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Taking Advantage of Valuation Discounts for Family-Controlled Businesses:
The Time to Act May Be Now

By Tara M. Walsh

On Aug. 2, the Internal Revenue Service released proposed regulations to Internal Revenue Code Section 2704 which seek to restrict or eliminate certain valuation discounts applied to family-controlled corporations, partnerships, limited partnerships and limited liability companies in intra-family transfers. For many years, families who owned controlling interests in such entities have used valuation discounts (such as discounts for lack of control or lack of marketability) to reduce the value of an interest transferred during lifetime or at death, and thereby reduce accordingly the federal gift tax, estate tax and generation skipping transfer tax implications of such transfers. The proposed regulations, in many cases, will prohibit the use of certain discounts, which will result in an increase in gift, estate and generation skipping transfer taxes for certain intra-family transfers.

Timing

The proposed regulations are not scheduled to become law until the end of the year, at the earliest. The IRS has requested comments on the proposed regulations, which are due by Nov. 2. Following this 90-day comment period, there will be a hearing on Dec. 1. Families who own controlling interests in corporations, partnerships, limited partnerships and limited liability companies should review their planning with their advisers and determine whether transferring any part of their affected business interests before year-end is prudent to reduce or eliminate federal gift, estate and generation skipping transfer taxes.

The Proposed Regulations

As indicated above, if enacted into law, the proposed regulations will have significant ramifications with respect to the valuation of, and therefore the taxation of, family-controlled entities upon the transfer of interests therein. Specifically, the proposed regulations seek to accomplish, *inter alia*, the following:

- The proposed regulations provide a broad definition of entities covered by the regulations, which include corporations, partnerships, limited partnerships, limited liability companies, and other entities and arrangements that are business entities.

- An entity must be family-controlled in order for the proposed regulations to apply. The proposed regulations define “control” for limited liability companies (or other entities that are not corporations, partnerships or limited partnerships) to mean 50 percent of either the capital or profits interest, or owning equity with the power to cause a liquidation. Current regulations define “control” for corporations to mean at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation and for partnerships to mean at least 50 percent of either the capital interest

or the profits interest in the partnership, or the holding of any equity interest as a general partner in a limited partnership.

- Upon the transfer of an interest in a family-controlled entity made within three years of the transferor's death, the proposed regulations treat the transferor's lapse, if any, of liquidation rights as an additional transfer at death, thereby increasing the value of the transferor's gross estate for federal estate and generation skipping transfer tax purposes by an amount equal to the loss of such rights.

- The proposed regulations provide the following example: An individual owns 84 percent of the stock in a corporation. The bylaws of the corporation require at least 70 percent of the vote to liquidate. The individual gives one-half of the individual's stock in equal shares to the individual's three children (14 percent interest to each). By making such transfers, the individual relinquished his right to liquidate or control the corporation. The example states that if these transfers occurred within three years of the individual's death, the transfers would have been treated as if the lapse of the liquidation right occurred at the individual's death, and such a lapse would be included in the individual's estate.

  The result of such tax inclusion is the creation of a phantom asset in the estate of the transferor, meaning the asset is included in the estate for tax purposes, but of course the asset offers no means for payment of the tax attributable to it. Thus, the estate must use other assets to pay the tax on the phantom asset.

- Under current law, "applicable restrictions" are disregarded when valuing a transfer of an interest in a family-controlled entity. "Applicable restrictions" are limitations on the ability to liquidate the entity, in whole or in part (as opposed to a particular holder's interest in the entity), that lapse or that can be removed by the transferor or the transferor's family after the transfer. However, under current law, if the restriction on the ability to liquidate the entity is imposed or is required to be imposed by state law (i.e., if it is a "default state law restriction"), the restriction is not deemed to be an "applicable restriction" and thus is not disregarded for valuation purposes.

  The proposed regulations include in the definition of "applicable restrictions" default state law restrictions. The only exception to this broad definition of "applicable restrictions" is in the case of a default state law which provides that a restriction cannot be modified. This exception will rarely be invoked as most jurisdictions permit an entity to supersede restrictions on transfer in its organizational documents.

  In short, under the proposed regulations, default restrictions under state law will generally not be taken into account in valuing a transferred interest in a family-owned entity.

- The proposed regulations create a new class of "disregarded restrictions." A disregarded restriction is a limitation on the ability to redeem or liquidate one's particular interest in an entity if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or the transferor's family. Such "disregarded restrictions" would not be taken into account in valuing an interest in a family-controlled entity for federal gift, estate and generation skipping transfer tax purposes. A "disregarded restriction" includes one that:

  1. Limits the ability of the holder of the interest to liquidate the interest.

  2. Limits the liquidation proceeds to an amount that is less than a minimum value ("minimum value" is the interest's share of the fair market value of the property reduced by certain outstanding obligations of the entity on the date of liquidation).

  3. Defers the payment of the liquidating proceeds for a period of more than six months.

  4. Permits the payment of the liquidation proceeds in any manner other than in cash or other property (a promissory note is not considered "property" unless the entity is engaged in an active trade or business, the proceeds are not attributable to passive assets, the note is adequately secured and the note is issued at a market interest rate).

- In determining whether a restriction can be removed by the transferor or the transferor's family, the proposed

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regulations disregard the interests of non-family member owners, which interests may give such non-family members the ability to prevent the removal of restrictions, unless those non-family members meet certain strict requirements with respect to their interests in the entity.

- The proposed regulations may disregard any discount taken upon an assignment of an interest in a family-controlled entity to an assignee (i.e., one who is not an owner of the business and has no control over the business interest through voting rights or otherwise).

Summary

The proposed regulations raise many questions with respect to their application (specifically the extent to which the proposed regulations affect lack-of-control discounts, and perhaps even more uncertain, the extent to which they affect lack-of-marketability discounts). Nevertheless, it is reasonable to assume that, if enacted into law as is, the proposed regulations will have a significant impact on transferring interests in family-controlled entities to future generations or other family members. Therefore, if you have an interest in a family-controlled entity, it is imperative that you review your planning with your advisors as soon as possible and, if appropriate and desirable, take the steps necessary to transfer the affected business interests, or part thereof, at a discounted value before the door closes on this planning opportunity. ■

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