The landscape for future taxation of transfers of equity interests in family-controlled entities has become murky. But owners of those entities should continue to focus on planning for those interests.

On August 2, 2016, the Treasury Department issued proposed regulations related to transfers of interests in family-controlled entities to other family members. As widely read, those proposed regulations would largely eliminate, for transfer tax purposes, certain discounts that traditionally have been recognized. (For a more detailed discussion of the proposed regulations, see our August 2016 Alert: “For Owners of Family Entities: Change Is Coming.”)

The proposed regulations are subject to a public comment period that closes on November 2, 2016, and a public hearing to be held on December 1, 2016, before the regulations can be finalized and become effective. In the previous Alert, we predicted that there would be fierce criticism of the proposed regulations. That prediction has not only been borne out, but it has also come from some unexpected places.

On September 15, Rep. Jim Sensenbrenner (Wis.) introduced a bill intended to nullify any regulations issued under Section 2704 of the Internal Revenue Code. The introduction of new legislation to prevent regulations is a rare occurrence, particularly in the tax arena. The next week, Rep. Warren Davidson of Ohio introduced a bill that would prevent any funding for Treasury for work on the proposed regulations, or any similar rules. Florida Sen. Marco Rubio introduced the same bill in the Senate. Each of those bills has received substantial support from various industry groups.

Separately, 41 Senate Republicans wrote Treasury Secretary Jacob Lew in late September to encourage that the proposed regulations be abandoned. The letter argued that the changes would create tax burdens that would discourage the continued operation and growth of family-run businesses, particularly farms.

At a recent industry conference, a Treasury Department official expressed surprise at the reaction. Catherine V. Hughes, Treasury’s estate and gift tax attorney-advisor, indicated that the proposed regulations were not intended to eliminate all discounts for family-controlled entities. She further indicated that Treasury is not trying to push the regulations through before the end of the year or even prior to the end of the current administration on January 20.

While the future of the proposed regulations is unknown, we do know that the law as it exists and as generally interpreted recognizes two discount factors when valuing an equity interest in a family-controlled entity that is transferred from one family member to another:1

- A “lack of control discount” (if the interest lacks control over the entity)2
- A “lack of marketability discount” (if restrictions on the transferability of the interest make it less marketable than a publicly traded security)

These intra-family transfer discounts can routinely amount to a 35% reduction in the value of the transferred interest, according to William H. Frazier, valuations expert with Stout Risius Ross, who spoke at a recent webinar J.P. Morgan hosted for professional advisors.

Thoughtful planning that takes those discounts into consideration can greatly reduce the tax costs of transferring equity interests in family-controlled entities.

ON THE HORIZON

While there is considerable uncertainty about the future of the proposed regulations, if you have contemplated but not yet acted on implementing the transfer or sale of family-controlled entities for estate planning purposes, we recommend that you visit your estate planning counsel to discuss an appropriate course of action.

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1 If the proposed regulations are enacted without change, there is the possibility that gifts made even before December 1 may be subject to a “look-back” provision, which if applicable could create “phantom” assets for U.S. estate tax purposes if the donor dies within three years of the transfer. If the result of the look-back provision is the creation of a “phantom” asset in the decedent’s estate for U.S. estate tax purposes, then the phantom asset could cause the decedent’s estate to then owe U.S. estate tax for which a marital deduction may not be claimed, when the estate otherwise was not anticipating paying an estate tax. If a client is concerned about this possible unintended consequence, the client might wish to consider purchasing term life insurance to cover the three years from the time a gift is made for any estate tax that could be owed.

2 “Control” for the purposes of these proposed regulations generally means for:
- Corporations—50%, on a family attribution basis by vote or value
- Partnerships—50% of profits or capital, or owning a general partnership interest
- Other entities—50% of profits or capital, or the ability to cause the liquidation of the entity
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