IRS Proposed Regulations Target Gift and Estate Tax Planning Strategies

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The IRS has released proposed regulations that would close so-called tax loopholes that many wealthy taxpayers have used to minimize transfer taxes (such as gift and estate taxes) when transferring interests in a closely held family business to relatives. If finalized, the regulations would significantly limit the effectiveness of certain tax-saving vehicles, including family limited partnerships, for reducing the taxable value of transferred interests. They would apply to family-controlled corporations, partnerships and limited liability companies.

If you've been considering such a strategy, you may need to act soon to take advantage of current tax provisions in the event the rules change.

Deathbed transfers targeted

Among other things, the proposed regulations address deathbed transfers of interests in family businesses that result in the lapse of a liquidation right (the right or ability — including by reason of voting power — to force the business to buy all or part of the transferor's interest in the business). A lapse generally is treated either as a gift or as a testamentary transfer (that is, a transfer at death) includible in the transferor's gross estate. In other words, it could be subject to transfer taxes.

In addition, the proposed regulations would treat a transfer that results in the restriction or elimination of any of the rights associated with a transferred interest as a lapse, regardless of whether the transferor can exercise the right after the transfer.

Valuation discounts narrowed

Additional changes in the proposed regulations would dramatically limit the availability of discounts when transferred interests in family businesses are valued for tax purposes. Currently, taxpayers can obtain significant discounts for lack of control and marketability. These discounts can help keep the value of taxpayers' estates within the lifetime gift and estate tax exemption. (For 2016, the exemption is $5.45 million for individuals or $10.9 million for married couples filing jointly.)

Act now

A public hearing on the proposed regulations has been scheduled for December 1, 2016, and the regulations won't take effect until at least 30 days after they're finalized. But the IRS faces an uphill battle against many taxpayers, estate planning advisors and some lawmakers when it comes to closing the door on this gift and estate planning tool. Opponents argue that the IRS may have overstepped its authority in issuing these proposed regulations. The IRS might be persuaded to water down its proposal before finalizing it.

If the regulations are approved as-is or in a modified format, they'll apply prospectively, so you still have a window to take advantage of the current regulations if you're considering transfers of interests in family businesses. Contact us for assistance in structuring transfers and applying discounts in a way that will pass muster with the IRS.