Updated: Gift and Estate Tax Discounts Not Likely to Shrink for Closely Held Businesses

Family business owners may want to consider making gifting decisions before January 1, 2017, if the regulations are finalized as currently written.

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Important update: 12/6/16

The U.S. Treasury Department and the IRS have not publically indicated any departure from the Section 2704 regulations or the timeline as reported here. However, it is widely believed that the regulation will not be in place in January 2017 in its current form. In addition, President-elect Trump's administration is expected to rescind or make significant alterations to the proposed regulatory changes. We will continue to monitor this matter and make updates as more details are released and we invite you to contact us with questions or concerns.

Executive summary

For many years it has been common for estate planners to advise an owner of a closely held business to gift or sell minority/noncontrolling interests to children and other related parties. Because of the inherent restrictions in a minority interest in a closely held entity (discussed later in this paper), the interest was valued at a discount to its pro-rata value. These discounts, consisting of a discount for lack of control (DLOC) and for a lack of marketability (DLOM), often combined for an effective discount of 35 – 45 percent, or more in some cases. This has been a great way to leverage the gift tax exemption by moving $1 of stock while reporting that value at significantly lower values for gift tax reporting purposes (e.g., 60 cents or 65 cents in many cases).

In early August 2016, the IRS issued proposed regulations to Internal Revenue Code Section 2704 which attempts to severely reduce the ability to take these discounts when valuing the transfer of minority interests between family members. If these regulations are finalized as written, the thought among many estate planning and valuation professionals is that the discounts for these types of transfers will be essentially eliminated.

There are some "safe-harbor" exceptions that would allow the discounts to be applied, that involve the presence of a nonfamily owner in the business:

- The nonfamily owner must own at least a 10 percent interest
- The nonfamily ownership block needs to be at least 20 percent
- The ownership needs to be held for at least three years
- Ownership must be given a "put" right allowing the nonfamily member to request payment for the shares at any time and they must be paid within six months
- Ownership must be paid "minimum value," which is essentially pro-rata value of the business as a whole

Obviously, qualifying for this safe-harbor would be very difficult in most family business situations.

Some valuation professionals, ourselves included, believe there are still opportunities to apply both the DLOC and the DLOM for intrafamily transfers of closely held stock and partnership interests; the discounts would be less than those taken prior to the proposed 2704 regulations, if finalized as written.

Given the presence of these proposed regulations, CLA is advising clients to review their estate plans. If the gifting of closely held stock or partnership interests to family members makes sense from an overall estate planning perspective, these transfers should be made prior to January 1, 2017, which is the earliest the regulations can become final. By transferring the shares prior to the finalization of the regulations, the discounts should be allowed under the current regulations and relevant case law.

Background of IRC Section 2704

Since 1990, the IRS has had regulations in place under Chapter 14 of the Internal Revenue Code (Sections 2701, 2703, and 2704) that were intended to prevent the owners of closely held interests in businesses from transferring non-controlling interests in those entities at significant discounts to value. This was due to the transferred interest having no right or ability to control the business, and having no ready market for the shares. Oftentimes, the entity's shareholder agreement would contain restrictions that prevented minority owners from liquidating or transferring their ownership in the company without either a supermajority or unanimous approval. This effectively reduced the value of those minority shares.

The current regulations, in essence, state that if certain criteria were met, the value of a transferred interest in a closely held business to a *related* party could *not* be discounted for the lack of control in that interest. This was done by effectively ignoring any "applicable restrictions"[1] that would have the effect of lowering the value of the transferred interests. Fortunately for the taxpayer, the regulations contained certain exceptions that were broad enough to allow for the appraisal expert to take DLOC in most of the related-party transfers of these minority interests.

As business appraisers, we have been able to apply full discounts for lack of control while still satisfying the mandates of Chapter 14. As a result, despite the enactment of the regulations in 1990, owners of closely held businesses have been able to transfer interests in their business to their children and other related parties. These DLOCs can be significant, ranging from 15 – 30 percent or more depending on the situation.

The IRS responds with proposed regulations to plug the holes

As you can imagine, the IRS has reacted negatively and aggressively to the taxpayers' continued transfer of non-controlling interests in their businesses at significantly reduced values from their pro rata value. When auditing these transactions, it is not uncommon for the IRS to argue that discounts taken for the lack of control and the lack of marketability of the business interests are too large or inappropriate. Despite the IRS's efforts, taxpayers have been able to defend the application of the DLOC to these transfers.

There have been multiple attempts to introduce legislation that would effectively eliminate these discounts as far back as the Clinton administration, where legislation was introduced to require interests in "nonactive" businesses to be valued at pro rata value.[2] There have been similar efforts since then that have not proceeded to final passage. Finding no success in the legislative arena, the IRS has now turned to its power to issue regulations to address what it calls the "undervaluation" of such transferred interests.[3] Section 2704(b)(4) provides that:

> The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

Content and impact of the proposed regulations

The proposed regulations appear to have attempted to remove or greatly reduce the ability of a transferor to apply a discount when transferring an interest in a closely held business. They have done this by closing the perceived loopholes or exceptions found in the original regulations, specifically by tightening the applicable restrictions language and exceptions to those restrictions. The regulations are complicated and extensive. We are not attempting to summarize the entire document in this white paper; rather, we will highlight those areas that will directly impact the valuation of these interests if these regulations are finalized in their current form.

Since the release of the proposed regulations, there have been numerous whitepapers, articles, and commentary on their controversial nature. It is the authors' opinion that the proposed regulations have overreached and have attempted to modify long-standing precedent via regulation rather than via legislation. The growing consensus appears to be consistent with this view.

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[1] Defined in the regulations as focusing on the ability to liquidate the entity, and the lapsing of this ability.

[2] See the article "Valuation Discounts – An Analysis of the Service's Position Compared With Litigated Cases," published in *The Journal of Taxation*, volume 91 (1990).

[3] See the first page of the summary in the proposed 2704 regulations.

This is clear by simply viewing the legislative history of Section 2704. As noted in the 1990 conference report, Chapter 14 was not intended to affect minority discounts or other discounts available under law, and yet that is precisely the effect of these proposed regulations. It is likely that this argument will be presented during the comment period, along with a number of other criticisms of the proposed regulations.

What transfers are covered by the regulations?

The proposed regulations "... would clarify, in Sections 25.2704.1 through 25.2704-3, that Section 2704 applies to corporations, partnerships, LLCs, and other entities and arrangements that are business entities within the meaning of Section 301.7701-2(a)." In addition, the regulations are applicable where the transferor (either directly or through family attribution) controls the entity. Control is defined as "holding at least 50 percent of either the capital or profits interests of the entity or arrangement, any general partnership interest, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement" under Section 2704(c)(1) and 2701(b)(2). This control definition is different from what appraisers view as control. Appraisers typically look at control being *more than* 50 percent, which allows the owner to make decisions independently of other owners. The proposed regulation's definition of control is not consistent with the realities of the marketplace.

The treatment of related-party donees and donor as a single owner for these purposes is in direct conflict with Revenue Ruling 93-12, which specifically ruled that, for the purposes of gifting shares to related parties, the donor and the donee's ownership in the entity is ignored when determining the value of the gifted block of shares. This means that under Revenue Ruling 93-12 you treat the donee as though he or she does not have any current ownership in the entity. This allows for the application of a DLOC for the transfer of a minority block of shares to a donee even if the donee has current ownership, and even if the gift would result in the donee gaining control of the entity. The proposed regulations effectively override this existing precedent.

In essence, if the proposed regulations are passed in their current form, absent a 20 percent ownership in the entity by a nonfamily member(s) (discussed later in this article), the value of the transferred shares will be determined by looking at the total holdings of the family unit. If the family unit holds at least 50 percent of the outstanding shares, both before and after the transfer, the interest is considered a controlling interest for purposes of applying the proposed regulations, and the DLOC would be lower than if there were no deemed control under the regulations.

Who are family members under the proposed regulations?

Section 25.2702-2 of the proposed regulations defines "member of the family" for control purposes to include:

A. An individual's spouse
B. Any ancestor or lineal descendent of an individual or individual's spouse
C. Any brother or sister of the individual
D. Any spouse of any individual described in subparagraph (B) or (C)

What are disregarded restrictions under the proposed regulations that will not be considered in valuing the transferred interest?

The restrictions that will be disregarded under the proposed regulations include those that:

1. Limit the ability of the holder of the interest to liquidate the interest
2. Limit the liquidation proceeds to an amount that is less than a minimum value
3. Defers the payment of the liquidation proceeds for more than six months
4. Permits the payment of the liquidation proceeds in any manner other than in cash (other than certain notes) or other property

These ignored restrictions would effectively reduce the DLOC for transfers to related parties where the transferor (including attribution) owns at least 50 percent of the entity before and after the transfer. Some professionals are suggesting the DLOC would completely disappear due to these changes. We'll address the first three exceptions separately.

Limits the ability of the holder of the interest to liquidate the interest

Under current regulations, the restriction to liquidate the interest would not be ignored if the restriction is no more restrictive than state law. Also, the restrictions were viewed at the entity level. In most cases, state statutes were amended to require unanimous or supermajority vote to liquidate. Therefore, transfers of minority interests would be allowed discounts because the interest could not unilaterally liquidate the entity under state law, so the agreement was no more restrictive than state law. The new rules would eliminate the state law exception, and would only apply restrictions that are *mandated* by state law that can't be eliminated or overridden. (In most states, corporate bylaws or partnership agreements can override state law.) As a result, where the transferor controls the entity (as defined in the regulations), any liquidation restriction will be ignored and cannot contribute to or create a DLOC.

Limits the liquidation proceeds to an amount less than a minimum value

The proposed regulations define minimum value:

- The interest's share of the net value of the entity on the date of liquidation or redemption
- Fair market value, as determined under Section 2031 or 2512, of the property held by the entity reduced by the outstanding obligations
- Only the outstanding obligations allowable as deductions under Section 2053 if those obligations instead were claimed against an estate

In essence, minimum value is the net asset value of the assets held inside of a holding entity (the fair market value of the assets less liabilities); and for operating companies, fair market value would likely be the entity's enterprise value. This section appears to require valuation of the entity as if the entity was required to purchase an owner's interest at its undiscounted pro rata value upon a redemption event. Anything in the shareholder agreement to the contrary would be ignored. This guarantee of receiving the pro rata value of the shares would appear to create a floor value for the shares, thus eliminating the ability to take any reduction in the value due to the lack of control inherent in a minority interest, or as noted below, the timing of the receipt of the proceeds.

Defers the payment of the liquidation proceeds for more than six months

Any terms in the shareholder agreement (or similar document) that delays the payment of the proceeds to the owner beyond six months will also be ignored. This appears to set a maximum timeframe for the receipt of the proceeds, which would reduce any impact on the DLOC, and would also likely affect the magnitude of the DLOM.

Three-year look-back

The proposed regulations have also added a three-year look-back which can lead to unexpected and undesirable results. Under 25.2704-1(c)(1), any lapse of a restriction or a liquidation right as a result of a transfer of an interest within three years of death is treated as a lapse at death. The result of this provision is that the estate would lose the minority discount applied on any transfers within the three-year period, and that value reduction would be included in the estate as a "phantom asset." In other words, the estate would have to pay tax on an asset that doesn't really exist and can't be sold or transferred by the estate.

The use of nonfamily members to achieve discounts

Prior to the proposed regulations, one planning technique to ensure that discounts could be applied was to include a nonfamily member or a charity as an owner of a nominal share of the company. Because there were nonfamily members, the family members could not, as a family group, liquidate the entity without the consent of the nonfamily member. This proved to be an effective planning technique and favored the taxpayer in defending the applied discounts. The proposed regulations deal specifically with this issue in an attempt to remove the impact of a nominal ownership in a family entity.

Under the proposed regulations, nonfamily members will be disregarded unless they meet all of the following tests:

1) The interest has been held more than three years prior to the transfer

2) The interest constitutes at least 10 percent of the value of the entity

3) When combined with the interests of other nonfamily members, the total ownership is at least 20 percent of the value of all the equity interests; and

4) The interest has a "put" right which allows the nonfamily member to put the interest to the entity and be paid minimum value (as defined earlier), within six months in either cash or other property.

If the nonfamily ownership meets these tests, then their interests will be considered when valuing the transfer of an interest in the closely held business to a family member.

Example 11

The proposed regulations contain an example where the nonfamily members meet the tests described above, and that nonfamily interest is considered when calculating control. In the example, under the governing agreement, the approval of the shareholders holding 75 of the 100 outstanding shares is required to liquidate the partnership. Four years before the donor dies, the nonfamily member (A) owns 15 of the shares and a charity (C) owns 10 shares; the family members own 75 of the shares. Under the terms of the agreement, only the nonfamily owners have the right to withdraw from the partnership. The nonfamily members may withdraw on six months' notice and receive their interests' share of the minimum value of the partnership.

Upon his death, the donor bequeaths 10 shares to a nonfamily member (B) and the remaining 65 shares to family members. Because the transfer to B was not made three years or more before death, that nonfamily interest is ignored when calculating control. Because the nonfamily interests of A and C meet all of the requirements for inclusion in the ownership calculation, these interests, totaling 25 shares, are considered in the calculation. As a result, the family members are deemed to own 65 of 90 shares (100 total, less the 10 shares bequeathed to B). This calculates to 72 percent ownership by the family. Since it is less than the 75 percent ownership needed to liquidate, Section 2704(b) does not apply.

Are these proposed regulations the death knell for control discounts?

The end result of the proposed regulation is to limit the size of the DLOC when valuing the transfer of a minority interest in these closely held entities. But do the new proposed regulations eliminate the DLOC for transactions between family members?

There are many factors that influence control, in addition to the ability to liquidate the interest.

A DLOC or minority interest discount represents a reduction from the pro rata share of an entire business to reflect the absence of control. The concept of DLOCs and control premiums can be validated by analyzing the transactions on stock exchanges that involve the purchase of both minority interests and controlling interests of the common stock of various companies.

Common prerogatives of control

The value of control depends on the owner's ability to exercise any or all of a variety of rights typically associated with control. Common prerogatives of control include:

- Electing directors and appointing management
- Determining management compensation and perquisites
- Setting policy and changing the course of business
- Acquiring or liquidating assets
- Selecting people with whom to do business and award contracts
- Making acquisitions of other companies
- Liquidating, dissolving, selling out, or recapitalizing the entity
- Selling or acquiring treasury shares
- Registering the entity for public offering
- Declaring and paying dividends
- Changing the entity's owner agreement
- Blocking any of the above actions

Obviously, many factors can impact the degree of control an owner has over the operations of the entity. When any of the control elements are not available to the ownership interest, the value attributable to control must be reduced accordingly. Some of the factors that tend to influence the value of minority shares relative to control shares include:

Factors that may increase a minority interest discount or a control premium
1. The presence of non-voting shares or units.
2. An extreme lack of consideration for the interests of minority or limited partners on the part of the entity's management, board of directors, and/or majority owners.

Factors that may decrease a minority interest discount or a control premium
1. The presence of enough minority interest votes to elect — or have meaningful input on electing — one or more directors in a company with cumulative voting.
2. The presence of enough minority interest votes to block certain actions (subject to state statutes and/or articles of incorporation).
3. The presence of state statutes granting certain owner rights.

The proposed regulations specifically address the ability to liquidate, the value of the shares upon redemption, and the timing required for the payout. The proposed regulations do not impact the majority of the control factors above. In fact, the wording of one example clearly states:

> … therefore, under section 2704(b) and (a) of this section, the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of each transferred interest. Accordingly, the amount of each transfer is *the fair market value of the 33 percent limited partner interest determined under generally applicable valuation principles taking into account all relevant factors affecting value including the rights determined under the governing documents and local law* and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. (*Emphasis added.*)

As noted above, there are many different control rights, other than the right to liquidate, that negatively impact the value of an interest in a closely held entity. While the right to liquidate is a very important right, it does not, by itself, magically transform a noncontrolling interest into an equivalent control value interest. The controlling shareholder/owner still has significant influence in how the company is run, how the cash flow is invested or distributed, and other major operational decisions. Therefore, there are significant lack of control factors that would contribute to a sizable DLOC, even without considering a restriction to liquidate.

Do the proposed regulations limit or remove the discount for lack of marketability?

Marketability relates to the liquidity of an investment. Investments such as publicly traded stocks are highly liquid in that an investor can, under normal circumstances, sell stock and obtain cash proceeds within three working days. Shares of stock in privately held companies are, in comparison to publicly traded securities, highly illiquid and usually warrant large discounts from their stated marketable price.

The ability to receive minimum value within six months appears to provide a market for the minority interests. In the absence of a qualified nonfamily member ownership (at least 20 percent of ownership/equity value), the liquidation provisions, including the right to minimum value within six months, would apply, effectively creating a market for the interests. However, as is the case for a DLOC, there are many factors that contribute to a DLOM. In fact, even controlling interests can be subject to a DLOM.

Despite this apparent market for the stock, there is still the requirement to wait six months for payment, which carries risk. In addition, the make-up of the company's assets, its own liquidity, and the ability of the entity to pay the owners the required minimum value in six months must be carefully considered. The requirement for essentially a forced liquidation could significantly lower the value of the assets. This reduction can be substantial. If the partnership is forced to dissolve as a result of the shareholder put, this would, of course, impact the value of the partnership. If the partnership has the ability to borrow funds to satisfy the redemption, the taking on of significant debt would impair the cash flow of the partnership and would also reduce the net asset value. There is no discussion in the proposed regulations regarding whether these economic realities can be considered in arriving at the entity's minimum value, but if the assets and liabilities cannot be adjusted for this new economic reality, it would be appropriate in these authors' opinion, to consider these issues in the DLOM.

Conclusion

The proposed 2704 regulations, if not changed prior to finalization, will have a significant impact on the ability to take discounts on transfers of minority interests in closely held entities. There are still significant factors that would contribute to both a DLOC and a DLOM, but it is likely the IRS will not take that view when determining the value of these interests.

The regulations will not be effective until they become final, which would not occur until December 2, 2016, at the earliest, and cannot go final until 30 days after that, meaning they won't be in effect until January 1, 2017, at the earliest. Until the regulations become final and effective, it is highly advisable for those taxpayers that are contemplating gifts of closely held interests to make those gifts prior to that date to ensure the ability to take full discounts on those interests. If the regulations are finalized as proposed, it will be significantly more difficult to take these discounts at their historic levels.

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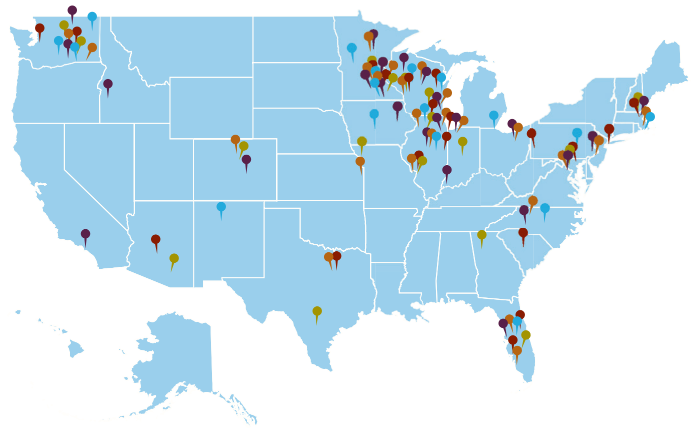

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