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Attorneys Must Consider How Treasury Proposed Regulations Will Affect Dealer Clients' Estate Plans

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On August 4, 2016, the U.S. Treasury Department published the long-anticipated proposed regulations under Section 2704 of the Internal Revenue Code, which deal with the valuation of transfers of interests in family-controlled entities (including corporations, partnerships, and LLCs) for estate, gift, and generation-skipping transfer tax purposes.[1] Consequently, it is imperative for attorneys to familiarize themselves with these proposed regulations as to not only inform their clients of what is likely to come, but also to be able to provide them better legal advice and sensible planning.

The Changes

It has been rumored for more than a year that these proposed regulations would eliminate restrictions that effectively reduce the otherwise determined value of a family-owned business – which is largely applicable to the dealership industry, as the large majority of dealerships are family-run.

According to the current interpretation of IRC section 2704(b)(2), if a dealer transfers an interest in his/her business to (or for the benefit of) a member of his/her family, and the dealer and members of the dealer's family hold control of the entity immediately before the transfer, then the "applicable restriction" is disregarded in valuing the transferred interest.[2] Therefore, a minority interest gift in a family-owned dealership is presently valued at its fair market value and takes into account any applicable discounts for lack of control and marketability. However, the proposed regulations would disregard restrictions on a minority owner's ability to withdraw from a given dealership entity should it be family-controlled.

Specifically, under the proposed regulations, a restriction is disregarded if it:

- Limits the ability of the interest holder (presumably the dealer) to liquidate the interest;
- Limits the liquidation proceeds to an amount that is less than a minimum value;
- Defers the payment of the liquidation proceeds for more than six months; or
- Permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.[3]

The proposed regulations also stipulate that the interest of a non-family member will be disregarded unless:

- The aggregate interests of non-family members is at least 20 percent;
- Each non-family member interest is at least 10 percent;
- The interest of each non-family member has been held for at least three years; and
- Each non-family member has a put right in exchange for a proportionate share of net asset value.[4]

An additionally important note to bear in mind is that, according to the proposed regulations, operating family dealerships are subject to the same valuation rules as entities with passive investments.

What This Means for Your Dealer Clients

The potential finalization of the proposed regulations as they are currently drafted have significant implications that may impact your clients:

1. An interest in a family-owned dealership entity transferred to a family member during life or at death will be valued for transfer tax purposes at the net value of the entity multiplied by the percentage interest in the entity that is being transferred, without the application of a lack of control discount.

2. They will greatly impair the availability of minority interest discounts in estate planning. The hearing on the regulations is scheduled for December 1, 2016, meaning your clients who are interested in taking advantage of the current law's valuation principles and making inter-family transfers must act promptly.

3. Past the immediate implications, it is also important to consider the long-game. Dealers will need to reconsider how they tend to their estate plans over the course of the lifetimes – particularly during their most dynamic years of wealth accrual in order to accomplish the most tax efficient transfer of wealth.

Effective Planning

Pending the December 1 hearing, the effective date of the regulations would be 30 days following the final regulations being published in the Federal Register. Thus, the regulations may not be finalized for another several months and there remains opportunity for you to help your clients to advantageously make gifts under the current rules. Effective estate planning to reduce transfer taxes under current law includes:

- Outright gifts of minority interests to family members;
- Outright gifts of minority interests to trusts for family members;
- Sales of interests to family members; and
- Sales of interests to trusts for family members.

While there is chatter surrounding the likelihood of challenges to the validity of the regulations should the regulations be finalized, these challenges would necessitate expensive, prolonged court proceedings and are just as likely to be unsuccessful. Erring on the side of caution and proactivity, it is strongly recommended that you proceed with your clients' planning under the assumption that the final regulations will be close to what we see in the proposed regulations and that dealers' valuation discounts under current law will be undesirably impacted.

Your legal advice to your dealer clients should be carefully coordinated with input from the clients' CPAs. You will often find that the CPAs have pieces of the puzzle that the client has omitted from consideration, which can significantly affect planning decisions. Determining how these proposed regulations may affect dealer clients and their families and what they can do to maximize after-tax benefits of wealth transfer planning will be most effectively and advantageously achieved through merging both legal and accounting perspectives. ■

References

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2. *Id.*
3. "Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest". The Federal Register. August 4, 2016. https://www.federalregister.gov/articles/2016/08/04/2016-18370/estate-gift-and-generation-skipping-transfer-taxes-restrictions-on-liquidation-of-an-interest
4. *Id.*

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