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Proposed Treasury Regulations Will Eliminate Most Valuation Discounts in Connection with Transfers of Interests in Family Controlled Entities

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On August 4, 2016, the Treasury Department and the IRS published Proposed Regulations under Internal Revenue Code § 2704 that, once effective, will eliminate most valuation discounts in connection with interests in family controlled corporations, partnerships, limited liability companies and other business entities.

Congress enacted § 2704 in 1990 as one of four sections constituting the so-called special valuation rules designed to attack several perceived loopholes in the estate and gift tax laws. By its terms, § 2704 addresses two things: lapses of voting and liquidation rights in family controlled entities, and restrictions that prevent liquidation of family controlled entities. Such rights and restrictions are ignored in valuing interests in family controlled entities. Until now, § 2704 has been fairly innocuous, and the existing Treasury Regulations interpreting the section stake out clear paths around its application:

- With respect to lapsing voting and liquidation rights—
  - Currently, if a holder of an interest in a family controlled entity transfers an interest to a family member and as a result loses the right to liquidate the entity (because, for example, the transfer brings the holder's interest below the necessary percentage threshold), there is no lapse of a liquidation right as long as the interest passing to the family member still has the right to participate in a liquidation vote.
  - Currently, if a holder of a controlling interest in a family controlled entity transfers a small percentage to a family member and as a result no longer holds a controlling interest, there is no lapse of a voting right as long as the interest passing to the family member still has a voting right attached to it.
- With respect to restrictions on liquidation that are to be ignored for valuation purposes, which the statute and the current regulations call "Applicable Restrictions"—
  - Currently, the only Applicable Restrictions in the governing provisions of a family controlled entity that are ignored for valuation purposes are those provisions that are more restrictive than the default state law provisions applicable to the entity.
    - If, for example, a limited partnership does not permit a limited partner to withdraw, the no-withdrawal provision is taken into account in valuing a transferred limited partnership interest as long as the state law default rule applicable to the partnership does not give a limited partner the right to withdraw.
    - Similarly, if a limited liability company agreement provides that liquidation may be directed only by the vote of two-thirds of the membership interests in the company, that provision will be respected (for valuation purposes) as long as the default provision under the state's limited liability company act provides that two-thirds or more of the membership interests are required to vote for liquidation.

The Proposed Regulations would substantially undo these existing rules, and would go significantly further.

Under the Proposed Regulations:

- With respect to lapsing voting and liquidation rights, the current rules would no longer apply if the holder of the transferred interest were to die within three years of the transfer. This new provision is designed to attack deathbed transfers that would shift control away from the transferor.

- With respect to Applicable Restrictions that are to be ignored for valuation purposes, the new rules no longer focus only on restrictions that are more restrictive than the relevant state law default rules, but instead apply to virtually any restriction that limits the ability of an entity to liquidate.

- The Proposed Regulations create a new class of restriction that is to be ignored in valuing any interest in a family controlled entity—it is called a "Disregarded Restriction" and includes any provision that limits or permits the limitation of the holder of an interest to compel liquidation or redemption. In other words, this new rule assumes for valuation purposes that each holder of an interest in a family controlled entity has the right to liquidate or redeem the interest for its proportionate share of the entity's net asset value in cash or other property payable within six months of exercise. The Proposed Regulations also include new rules for determining when a nonfamily member's holdings in an entity should be ignored for purposes of determining family control, and they broaden and clarify other rules relating to family control and attribution of family ownership.

If the Proposed Regulations go into effect as written, they will have a dramatic impact on estate planning for owners of family controlled entities. **Most significantly, these rules prohibit any meaningful discount for lack of control or lack of marketability in connection with the transfer of an interest in a family controlled entity, even if the entity operates a business.**

Comments have been requested on the Proposed Regulations, and a hearing has been scheduled for December 1, 2016. The effective date will be the date the final regulations are published in the Federal Register, except the rules relating to Disregarded Restrictions will go into effect 30 days after publication. Consequently, it is unlikely that the Proposed Regulations will become effective before the end of 2016. There is also some question whether the Proposed Regulations exceed the regulatory authority of the Treasury Department under § 2704, but that issue will not be resolved until a court considers the regulations long after they have been finalized.

If you hold an interest in a family controlled corporation, partnership or other entity, it is crucial to consider whether you want to make any transfers to family members, because such transfers will need to be completed before the Proposed Regulations become final in order to claim any meaningful valuation discount when reporting the transfer. Although the Proposed Regulations do not by their terms apply to interests in real estate or other property held as tenants in common or through so-called nominee or realty trusts, there is some concern that the IRS would characterize such an arrangement as a partnership and that it would therefore be subject to these new rules.

We would be happy to talk with you about the potential impact of the Proposed Regulations on your situation and the planning issues they may present for your. Please contact your advisor at Ropes & Gray with any questions.