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Private Client Alert

Act Now to Avoid Proposed IRS Rules Which Would Eliminate Valuation Discounts for Intra-Family Transfers of Interests in Family Controlled Entities

Action Item: Owners of family businesses and investment entities (such as family limited partnerships, limited liability companies ("LLCs"), and corporations) are urged to consider making transfers of interests in those entities before new IRS rules which would reduce or eliminate valuation discounts are finalized later this year.

On August 2, 2016, the Treasury Department issued proposed regulations under Section 2704 of the Internal Revenue Code which, among other things, include new rules for valuing interests in family controlled entities for federal gift, estate, and generation-skipping transfer tax (collectively, "transfer tax") purposes. The proposed regulations would, if adopted in their current form, severely limit, or even eliminate, the ability to take advantage of valuation discounts (most notably, discounts for lack of marketability and lack of voting control) in connection with intra-family transfers of interests in family controlled entities.

Current law allows the application of valuation discounts when transferring interests in family controlled entities. The IRS will conduct hearings on the proposed regulations on December 1, 2016, after which they may be finalized. We therefore urge you to consider taking action before December 1, 2016 in order to take advantage of the more favorable rules currently in effect.

Transfers to members of the "Transferor's Family" (the transferor's spouse, any ancestor or lineal descendant of the transferor or the transferor's spouse, any sibling of the transferor, and any spouse of the foregoing) of a family controlled business or investment entity are generally subject to the proposed regulations.

An entity is a "Family Controlled Entity" if, immediately before the transfer, the transferor and/or members of the Transferor's Family own, directly or indirectly, at least 50 percent (by vote or value) of the stock of a corporation, at least 50 percent of the capital or profits interest of a partnership, LLC, or other entity, any interest as a general partner of a limited partnership, or any equity interest with the ability to cause the full or partial liquidation of the entity.

It is important to note that the proposed regulations affect family limited partnerships and family LLCs, which are typically passive investment holding companies, as well as active operating businesses, which were not expected to be impacted by the new rules.

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Estate planning for wealthy families has traditionally included transfers of minority, non-controlling interests in family business and investment entities, either by gift or by sale, to the owner's descendants or to trusts for their benefit. For federal transfer tax purposes, the value of the transferred interest is determined on the basis of what a hypothetical willing buyer would pay a hypothetical willing unrelated seller for such interest negotiated on an arms-length basis. Typically, such parties would agree to discount the value of the transferred interest from the entity's net asset value based upon lack of control (a buyer will generally pay less for a business whose operations they can't control) and lack of marketability (a buyer will generally pay less for an investment that is not readily saleable on an established securities market). These discounts would often result in a substantial discount from the pro rata net asset value of the interest in the entity being transferred.

For years, the IRS has been unsuccessful in challenging these discounts in court despite statutory authority that has been in place since 1990, which was designed to reduce valuation discounts. Rather than continue to argue each case in court, the Treasury Department is exercising its apparent authority under Internal Revenue Code Section 2704(b)(4) to issue regulations which all but eliminate the ability to utilize discounts when valuing interests in family controlled entities.

The proposed regulations are too complex to fully explain in this alert. However, the proposed regulations generally provide that for federal transfer tax valuation purposes, each owner is hypothetically considered to have the right to force the entity to buy back his or her interests (a "Put Right") for a cash payment equal to a minimum value (a pro rata portion of the fair market value of the entire entity reduced by certain outstanding obligations) which will be paid within six months of exercising the Put Right, even if the Put Right does not actually exist. Further, any provision which limits the hypothetical Put Right, either in the governing document or under state or local law, is generally disregarded for valuation purposes. As a result of the hypothetical Put Right, a member of the Transferor's Family who is the recipient of an interest in a Family Controlled Entity is deemed to be able to quickly and easily liquidate the interest for valuation purposes, thereby eliminating valuation discounts for lack of control or lack of marketability. The effect of the proposed regulations is illustrated by the following example:

Assume that T owns 95 percent of the equity interests in an LLC ("X"), T's daughter, D, owns the remaining 5 percent of X, and that the fair market value of a 100 percent interest in X is $20 million. Assume further that T and D have entered into an LLC Operating Agreement providing that no member can force a redemption of his or her membership interests or the liquidation of the company, no member may sell his or her membership interests without the consent of a majority of the members, and the agreement may be amended only by a majority of the members. T would like to transfer an additional 10 percent of the membership interests to D. The proposed regulations would disregard the lack of voting control and restricted redemption right when valuing the transferred interest.

	Current Law	**Proposed Regulations**
X's Value:	$20,000,000	$20,000,000
Percent Transferred:	10%	10%
Pro Rata Value of Transferred Shares:	$2,000,000	$2,000,000
Assumed Valuation Discounts for Lack of Control and Lack of Marketability:	30%	0%
FMV of Transferred Shares:	$1,400,000	$2,000,000
Potential Transfer Tax Savings From the Valuation Discount[1]	**$240,000**	**$0**

Public hearings on the proposed regulations are scheduled for December 1, 2016, and the IRS has indicated that, generally, the new rules will not take effect until 30 days after the regulations become final. Therefore, until that time, it is possible to transfer family business interests and take advantage of valuation discounts for lack of control and lack of marketability.

There are a myriad of techniques available for transferring interests in Family Controlled Entities within the next few months. These include, outright gifts, grantor retained annuity trusts ("GRATs"), sales to irrevocable grantor trusts, and other gifts in trust. Techniques that involve the time value of money (such as GRATs and sales to irrevocable grantor trusts) are especially effective given the current low interest rate environment that is expected to continue through the end of this year. Determining which technique is best for you will require a careful analysis which, of course, takes time. **We therefore strongly urge owners of family businesses and family investment entities to contact their Blank Rome attorney to discuss whether they can take advantage of the short window of opportunity before the proposed regulations are finalized.**— © 2016 BLANK ROME LLP

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1. The potential transfer tax savings is calculated as 40 percent (the current Federal gift and estate tax rate) times the difference between the pro rata value of the full fair market value of 10 percent interest in X and a 10 percent interest in X valued assuming a 30 percent valuation discount. (($2,000,000-$1,400,000) * 0.40%). Additional transfer tax savings would occur as the value of X appreciates in the future.

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