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Proposed regulations would limit family entity valuation discounts

On Aug. 2, 2016, the IRS released proposed regulations for Section 2704 of the Internal Revenue Code, which would disallow the application of most valuation discounts to transfers of interests in family-controlled entities for transfer tax purposes. The proposed regulations and restrictions on such valuation discounts could become effective as early as December 2016.

Historically, gifts of closely held business interests to family members (or Trusts for the benefit of family members) allowed transferors to leverage their Gift and Estate Tax exemptions through discount planning. This is largely because taxpayers valuing fractional interests in closely held businesses were entitled to various discounts including those for lack of marketability and lack of control.

Section 2704 of the Code was enacted in 1990 to impose restrictions on the use of valuation discounts applied to intra-family transfers. However, court decisions and state statutes passed after the enactment of Section 2704 have limited the application of such restrictions.

The new proposed regulations will significantly reduce the ability to apply valuation discounts for intra-family transfers of interest in family entities by (a) further restricting lack of control discounts for such transfers as well as marketability discounts; and (b) establishing a bright line test which would subject to estate tax the valuation discounts attributable to a transfer to family members if the transfer to family members was made within three years of the transferor's death. The proposed regulations would apply to any entity, however organized (e.g., corporations, partnerships, LLCs, etc.), and would apply to passive entities as well as entities operating active businesses.

In light of the proposed regulations, clients with interests in family-controlled entities are advised to contact a member of the Estate Planning team to discuss whether a transfer of such interests before the enactment of the final regulations is appropriate.

The information contained herein is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.