

Proposed Regulations Issued to Further Restrict Valuation Discounts of Closely-held Businesses

Allan J. Weiner

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On August 2, the [Internal Revenue Service issued proposed regulations](#) that, if adopted, will have far-reaching effects on the valuation of interests in closely-held business entities for estate, gift and generation-skipping tax purposes. These proposed regulations are the culmination of a plan announced over a year ago to issue new regulations to amend existing regulations (the "Current Regs") issued under Tax Code Section 2704.^[1]

Background

Prior to 1990, taxpayers were claiming significant discounts in the valuation of closely-held business entities for estate, gift and generation-skipping tax purposes. They claimed that provisions in organizational documents or state law restricted their rights to receive full value for their interests (e.g. by restructuring to freeze the value of senior interests and allowing junior interests to continue to appreciate). Recognizing that taxpayers could modify or control actual application of the claimed restrictions, in 1990, Congress enacted several new provisions, including Tax Code Section 2704, to limit the effects of certain lapsing rights and liquidation restrictions that taxpayers were using to claim discounts. Tax Code Section 2704 provides, in general, that if a transferor or the transferor's family controls a business entity, then certain specified lapsing rights and liquidation restrictions ("applicable restrictions") are disregarded in determining the value of that entity. The Current Regs were adopted to implement the statute. Over the years, however, taxpayers have had success in limiting the application of the Current Regs and claiming significant discounts on the valuation of their transferred interests by implementing family limited partnership or LLC arrangements or adding minority owners whose consent was required to make changes.

Proposed Regulations

The [proposed regulations](#) are designed to eliminate or reduce the planning approaches and judicial interpretations used to avoid or limit application of the Current Regs, primarily by expanding the determination of "control" and adding a new class of restrictions ("disregarded restrictions").

Key Provisions of Proposed Regulations

If adopted, the proposed regulations would modify the Current Regs by adding the following key provisions:

Broaden Scope of Applicable Entities

The Current Regs apply to corporations, partnership and limited partnerships. The proposed regulation will clarify that LLCs and other entities and arrangements that are treated as “business entities” are also covered. These business entities are covered regardless of whether they are domestic or foreign, regardless of how they are classified for other federal tax purposes, and regardless of whether they are disregarded as entities separate from their owners for other federal tax purposes (e.g., single member LLCs; qualified Subchapter S corporations).

Which Laws Apply

To avoid opportunities to “mix and match” legal analysis in determining whether a transferor (or the transferor’s family) has the requisite control of a business entity and whether an “applicable restriction” exists, the proposed regulations limit the analysis to matters of local law. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the business entity is created or organized.

Control Elements

Provisions are added to establish the parameters of “control” of a LLC. The tests are similar to those applicable to partnership and limited partnerships: either the holding of (a) at least 50 percent of either its capital or profits interests, or (b) any equity interest having the ability to cause the full or partial liquidation of the LLC. Furthermore, for all business entities, an individual, the individual’s estate and members of the individual’s family are treated as holding interests held indirectly or beneficially through a corporation, partnership, trust or other entity.

Transfer Elements

Any transfer that results in the restriction or elimination of any of the rights or powers associated with the transferred interest is treated as a disregarded “lapse.” Thus, for example, the assignment of only economic interests in a LLC is treated as such a lapse even though the transferor retains voting rights as a member of the LLC.

Any transfer of an interest with unrestricted rights (an exception to the lapse rule) must occur three years or more prior to the transferor’s death, thus avoiding death bed transfers intended to avoid the valuation limitations.

New Class of Restrictions

The principal focus of Tax Code Section 2704 is whether valuation will include regard for various types of restrictions. The Current Regs include a class of restrictions denominated as “applicable restrictions” that focuses on entity level limitations. A new class of “disregarded restrictions” is added to address restrictions that are disregarded in determining the value of an interest in a business entity. Thus, a restriction is disregarded if it (a) limits the ability of the holder of the interest to liquidate the interest; (b) limits the liquidation proceeds to an amount less than a “minimum value”; (c) defers the payment of liquidation proceeds for more than six months; or (d) permits payment of liquidation proceeds in any manner other than in cash or other property, other than certain notes. For this purpose, “minimum value” is the interest’s share of the net value of the entity (fair market value of its assets, less outstanding obligations that would be deductible in determining claims against an estate). For any deferred payment in excess of six months, the only permissible promissory note is generally that of an active trade or business (at least 60% of its assets are non-passive) which is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates and has a fair market value (on a present value discounted basis) equal to

the liquidation proceeds.

There is an exception to “disregarded restrictions” that applies if all interest holders in an otherwise controlled business entity have a put right designed to override, in part, the limitations of the restriction (e.g., assures receipt of minimum value, payment in cash or specified notes of entity carrying on an active trade or business).

Effect of Non-family Member Ownership

Generally, a non-family member’s interest in a business entity is taken into account in determining whether the transferor or the transferor’s family (or both) has the ability to remove an otherwise disregarded restriction (e.g., requiring consent). The proposed regulation overrides that general rule and disregards a non-family member’s interest if held for less than three years, constitutes less than 10 percent of all interests in the business entity, when combined with other non-family member’s constitutes less than 20 percent of all interest in the business entity, or does not have an enforceable right to receive, on no more than six months prior notice, the minimum value for the interest.

Effective Date

Importantly, the proposed regulations will become effective only at or soon after issuance of final regulations, thus eliminating concerns of retroactive application.

IRS has announced a plan to hold a hearing on these proposed regulations on December 1, 2016, along with consideration of comments, before issuing final regulations. There is some time to consider how application of the proposals would affect current planning for intra-family transfers of closely-held business entities or interests in those entities. In some cases, that may suggest accelerating plans for such transfers to obtain maximum benefit from current rules. Therefore, we encourage you to contact us to discuss how these changes may affect your estate plan and whether any action is necessary.

For more information about this advisory, please contact:

Allan J. Weiner
(202)342-8431
aweiner@kelleydrye.com

[1] Initially, in 2013 and 2014, Treasury proposed new legislation to address concerns about the application of Code Section 2704. That proposal was dropped in favor of issuing new regulations pursuant to implementing authority provided in the statute.