Update Brief on 2704 Proposed Regulations

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On December 1, the U.S. Treasury and Internal Revenue Service held hearings on proposed regulations changes to Section 2704 of the tax code. They received 28,000 written comments, all opposed with a few exceptions. Thirty-seven speakers testified, and thirty-six requested full withdrawal of the proposed regulations.

Essentially, the issues at hand regard applying the Fair Market Value standard to fractional interests in small businesses and asset holding companies for estate transfers and gifting. For the first four years of the current administration, code changes were attempted through the congressional budget process, but were rebuffed. Since that time, a regulatory approach has been working its way through the Treasury Department and the proposed regulations released for comment in August 2016. They could go into effect as early as next month.

Fair Market Value is a very simple concept. Treasury regulations basically have defined it in one sentence. It is based on three ideas: a willing buyer and willing seller, with reasonable knowledge of all facts and circumstances, and neither being compelled to buy or sell. When it comes to fractional interests in a company, prudent buyers do not pay full value. Prudent buyers buy at discounted values. The primary drivers of these discounts for lack of marketability are the inability to re-sell the interest like you can sell a public stock, the risky nature of being in private businesses and a lack of control of management. A buyer of a minority interest is at the complete mercy of others with regard to the ability to recover the investment and alter its course toward profit or loss.

So what is the hubbub about? The IRS appears to be working to overturn sixty years of settled case law on the definition of Fair Market Value and attribution of family interests. By regulation, they desire to impose these artificial terms to estate and gift valuations:

- Aggregating family interests to assemble a control interest
- Broadening the definition of family to assemble a wider range of interests
- Lowering the ownership threshold for control analysis
- Adding a hypothetical liquidation feature to the valuation problem
- Eliminating contingent liabilities from net asset value
- Instituting a bright line test where if the transferor dies early, certain gifts will escalate in value

Currently, individuals and corporations are considered separate owners when they hold a company's stock. When stock is valued, it is valued based upon the percentage held owner-by-owner. The Treasury proposes aggregating family interests, including those held by a corporation if they have common stockholders, and broadening the definition of family interest to include nieces, nephews and other companies in which a decedent may hold an interest. Pooling the interests, where it pushes total ownership into the majority share, often eliminates discounts for lack of control and marketability. And with the broadening to a wider group, they propose lowering the threshold for determining control. When these interests reach 50%, a control position will be declared and the regulations impose a Minimum Value, replacing Fair Market Value.

As a myriad of attorneys will attest, dividing assets of the families among its members does not produce accord and control. Not only are economic interests different, emotional motivations also play out. Courts have denied this aggregation in the past, and in fact, the IRS produced a ruling in 1993 codifying these precedents. Another snippet to note is the stealthy lowering of the control threshold. In the process of assembling these disparate interests into a control position, which has no existence in reality, the Treasury has also developed a new measure of operational authority. 50% ownership was declared a control interest for estate and gift valuations. However, this level of ownership does not have the ability to control an enterprise, only the ability to block action. If two 50% interests are present, it takes agreement to move forward. Obviously these two can't both be control interests for one company. The control level proposed is only for the effect of imposing artificially high market values, and essentially creates new law for estate valuations. The proper control threshold is 50% plus one share. No company can have two operational control interests.

The confusion continues. Along with these new standards, appraisers are to consider a hypothetical condition when making appraisals. In the event that Minimum Value and

50% control don't achieve the artificial increase in value, a put right is to be attributed to the minority interest, where the security can be sold to the company at undiscounted net asset value. This drives an appraiser to assume that fictitious liquidity exists, so all business valuations under these conditions clearly become hypothetical in nature. Not a very useful product, outside of filing taxes.

And there's more. The proposed regulations eliminate contingent liabilities from the company balance sheet. These are present in assets with built-in capital gains, or clean-up liabilities for environmental concerns, and have been accepted on one-for-one basis in case law. A prudent buyer, will reduce their offer price for a security if it contains liabilities that must be paid in the future, such as taxes on capital gains or site clean-up. But neither of these real costs will be allowed for consideration under the new regulations.

Then we have unequal treatment between classes of company investors. If these rules go into effect, gifts made to charities receive Fair Market Value, and non-family members receive Fair Market Value, but family members? The rational conclusion is that family receives Un-Fair Market Value. How could this stand in court?

And the new regulations also apply a bright line rule. This rule voids any discounts if the donor dies within three years of the gift. Why such a large time period?

Prohibiting discounts is probably good policy for actual deathbed transfers, but what about a healthy fifty year old business owner that makes family gifts of stock and dies in a car accident two years after making the gifts? Think about the accounting complexities of having to reverse these valuations. Business owners will need at least two sets of books for government reporting; one established for income tax and one for estate tax.

All these changes appear to be in direct conflict with the intent of Congress, having expressly ignored executive branch requests for change. It is interesting to note that Section 2704 has not been amended since it was added in 1990 except for one small revision in 1996. As multiple people testified at the hearing, there is a reason that Treasury went first to Congress to make these changes. The reason is that it lacks the legal authority to implement them on its own, particularly the bright line test.

So if promulgated, we have multiple new definitions and rules that will create uproar in the estate planning industry. Just defining the parameters to complete a valuation will

take legal counsel. And as many of us have seen in years past, these changes potentially tax small businesses at a rate that will force company liquidations and ownership changes at the death of the founder. Without a doubt, estate planning and valuation costs will increase significantly, and life insurance costs will increase to cover the eventual estate taxes at death of a company owner.

From the IRS standpoint, a narrow elimination of discounts for partnerships only holding marketable securities, and for death bed transfers is surely understandable, but this proposal is an extreme over-reach. The proposed shotgun approach to denying valid discounts will be an artificial tax increase that decimates family businesses and is something that needs to be fought. And if these regulations are imposed, the divisiveness within the courts and the expense and burden of trying to figure out their acceptability will be a two decade struggle.

The proposed regulations are fatally flawed and cannot be salvaged. They should not be allowed to linger as a threat to America's family-owned businesses and all those that depend on them. The only sensible conclusion is that the Treasury withdraw them.

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