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New IRS Proposal Severely Limits Effective Estate Tax Planning Strategy

Estate Planning & Wealth Transfer

Tax Planning & Structuring

Family Offices, Businesses & Entrepreneurs

For more than 25 years, the Internal Revenue Code has allowed discounts on the fair market value of ownership interests in family-controlled or closely-held businesses and other investment entities when it came to calculating federal estate, gift and generation-skipping transfer (GST) taxes. Last week, though, the IRS proposed a sweeping change to the regulations governing those discounts, virtually eliminating them in most circumstances and increasing the amount of assets subject to estate, gift and GST taxes.

Why this matters

Unless they are declared invalid by a court challenge, the proposed changes could go into effect as soon as the end of 2016, following a public hearing set for Dec. 1. The new regulations would not be retroactive, allowing a short window of time for family-controlled businesses and other investment entities potentially affected by this upcoming change to address any contemplated transactions or transactions in process, for which the current rules would be more favorable.

The main issue affected by this pending change is the valuation of assets transferred to family members, by sale, gift or on death. Under current law, restrictions under state laws that impact the liquidation of ownership interests in family-controlled businesses and other investment entities are taken into account in valuing those interests even if family members can waive those restrictions. These restrictions for lack of control and marketability generally result in the same discounts in valuation, for estate, gift and GST tax purposes, of interests in family-controlled businesses and other investment entities that are transferred to other family members, which would apply if the ownership interests were transferred to a non-family member.

What is affected by the proposed changes?

The IRS-proposed regulations regarding discounts on valuation apply broadly to corporations, partnerships, limited partnerships and other entities and arrangements, including S corporations, S subsidiaries and limited liability companies. Whether the new rules eliminate any discount on valuation first depends on whether the entity is “controlled” by family members. In most cases, family-owned business and investment entities will be controlled.

If the entity is controlled, then the newly proposed IRS rules would generally disregard restrictions, whether imposed by state law or otherwise if the restrictions can be waived or modified by family members, in determining the value of the family member’s interests in a controlled entity, while other, non-family interests, including charitable interests, would not be affected.

The result of the proposed rules is that the lack of marketability of a family member’s interest and the lack of control by that family member cannot be taken into account in determining the fair market value of that family member’s interest in a controlled entity for purposes of determining if estate, gift and GST taxes apply to the transfer, even if that family member actually lacks control and the ability to liquidate his or her interest.

What the potential changes mean for you and your family

As we continue evaluating the full extent of the proposed regulations’ impact, it remains clear that these potential new rules could increase the estate, gift and GST tax costs for clients with family-owned business and investment entities.

If you have been considering transfers of interests in any family-owned entities to other family members, it may be prudent to consider the near- and long-term impact potentially higher estate, gift and GST tax costs will have on your business and succession planning.

We are committed to helping you understand how these potential new rules affect you and your family businesses and other investment entities, and we look forward to working with you to actively manage any business and estate planning consequences. You can reach any of our Tax and Wealth Transfer attorneys at 312-236-3003 or by visiting our website at www.gouldratner.com.