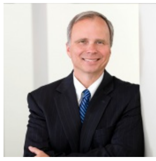
Proposed IRS Valuation Rules Could Have Major Impact on Family Wealth Transfers



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New rules proposed by the IRS on August 2 could severely limit or eliminate the use of discounts commonly applied to value interests in family businesses for tax purposes. These discounts, which have been approved in numerous prior court decisions, have significantly reduced the gift and estate tax cost of transferring interests in family businesses over the past several decades.

The proposed rules amend and expand on regulations previously issued under Section 2704 of the Internal Revenue Code, which was adopted by Congress in 1990 to combat perceived abuses in the valuation of interests in family-controlled entities. Although regulations under Section 2704 have been in place since 1992, the IRS considered the existing regulations ineffective, and had included new 2704 regulations on its list of "priority guidance" projects for several years.

Key changes proposed in the new rules include the following:

1. *Application to Broader Class of Business Entities* The proposed rules would apply to virtually all types of business entities, including LLCs, while the existing rules apply only to partnerships and corporations.
2. *Eliminating Discounts for Certain Transfers Within Three Years of Death* Under the proposed rules, a transfer within three years of death that results in the loss of the power to liquidate a business will cause the value of the lost liquidation right to be added to the transferor's estate. The loss of a liquidation right can occur when the owner of a controlling interest in the family business transfers control to other family members.

3. *Removing Major Exception to Types of Restrictions That Are Ignored for Valuation Purposes*. Existing regulations provide that limitations on an owner's ability to liquidate an entity are ignored in valuing interests transferred to family members if the family has the ability to remove those limitations, *unless* the limitations on liquidation are no more restrictive than default rules under state law. Over time, this state law exception effectively rendered the existing regulations toothless, as most state statutes were changed to include defaults rule requiring the consent of all owners to liquidate a partnership or LLC, and providing that an owner has no right to require the partnership or LLC to redeem the owner's interest. The proposed regulations eliminate this state law exception.
4. *Adding a New Category of "Disregarded Restrictions" That Are Ignored for Valuation Purposes*. The proposed rules create a new category of "disregarded restrictions" that are ignored for purposes of valuing interests in a family-controlled entity. These restrictions include virtually any limitation in an entity's governing documents or default state law rules that would prevent an owner from
5. forcing the redemption of his interest in the entity at a price equal to a proportionate share of the entity's net asset value, to be paid within six months after notice.

The proposed regulations, if adopted in their current form, would drastically curtail wealth transfer and tax reduction strategies available under current law. Taken as a whole, the proposed rules would virtually eliminate valuation discounts for lack of control traditionally applied in gifts and sales of family business interests and could substantially impact discounts for lack of marketability, as well.

Fortunately, the majority of the new valuation rules will apply only to transactions that occur *after* they are finalized. (It is possible that the new rules will apply to certain transfers completed before the rules are finalized if the transferor dies within three years of the transfer and after the rules are made final.) The IRS is currently accepting comments on the proposed rules and has scheduled a hearing on the rules for December 1, 2016. At the very earliest, then, final regulations could be published sometime in 2017, impacting transactions that close after that date.

This timeline gives families currently contemplating wealth transfers a window of opportunity to complete transactions while the traditional approach to valuation discounts remains in effect. If you hold an interest in a family business entity and would like to discuss the potential impact of the proposed rules on your situation, please contact one of the attorneys linked below.