November 8, 2016

Proposed Treasury Regulations Would Alter Valuation of Closely-Held Interests and Affect Estate Planning

On August 2, 2016, the IRS issued proposed regulations taking aim at valuation discounts with respect to closely-held interests for gift, estate and generation-skipping transfer tax purposes. If adopted, even with clarifying language, the proposed regulations will impact certain estate planning strategies.

- Many commentators have read the proposed regulations to eliminate certain valuation discounts that traditionally have applied to closely-held interests.
- However, at least one Treasury official informally has suggested that the IRS does not intend for the proposed regulations to eliminate such discounts. Rather, it has been suggested that the proposed rules are designed to limit (but not preclude) valuation discounts by disregarding certain restrictions on the ability to liquidate closely-held interests, whether imposed by an entity's governing documents or state law.
- The proposed rules, as now informally suggested by the IRS, will require that the valuation of certain closely-held interests be based on an assumed negotiation between a hypothetical party and the entity, without regard to the targeted restrictions. Such hypothetical negotiations presumably would take into account various factors, such as the entity's liquidity, relative negotiating power and other economic and business considerations.
- The proposed regulations further provide that a transfer of an interest may give rise to a lapse of voting and liquidation rights, resulting in a taxable transfer, even where those rights remain with the transferee, if the transferor's death occurs within three years of the transfer.

Given the apparent disconnect between the language of the proposed regulations and Treasury's informal statements, we expect that Treasury will modify the proposed regulations before they are adopted. The new rules affecting valuation discounts likely will not become effective before early next year (and likely later, as Treasury will need to sift through thousands of comments).

In this Client Alert, we summarize the purpose and mechanics of the current rules, describe the IRS's proposed regulations and examine their impact if adopted as drafted. We also highlight certain action steps to consider prior to promulgation of final regulations.

I. Background

A. Fair Market Value Principles

In general, estate and gift taxation is determined by reference to the fair market value of property owned at the time of death or transferred as a gift during lifetime. Fair market value, in turn, generally is based on the price at which property would change hands between a hypothetical willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the facts. Restrictions on the ability to liquidate an interest in an entity affect value.

B. Family Attribution

The willing buyer-willing seller test does not take into account the identity of the transferee. Therefore, valuation principles concerning restrictions have applied to intra-family transfers. Indeed, in one published ruling, the IRS confirmed that, when a 100% shareholder makes a gift of a 20% interest to each of his five children, each 20% interest would be valued separately, taking into account valuation discounts for lack of control and lack of marketability. That ruling superseded the IRS's earlier position that, where the family, as a whole, controlled the enterprise, absent a showing of disharmony, no minority discount would be available in connection with intra-family transfers.

C. Lapses of Voting and Liquidation Rights

The lapse of an interest holder's liquidation or voting rights in an entity indirectly may shift value from the interest holder to the other owners of the entity. This potential shift in value particularly is acute where family members of the person whose rights have lapsed have voting control with the ability to liquidate the entity.

D. Section 2704

In an effort to address certain perceived abuses involving liquidation restrictions and lapsing rights in connection with closely-held interests, in 1990, Congress enacted Section 2704 of the Internal Revenue Code.

Section 2704(a) addresses lapses of liquidation and voting rights in family-controlled entities by treating certain lapses as taxable transfers. To date, this statute has applied only where the voting or liquidation rights disappear with respect to the transferred property; it has not applied where the voting rights remain with respect to the transferred interest. Section 2704(b) focuses on liquidation restrictions with respect to interests in family-controlled entities, where the family ultimately has the power to remove the restrictions. Under the statute, certain liquidation restrictions are ignored, thereby enhancing the value of the interests for transfer tax purposes (as compared to the value which otherwise would be determined under the willing buyer-willing seller test).

Despite the passage of Section 2704, transfers generally have been structured to avoid giving rise to a taxable lapse, and minority and lack of marketability valuation discounts have remained prevalent with regard to family-controlled entities.

E. Proposed Regulations

The IRS has the authority to issue regulations to provide rules regarding the application of Sections 2704(a) and 2704(b). For years, the IRS indicated on its Priority Guidance Plan that it intended to publish such regulations, particularly with the goal of overriding certain taxpayer-favorable court decisions. On August 2, 2016, the IRS released the highly-anticipated proposed regulations.

Based on a plain reading of the proposed regulations, it initially appeared that the proposed regulations would seek to eliminate all minority and lack of marketability valuation discounts for interests in closely-held companies transferred to family members. However, based on informal statements by Treasury, it is more likely that the proposed regulations will limit (but not preclude) traditional valuation discounts by ignoring restrictions placed on liquidation rights (either under the entity's governing documents or state law).

The proposed regulations are not effective immediately. Before becoming effective, comments are to be submitted to the IRS and a public hearing is to be held on December 1, 2016. Following the hearing, the IRS will consider the comments and, thereafter, publish final regulations. The new rules generally will become effective on or after the final regulations are published, or in the case of certain regulations, 30 days after the final regulations are published. Accordingly, the new rules likely will not take effect until sometime in 2017.

The full proposed regulations are complicated and quite lengthy (with the preamble and proposed rules exceeding 50 pages). Accordingly, this Client Alert provides a brief overview by presenting the most pressing issues.

II. Liquidation Restrictions

Under the current rules of Section 2704(b), if an interest in a family-controlled entity is transferred to a family member, a restriction on the ability to liquidate the entity is disregarded for valuation purposes if the restriction (1) lapses by its terms or (2) may be removed by the family after the transfer. The current rules include an important exception: restrictions that are no more restrictive than those provided under default state law will not be disregarded. In response, the default rules in many states (which readily can be overridden in the governing document) were made more restrictive, thereby making it easier to fall within the exception. Accordingly, the current rules leave room to structure transfers that allow for minority and lack of marketability valuation discounts.

The proposed regulations expand the reach of Section 2704(b). However, the scope and impact of the new proposed rules are unclear.

A. Disregarded Restrictions

At least one court has ruled that, under the current rules, only restrictions on the ability to liquidate the *entity itself* are to be disregarded. Under the proposed regulations, restrictions on the ability to liquidate the transferee's *individual interest* in the entity also would be disregarded. The proposed regulations further would ignore restrictions that limit liquidation proceeds to less than a certain minimum value. The minimum value is defined as the pro rata share of the net value of the entity. Consequently, if a taxpayer makes a gift of an interest in a family-controlled business to his or her child, any restriction that prohibits the child from liquidating the interest, as well as any restriction on the ability to liquidate the interest for less than an amount equal to the pro rata portion of the net value of the entity, would be ignored for purposes of valuing the gift. The key question, as discussed below, is: what is the effect on valuation of requiring that certain restrictions be ignored?

B. Nonfamily Members

Under the proposed regulations, for purposes of determining whether the family has the ability to remove a restriction (thereby falling within the purview of the statute), interests held by nonfamily members generally will be ignored, unless the nonfamily member holds a substantial interest (as defined in the proposed regulations). This change would eliminate the possibility of transferring nominal interests to nonfamily members, such as charities, in order to divest the family of sufficient control to remove the restriction.

C. Operating Businesses

The proposed rules generally would apply with equal force to operating businesses. This approach with regard to the treatment of operating businesses is quite surprising, given that many practitioners speculated the revised rules primarily would take aim at the transfer of interests in entities holding mostly passive assets. Nevertheless, the valuation of operating businesses, even if certain restrictions are to be ignored, presumably will continue to reflect discounts under a paradigm that assumes a hypothetical negotiation, taking into account business and liquidity obstacles to a redemption.

D. Elimination of Default State Law Exception

The proposed regulations also eliminate the exception for restrictions that are no more restrictive than those which apply under default state law. Under the proposed regulations, only restrictions mandatorily imposed by state law may be factored into the valuation of a closely-held interest. Since state laws regarding partnerships, corporations and other entities are, in general, primarily default rules (with few, if any, mandatory restrictions), this so-called exception would have little practical application.

E. Impact on Estate and Gift Planning

Most commentators initially suggested that the proposed regulations, as drafted, for transfer tax purposes (but not property law purposes), conferred a put right upon any interest in a family-controlled entity, effectively eliminating minority and lack of marketability valuation discounts.

However, at least one Treasury official informally has suggested that the IRS did not intend to eliminate minority and lack of marketability discounts, and further did not intend to confer an automatic put or redemption right. Rather, while withdrawal and redemption restrictions are to be ignored in valuing closely-held interests, we are to assume that the entity and the recipient of the transferred interest would be required to negotiate the price and terms, as if the transferee had the right to withdraw or be redeemed. That hypothetical negotiation, in turn, could reflect valuation discounts to take into account a variety of circumstances, including the inability of the enterprise to pay full value due to business and liquidity constraints, relative negotiating positions, potential litigation, and lack of control if the transferee remains as a minority equity owner. Assuming these informal statements by Treasury reflect the IRS's view, we would expect important modifications to be made before the regulations are finalized.

To be sure, the proposed regulations lack clarity and we expect changes. Further, it is possible that, in the end, Treasury may adopt a different approach. Under the current proposal, as informally described by Treasury, the goal is to value certain interests as if neither applicable state law nor the governing document addresses liquidation or redemption rights. We are to assume a vacuum. This approach seems at odds with the traditional tax principle that the starting point is to determine the rights and obligations under state law and the governing documents, and thereafter apply the federal tax law to the arrangement.

III. Lapsing of Voting or Liquidation Rights

The current rules under Section 2704(a) treat a lapse of a taxpayer's voting or liquidation right in a family-controlled entity as a taxable transfer of such voting or liquidation right. However, under current rules, if an individual ceases to control as a result of making an actual transfer of an equity interest, the transfer will not be treated as a lapse. The proposed regulations to Section 2704(a) would eliminate this exception for transfers occurring within three years of death. As a result, where a transferor loses the ability to control by reason of a transfer made shortly before death, the value of the transferor's retained interest will not be discounted for estate tax purposes. For example, if a taxpayer owns 51% of a closely-held corporation and transfers 2% to a child, under the current rules, the transfer would not be treated as a lapse. Under the proposed rules, if the taxpayer were to make this transfer and die within three years, the transfer would be treated as a lapse occurring at the taxpayer's death. As a result, in addition to the value of the taxpayer's retained 49% non-controlling interest, the value of the lapse (that is, the difference between the value of the controlling interest previously held by the taxpayer and the non-controlling interest retained by the taxpayer) would be includable for estate tax purposes.

IV. Recommendation

We believe that the proposed regulations will be modified. We further believe that, once finalized, valuation discounts—albeit at lower levels—still will be recognized. Accordingly, individuals currently contemplating making gifts of interests in family-controlled entities may consider accelerating the transfers so that they occur before the proposed regulations are finalized in 2017 (or later).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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