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IRS issues proposed regulations limiting the availability of valuation discounts for interests in family entities

On August 2, 2016, the IRS issued proposed regulations which have the potential to severely affect estate and gift tax planning. If these proposed regulations are finalized in their current form, the effect will be to eliminate discounts for lack of control or minority interest in valuing interests in family businesses.

For many years, an effective estate and gift tax planning strategy has been to transfer to children, or trusts for their benefit, non-controlling interests in family business entities, such as limited partnerships. In valuing the transferred interests, appraisers applied discounts to reflect lack of control and lack of marketability due to transfer and governance restrictions. These discounts can be very substantial, thereby reducing the value of the transferred interests for estate, gift and generation-skipping transfer tax purposes and potentially providing significant tax savings.

The U.S. Treasury Department and the IRS have long resented this strategy and challenged valuation discounts on audit and in litigation. The courts, however, have generally upheld valuation discounts, although sometimes the extent of the discounts claimed by the taxpayer has been reduced. In 1990, Congress created a weapon to combat these discounts—Section 2704(b)(3) of the Internal Revenue Code, which grants the Treasury Department broad authority to issue regulations that eliminate gift and estate tax discounts created by transfer and governance restrictions imposed on interests in closely held family businesses. Nevertheless, the Treasury Department did not act to use this authority, until now.

Many practitioners had expected that the application of these proposed regulations would be limited to passive, non-operating investment entities; however, the scope of the proposed regulations is extremely broad and covers all types of entities, including investment and real estate holding companies and those that hold active, family-run businesses.

The proposed regulations are not yet effective. The IRS has scheduled a public hearing on the proposed regulations for December 1, 2016 and will accept written comments until November 2, 2016. We anticipate that numerous comments will be submitted to the IRS raising issues with the current form of the regulations and requesting changes. Many commentators have argued that the IRS has overstepped its regulatory authority. It is unknown when, or if, final regulations will be issued; although, some worry that, because this is an election year, the IRS may seek to finalize the proposed regulations before the next administration takes office.

In any event, until the final regulations are issued, there is a window of opportunity for taxpayers to implement estate planning techniques incorporating valuation discounts that presently are available. Therefore, if you have been considering transferring ownership interests in a family business for estate planning purposes, a prudent course of action is to complete any transactions, such as sales or gifts, before the end of the year. Even if you have never given transfer tax planning much thought, you should consider how these rules may affect you.