New IRS Regulations Affecting Transfers of Interests in Family Entities

On August 3, the Internal Revenue Service released proposed regulations dealing with family entities, such as family limited partnerships and family LLCs. Long promised (threatened?) by the Service, the regulations would effectively restrict valuation discounts resulting from restrictions on the ability to liquidate an entity or withdraw from it.

The proposed regulations would also affect the transfer of minority interests in family corporations, partnerships and LLCs. Under the proposed regulations, if a transferor dies within three years of transferring minority interests in family entity, the discount attributable to the minority status is includible in the transferor's estate for estate tax purposes.

The proposed regulations would also effectively proscribe the use of minority discounts in setting a value in a redemption or liquidation and would prescribe certain provisions in a buy-sell agreement, including when and how a departing owner is to be paid for his or her interest.

The proposed regulations do not invalidate the use of family entities or the transfers of minority interests. Rather, the valuation of a decedent's interest in such an entity is affected. In the case of a transfer of a minority interest within three years of death, effectively a phantom asset is created for estate tax purposes, which is the difference in the value of the interest with and without the discount.

The effect of the regulations in any situation will depend upon the interplay between estate tax savings and the income tax disadvantages of such entities. With entities such as partnerships and LLCs, the basis of the assets owned by the entity receive a change in their basis upon the owner's death, generally an increase in basis, which is proportional to the deceased owner's interest in the entity.

For example, assume a partnership owns an apartment building that was fully depreciated and worth $1 million. If a decedent owned a one-third interest in the partnership, the basis of the building could be stepped up to $330,333 absent any valuation discounts. If, however, owing to the valuation discounts, the interest was determined to be worth only $200,000 for estate tax purposes, the basis increase would be limited to $200,000. As a result, whoever received the decedent's interest would have a smaller basis from which to take depreciation deductions.

The regulations, long rumored, have been the subject of criticism as exceeding the Congressional mandate for such regulations. Without delving into the arcana of U.S. Supreme Court precedent about the deference due the regulations issued by administrative agencies, suffice it to say that the challenges to portions of the proposed regulations may well be sustained. Of course, it may be some time before any challenge has fully played itself out in the courts.

Perhaps more to the point is the effective date of the regulations. Comments on the regulations are due within 90 days of publication in the Federal Register (the proposed regulations have not yet been published in the Federal Register). The public hearing is scheduled for December 1, 2016. Assuming no comments, which seems unlikely, the regulations would be effective thirty days after having been published as final in the Federal Register. The beginning of the year is the earliest that the regulations will be effective.

Thus, anyone who is in the midst of planning for family entities or is contemplating doing such planning, still has time to put the planning in place prior to the effective date of the regulations. As suggested with the comments about the potential income tax disadvantage of such an entity, the use of family entities as a transfer tax device has both advantages and disadvantages, which should be carefully weighed in any planning situation.

As the regulatory process moves forward, stay tuned.

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