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TRUSTS & ESTATES

NEW IRS-PROPOSED REGULATIONS PUT A DAMPER ON DISCOUNTS

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On August 2, the IRS proposed Treasury Regulations regarding the valuation of interests in family-controlled business entities, including corporations, partnerships, and LLCs. If adopted in their proposed form, those regulations may dramatically increase estate and gift taxes by sharply curtailing the ability to discount the value of closely held and family businesses and investment entities.

Under current law, a gift or bequest of a minority interest in a closely held business typically is valued by taking into account lack of control and lack of marketability associated with that interest.

> **Example:** A Family LLC holds business and investment assets with a net asset value of $50,000,000, not taking into account valuation adjustments. A Family LLC has a single class of membership interests, 90% of which are owned by Mom. The operating agreement governing A Family LLC prevents each member from withdrawing his or her capital account without the consent of the other members.
>
> Mom would like to give a 5% interest in A Family LLC to Son and a 5% interest in A Family LLC to Daughter. As a result of the withdrawal prohibition, and because a 5% interest does not control the LLC, these interests are worth substantially less than a pro rata share of the underlying assets ($5,000,000). Current law recognizes this reality and permits valuation adjustments discounting the value.

The newly proposed regulations, if adopted, would impose several rules disregarding various restrictions on interests in family-controlled business entities.

Control. The proposed regulations apply to transfers (by gift or at death) of interests in “controlled entities.” For an LLC, “control” means ownership (direct, indirect, or by attribution from various related persons) of <u>either</u>:

(i) at least (note – not “more than”) 50% of either the capital interest or the profits interest; or

(ii) any interest that can cause the liquidation of the LLC in whole or in part.

In our example, A Family LLC is a “controlled entity” because Mom owns at least 50% of both the capital interest and profits interest. It would still be a controlled entity even if Mom’s interests were less than 50% if other interests aggregating at least 50% were held by companies owned by Mom or her family (or trusts for their benefit).

Disregarded Restrictions–Individual Liquidation/Withdrawal Rights. Current law and regulations disregard certain rights of equityholders (e.g., corporate shareholders, partners, LLC members) to liquidate the entity as a whole in valuing equity interests for gift and estate tax purposes. The proposed regulations, if adopted, would also disregard most restrictions on the equityholder’s right to liquidate an individual equity interest being transferred, as well as restrictions on the amount to be received in liquidation of the interest, the timing of payment, or the form of payment in liquidation.

Those individual liquidation restrictions will be disregarded only if the transferor (or the transferor’s estate) and members of the transferor’s family are deemed to have the power to remove those restrictions. However, the proposed regulations not only apply attribution rules to ascribe powers to that family group, but they also disregard the powers of any nonfamily equityholder unless the following four-factor test is met:

(i) The nonfamily member must have held the interest for at least three years before the transfer;

(ii) The nonfamily member must own at least a 10% equity interest in the entity;

(iii) At least 20% of the entity’s equity, in aggregate, must be owned by nonfamily members; and

(iv) The nonfamily member has the right to liquidate the equity interest at “minimum value” (i.e., without regard to equityholder-level discounts) on six months’ notice.

> **Example:** Dad, Son, and Daughter each own a 16% interest in B Family LLC. Two years ago, Dad’s Cousin (who is not considered a family member for this purpose) purchased a 33% interest in B Family LLC from Dad; Dad’s Cousin continues to own that interest. Service Provider (who is unrelated to Dad) owns a 9% interest in B Family LLC. Two public charities own the remaining 10% of B Family LLC’s equity, with each holding 5%.

Service Provider and the charities each acquired their equity interests four years ago. B Family LLC's operating agreement provides that no member has the right to withdraw any portion of the member's capital account without the consent of a majority of the members. Dad now wishes to make a gift of his 16% interest equally to Son and Daughter.

Under the proposed regulations, the restriction on withdrawal would be disregarded in determining the value of Dad's gift. Dad and his family members (Son and Daughter) collectively own only 48% of the LLC interests and thus cannot remove the withdrawal restriction by themselves. However, the family members are deemed to have that power under the proposed regulations. The nonfamily members' voting powers are disregarded because (i) Dad's Cousin has owned his interest for less than three years, (ii) none of the other nonfamily members has a 10% interest, and (iii) none of the nonfamily members has a qualifying right to liquidate their respective equity interests.

Disregarded Restrictions: Entity Liquidation Rights. The proposed regulations also expand the class of disregarded restrictions on an equityholder's ability (alone or together with family members) to liquidate the entity as a whole. Under the current regulations, such restrictions are respected (i.e., not disregarded) if they are not more restrictive than limitations that, under federal or state law, would generally apply to the entity. The proposed regulations now limit that exception to mandatory, broadly applicable legal restrictions (i.e., restrictions that cannot be waived or modified under the entity's governing documents, and that do not apply only to family-controlled entities).

Lapsing Rights. Generally, the lapse of a voting or liquidation right in an entity is treated as a taxable gift (or a transfer subject to estate at death) if the holder of the lapsed right and members of that holder's family control the entity both before and after the lapse. Current regulations provide an exception that protects lifetime transfers of one or more minority voting interests by a majority holder. The proposed regulations eliminate that exception for transfers occurring within three years of the holder's death.

Example: Mom owns 60% of C Family LLC's voting equity. Mom makes a gift of an 11% voting equity interest to Daughter. Under C Family LLC's operating agreement, the LLC may be liquidated by majority vote of the membership interests.

Under the currently applicable law and regulations, Mom is treated as having made a gift of a minority interest in C Family LLC to Daughter. Since that interest does not have the power to compel liquidation, this impairment would give rise to a valuation adjustment in an appraisal. Mom's holding of only 49% after the transfer would not give rise to gift tax consequences.

Under the proposed regulations, Mom would be treated as having made an additional gift at her death (based on the value of the majority-control liquidation right) if Mom dies within three years after transferring the 11% interest to Daughter.

Preliminary Conclusions. Many factors go into valuing equity interests in business entities, and it is far from clear how the proposed regulations – if adopted – would affect the valuation of any specific equity interest for transfer tax purposes. At this point, we make the following observations:

<u>Asset Mix Matters.</u> The composition of the entity's assets will make a substantial difference under the proposed regulations. If equityholders are deemed to have the right to liquidate their interests in an entity that holds cash, marketable securities, or other liquid assets, it appears likely that most, if not all, of the valuation discounts for those interests will be eliminated for transfer tax purposes.

On the other hand, if the entity owns illiquid assets (e.g., real property, an operating business), substantial valuation discounts may remain, because the deemed right to withdraw a fractional interest in such illiquid assets would not eliminate other obstacles to realizing underlying market value.

<u>Controversy.</u> While these proposed regulations have been anticipated for years, they remain controversial. Even if they are adopted in their current format, there are credible arguments that they exceed the scope of the Internal Revenue Code section from which they derive authority. Indeed, the imposition of transfer taxes on value that does not exist "in real life" may raise constitutional questions. Closely held business owners who have the appetite for a struggle with the IRS may have the opportunity for a win in court.

In some circumstances, elimination of valuation discounts may actually be favorable to taxpayers.

Effective Dates: Consider Acting NOW. The proposed regulations cannot be finalized until December 1, and that deadline may be extended based on public comments. The provisions disregarding individual liquidation and withdrawal rights will not become effective until 30 days after the regulations are finalized, while the other provisions will become effective on the date the regulations are finalized. Holders of family business interests who wish to avoid the impact of the proposed regulations' valuation rules have the next several months to make gifts or engage in other planning for those interests. Considering the level of complexity typically involved in designing and implementing such transfers, it is best to start that process right away.

contacts

To learn more about the effect of the proposed regulations on your family entity and your estate plan, please contact one of the Lowenstein Sandler LLP attorneys listed below.

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