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To Gift or Not to Gift – That is the Question

How to Make an Informed Decision In Light of the Proposed Valuation Discount Killer Regulations

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Synopsis

Newly proposed tax regulations may substantially increase taxes on gifts and estates for intra-family transfers of family-controlled businesses. If enacted in their current form, the new rules may limit or even eliminate previously available valuation discounts on certain intra-family gifts and estates of family-controlled businesses for estate, gift, and generation-skipping transfer tax purposes, which may significantly increase taxes on family gifts and estates.

Clients who are considering gifts of family-owned entities should seek the advice of their legal counsel before the proposed regulations are finalized, which may be as soon as early 2017.

The Situation

Discounts for lack of control and lack of marketability have historically been a key component of estate planning, where such discounts are used to reduce the value of certain transferred interests thereby lowering the tax impact to the transferor.

However, the IRS has continued to scrutinize and challenge the use of discounts in certain situations. According to Mark Mazur, Assistant Secretary for Tax Policy at the U.S. Department of the Treasury, the proposed regulations are intended to "close a tax loophole that certain taxpayers have long used to understate the fair market value of their assets for estate and gift purposes." These proposed regulations apply to businesses controlled by members of the same family where interests in the business are gifted to family members or included in a family member's estate.

The Potential Practical Impact

If finalized as currently drafted, the proposed regulations would increase gift and estate taxes on family-controlled businesses. These regulations reverse long-standing valuation practices of applying discounts where interests in closely held businesses are subject to real limitations.

Such discounts are not arbitrary. Under generally accepted valuation practice, they are used to reflect the fact that a typical interest in a family-owned entity possesses less marketability and less control than enjoyed by a typical interest in a publicly traded company (the benchmark by which many family-owned interests are valued).

Under the proposed regulations, no discount may be taken in valuing closely held business interests for gift and estate tax purposes where the transferor, individually or with other family members, controls the business. This applies to transfers of interests in family businesses, lapses of voting control in a family business, or limitations on liquidation rights in a family business.

In general, these limitations apply to businesses where members of the same family have more than 50% of the voting control or value of a business. Family members include the person making a gift or a decedent, as well as their brothers, sisters, and spouses (and their ancestors and lineal descendants and spouses of the ancestors and descendants).

If the proposed rules are applied, no lack of control or lack of marketability discount may be taken in valuing most interests in family businesses for gift or estate tax purposes.

These rules would apply even where the documents (e.g., articles of incorporation/by-laws, operating agreement, and shareholder agreements) impose real limitations, such as a limitation on an owner's ability to require the business to buy back their shares.

The regulations may also require that the net equity value (fair market value of the assets minus the liabilities) of a family business be used for gifts and estate valuation purposes (so-called "minimum value"), which would prevent discounts for lack of control/minority discounts. As an example of this rule, a parent's transfer of 10% of the stock of a family business worth $100 million (en bloc) to a child would be valued at $10 million (10% of $100 million) for gift tax purposes even if the child's rights are severely limited under a shareholder agreement.

Finally, no minority discount would be allowed in valuing a decedent's estate if the decedent's majority control was reduced to minority status within three years of death.

Conclusion

Owners of family businesses should seek advice from legal, valuation, and tax professionals if considering intra-family gifts before the proposed regulations are finalized. These regulations will likely not apply to transfers made during 2016, but will apply to transfers after the regulations are finalized, which may be in early 2017.

The proposed regulations are subject to a 90-day public comment period and a public hearing is scheduled for December 1, 2016. The regulations themselves will not go into effect until the comments are carefully considered and then 30 days after the regulations are finalized.

We anticipate that these regulations may not be finalized in the current form, for many reasons; including that they may be contrary to real economic limitations to value, that they are contrary to long-standing valuation practices, and that the potential applications of the regulations create uncertainty because their potential application may be far reaching and difficult to predict.

For information on how Houlihan Lokey can assist holders of interests in family-controlled business and their advisors in assessing the potential impact of the proposed regulations on estate planning, please visit HL.com or contact one of the individuals listed below.

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