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Treasury Issues Proposed Regulations Limiting Valuation Discounts on Transfers of Family-Controlled Entities

The Treasury Department recently issued long-awaited proposed regulations regarding valuation discounts of interests in corporations and partnerships for estate, gift and generation-skipping transfer tax purposes. If finalized as currently drafted, the proposed regulations would severely limit the potential for taking valuation discounts on the transfer of an interest in a family controlled entity, which will significantly increase the transfer tax cost of transferring interests in such entities. Therefore, we recommend that you consider planning with such entities now before the proposed regulations are finalized.

On August 2, the Treasury Department issued long-awaited proposed regulations regarding valuation discounts of interests in corporations and partnerships for estate, gift and generation-skipping transfer tax purposes. A public hearing to discuss these proposed regulations is scheduled for December 1.

Under current tax law, when transferring a minority interest in a family-controlled entity, it is possible to discount the value of the transferred interest due to lack of marketability and lack of control. Such discounts result in increased transfers of wealth from the transferors to the transferees (typically younger generation family members) at a reduced transfer tax cost.

If finalized as currently drafted, the proposed regulations would severely limit the potential for taking valuation discounts on the transfer of an interest in a family-controlled corporation, partnership, limited liability company (LLC) or similar entity, which will significantly increase the transfer tax cost of transferring interests in family-controlled entities. The proposed regulations aim to curb what the Treasury perceives as an abuse of these valuation discounts by, among other changes, (1) expanding the class of applicable restrictions that are disregarded for the purposes of valuing the transferred interest for transfer tax purposes, (2) treating the lapse of voting and liquidation rights incident to transfers of interests in family-controlled entities made within three years of death as occurring on the date of death and includible in the estate and (3) clarifying that the rules apply to family-controlled LLCs, S corporations and similar entities in addition to corporations and partnerships.

In general, the proposed regulations provide that they will be effective as of the date of publication of the regulations in final form, although certain portions will be effective for transfers occurring 30 or more days after the date of publication of final regulations.

It is hard to predict with any certainty when the proposed regulations will be finalized. Given that we expect substantial public comment prior to the December 1st hearing date, we would expect that the regulations would not be finalized until sometime in 2017 at the earliest. Until such time, there remain significant planning opportunities to transfer wealth from one generation to the next using discounted interests in family-controlled entities. As IRS issued interest rates remain historically low, both grantor retained annuity trusts (GRATs) and sales to intentionally

defective grantor trusts are attractive options for planning with such entities. However, in light of these proposed regulations and the uncertainty surrounding the future potential for taking valuation discounts for transfer tax purposes on the transfer of interests in family-controlled entities, the window for planning under today's more favorable rules may be closing.

In addition, there is a strong possibility of further adverse legislative changes to existing tax laws should a Democratic Congress and Democratic President be elected in November. For example, the Obama administration has previously proposed reducing the lifetime estate and gift tax exemption to $3.5 million (currently $5.45 million) and raising the highest rate of estate, gift and generation-skipping transfer tax to 45% from the current 40%, and also has proposed reforms that would make GRATs a much less attractive strategy. Therefore, we recommend that you consider planning with such entities now before the proposed regulations are finalized.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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