IRS Proposes Regulations That Would Increase Wealth Transfer Taxes in Family-Controlled Entities

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09/27/16

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The Internal Revenue Service (IRS) proposed regulations on August 2, 2016, under which transfers to family members of interests in family-controlled entities — including partnerships, limited liability companies (LLCs) and corporations — likely would incur higher gift, estate and/or generation-skipping transfer taxes. Before the rules take effect, those with family-controlled entities should consider proactive estate and gift tax planning that could reduce their wealth transfer taxes.

Background

For many individuals, interests in family-owned operating businesses constitute a significant portion of their net worth. Additionally, LLCs, limited partnerships, S corporations and other business entities are used by many families seeking to consolidate the management and control of family assets and obtain certain creditor protections. In order to facilitate continued operations and maximize these benefits, the rights of individual family members in a family-controlled entity are often restricted pursuant to a partnership or similar operating agreement.

As a result of these restrictions, the fair market value of an interest in a family-controlled entity is often significantly less than its proportionate share of the entity's underlying value. A member subject to such restrictions has little or no control over the management of or distributions from the entity, and the ability to monetize his or her interest in the entity is significantly limited. A hypothetical buyer of such an interest would take these restrictions into account in determining the price he or she is willing to pay. Existing law reflects this in the form of discounts for a minority interest and a lack of marketability when valuing such interest for purposes of wealth transfer planning.

Proposed Changes

The proposed regulations generally would disregard restrictions on a family member's right to redeem his or her interest in family-controlled entities. As a result, when transferred to another family member (or to a trust for that person), the interest would be valued at an amount closer to its proportionate share of the entity's total value rather than the discounted valuation available under current law.

The proposed regulations allow a few exceptions. Restrictions imposed by a mandatory provision of state or federal law or by a commercially reasonable third-party lending or equity agreement would continue to be taken into account. Additionally, family-controlled entities in which nonfamily members hold significant (20 percent or more) equity interests may avoid application of the new rules. Notwithstanding these exceptions, the proposed rules are intended to — and if finalized, likely will — increase the wealth transfer taxes imposed on most intrafamily transfers of interests in family-controlled entities.

For decades, individuals have successfully transferred interests in family-controlled entities using valuation discounts. These proposed regulations are in direct response to such planning and are intended to increase wealth transfer taxes.

The new rules will not go into effect until the proposed regulations are published as final or, in the case of certain provisions, shortly thereafter. Until finalized, members of family-controlled entities have a window of opportunity to consider whether transferring interests in that entity will further their personal wealth planning objectives and, if so, take advantage of the more taxpayer-friendly valuation rules under current law. This window of opportunity is expected to remain open until at least the end of 2016.