September 30, 2016

Estate Planning Update September 2016 - Family Business Planning in Light of Proposed Regulations under Section 2704

The IRS recently issued proposed regulations under Internal Revenue Code Section 2704 that, if finalized, would curtail or eliminate valuation discounts for gift and estate tax purposes. These regulations would affect the gift and estate tax value of family-owned business entities, including both active businesses and family investment vehicles such as family limited partnerships (FLPs) and limited liability companies (LLCs).

We want to answer a few basic questions you might have about the proposed regulations. Please contact your Day Pitney attorney if you would like to discuss their impact on your own situation in more detail.

Do these proposed regulations affect me?

If you have an interest in a family-owned business entity and your estate could be subject to federal or state estate tax (and thus affected by no longer being able to value those interests based on fractional-interest or other discounts), these regulations could have a major impact on you.

How might these regulations affect me if I have an active family business, FLP or LLC, or if I am planning to set up an FLP or LLC?

These regulations, if finalized, could significantly increase the estate tax attributable to these business interests, which would be due on your death.

It is often advantageous to give or sell minority or noncontrolling interests in family entities to loved ones or to trusts for the benefit of loved ones. Under current law, noncontrolling interests can be discounted for gift tax purposes due to a lack of marketability and/or a lack of ability to control the entity. These valuation discounts can reduce the gift tax value of the interests that are transferred (on the order of 30-40 percent in many cases). For estate tax purposes, similar discounts may apply if the decedent did not own a controlling interest in the entity on her death. These discounts can lead to considerable gift and estate tax savings.

The proposed regulations would eliminate valuation discounts for FLPs and LLCs and reduce or possibly eliminate valuation discounts for active family businesses.

Is there any good news in these proposed regulations?

Although there is a lot of uncertainty, there is some time to plan for these potential changes. Also, the proposed regulations could actually lead to some income tax benefits for people who inherit noncontrolling interests in family businesses and later sell them, by creating a higher step-up in “basis” for income tax purposes at death. For smaller estates under the estate tax thresholds, the income tax advantages may actually outweigh the estate tax disadvantages.

OK, so what should I do?

Every situation is different, of course, and individualized advice is essential, but you may wish to:

- Transfer interests in existing entities before these regulations are finalized.
- Review the increased estate taxes that might be due on your death and consider strategies to increase the liquidity of your estate to pay those taxes. For example, you could obtain additional life insurance; make gifts using other estate planning strategies; or favor liquid assets over illiquid ones when making future investments.
- Consider the advantages of creating an FLP or LLC.

... And when should I do it?

It is impossible to know when or whether these proposed regulations will be finalized and what changes might be made to them before they are finalized. For planning purposes, we have to assume these regulations will be finalized in something like their current form and go into effect as soon as the end of this year.

If you are concerned that these regulations might affect you, please contact your Day Pitney estate planning attorney right away in order to better understand your planning options. It will take some time to make decisions and then to plan and implement any transfers or other changes.