ROBERTS & HOLLAND LLP

NEW YORK
(212) 903-8700

WASHINGTON D.C.
(202) 293-3400

August 2016

ESTATE & GIFT TAX PLANNING NEWSLETTER

A SEA CHANGE IN THE VALUATION DISCOUNT RULES: PROPOSED REGULATIONS UNDER THE SPECIAL VALUATION RULES

By: Quincy Cotton, Stuart J. Gross and Mark David Rozen

On August 2, 2016, the Treasury Department issued proposed regulations which, if enacted in the form proposed, could in many cases eliminate the minority interest and lack of marketability discounts that are often a major element in gift and estate planning. The proposed regulations generally do not take effect until after they have been finalized. Accordingly, this is a good time to consider whether it is appropriate to transfer entity interests now (this fall), to "lock in" valuation discounts that may be difficult to achieve after the regulations have been finalized.

The proposed regulations were issued primarily under section 2704 of the Internal Revenue Code, one of the "special valuation rules" that applies with respect to a family controlled entity: an entity (corporation, partnership, or limited liability company) owned, directly or indirectly through trusts or other entities, at least 50% by members of the same family (a "Family Entity"). If certain restrictions with respect to an interest in a Family Entity trigger the application of section 2704, the value of the interest for transfer tax purposes -- for purposes of the gift, estate, and generation-skipping taxes -- will be determined without the valuation discounts that would otherwise apply on account of such restrictions.

The proposed regulations raise many questions (including as to their validity under the regulatory authority provisions) and it is not clear what changes may be made between now and when they are finalized. In whatever form, however, they are likely to result in a fundamental change in transfer tax valuation. Importantly, in order to capture the benefits of the existing valuation discount rules, you must make a transfer of your interest in a Family Entity prior to the effective date of the proposed regulations. It is generally not enough that the Family Entity was in existence prior to the effective date.

Following is a brief summary of the impact of the proposed regulations.

It is common for a Family Entity agreement to prohibit the withdrawal of a member, liquidation of the entity, or transfer of an interest (among other important rights) without the consent of the other members or manager (or both). Often, Family Entities are structured so that one class of interests has little or no vote on any of these decisions. Also, a transfer (or attempted transfer) of an entity interest often triggers a buy-out right under which other members may purchase the entity interest for its discounted value (discounted from underlying net asset value, because of the restrictions that apply to the interest), with payments made over time under the buyer’s promissory note. These prohibitions and restrictions make it extremely difficult for the member holding the interest to obtain the pro rata underlying net asset value associated with the interest and this, in turn, reduces the value of the interest. For example, if Family Entity owns net assets of $10,000,000, Junior's 10% interest, subject to all the restrictions described above, is worth a lot less than its $1,000,000 share of underlying net asset value, because Junior has essentially no way to get his hands on that value.

The reduction in value of the interest compared to the underlying net asset value – the "discount" – has long been a source of tension between taxpayers and the IRS, where Family Entities are concerned. Fair market value based on the hypothetical buyer-hypothetical seller transaction (which is the standard for transfer tax valuation) necessarily takes into account the restrictions on the interest, because a third party buyer would not pay a price equal to pro rata underlying net asset value; the third-party buyer would require a price incentive (i.e., a discount) to purchase such an interest. The government, however, has viewed discounts in the Family Entity context as a loophole allowing the difference between "real" value and discounted value to pass from one generation to the next without gift or estate tax.

Under the proposed regulations, the restrictions described above that are typically found in Family Entity agreements are disregarded for transfer tax valuation purposes. This could result in a gift or estate tax value of the Family Entity interest that is essentially equal to a pro rata share of underlying net asset value (no discount).

The proposed regulations create a new class of "disregarded restrictions" (i.e., restrictions that will not be considered in determining value), including a limitation on the ability of the holder of the interest to compel the liquidation or redemption of the interest, a buy-out right that provides for a price less than a pro rata share of underlying net asset value (the "minimum value," as defined in the proposed regulations), and a buy-out right that provides for payment more than 6 months after the buy-out date or by the issuance of the Family Entity's (or another family member's) promissory note. The exception in the existing regulations that permits a restriction to be taken into account if it is not more restrictive than the "default" rule under state law is effectively eliminated.

Surprisingly (some might say outrageously), the proposed regulations do not distinguish between active business entities (such as a Family Entity that owns and operates a business) and passive entities that own primarily securities and other investment assets. The holder of an interest in an operating entity will usually be unable to obtain a pro rata share of underlying net asset value without the entire business being liquidated (a result that Congress purports not to desire). The decedent whose estate owns such an interest may be stuck with estate tax based on underlying net asset value, yet will have no ability to withdraw ("cash out") from the entity, and will be able to realize, on a sale of the interest, only its discounted value.

If the proposed regulations are finalized in their current form (or close to it), they will very significantly limit valuation discounts. This in turn will change the way we think about gifting techniques and planning for the estate tax. A public hearing for comments on the proposed regulations is scheduled for December 1, 2016, and the regulations are generally proposed to be effective after they have been finalized. Accordingly, there is a window of opportunity this fall to consider restructuring and/or making transfers of interests in Family Entities. Unless the entity pre-dates 1990, there is no exception to the proposed rules for an entity that was in existence on the effective date. It is necessary to take action – to transfer an interest or restructure the entity in a way that captures valuation discounts – in order to "lock in" the existing valuation discount rules. Please call one of the members of our estate planning team if you would like to discuss such a transaction.

If you would like more information on estate planning generally or any of the specific items discussed herein, please contact any member of our Estate Tax Planning Practice Team.

Our Estate Tax Planning Practice Team

Stuart J. Gross	(212) 903-8723
Mark David Rozen	(212) 903-8743
Quincy Cotton	(212) 903-8739
Lionel Etra	(212) 903-8721
Debra G. Kosakoff	(212) 903-8735
Jessica G. Weinberg	(212) 903-8750