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What's Next?

Implications of proposed IRS regulations for family-owned entities

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At the American Bar Association's Section of Taxation meeting in May 2015, Cathy Hughes, estate and gift tax attorney advisor with the U.S. Treasury Department's Office of Tax Policy, indicated that proposed regulations under IRC Section 2704(b)(4) (§2704) concerning restrictions on valuation discounts pertaining to the transfer of family-owned entity interests could be issued by mid-September 2015. As of this writing, no such regulations have been issued, though further informal communication on behalf of the Internal Revenue Service (IRS) suggests that new regulations are forthcoming. Meanwhile, questions and speculations abound.

For now, many advisors urgently suggest effectuating a transfer before the proposed regulations are issued.

Background

Corporations, partnerships, limited partnerships and limited liability companies (LLCs) are common ownership structures for family businesses created for a multitude of legitimate planning and business purposes. These include pooling and management of family assets, succession and generational planning, asset protection, development of consistent investment philosophy, and confidentiality of ownership.

The transfer of partnership and LLC interests among family members is subject to gift and estate tax based on the interest's fair market value (FMV). In determining FMV for income tax purposes, valuation discounts are hotly debated, as their usage effectively reduces federal estate and gift taxes on transfers of interests in privately held family entities.

It has been a long-standing practice of the IRS to challenge and scrutinize the use and validity of valuation discounts. IRC§2704 was enacted to limit the use of discounts in transfers or gifts of interests in family entities. According to Jonathan G. and Matthew Blattmachr in their article "Anticipating New Regulations under IRC Section 2704":

"Effective Oct. 9, 1990, IRC §2701 through 2704 were enacted to prevent the reduction of taxes through the use of 'freezes' and other arrangements designed to reduce the value of the transferor's taxable estate or gifts and discount the value of the taxable transfer to the beneficiaries of the transferor without reducing the economic benefit to the beneficiaries. Generally, IRC Section 2704(b) provides that certain 'applicable restrictions' (that would typically justify discounts in the value of the interests transferred) are to be ignored for purposes of valuing interests in family-controlled entities, if those interests are transferred (either by gift or on death) to or for the benefit of other family members."[1]

> ***New regulations are enforced when finalized, which could take months or years.***

What's Next?

While proposed regulations suggest the IRS is considering a new rule, regulations are legally effective and enforced when finalized, which could take months or years. There are indications that the effective date will be retroactive to the date of the release of the regulations and applicable to all transfers after that date.

In addition to the uncertain timing of the proposed regulations' effective date (whether retroactive or not), two factors are in question: (1) whether valuation discounts will be eliminated completely or just reduced; and (2) whether the regulations will apply to entities owning passive assets or operating companies.

Assuming the regulations are released in the near future, and given the information currently available, it's worth considering the following:

- It will be more costly to transfer interests in family-owned entities.
- There may be a safe harbor provision permitting taxpayers to draft governing documents of a controlled entity to avoid the application of new valuation provisions.
- There will be additional categories of restrictions outside of the current "applicable restriction" under IRC§2704.
- It's possible that regulations will apply only to holding entities and *not* operating businesses. If so, actual operating companies will be exempt from the regulations, allowing for standard valuation discounts.
- Discounts could be denied not merely for interests in family-owned entities, but also for interests in private equity funds and hedge funds held by fund managers.
- Proposed regulations might apply broadly to all entity forms, eliminating valuation discounts.

Potential Upside at Death

If the proposed regulations are released, there's a potential upside waiting at death. If discounts aren't allowed, an appreciated asset owned at death receives a step-up adjustment in basis to its discounted FMV for income tax purposes. Therefore, the recipient of the asset will pay less income tax once the asset is sold.

Looking Forward

Although there's now renewed energy and interest in setting up family entities and transferring interests in those entities to family members, there are added complexities and administrative burdens involved. Such decisions should not be driven solely by tax consequences arising from discounts being curtailed by future regulations, but must make sense from personal, familial and business perspectives.

To review the footnotes to this article, visit http://www.metrocorpcounsel.com

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