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Proposed regulations affecting valuation discounts on transfers of interests in family controlled entities for transfer tax purposes

The U.S. Treasury Department and IRS today released for publication in the Federal Register a notice of proposed rulemaking (REG-163113-02) concerning the valuation of interests in corporations, partnership, and other entities for purposes of the estate, gift, and generation-skipping transfer taxes. These proposed regulations have been widely anticipated for some months.

Specifically, the proposed regulations address the treatment of certain lapsing rights and restrictions on liquidations in determining the value of the transferred interests, and are intended to prevent under-valuation of these transferred interests.

The **proposed regulations** [245 KB] include provisions that would:

- Amend existing Reg. section 25.2701-2 to address what constitutes control of a limited liability corporation (LLC) or other entity or arrangement that is not a corporation, partnership, or limited partnership

- Amend existing Reg. section 25.2704-1 to address deathbed transfers that result in the lapse of a liquidation right and to clarify the treatment of a transfer that results in the creation of an assignee interest

- Amend existing Reg. section 25.2704-2 to refine the definition of “applicable restriction” by eliminating a comparison to the liquidation limitations of state law

- Add new Reg. section 25.2704-3 to address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interests held by persons who are not members of the family

Comments concerning the proposed regulations and topics to be discussed at a December 1, 2016 public hearing are due by a date that is 90 days after the regulations appear in the Federal Register on August 4, 2016.

Read a related Treasury Department **blog** item on the proposed regulations.

Regulations under section 2704

Section 2704 provides special transfer tax valuation rules for valuing intra-family transfers of interests in corporations and partnerships which are subject to lapsing voting or liquidation rights and other restrictions on liquidation. In part, the existing regulations under section 2704 disregard certain limitations on liquidation for purposes of determining the fair market value of the transferred interest. The IRS and Treasury assert that judicial interpretation of portions of these regulations, as well as some state law changes, have rendered portions of the regulations ineffective, necessitating various changes, clarifications and additions to the current regulations.

Disregarded restrictions

Perhaps the most significant addition to the regulations is the creation of a new class of restrictions that will be ignored when valuing gifts to family members of interests in family-controlled entities—referred to as "disregarded restrictions." In the case of a family-controlled entity, any restriction (described below) on a shareholder's, partner's, member's, or other owner's right to liquidate his or her interest in the entity will be disregarded if the restriction will lapse at any time after the transfer, or if the transferor, or the transferor and family members (without regard to certain interests held by nonfamily members), may remove or override the restriction.

Under the proposed regulations, such a disregarded restriction includes one that:

- Limits the ability of the holder of the interest to liquidate the interest
- Limits the liquidation proceeds to an amount that is less than a minimum value
- Defers the payment of the liquidation proceeds for more than six months or
- Permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes

KPMG observation

These restrictions are typically used today to justify the allowance of discounts when valuing gifts of closely held business interests to family members.

Insubstantial interest to nonfamily member

The IRS and Treasury also concluded that the grant of an insubstantial interest in the entity to a nonfamily member should not preclude the application of section 2704(b) because "in reality, such nonfamily-member interest generally does not constrain the family's ability to remove a restriction on the liquidation of an individual interest."

As further explained by the preamble, the interest of these nonfamily members does not truly affect the family's control of the entity but—when combined with a requirement that all holders approve liquidation—is designed to reduce the transfer tax value of the family-held interests while not ultimately reducing the value of those interests to the family member transferees.

As provided in the proposed regulations, the presence of a nonfamily-member interest should be recognized only when the interest is an "economically substantial and longstanding one that is likely to have a more substantive effect."

The proposed regulations provide a "bright-line test"—the interest held by a nonfamily member will be disregarded if: (1) it has been held for less than three years before the date of the transfer; (2) it constitutes less than 10% of the value of all equity interests; (3) when combined with the interests of other nonfamily members, it constitutes less than 20% of the value of all equity interests; or (4) the nonfamily member lacks a right to put the interest to the entity and receive a minimum value.

KPMG observation

The regulations, if finalized as proposed, will have a significant impact on the transfer tax consequences associated with transfers of interests in controlled family entities to family members. From a valuation perspective, taxpayers and appraisers currently incorporate applicable restrictions, as defined under section 2704, through the application of discounts for lack of control (i.e., minority) and lack of marketability, which, in aggregate, typically range from 15% to 40%. By refining the definition of applicable restrictions under section 2704, adding the new category of disregarded restrictions, and ignoring insubstantial interests held by nonfamily members and charities, the proposed regulations significantly limit the ability of taxpayers and their estates to apply these discounts when estimating the fair market value of interests in certain family-owned entities that are transferred to family members.

Effective date

The proposed regulations will apply to transfers made after the date the regulations become final. Thus, valuation discounts may still be available for transfers made before such time.

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