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Subject: Fwd: Alert: Proposed Federal Tax Regulations Would Curtail Valuation Discounts
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From: Sadis & Goldberg Tax Group <[REDACTED]>
Date: September 15, 2016 at 2:31:59 PM EDT
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Subject: Alert: Proposed Federal Tax Regulations Would Curtail Valuation Discounts
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TAX ALERT

SEPTEMBER 15, 2016

**Proposed Federal Tax
Regulations Would
Substantially Curtail
Valuation Discounts
Available for Transfers of
Interests in Family-
Controlled Entities**

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Please feel free to discuss any aspect of this *Alert* with your regular Sadis & Goldberg contact or with any of the partners whose names and contact information can be found at the end of the *Alert*.

In August, the Treasury Department released proposed regulations under Section 2704 of the Internal Revenue Code that, if adopted as final regulations in the same form, would affect the valuation of interests in family-controlled entities transferred among family members for federal estate, gift and generation-skipping transfer tax purposes by eliminating certain discounts currently recognized under the law. **Prompt action is recommended to take advantage of the valuation discounts available under current law before such proposed regulations are finalized.**

I. BACKGROUND

Wealthy families have for years utilized family-controlled entities as part of their estate and wealth transfer planning. Appraisers have long recognized that interests in closely held partnerships and other entities that are subject to certain restrictions are valued at a discount to liquidation value. Such discounts have been applied and upheld in valuing interests in family-owned entities as well as nonfamily private entities. The new proposed regulations, if adopted in their present form, would make those discounts largely unavailable to family-controlled entities for purposes of applying federal transfer taxes.

1990 Tax Legislation. Congress originally enacted Section 2704 in 1990 to limit the scope of available valuation discounts for estate and gift tax purposes in valuing interests in family-controlled entities that are transferred to family members. Section 2704 as enacted and the current regulations placed boundaries on the use of valuation discounts, but did not completely eliminate them. The proposed regulations further curtail the availability of valuation discounts and override certain court decisions which, in the Internal Revenue Service's view, have rendered the current Section 2704 regulations "substantially ineffective in implementing the purpose and intent of the statute."

II. SCOPE AND EFFECT OF PROPOSED REGULATIONS

Types of Entities Subject to Section 2704. Entities subject to the new proposed regulations are defined to include any business entity or arrangement "controlled" by the family, such as partnerships, limited partnerships and closely held corporations, regardless of whether the entity is organized under United States or foreign law. The proposed regulations also specifically cover limited liability companies regardless of whether the LLC is a partnership, corporation or disregarded entity.

State Law Applicable Restrictions. Under current Section 2704 regulations, state laws with default restrictions on the ability of the family to liquidate closely-held entities are generally given effect for valuation purposes. The proposed regulations do away with this exception. State-imposed applicable restrictions that can be overridden by the family acting together would be disregarded and ignored for valuation purposes. Therefore, if the family entity is located in a state where the restriction is limited to only family-controlled entities, or state law provides an option for the family to avoid the restriction, then such restrictions would be disregarded for valuation purposes.

Disregarded Restrictions. Generally, the proposed regulations would eliminate any valuation discounts for a new category of "disregarded restrictions" on the availability of forced liquidation or redemption of interests in the family-controlled entity, if the restriction either lapses after the transfer or can be removed by the transferor or any member of the transferor's family, either alone or collectively. Such disregarded restrictions include one that (a) limits a family member's ability to redeem his or her interests in the family entity; (b) limits the liquidation proceeds to an amount less than a "minimum value" (a pro rata share of

the entity's net asset value); (c) defers the payment of liquidation proceeds for more than six months or (d) permits the payment of liquidation proceeds in any manner other than in cash or other property, other than certain notes.

Exceptions for Commercially Reasonable Restrictions in Business Entities. The proposed regulations provide an exception for "commercially reasonable restrictions", provided that the family entity has active trade or business operations. In order for this exception to apply, every owner must have the right to sell its interest to the entity or the other owners, with payment made within six months, and generally a payment cannot be in the form of a note.

"Deathbed" Transfers. The lapse of voting and liquidation rights in the hands of the transferor pursuant to a transfer of an interest in a family-controlled entity that is made within three years of the transferor's death (i.e., deathbed transfers) would be deemed an additional transfer of property potentially subject to transfer tax (but would not be eligible for the marital deduction or charitable deduction).

III. REMAINING TIMELINE FOR ACTION

Proposed Effective Date. The proposed regulations are subject to public comment and a public hearing has been scheduled for December 1, 2016. It is expected that a significant number of comments will be submitted. After the hearing, the proposed regulations may be further revised or published in final form. The proposed effective date for adoption is 30 days after the regulations are published as final in the Federal Register. The proposed regulations also include a "**three year rule**" that could effectively cause a transaction made before the effective date to be subject to the new regulations if the transferor dies within three years of the transfer.

At this time, the full impact of the proposed regulations under Section 2704 is unknown. In the meantime, we recommend that any client who is interested in moving forward with a transfer of an equity interest in a family-controlled business or other closely held entity consider acting quickly, as the proposed regulations will not apply to transfers before the date the proposed regulations are published as final regulations (except in the case of the transferor's death after the effective date but within three years of the transfer). Please contact us as soon as possible to discuss these issues further.

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Please feel free to discuss any aspect of this *Alert* with your regular Sadis & Goldberg contact or with any of the partners, whose names and contact information are provided below.

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