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Proposed IRS Regulations Would Increase Estate and Gift Taxes on Transfers of Family-Controlled Entities

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In August, the Internal Revenue Service published proposed regulations that would have a significant impact on the estate and gift tax consequences of many transfers of certain family-controlled entities, such as corporations, partnerships and limited liability companies (regardless of whether the entity is a passive or active business). If adopted in their current form, the regulations will dramatically reduce the effectiveness of many common estate planning techniques involving these types of entities.

The regulations relate to a provision (Section 2704) of the Internal Revenue Code that governs the valuation of certain property when transferred among family members. It is common for the transfer of interests in family-controlled entities to receive valuation discounts for lack of control and lack of marketability. The proposed regulations would, in many circumstances, significantly reduce or eliminate the valuation discounts that currently are allowed when a person transfers an interest in a family-controlled entity to another family member (or a trust for a family member) during life or at death. As a consequence of the potential loss of valuation discounts, the gift or estate tax consequences of such a transfer could increase significantly. The proposed regulations would also apply a so-called “look-back” rule to some transfers within three years of a transferor’s death in order to negate valuation discounts that otherwise would have been warranted.

In general, the provisions of the proposed regulations will not become effective until they are finalized. However, in certain circumstances, the "look-back" rule would have retroactive effect.

A public hearing on the proposed regulations is currently scheduled for December 1, 2016. In the interim, we will continue to monitor the status of these proposed regulations. There are many uncertainties raised in the proposed regulations and it is not known whether, and the extent to which, any changes will be made prior to the issuance of the final regulations. While the proposed regulations need to go through a public hearing period, we recommend that if you are considering making any such transfers, you do so prior to December 1, 2016. (In order to take advantage of existing rules, you would need to make a transfer of an interest in a family-controlled entity prior to the effective date of the final regulations, though, under the "look-back" rule, certain transactions now may be brought back into a person's estate if he or she dies within three years of the transfer.)

Please contact your attorney at Schulte Roth & Zabel if you wish to discuss how these proposed regulations may apply to your specific financial and personal situation.

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