

Trust & Estates Alert: Proposed IRS Regulations to Take Away Valuation Discounts for Family-Owned Businesses

September 1, 2016

The U.S. Treasury Department recently released proposed regulations that could negatively impact taxpayers with family-owned businesses. Currently, taxpayers with family-owned businesses can take advantage of valuation discounts when transferring interests in their businesses to family members. These discounts reduce the value of the business for gift, estate, and generation skipping transfer tax purposes. If the regulations become permanent, they would effectively take away what is commonly referred to as the "lack of control" discount for transfers of minority interests in businesses controlled by family members either before or after the transfer. Treasury considers a business "controlled" by family members if 50 percent or more is collectively owned by members of the transferor's family, including the transferor's spouse, siblings, ancestors, descendants, and spouses of the transferor's siblings, ancestors, and descendants.

Family business owners should reexamine the amount of assets that they or their heirs can easily convert to cash in light of the proposed regulations. A concern for many family business owners is ensuring there is enough liquidity to pay estate taxes or fund buy-sell agreements to keep their businesses intact. If prior liquidity calculations assumed valuation discounts that would not be available if the proposed regulations become final, current liquidity planning could be inadequate.

Illustration of the impact of the proposed regulations: Family business owners use many estate planning strategies to take advantage of valuation discounts. To illustrate one of these strategies, assume the following facts about Jack. Jack has a federally taxable estate (currently an estate greater than \$5.45 million). Part of Jack's estate consists of commercial real estate valued at \$1 million owned solely by Jack. Jack has one child, Jane, who will ultimately receive his estate. Jack wants to minimize gift and estate taxes and maximize the amount of his estate passing to Jane.

Assume Jack transfers 45 percent of the real estate to Jane valued at \$450,000 for gift tax purposes. The IRS may allow a small discount for transfer of a fractional interest in real estate, so Jack might be able to reduce the taxable value of the gift by 5 to 10 percent. Alternatively, if Jack forms a limited liability company, contributes the real estate to the company, and then transfers 45 percent of the company to Jane, the value of the gift is \$450,000 less any applicable valuation discounts. Currently, Jack can apply the lack of control



discount because he is transferring a minority interest in the company to Jane. While the amount of the discount will depend on each individual situation, it could be as much as 20 percent. Under these facts, a 20 percent valuation discount reduces the gift tax value of the property transferred by \$90,000. If the proposed regulations become law, Jack will not be able to use this valuation discount and the value of his taxable gift will increase by \$90,000 in this example.

Depending on Jack's situation, he could consider other strategies taking advantage of valuation discounts and reducing gift and estate taxes, such as grantor retained annuity trusts and installment sales to defective grantor trusts. However, once the proposed regulations are finalized, Treasury's limitations on valuation discounts will reduce the effectiveness of these strategies.

The proposed regulations are set for a public hearing on December 1, 2016. After considering any comments, Treasury will likely issue final regulations and set an effective date for the new limitations, which could be as early as a few months after the public hearing.

If you are a family business owner, please contact an attorney in Gray Plant Mooty's Trust, Estate & Charitable Planning group as soon as possible and well before the proposed regulations are finalized to discuss how the proposed regulations apply to your situation.