



Business Valuation
& Advisory

The Future of Valuation Discounts - Potential IRC Section 2704 Regulations

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Executive Summary

- At the ABA RPTE Conference in late April 2015, Treasury Department Attorney Catherine Hughes indicated that new regulations under IRC Section 2704 (Treatment of certain lapsing rights and restrictions) are in the works, and may be finalized before the September 2015 ABA Tax Section Conference.
- These “valuation discount rules” or “disregarded restrictions” are thought to be a new tool in the government’s stance against business valuation discounts taken on interests in family owned companies and partnerships for gift and estate tax purposes.
- The objective of the potential regulations appears to be what was originally sought when 2704 was enacted in 1990 as part of Chapter 14; “Applicable Restriction” was defined under 2704(b).
- The Obama Administration appears to be going the route of regulations rather than seeking legislation to accomplish a goal last outlined in the FY 2013 Greenbook.

But How Can They Do This?

- The current Administration (via Treasury) looks to be issuing regulations rather than seeking to have new legislation passed. Over the years, legislation has been proposed countless times on this topic, but to no avail.
- Such an approach is consistent with the “Chevron Doctrine,” which says that the courts will defer to an agency’s reasonable interpretation of an ambiguous statute that the agency is charged with administering. See Supreme Court Ruling: *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).
- Further clarified in *United States v. Mead Corp.*, 533 U.S. 218 (2001).
 - “Administrative implementation of a particular statutory provision qualifies for Chevron deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority.”
- Pursuant to Section 7805 of the Internal Revenue Code, the IRS, a division of the Treasury Department, issues tax regulations, officially known as Treasury Regulations. Its regulations are the Treasury Department’s official interpretations of the Internal Revenue Code and are a source of law.
- Section 2704(b)(4) gives authority to the Treasury to issue regulations that would disregard “other restrictions” if such restrictions have the effect of reducing the value of the transferred interest for valuation purposes but do not reduce value to the transferee.

IRC Section 2704(b) – Certain Restrictions on Liquidation Disregarded

- Any applicable restriction shall be disregarded in determining the value of the transferred interest;
- Applicable restrictions include those that (1) limit the ability of the entity to liquidate; (2) lapse in whole or in part after the transfer; and/or (3) allow the transferor or any family member to remove such restriction after the transfer.
- Exceptions: Applicable restrictions shall not include (1) any commercially reasonable restriction that arises as part of any financing with a third party; or (2) any restriction imposed by any Federal or State law.
 - The State law exception is critical, as many states, subsequent to 1990, revised laws to restrict the rights of limited partners and LLC members.
- Clearly, Treasury would like to eliminate the effectiveness of the exceptions.

Summary of Proposed Regulation

- The proposed regulation may include the following features, as outlined in the FY 2013 Greenbook:
 - Create an additional category of “disregarded restrictions” that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor’s family.
 - Disregarded restrictions would include (1) limitations on a holder’s right to liquidate that holder’s interest that are more restrictive than the standards to be specified in regulations; and (2) any limitation on a transferee’s ability to be admitted as a full partner or to hold an equity interest in the entity.
 - For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or other individuals who are not family members of the transferor would be deemed to be held by the family.
 - Specifically, the transferred interest would be valued by substituting the disregarded restrictions with certain assumptions to be specified in regulations.
 - This is where we get into unknown territory. Can Treasury create substituted assumptions w/o Congress?
 - Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of Section 2704 if certain standards are met.
 - Would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.

Teasers – Possible Planning Techniques

- The Greenbook states that the proposal would apply to transfers, after the date of enactment, of property subject to restrictions created after October 8, 1990 (the effective date of Section 2704).
 - Dig out those old and cold pre-1990 partnerships and LLCs and put them to work!!!
- If a Real Estate LLC structure will be ignored, why not simply transfer/sell/gift a fractional interest in the real property itself?
 - Or might “operating businesses” be exempt, and real estate companies fall under such an exemption (see definition of operating businesses within Section 6166 for purposes of estate tax payment extensions)
 - Is a real estate LLC considered an operating business or a holding company? Chapter 14 does not distinguish, and Treasury is not authorized to create these distinctions.
- With the basis step-up so valuable for estates, the new regulations may be beneficial to certain clients.

Closing Remarks

- It does not appear as though we will receive any more information prior to the regulations being issued, although there may be a comment period after issuance.
- The timing of issuance is unknown, but expected between now and January 2016.
- The extent of the regulations and the impact on business valuations and estate planning are hard to predict. But based on what we know today, the ramifications could be significant.

Richard Dees Speaks Out

- Richard Dees (McDermott Will & Emery) told Bloomberg BNA in May that, “My concern is that the regulations may limit the availability of minority ownership and lack of marketability discounts for valuing equity in family-owned companies... they may revive the concept of family attribution under the pretext of limiting liquidation and other restrictions... reinstating family attribution is specifically contrary to the history of the legislation enacting Section 2704 and, therefore, any such regulations are likely to be invalid.”

References

- FY 2013 Greenbook: <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>
- Bloomberg BNA (Freda) Article – “Guidance on Material Participation For Trusts, Estates May Emerge in Stages” (June 2015)
- Wall Street Journal (Moyer) Article – “IRS Takes Aim at an Estate-Planning Strategy” (June 26, 2015)
- Jonathan Blattmachr Article: “Anticipating New Regulations under IRC Section 2704” (June 2015)
- Bessemer Trust (Akers) Article – “Speculation About Upcoming Section 2704 Proposed Regulation” (June 2015)
- MPI (Povlich) Blog Post – “Section 2704 Changes Coming?” (June 10, 2015)

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John is a Partner at MPI and is based in the firm's New York City office. Since joining MPI, John has determined the value of closely held securities of companies for a variety of purposes, including estate and gift taxes, income taxes, sale and merger, stock purchase plans, buy-sell agreements, ownership succession, Employee Stock Ownership Plans and corporate and shareholder planning. John has extensive valuation experience in many industries including complex real estate development and management organizations, technology firms (including start-up phase companies) and manufacturers of equipment and components for the automotive, consumer and industrial sectors.

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