CANADIAN TAX Highlights

Editor: Vivien Morgan, JD

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Proposed Regs May Limit US Estate Plan

On August 2, 2016, the US Treasury issued long-awaited proposed regulations under Code section 2704 that make comprehensive and very significant changes to the valuation of interests in many family-controlled entities for US estate, gift, and generation-skipping transfer tax purposes. US tax practitioners have been anticipating these proposals since 2003, when the project began to appear annually in the "IRS Priority Guidance Plan." No specific date has yet been set for the proposed regulations' becoming effective.

Congress enacted section 2704 in 1990 to limit valuation discounts for gift and estate tax purposes applicable to intrafamily transfers of interests in family-owned and closely held corporations and partnerships. If an individual and his or her family hold voting or liquidation control over a corporation or partnership, section 2704(a) generally provides that the lapse of a voting or liquidation right is taxed as a transfer subject to gift or estate tax. Section 2704(b)(4) authorizes the Treasury to issue regulations that similarly disregard other restrictions in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family, if that restriction effectively reduces the value of the transferred interest for transfer tax purposes but not ultimately for the transferee.

Under current law, a taxpayer can transfer interests in a closely held business to family members (generally, children and grandchildren) at a discounted value. Usually, the recipient is given a non-voting, minority (less than 50 percent) interest, and his or her ability to dispose of that interest is restricted (usually by transfer restrictions in the business's governance documents). These minority and lack-of-marketability discounts, which can reduce the value of the transferred interest by as much as 40 percent, are designed to reflect the economic reality that an arm's-length buyer would not pay $10,000 for a 10 percent interest in a $100,000 family business because, as a minority owner, the third party (1) cannot control business decisions and (2) cannot easily sell or otherwise liquidate the business interest because of transfer and liquidation restrictions and the small market for selling closely held business interests.

The proposed regulations limit the existing regulatory exceptions to transfer taxes upon the lapse of a voting or liquidation restriction. The proposals also further restrict valuation discounts for transfers between family members of interests in family-controlled corporations, partnerships, limited liability companies, and other business entities or arrangements, both domestic and foreign. More specifically, the proposed regulations

- treat as an additional transfer the lapse of voting and liquidation rights for transfers of interests in a family-controlled entity made within three years of death (discounts reflecting lack-of-control and minority interests that are typically taken in these transactions are thus substantially limited or eliminated);
- disregard the ability of most non-family-member owners to block the removal of covered restrictions unless the non-family member has held the interest for more than three years, owns a substantial interest in the entity, and has the right, upon six months' notice, to be redeemed or bought out for cash or property;
- disregard restrictions on liquidation that are not mandated by federal or state law in determining the transferred interest's FMV; and
- clarify the description of entities covered to include limited liability companies and other entities and business arrangements, in addition to corporations and partnerships.

US tax practitioners have long speculated about whether these proposed regulations would focus solely on closely held entities holding passive investment assets or whether active trade or business operations would also be affected. The proposed regulations, as currently drafted, apply similarly to both types of entities.

Planning opportunities still exist, because the proposed regulations are not yet effective. Proposed regulations may be useful indicators of the Treasury's position and interpretation of the law, but they are generally not binding either on the Treasury or on taxpayers. Currently, we are in the midst of a 90-day public comment period for the proposed regulations, and interested parties may submit written comments; a public hearing is scheduled for December 1, 2016. Any final regulations, if adopted, may be substantially different from the proposed regulations and are only effective on, at the earliest, the publication date of the Treasury decision to adopt them as final. Even for less controversial projects, the finalization of regulations is typically a multi-year process. However, some commentators are of the view that the IRS may make the project a high priority, and thus an effective date in mid-2017 is possible.

Republican members of Congress have already introduced three bills calling for the Treasury's effective withdrawal of the regulations. The latest bill, introduced on September 29, 2016

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by Senators Marco Rubio, Jerry Moran, and Jeff Flake, highlights the impediments that the regulations create for the effective transition of ownership of family-owned businesses and farms to the next generation.

Final regulations that are similar to the proposed regulations will cause the disappearance of a significant estate-planning technique and will increase, accordingly, the tax cost of transferring interests in family-owned entities. Not only will lack-of-control discounts be affected to the taxpayer's detriment, but undoubtedly appraisal costs will substantially increase in order to comply with the regulatory mandate.

Leslie R. Kellogg
Hodgson Russ LLP, Buffalo