

Estate Planning & Closely Held Business Owners

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In August of 2016, the IRS issued long awaited proposed regulations under IRC Section 2704. If adopted, these proposed regulations may significantly reduce the opportunity to apply valuation discounts when making intra-family transfers of interests in various entities. For estate planning attorneys and their clients this translates to impending restrictions on tools often utilized to pass along interests in closely held businesses in a tax efficient manner to the next generation. These regulations will not be effective unless and until they are finalized, but a hearing on the proposed regulations is scheduled for December of 2016. Therefore, it is crucial that clients desiring to minimize potential federal tax on the transfer of their estates act quickly to determine if they should make gifts of business interests prior to the finalized regulations.

Two targets of the proposed regulations are discounts for 'lack of control' and 'lack of marketability.' These planning techniques presently allow some business owners to gift over interests at a substantial discount to the pro-rata value of their underlying businesses – discounts of 30% or more are not uncommon – and this strategy ultimately reduces the size of their taxable estates. Put simply, a minority shareholder's interest may be worth less than a majority shareholder's (lack of control), or owners of a closely held entity may find it difficult to sell their stakes to an outsider (lack of marketability). Consequently, taking a discount on such interests has been an accepted estate and gift planning tool for closely held and family business owners to seek potential estate and gift tax savings.

As currently proposed, the IRS intends to restrict, or possibly eliminate, the ability to take lack of control discounts in covered entities (corporations, LLCs, and partnerships). Additionally, these regulations are expected to impact marketability discounts as well. Again, nothing will be effective until the regulations are finalized. Thereafter, they will only apply to transfers made more than 30 days after the effective date, but there are still potential risks to transfers made within a 3 year window. The final regulations could be in place as soon as the beginning of 2017 should the IRS prioritize issuing them after the hearing.

The proposed changes will represent a significant shift in tax strategy for business owners and their attorneys. Affected clients should contact Einhorn Barbarito to determine if this type of planning should be accelerated to 2016. There is often a significant amount of time required to establish trusts and obtain a necessary valuation of the business prior to making any gifts. For that reason, the window is quickly closing to make a transfer of interest before the new regulations are finalized.