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Proposed 2704 changes meet stiff resistance at IRS hearing

Among other final outcomes, there's a very real chance increased tax costs will be instituted in 2017 for transferring interests in family-owned entities

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Since the IRS on Dec. 1 refused to withdraw its proposed expanded Internal Revenue Code 2704 regulations despite strong industry pushback, American Society of Appraisers (ASA) representatives attending the Washington, D.C. hearing on the controversial topic advise attorneys to stay vigilant to protect their clients' estates until a final verdict is rendered.

The IRS panel adjourned the public hearing stating they will study and clarify key issues and reconvene at an undetermined date. So they may still limit discounts for family-owned businesses—as feared—and more.

Recapping the series of events surrounding the topic this fall, the IRS released proposed regulations on August 2, 2016, that would modify and expand Internal Revenue Code 2704 (IRC 2704) impacting the valuation of privately-held, minority interests that are controlled by the same family. Since the tax court decision of *Kerr v. Commissioner* (113 T.C. No. 30), the IRS has been concerned that certain loopholes exist in IRC 2704 that allow taxpayers to gift interests to family members in entities that have no business purpose and allow the transfer of wealth without due consideration of the value to the transferor.

While many attorneys, accountants and business advisors expected the proposed regulations to target partnerships with liquid assets, the ramifications of the regulations appear to be more far-reaching than initially believed and may have unintended consequences for valuation discounts for intra-family interest transfers.

The effect of the amended and expanded regulations could eliminate discounts for lack of control and lack of marketability for privately-held businesses and partnerships that are family controlled. Therefore, it may be advisable to thoroughly review your clients' personal situations and estate plans and, if such transfers were being considered or planned, implement them before these proposed regulations are issued.

More than 9,800 written comments were submitted to the IRS in response to the proposed regulations. The vast majority of these comments were opposed to the proposed changes. In addition to these formally filed public comments, a total of 37 attorneys, CPAs, business appraisers and owners of family-controlled businesses testified at the Washington, D.C. hearing in front of a panel of four IRS representatives, including Kathy Hughes, the primary IRS official who drafted the proposed regulations. Each speaker was given 10 minutes to discuss the impact of the proposed regulations and present their opinions at the public hearing. Only one of the speakers was supportive of the proposed regulations. The other speakers stated that the change would contradict the historic methodology accepted by the IRS and tax court for valuing minority interests in privately-held entities, and requested that the IRS withdraw the proposed regulations. Some key points that were made included the following:

- **Fair Market Value** – Under the definition of Fair Market Value established in Revenue Ruling 59-60, the willing buyer and willing seller are hypothetical persons dealing at arm's length rather than any "particular buyer or particular seller." This proposal would assume that the buyer and seller are a particular person and require certain valuation assumptions if they are family members. Consequently, this would fundamentally change the way that family-owned, privately-held businesses are valued and discard the vast historic record of court case.
- **Family Attribution** – The proposed regulations contradict the *Estate of*

Bright v. U.S., 658 F.2d 999 (5th Cir. 1981) case which ended the aggregation of interests owned by the same family. Under the new proposal, if family members own a controlling interest in a privately-held entity in aggregate, the IRS would require the interest to be valued as if it has the right to liquidate. This would create an assumption which would increase the value of the interest and increase taxes on family-owned businesses.

- **False Economic Reality** – The proposed regulations would establish a false economic reality because privately-held businesses do not typically offer "put provisions" that can be exercised at any time. Privately-held businesses do not grant "put provisions" in the real world because they could cause liquidity problems which would jeopardize the operations of the company, since shareholders could withdraw and demand cash at any time.
- **Uncertainty** – The proposed regulations would complicate an established methodology for the valuation of privately-held interests that has a 60-year history of court case precedent. Additionally, the proposed regulations introduce new terminology such as "minimum value" which are not financial terms and could cause confusion for taxpayers and their advisors.

The IRS panel was receptive and accommodating to the speakers and expressed that many of these issues were unintended. Ms. Hughes stated that the proposed regulations are not close to being finalized and that they hoped to clarify the proposal so that:

1. There would be no deemed "put option" that would eliminate discounts for lack of control and lack of marketability.
2. The three year clawback provision would not be retroactive.
3. The proposed regulations would be clarified regarding the family attribution clause.

While no definitive statement regarding the outcome was announced, it was evident that the IRS was planning on considering the input from the written comments and the speakers at the public hearing before moving forward. Many professionals expect that the proposed regulations cannot move forward in light of the results of the Nov. 8, 2016 election. However, the IRS did not discuss the impact of the election on their plans. They only stated that they looked to clarify a number of issues.

In common practice, valuation theory is based on risk and return that is observable in the financial marketplace. Certain valuation principles have long been established, demonstrating that noncontrolling, nonmarketable interests in privately-held businesses are worth less than controlling interests and equity interests in publicly-held companies. Accordingly, certain adjustments are made when valuing noncontrolling interests in privately-held entities because the data used in the valuation process is based on publicly traded stock information.

The two most common adjustments are known as the discount for lack of control and the discount for lack of marketability. A discount for lack of control adjusts the value of a business interest because the owner does not have the ability to manage the operations of the business and also does not have the ability to control the sale and liquidation of the business, including the underlying assets. The discount for lack of marketability adjusts the value of a business interest because the interest cannot be sold and converted to cash as quickly as a publicly traded stock. These adjustments reduce the value of a noncontrolling interest in a privately-held business or partnership to compensate for the increased risk of owning an interest that has no control and cannot be quickly converted to cash.

IRC 2704 was originally enacted by Congress in 1990 to curb valuation discounts that were based on restrictions limiting the liquidation of an interest. Additionally, Congress gave the Department of Treasury the right to issue new regulations to limit restrictions included in the partnership agreement that reduced the value of an interest for the transferor but did not have the same impact on the value for the transferee. However, the IRS and Treasury have not been successful in getting Congressional support for these changes since IRC 2704 was enacted. The new 2704 proposed regulations appear to directly implement what formerly had not gained Congressional support and have not been successfully adopted in tax court decisions over the past 20 years. If officially finalized, as proposed, the regulations would impose special valuation rules for family-owned entities that include the following:

- **Disregarding Restrictions** – The proposed regulations would disregard restrictions on liquidation that are not mandated by federal or state law in determining the fair market value of the transferred interest in a family-owned business.
- **Elimination of Assignee Interest** – The proposed regulations would eliminate any discount based on the transferee's status as an assignee and not a full voting owner in the entity for an interest being transferred in a family-owned business.
- **Three Year Lookback** – If a transfer of an interest occurs within three years prior to the transferor's death, the proposed regulations would stipulate that an additional transfer occurred at the transferor's death if a lapse of the transferor's voting and liquidation rights occurred. This additional transfer is subject to taxation but not eligible for the marital deduction.
- **Assumed "Put Option"** – The proposed regulations would assume that the transferee in a family-owned business has a "put option" to sell their interest back to the entity for cash or equivalents within six months at a nondiscounted value.
- **Broadened Scope** – When IRC 2704 was originally written, it was meant to cover partnerships and corporations. The amended proposal would extend coverage to all business relationships, including limited liability companies.

If the proposed regulations are accepted, the IRS hopes that this effort will close the perceived loopholes that they believe exist. From a family-owned business standpoint, the implementation of the proposed regulations will result in increased tax costs for transferring interests in family-owned entities.

The bottom line is that the proposed regulations and their possible revisions deserve careful study and consideration. While their full impact and timeline for implementation is uncertain, they do appear to substantially limit—and in some cases, eliminate—discounts for lack of control and lack of marketability in entities that are owned by the same family. The IRS representatives did not say that they were withdrawing the proposed regulations. In fact, they stated that they plan to clarify them, which could lead to the conclusion that they may reintroduce them at some point in the future.

It would, therefore, be prudent for attorneys to understand the potential impact of the proposed regulations and to be vigilant in the event the proposed regulations are revised and reintroduced. ■

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