



CLIENT ALERT - IRS PROPOSES DRAMATIC CHANGES IN VALUATION DISCOUNTS FOR FAMILY-OWNED BUSINESSES AND ENTITIES FOR GIFT AND ESTATE PURPOSES

August 31, 2016

On August 2, 2016, the IRS proposed major changes to the Regulations under Section 2704 of the Internal Revenue Code affecting how interests in family-held businesses are to be valued when transferred among family members. If made final, the proposed Regulations would dramatically affect the ability to take discounts with regard to the valuation of these transfers for gift, estate and generation-skipping transfer tax purposes. The changes could go into effect as early as December of this year, after a public hearing is held on December 1, 2016.

The Internal Revenue Code generally requires that gifts and other transfers be valued at their fair market value for gift, estate and generation-skipping transfer tax purposes. Valuation experts often use valuation discounts or premiums to determine the fair market value of a minority interest or a controlling interest in a business entity. The premium or discount represents what a willing buyer would pay for control of the entity or for a minority interest where the buyer has no ability to liquidate the entity or sell his or her interest in the entity. For estate and gift tax purposes, the fair market value of an asset is the measure of what is subject to either a gift or estate tax.

The use of minority interests in family-owned entities is common in estate and gift tax planning in connection with Grantor Retained Annuity Trusts, installment sales to defective grantor trusts and gifts to family members and trusts for family members. By making transfers of minority interests in family entities taxpayers have taken advantage of the market forces that drive down the fair market value of minority interest gifts or sales so that families can pass wealth to future generations tax-efficiently while allowing senior generations to maintain control of the entities.

The proposed changes would require that certain restrictions typically included in normal business organizational documents be disregarded for family-owned entities for purposes of gift and estate tax computations. Essentially, the proposed regulations would require that fair market value be determined without regard to these important factors if the transfer occurs between family members. Rather, the IRS is proposing that in intra-family transfers, liquidation value should be the value for estate and gift taxes rather than fair market value. The use of the traditional method for determining fair market value would still be acceptable for transfers between non-family members in most circumstances.

If you are contemplating or are in the process of transferring interests in a family-held entity (corporation, limited liability company, partnership or other business entity) to family members or trusts for family members and the use of minority interest discounts to determine fair market value would be applied by your valuation expert, you should assume that such discounts may no longer be available as early as December of this year. Accordingly, you should consider whether such transactions can be closed before December 1, 2016.

If you have questions about this alert or how the proposed new Regulations may affect your family's estate planning, please contact your Cummings & Lockwood attorney.