The Obama Administration's Parting Gift to Gift Taxes

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2016–Issue 26 – It's no secret that the popular estate planning mechanism of valuation discounts has been a targeted area of estate planning for many years. The Obama Administration had included recommendations to Congress in its annual proposed budget to restrict or eliminate valuation discounts for transfers of interests in family–controlled entities from 2009 to 2012. While the Administration dropped this from the annual budget proposal in 2013, the IRS also had its sights set on these regulations and has included proposed regulations for Section 2704 since 2003 in its Priority Guidance Plan. On August 2, 2016, Treasury released proposed regulations that made Section 2704 considerably more restrictive. While there is considerable ambiguity as to many of the details, which hopefully will be addressed before they are issued in final form, it is evident that the days of widespread application of minority and marketability discounts on the transfer of interests in family–controlled entities are likely coming to an end.

Section 2704(a) generally provides that a lapse of any voting or liquidation right in a family–controlled entity shall be treated as a transfer subject to gift or estate tax. Control is defined as the holding of at least 50 percent of vote or value of the stock of a corporation or at least 50 percent of either the capital interests or the profits interest in an entity classified as a partnership by the transferor or certain members of the transferor's family when combined. Section 2704(b) generally provides that any restriction placed on the ability to liquidate shall be disregarded if the interest is transferred within the family, and the family has the ability to remove the restriction.

The regulations as currently written provide an exception to this rule that has allowed family–controlled entities to apply valuation discounts for lack of marketability and minority interest discounts. Reg. Sec. 25.2704–1(c)(1) provides that a transfer of interest is not subject to these rules if the rights with respect to the transferred interest are not restricted or eliminated. Using this language, the courts have ruled that Section 2704(b) applies only to restrictions on the ability to liquidate the entire entity, not restrictions to liquidate an individual interest. A popular planning technique under these regulations is to set up a family limited partnership or LLC that has limitations on the ability to force a redemption of the transferred interest. In effect, this allows the transfer of a minority interest where the individual does not have the right to force the liquidation of the entity or the individual interest to be valued after taking into account the restrictions.

To illustrate, under the current regime, an individual could transfer a 10 percent interest in a $1,000,000 asset and, after applying a lack of marketability discount and minority interest discount, only be subject to transfer or gift tax on $65,000 (10 percent of $1,000,000 with a 35 percent discount applied). Under the proposed regulations, assuming this interest is transferred to a family–controlled entity, no discounts can be applied and the value of the transfer subject to gift or transfer tax is the full $100,000.

Further, this exception gave taxpayers the ability to apply, in some instances, multiple levels of discounts when transferring assets. Valuation practitioners first looked to the underlying assets held by the transferor. Assuming the transferor did not have control of the assets individually, a lack of marketability and minority interest discount was applied at the asset level. If the transferor then transferred only part of his interest into a family limited partnership, an incremental discount for lack of marketability and lack of control was subsequently applied.

Unfortunately, the IRS seems to believe that these discounts should not apply in the context of a family–controlled entity. The preamble suggests that there is no difference in the value in the hands of the decedent immediately before death and in the hands of the transferor immediately after death in cases where the family when acting as a unit could remove all restrictions or liquidate the entity. In an effort to limit the perceived abuse, the proposed regulations state this exception applies to transfers occurring more than three years before death. Any transfer occurring within three years of death will be treated as a lapse of liquidation right occurring at the time of death and therefore will be subject to transfer and gift tax at full value (the pro rata share of the net value of the entity). In cases where the gift was made more than three years prior to death, a few limited restrictions will be permitted. However, under the proposed regulations, the use of minority interest and marketability discounts to the extent we have become accustomed would be severely limited.

The proposed regulations create a new category of restrictions — disregarded restrictions — that address restrictions on the liquidation or redemption of interests in family–controlled entities even in cases where the transfer occurred more than three years prior to death. These disregarded restrictions would be ignored when valuing transferred interests in a family–controlled entity and work to virtually eliminate all valuation discounts — minority interest and lack of marketability — for family–controlled entities. The following limitations will be ignored for valuation purposes if the limitation can be removed by the transferor or transferor's family (either alone or collectively):

1. The provision limits the ability of the holder of the interest to liquidate the interest;
2. The provision limits the liquidation proceeds to an amount that is less than a minimum value (generally defined as the pro–rata share of the net value of the entity determined on the date of liquidation or redemption);
3. The provision defers the payment of the liquidation proceeds for more than six months; or
4. The provision permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.

As a result of the application of these rules, virtually all restrictions that would prohibit an individual from forcing a liquidation or redemption would be disregarded on the assumption that the family members collectively could vote to remove these restrictions and liquidate the entity for full value, regardless of whether this is the reality. Regardless of facts and circumstances, the rules assume that the entire family would vote to remove the restriction that prevents either liquidation of the entity or redemption of the interest, even though this may not be reflective of real–world scenarios. Oftentimes, even when a company is family–owned, its shareholders or partners have different opinions on the direction the company should take. Even family can disagree on whether a company should be liquidated or continue its operations or investments. If these interests were to be sold to third–party buyers, instead of transferred to future generations, a valuation discount for lack of marketability and lack of control would certainly be applied. However, the proposed regulations would cause the valuation to ignore the realities of an arms–length transaction.

The application of the disregarded restrictions effectively eliminates valuation discounts for minority interest and lack of control in most (if not all) family–controlled entities, including entities operating an active trade or business. However, in the case of an operating business, there seems to be a limited exception that will permit the minimum value to consider the fact that an interest may only be redeemable for a note that provides for a fair market value rate of interest. This may provide some relief for holders of closely held operating businesses, but is certainly nowhere near a complete exemption from the reach of the proposed regulations on operating businesses.

Alvarez & Marsal Taxand Says:

If the proposed regulations are finalized in their current form, these rules will be effective for rights and restrictions created after October 8, 1990, on transfers occurring after the date the regulations are finalized. Given the broad impact on the transfer and gift tax regime, we expect the IRS to receive a significant amount of comments on these regulations before the public hearing on December 1, 2016. It will likely be early 2017 before final regulations are issued.

Many tax practitioners are grappling with the question of whether the fact that the rules are effective when issued in final form is implicit acknowledgment by the IRS that any transfers between now and finalization are generally safe. We are not prepared to go as far as to say it is open season for the next few months. It is clear that discounts are an issue the IRS has in its sights.

However, if you are currently contemplating transfers that do not involve arbitrary structuring techniques to influence value, but rather the transfer of an interest subject to reasonable market terms dictating limitations on value, we urge you to move quickly, as valuation professionals are going to be very busy with this regime quickly coming to an end.

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