For Owners of Family Entities: Change Is Coming

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Treasury may make it far more expensive for you to transfer to family members interests in your family-controlled partnerships, limited liability companies and corporations

The U.S. government has made a bold move in its decades-long drive to stop perceived abuses as families seek to reduce the tax consequences of transferring, among family members, minority interests in private entities that the families control.

On August 2, 2016, the Treasury Department issued proposed regulations intended to significantly change the way interests in family-controlled partnerships, limited liability companies and corporations are valued for estate and gift tax purposes.

Therefore, if you are in the process of transferring to a family member an equity interest in a family entity—whether it is an operating business, real estate company, investment firm, or some other enterprise—you may be well advised to complete that transaction before December.

That’s because hearings are scheduled for December 1, 2016, in Washington, D.C., on these proposed regulations (“2704(b) regulations”), which can be adopted as final from that day on. For most purposes, the 2704(b) regulations (as currently proposed) would not be effective until finalized and, given the controversy they’ve sparked, it is likely they won’t be finalized until sometime in 2017.

But do not panic if you aren’t already in the process of transferring equity interests in your privately held entity. There will still be many effective planning techniques to reduce the tax costs of giving interests in family enterprises to other family members.

It’s possible that the proposed 2704(b) regulations may be substantially modified after Treasury receives public comments that are expected to question the regulations’ scope and legality. Even if finalized unchanged, there could be court challenges. In other words, it may be years before the full impact of the 2704(b) regulations is completely known.

Still, change is coming. So we recommend that you speak as soon as possible with your estate planning lawyer and consult with your J.P. Morgan Wealth Advisor to discuss the implications of the proposed 2704(b) regulations on your current estate plan and any anticipated future actions. It is important to stay abreast of these potential changes and make choices that best suit your circumstances.

How might you and your family be affected?

Families have long used partnerships, limited liability companies and family-controlled corporations to manage and control family assets and run family businesses.

When family members have transferred to each other minority interests in these entities, the law, when valuing the transferred asset, has generally taken into account two factors:

• That a minority interest lacks control over the entity (therefore a “lack of control discount” has been permitted)
• That restrictions on transferability make the asset transferred less marketable than publicly traded stock (therefore a “lack of marketability discount” has been permitted)

Historically, these discounts, when considered together, have been substantial: frequently up to as much as 35%.

For example, while a private company might have an enterprise value of $100 million, a 10% equity interest in that company is generally worth less than $10 million. The reasoning for valuing that interest for something less than its proportion of enterprise value is that the holder of the 10% interest generally cannot force payment of dividends or other distributions from the company, cannot control management decisions, has no right to force the company or another shareholder to buy his or her interest at enterprise value, and cannot force a sale of the company.

So, the 10% interest might be valued at $6.5 million. And if the holder of that 10% interest had gifted that interest to another family member, the resultant gift tax savings would have been $1.4 million—the reduction in value ($3.5 million) multiplied by the transfer tax rate of 40%.

Treasury’s war on perceived abuses

In 1990, a new Section 2704 was added to the Internal Revenue Code, imposing special valuation rules for transfers of interests in family-controlled corporations and partnerships.
Under Section 2704, certain specified restrictions and rights would be ignored when valuing interests in family-controlled corporations and partnerships. And Treasury was allowed to adopt regulations so that other restrictions shall be disregarded if they artificially reduce the value of a transferred interest.

Ever since the enactment of those new valuation rules, the battles between Treasury and taxpayers have largely been over the extent of the discounts and the impact of commonly used provisions for family-controlled entities.

Implicit in Treasury’s arguments is that those provisions do, in all instances, artificially reduce the value of transferred interests in family-controlled entities. To Treasury’s frustration, the courts have often sided with the taxpayer.

Now, Treasury has proposed the 2704(b) regulations. If adopted without change, they would effectively eliminate all valuation discounts for intra-family transfers of interests in family-controlled entities. And this applies to transfers at death, by gift during lifetime, or by sale.

Specifically, the proposed regulations would:

1. **Narrow the statutory safe harbor for restrictions imposed by state law**—Only restrictions that both are mandated by state law and cannot be overridden by a family’s governing agreement are to be considered in valuation discounts. So, for example, if a family’s partnership agreement can override a state law that restricts limited partners (LPs) from withdrawing from a limited partnership, the value of a transferred LP interest cannot be discounted because of the state law restriction.

2. **Provide new guidance on the effect of interests held by non-family members**—Historically, transferring a nominal interest in the family entity to a non-family member, typically a charity, meant that the 2704 restrictions no longer applied. It’s no longer that simple. The proposed regulations would impose four conditions before Section 2704 would not apply:
   - The non-family member must have held the interest for a minimum of three years before the transfer to a family member
   - The non-family member’s interest must constitute at least 10% of the outstanding equity of the entity

3. **Create a new class of “disregarded restrictions”**—Valuation discounts would no longer be available based on any provision in the entity’s governing agreement that:
   - Limits the interest holder’s ability to liquidate the interest
   - Limits the liquidation proceeds to an amount less than that interest’s share of the entity value
   - Permits deferring payment of the liquidation proceeds for more than six months
   - Permits the payment of the liquidation proceeds in any manner other than cash or other property (excluding certain notes for operating businesses)

4. **Limit “death-bed” transfers**—If a family member (assume it’s a parent) who could have liquidated the entity before, but not after, transferring interests to other family members dies within three years of the transfers, those transfers would be treated as a lapse of the parent’s right to liquidate, creating a “phantom” asset (the lapse) in the parent’s estate.

**Likelihood proposed regulations will be adopted?**

Criticism of the proposed regulations is likely to be fierce. Expect legal, accounting and similar professional organizations to submit comments to Treasury opposing the proposed regulations (in part or in whole) on numerous grounds. The comments period closes November 2, 2016.

For details of these proposed regulations and to fully evaluate whether they might impact your situation, we recommend speaking with your estate planning lawyer and your J.P. Morgan Wealth Advisor.

We look forward to keeping you apprised of future developments on this issue and to working with you and your other advisors to optimize your wealth planning.
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