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IRS Wants to Eliminate Valuation Discounts: Watch Out !

The Department of the Treasury and the IRS have published proposed changes to the regulations attached to IRC section 2704. The changes have the stated goal of making discounts from net asset value practically impossible for the purpose of valuing limited interests in family investment partnerships. This goal is being pursued through regulations, i.e. without getting congress involved in legislating new valuation rules. In fact, IRS believes it has the authority to issue the proposed changes "if the restriction has the effect of reducing the value of the transferred interest for transfer purposes but does not *ultimately* reduce the value of the interest to the transferee." The changes are being fast-tracked by the service, with hearings in early December and a possible implementation, short of judicial challenges, in 2017.

The proposed changes include the aggregation of ownership interests or voting rights of a family to determine if the family controls the partnership, or S or C corporation, or LLC. The inclusion goes as far as applying control to "applicable family members, and/or any lineal descendants of a parent of the transferor or his/her spouse." In other words, the threshold for control has been lowered, and even 2 sibling each owning 50% of an entity each have a control attribution. Also, under the proposed changes, the family members are assumed to exercise their control to allow any relevant restrictions on transfer or liquidation to be eliminated.

Applicable restrictions are to be disregarded under the proposed changes: "any applicable restrictions are disregarded in valuing the transferred interest." The definition of disregarded restrictions is broadly defined in the proposed regulations. In other words, appraisers would now disregard any provisions that limit the ability of a holder to compel liquidation or redemption of the interest. For valuation purposes, there is a presumption that the family can exercise the ability to liquidate. Also, any provision that limits the amount to be received by the holder of an interest or liquidation or redemption to an “amount not less than minimum value” is to be disregarded. Minimal value is defined as net asset value. The proposed regulations would also disregard any provision that would defer the payment to the holder of the full liquidation for more than six months. In effect, they eliminate the concept of investment holding period in valuing minority interests in family partnership. Finally, the proposed regulations disregard any provision that would permit the payment of liquidation or redemption proceeds in any form other than cash or property. Even a limited carve out for operating companies makes sure there is no discounting based on the consideration to be received.

A put right [proposed section 2704-3] is assumed: “any restriction that otherwise would constitute a disregarded restriction will not be considered a disregarded restriction if each holder has a put right as described.” This fictitious right will results in all appraisals under the proposed regulations to have “hypothetical conditions” under USPAP, the ASA’s Principles of Appraisal Practice and Code of Ethics. The hypothetical conditions, known to the appraiser to be contrary to the meaning of the governance documents, need to be highlighted in the report.

Does the IRS really have that sort of authority? Some in congress are not sure, and a bill, H.R. 6042, was filed recently forbidding application of the new rules. Clearly, the service is attempting to change agreements it does not like unitarily, but a minority interest in any entity is, in the market, worth less than its proportional value whether the service likes it or not. You really need to contact your representative in congress, particularly as the proposed regulations also apply to any business. In other words, IRS is going to war with the concept of family owned business! No wonder many estate planning attorneys are recommending doing all transactions involving a discount before year end, even if the regulations may be watered down before they become effective.

The American Society of Appraisers Weights In

The ASA has issued a summary of the issues found in the proposed regulations, which is well worth repeating here.

* The proposed regs unfairly increase the value of fractional interests in family-controlled businesses and holding companies for estate and gift tax purposes. The result is a stealth tax increase of 25 to 50% in taxes. The root cause is the IRS' institution of the discredited notion of "family attribution."
* IRS replaces the Fair Market Value with a new and unknown definition of value, and counters its own standard. Revenue ruling 59-60 has long been clear on the issue of what standard is to be applied: the price at which a hypothetical willing buyer and seller at arm's length would agree to buy/sell an interest for. Based upon the realities of the marketplace, the fair market value of a minority interest is not worth as much as that interest's pro-rata share of the whole entity. This is because such interests do not enjoy control or marketability. These required valuation adjustments are referred to as "discounts." The IRS now proposes the use of a new valuation theory for taxing intra-family estate and gift transfers, with the seller and buyer allowed to be known parties. Because of the lack of clarity in the proposed regulations, valuation discounts will either be reduced substantially or disregarded altogether. This renders useless that accumulated prior knowledge built up decades of tax court precedent, appraisal education and experience and academic research.
* The IRS's return of "Family attribution" has been rejected by the supreme court and the IRS itself. In *Estate of Bright*, the supreme court dismissed the IRS's position that families will always work in concert and always agree on business and financial matters. Subsequently, revenue ruling 93-12 makes clear that discounts for lack of control can not be denied simply because the interests are passed from one family member to another.
* The rules would treat intra-family transfers differently than those involved non-family third parties. The IRS has not explained why such discrepancy exits.
* The proposal would override limitations placed on interests in the business, including those imposed by state law. The IRS proposed to overturn both existing private party contractual agreements and various state laws by ignoring the marketability restrictions placed on interests for taxation purposes.

* The impact to family-owned businesses will be significant. At a minimum, these businesses will delay capital investments or hiring as the available cash will go toward paying an increased tax bill. Worse, the businesses will take on more debt to pay the IRS. Finally, business owners may sell or liquidate the business rather than continue on as a family owned going concern. The last outcome will be highly destructive, especially for small business.
* *Support the Protect Family Farms and Business Act*! The house bill is HR 6100, and the senate version is S-3436; they would repeal the proposed regulations.

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