

TAX ALERT!

October 20, 2016

THE IRS HAS PROPOSED IMPLEMENTING NEW VALUATION RULES FOR FAMILY BUSINESSES

There have been no significant changes to the gift and estate tax laws since January of 2013 when Congress avoided the so called “fiscal cliff.” However, in late Summer of this year, the IRS issued “**proposed**” regulations that, if made permanent, **will impact the way interests in family owned business entities are valued when such interests are transferred to family members.** The proposed regulations are to Internal Revenue Code Section 2704. Under IRS administration procedures, the proposed regulations will be finalized and adopted in a process that hopefully will provide more guidance and revisions to the current proposed regulations, which are not a “vision of clarity.” While at this early stage we cannot yet quantify the impact of the proposed regulations, what we can expect is that there will be some changes to the way family business entities are valued that will be less favorable than the current law. Such changes could come as early as January, 2017. We are sending this Alert because we know that some of our clients may want to take steps now under current law before the less favorable regulations are adopted.

Clients we expect to be affected by the new regulations are clients who: 1) own family business entities (meaning a corporation, partnership, limited liability company or even investment real estate that is owned in large part by the client and/or other members of the client’s family); and 2) expect to face an estate tax (meaning clients with estates in excess of his or her remaining applicable exclusion amount.)¹ These clients can expect their interests in family business entities to be valued higher under the new laws meaning that lifetime gifts of these interests will carry more gift tax and interests passing at death will carry more estate tax. The potential impact of the proposed regulations can be illustrated by the following simple example: If today your ABC Family Business Entity owned assets valued at liquidation of \$10,000,000 and you transferred a 10% interest in the entity to a child under the current laws, that 10% will not be appraised at \$1,000,000 (10% liquidation value of the entity) but at a lower value because the appraisal of the gifted interest will generally subscribe a valuation “discount,” sometimes of as much as 35%, for a minority interest. The “discount” reflects the **reality** that a minority interest holder cannot participate in the management of the entity and will have a difficult time selling a minority interest to a third party. The proposed regulations seek to change the current valuation rules to disregard **this reality** when the interest passes to a family member. While we cannot yet quantify how interests in family business entities will be valued under the new regulations, we can expect that in the example above, the 10% interest would likely be valued at something greater than under current law. Simply put the IRS is using this code section to attack a perceived abuse to circumvent the estate and gift tax. It is important to remember that the proposed regulations affect only a small part of the gift and estate tax laws. Neither the deductions for gift and estate tax nor the current credits for gift and estate tax are affected by this change. Any family owned business entities passing to a spouse or to charity will still be entitled to the marital deduction or charitable deduction from gift or estate tax. Also, an amount equal to \$5,450,000 (\$10,900,000 for a married couple), including family business entities, can pass to any individual or number of individuals during life or at death without gift or estate tax.

*Some clients may want to take advantage of the current laws before the laws change and transfer interests in family business entities before the end of the year. Transfers of family business entities can have a substantial impact on your lifestyle and family dynamics and should not be done solely to save estate taxes; nevertheless, this planning will make sense for some clients. **Please call us if you would like to discuss your situation.***

¹ The applicable exclusion amount currently \$5,450,000 for an individual or \$10,900,000 for a married couple, as reduced by lifetime taxable gifts and as adjusted each year for inflation.