Tax Alert

Taxpayers with Interests in Family Held Entities Urged to Consider Transfer Tax Planning While Discounts Remain Available

TAX PRACTICE BOARD

Stephen Brecher
646.225.5921
Stephen.Brecher@WeiserMazars.com

Jeffrey Katz
212.375.6816
Jeffrey.Katz@WeiserMazars.com

Howard Landsberg
212.375.6604
516.282.7209
Howard.Landsberg@WeiserMazars.com

James Toto
732.205.2014
James.Toto@WeiserMazars.com

EDITOR

Richard Bloom
732.475.2146
Richard.Bloom@WeiserMazars.com

Proposed regulations under Internal Revenue Code Section 2704 were issued by the Department of the Treasury on August 2nd and may severely restrict or even eliminate the availability of discounts in transfer tax planning. A hearing to discuss these regulations is scheduled for December 1st. The effective date will be the date that they are published as final regulations in the Federal Register with certain aspects becoming effective 30 days after they are published. Consequently, taxpayers should have until the end of 2016 to move forward on transfer planning to take advantage of discounts while they remain available.

The use of discounts is currently an important benefit of transfer tax planning with interests in family held entities in that the discounts allow for significant transfer tax savings.

For example, let's assume a taxpayer owns 100 percent of an LLC which is valued at $10,000,000, and would like to gift 40 percent interest in the LLC to her daughter. Since an owner with 40 percent interest cannot force liquidation of her interest and may not be able to transfer the interest freely, there are minority interest and marketability discounts available which have the potential to significantly decrease the value of the transfer. If the discounts (computed by a qualified appraiser) were determined to be 30 percent, then the gift tax value would be $2,800,000, resulting in a reduction in value of $1,200,000. Without the use of discounts, the gift tax value of the interest is $4,000,000. This example clearly illustrates the benefits of utilizing discounts as it reflects a potential gift tax savings of $480,000 ($1,200,000 X 40 percent).

Proposed Regulations

While we cannot be certain as to the specific provisions of the final regulations, it is clear that the language of the proposed regulations takes direct aim at discounts and may even serve to eliminate them entirely.

Under the current regulations and case law, a transfer to a family member of interest in a family held entity allows the retained interest to be eligible for a minority discount, even if the transfer itself creates the minority interest. For example, if a taxpayer with a 55 percent interest transfers 10 percent interest to his son, he is left with 45 percent minority interest which would generally be eligible for discounts due to the lack of liquidation rights. A judicially developed exception exists if the transfer was made right before death with the sole purpose of leaving minority interest in the decedent's estate. Under current case law, in the case of "deathbed" transfers, the retained minority interest is not eligible for discounts. The proposed regulations have taken this concept a bit further and adopted a bright-line test which provides that a transfer of interest in a family held entity to a family member made within three years of death is considered to be made at death. Accordingly, transfers within three years of death which cause the transferor to lose liquidation rights will be considered deathbed transfers and trigger an increase in the taxable estate equal to the value of the lapse in liquidation rights. The value of the lapse will be consistent with the minority discount which would otherwise have been allowed at death for estate tax purposes.

One may think that transfers made more than three years before death would escape the effects of the proposed regulations. However, the proposed regulations have also introduced a new concept of "disregarded restrictions" which are restrictions on an owner's rights and will be completely disregarded when valuing the owner's interest in the entity. As a result, even transfers made more than three years before death are significantly impacted by these regulations.

Disregarded restrictions include those provisions which: (i) limit the ability of the holder of the interest to compel liquidation or redemption of the interest; (ii) limit the liquidation or redemption proceeds to an amount which is less than a minimum value (net value of the entire entity multiplied by the percentage share); (iii) defer the payment of the redemption or liquidation proceeds for greater than six months; or (iv) permit the payment of the redemption or liquidation proceeds in any manner other than cash or property, other than certain notes. The proposed regulations include exceptions for commercially reasonable restrictions imposed by nonfamily members and restrictions which are mandated by state or federal law.

Therefore, critically, according to the proposed regulations (section (i) above), a restriction on the ability of a holder to compel liquidation of her interest is typically disregarded and the holder's interest would be valued as if the holder had a full right to liquidate. Since the lack of a right to liquidate drives minority discounts (and to a certain extent, marketability discounts), the availability of such discounts may be completely eliminated for transfers of family held interests to family members.

These regulations also impact the utilization of restrictions imposed or required to be imposed by any federal or state law. The reliance on these restrictions to support valuation discounts has been largely removed.

Bright Side?

The proposed regulations could be beneficial for many estates. For those estates which do not have a federal estate tax liability, the higher values mean that the beneficiaries will inherit assets with a higher tax basis, which will generate lower capital gains upon sale of the inherited assets.

The Treasury's desire to curtail the use of valuation discounts has been in existence for quite a while. The issuance of these proposed regulations is a large step towards the accomplishment of its goal. There is currently a window of opportunity to execute estate plans using valuation discounts. Now is the time to act while the window of opportunity exists.

Please contact your WeiserMazars tax professional for more information.

Gregory Black, CPA, JD, LLM
Partner
212.375.6894
Gregory.Black@WeiserMazars.com

Richard Bloom, CPA, PFS
Partner
732.475.2146
Richard.Bloom@WeiserMazars.com

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