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IRS Proposes New Regulations That Could Dramatically Increase Estate Tax Exposure for Family Business Owners

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By Trusts & Estates Group

On August 4, 2016, the IRS issued proposed regulations that would eliminate many estate and gift tax valuation discounts currently applicable to family-owned business entities. For many family business owners, this will artificially increase the estate tax value of their business interests far above the actual fair market value of the interests. The regulations would apply to all business entities that are controlled by members of a family, including C corporations, S corporations, limited partnerships and limited liability companies, and would apply both to entities used to pool family investments, and to entities operating businesses. The regulations would apply to entities that have non-family owners, unless the percentage of ownership of non-family members meets certain thresholds. Clients may wish to consider the following actions:

- Submitting comments on the proposed regulations with the IRS prior to their adoption.
- Making transfers of business interests prior to finalization of the regulations, while valuation discounts still apply.
- Reviewing the effect of the new regulations on their estate tax exposure, to determine whether their plans should be amended.

The proposed regulations are under Internal Revenue Section 2704. One purpose of that Code Section is to prevent estate and gift tax avoidance through the use of illusory restrictions on the liquidation of business entities owned by family members. For example, under Section 2704 and the existing regulations, if a shareholder control agreement for a family-owned business provides that an owner's shares may be redeemed by the company at book value, this provision will in most cases be ignored for purposes of determining the value of an owner's shares for estate and gift tax purposes. This prevents family business owners from reducing the estate and gift tax value of their shares by imposing unusual restrictions that may never be enforced.

The statute and current regulations do not, however, prohibit the application of valuation discounts based on restrictions that are generally applicable under state law. For example, under the laws of Minnesota and other states, a minority shareholder does not have the right to demand liquidation of the company or of his or her shares. Therefore, the value of a minority shareholder's stock for estate and gift tax purposes must take this illiquidity into account, regardless of whether the other owners are family members of the minority shareholder. Likewise, a minority shareholder's stock is subject to discounts for lack of marketability and lack of control, because these factors are present even if the business and its owners have adopted no agreements restricting the rights of shareholders.

The newly proposed regulations would eliminate most estate and gift tax valuation discounts for family-controlled businesses, thereby imposing gift and estate tax on a theoretical value that is well above the actual fair market value. This could lead to very harsh results. For example, if a company is worth $50 million and a particular shareholder owns 10 percent of the company's shares, the new regulations could cause the shareholder's interest in the company to be valued at $5 million for estate and gift tax purposes, even if the actual fair market value of the shares is $3 million (applying combined discounts of 40 percent). Assuming the shareholder has other assets with a value equal to or in excess of the available estate tax exemption, the combined federal and Minnesota estate tax on the shares at his or her death would be approximately $2.48 million – over 82 percent of the actual value of the shares.

The regulations are based on the faulty assumptions that members of an extended family will always cooperate with each other, negating discounts that are otherwise appropriate in businesses controlled by unrelated persons, and that an owner's interests can be liquidated without jeopardizing the entity's business operations. Using the example above, the regulations assume that the other owners of the company would allow the deceased shareholder's estate to liquidate the estate's shares at an undiscounted value. In reality, the factors that justify discounts (including the inability to appoint or change management or board members, the inability to liquidate, and the inability to influence frequency and magnitude of distributions) are often unaffected by family relationships, and many businesses lack the cash necessary to liquidate an owner's shares.

As noted above, we recommend that our clients consider the following actions:

Family businesses and their owners may wish to submit comments to the IRS regarding the negative effect the regulations would have on their operations. Comments must be received by the IRS by November 2, 2016. Comments may be submitted online at www.regulations.gov, or may be mailed to CC:PA:LPD:PR (REG-163113-02), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. We would be happy to assist in drafting comments.

The regulations will not apply to transfers completed prior to the date the regulations are finalized. The regulations cannot be finalized until after a December 1, 2016, hearing, and may not be finalized for several months after the hearing. Family

business owners should consider making transfers of minority business interests before the new regulations become effective, in order to take advantage of the ability under the current regulations to use actual fair market value for gift and estate tax purposes. The new regulations will have a three-year lookback period for certain transactions, which will have to be analyzed before implementing any particular transfer.

Finally, once the regulations are finalized, clients should review and update their estate plans in light of their estate tax exposure – which may be increased significantly. This could include engaging in wealth shifting strategies, and also reviewing and revising tax payment provisions that control which beneficiaries or assets will be burdened by the estate tax payable upon a client's death. It may also be appropriate to review life insurance coverage.

For further information and for assistance, please contact your Fredrikson & Byron relationship attorney.