IRS Launches Renewed Attack on Valuation of Family Businesses – A Seismic Shift for Estate and Gift Tax Valuations

Gray Reed & McGraw Legal Alert

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Taxation by Executive Fiat
IRS Launches Renewed Attack on Valuation of Family Businesses
A Seismic Shift for Estate and Gift Taxations

By Norm Lofgren, Gray Reed & McGraw

Unable to accomplish its long-standing legislative objective of eliminating valuation discounts involving family-controlled business entities, the Obama administration issued new proposed Treasury Regulations on August 2, 2016 designed to eliminate those valuation adjustments, which have long been available to decrease the value of family-controlled business entities for federal estate tax, gift tax and generation skipping transfer (GST) tax purposes. If made final, the rules, commonly referred to as the "Section 2704 Regulations," accomplish their work by precluding the consideration of restrictions built into entity agreements as well as those imposed by state law in valuing transfers of family-controlled entities for estate, gift and GST taxes. It is not a surprise that the proposed Section 2704 Regulations were published. However, the scope of the proposed rules and how they accomplish their desired result does have the professional planning community taking stock. One thing is for sure, if finalized the proposed rules signal a seismic shift in valuation rules for estate, gift and GST tax purposes, making the stakes high for impacted taxpayers.

Repeated efforts by both the Bill Clinton and Barack Obama administrations to eliminate valuation discounts of family-controlled businesses through legislative proposals consistently failed.

Efforts to accomplish the same result through the judicial process have similarly failed. In the landmark 2000 *Estate of Strangi* case, Gray Reed attorneys Norm Lofgren and Tom Rhodus successfully defeated a judicial attempt by the IRS (Tax Court and Fifth Circuit) to deny valuation adjustments to a family-controlled limited partnership. The IRS sought to (i) expand the breadth of Section 2703 (a companion to Section 2704) in an effort to disregard the existence of the limited partnership and (ii) disregard that entity for lack of economic substance. Shortly before trial in *Strangi*, the IRS abandoned its attack under Section 2704. *[An historical perspective of Section 2704 follows at the end of this alert.]*

The Tax Implications – Setting the Stage

Consider the following example: Texas Cabinet Company, a private Texas limited liability company, manufactures kitchen cabinets for sale to big-box retailers. It was founded by John Austin, and upon his death in 1997 he left it equally to his three adult children: Mary, Joe and Henry. Mary is the president. The Company Agreement of Texas Cabinet requires unanimous consent of the owners to (i) transfer his / her member interest outside of the family, (ii) force the company to redeem a member's interest or (iii) liquidate the company. Assume that Joe (unmarried with no children and no other assets) dies on December 31, 2016 leaving his member interest equally to his brother and sister. Assume that as of Joe's death on December 31, 2016, Texas Cabinet has a fair market value of $27 million. Under current law, regulations and court rulings, the approximate value for estate, gift and GST tax purposes of Joe's 33 1/3 percent member interest in Texas Cabinet (a minority interest) would be approximately $5.4 million (assuming a combined 40 percent adjustment for lack of control and lack of marketability are applicable to the interest), that valuation adjustment mirroring the "real-world" economic realities of a 33 1/3 percent interest in a private business which likely would be hard to sell. Current federal law exempts the first $5.45 million of a decedent's estate from estate tax. As a result, Joe's estate would pay no federal estate tax on his interest in Texas Cabinet under these facts.

Now, assume that the Section 2704 Regulations are published as final regulations on December 2, 2016, and made effective for transfers starting 30 days later (on January 1, 2017 and thereafter). If Joe were to die on January 3, 2017, under the 2704 Regulations, Joe's estate would be required to report the value of his 33 1/3 percent interest without regard to the restrictions on liquidation of either the company OR Joe's minority interest as an interest in a "family-controlled" corporation. The impact of the changed valuation rules would artificially increase the economic value of Joe's estate for federal estate tax purposes to $9 million (33 1/3 percent of $27 million), thereby increasing the estate tax his estate must pay the IRS on Joe's interest in Texas Cabinet by over $1.4 million. Needless to say, Joe's estate and its heirs would experience a substantially different outcome than under current law.

Overview of the 2704 Regulations

To achieve its intended result, the Section 2704 Regulations are designed to fundamentally alter the rules for valuation of "family-controlled" entities. By way of history, in establishing the federal estate, gift and GST tax system, Congress specified those taxes would be based upon the "value" of the asset being transferred. To that end, Treasury Regulation Section 20.2031-1(b), enacted decades ago, defines "value" for estate tax purposes as "fair market value." Fair market value is measured as the price at which property would change hands between hypothetical unrelated parties in a "willing buyer / willing seller" analysis.

The Section 2704 Regulations fundamentally impact these long-existing rules in the following manner:

1. **New "Disregarded Restrictions" Category Created.** The 2704 Regulations create a new category of "Disregarded Restrictions" which must be ignored in establishing the value of interests in "family-controlled" entities for estate, gift and GST tax purposes. Note that interests held directly by specified family members, as well as interests held indirectly such as through partnerships, corporations and trusts, are all considered to be held by the family for the purposes of these rules. The Section 2704 Regulations specifically provide that the following four restrictions are to be ignored in valuing an interest for estate, gift and GST tax purposes:

- A restriction on an owner's right to compel liquidation or redemption of his or her interest;
- A restriction which limits the liquidation proceeds to an amount that is less than "minimum value," ultimately described as the interest's share of the fair market value of the entity's property minus obligations of the entity;
- A restriction which defers or permits the deferral of payment of liquidation proceeds for more than six months; and
- A restriction which permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain types of notes.

These rules are at the heart of the changes in the 2704 Regulations which result in a disallowance of valuation adjustments for transfers of an interest in a family-controlled entity.

2. **Non-Family Members Generally Disregarded**. In determining whether an entity is "family-controlled" and therefore subject to the Section 2704 Regulations, if the transferor's family has the power to remove a restriction, any interest held by a non-family member is disregarded for valuation purposes unless **all** of the following are satisfied with respect to any non-family interest:

- The non-family interest has been held for at least three years;
- The non-family interest is at least a 10% equity interest in the entity;
- Non-family members hold at least 20% equity in the entity; AND
- Each non-family member has a put right to have their interest redeemed with a maximum of six month's notice at the "minimum value."

Not surprisingly, the specificity of these rules prevent most non-family interests from counting when determining whether there is family control over an entity and are also critical to the impact of the proposed new rules.

3. **Lapses Within Three Years of Death**. The Section 2704 Regulations, taking apparent inspiration from Section 2035 of the Internal Revenue Code, provides that transfers made within the three years preceding the transferor’s death will trigger estate tax consequences to the transferor’s estate regardless of whether any liquidation right with respect to the interest continues to apply to the interest. This "bright-line" rule would result in an increase in what is taxable in the transferor’s estate any time a de-controlling transfer is made closer than three years before the transferor’s death. Specifically, the proposed rules provide that the value of such a lapsed right within three years of death must be reported on the decedent’s federal estate tax return as an asset (effectively a "**phantom asset**" in that it results in additional value being taxed for estate tax purposes for which there is no "real" asset out of which the tax can be paid). The value of the phantom asset would seem to equate to any valuation adjustments associated with the transferred interest. The practical impact of these proposed rules would preempt de-controlling transfers within three years of death.

It is important to note that the additional value being added to the transferor’s gross estate as a result of this proposed rule would not be eligible for either the charitable or marital deductions.

4. **Modifications Concerning Applicable Restrictions.**

- State Law Restrictions. Current regulatory provisions recognize restrictions on liquidation and withdrawal contained in an entity’s governing documents if those restrictions are no more restrictive than restrictions imposed under applicable state law. The 2704 Regulations eviscerate the existing rules on that point. Of note, Texas law is expressly cited in the Section 2704 Regulations as an example of where the Treasury Department believes that state law changes facilitated the circumvention of Section 2704. The provisions of Revised Limited Partnership Act §6.03 were amended after the enactment of Internal Revenue Code Section 2704 to permit withdrawal of a limited partner only as provided in the partnership agreement. According to the Treasury Department’s explanation of the Section 2704 Regulations, the Internal Revenue Service will respect a state law restriction only if the "restriction (i) cannot be removed or overridden and it is mandated by the applicable law, (ii) is required to be included in the governing documents, or (iii) otherwise is made mandatory."

- Assignee Interests. Transfers of an "assignee interest" (which do not have voting or liquidation rights) are interests treated as an applicable restriction and subject Section 2704 such that the restrictions are disregarded.

5. **Covered Entities Expanded**. The Section 2704 Regulations make clear that all entities are covered by the special valuation rules of Section 2704 despite the fact that current Internal Revenue Code and Treasury Regulations only expressly deal with corporations, general and limited partnerships. The Section 2704 Regulations would add rules whereby any business entity arrangement, foreign or domestic, (other than corporations, general and limited partnerships that have their own express rules) in which the taxpayer owns at least 50 percent of the capital or profits or in which there is the ability to force a partial or full liquidation of such entity are covered by the valuation restrictions.

Where This Leaves Us

The Section 2704 Regulations are set to be discussed in a public hearing in the auditorium of the Internal Revenue Service Building in Washington, D.C. on December 1, 2016. It is not unreasonable to expect that numerous comments will be made in that hearing. If the Internal Revenue Service elects to make changes to the Section 2704 Regulations in light of comments received, that would obviously delay in the publication of final Treasury Regulations for some time. Even if the Internal Revenue Service chooses not to make any changes in light of comments received (or has determined it will not make any changes), the Section 2704 Regulations state that the final Treasury Regulations **will NOT become effective until 30 days after they are published as final in the Federal Register**. Thus, assuming the Internal Revenue Service elects to make no changes in light of comments received, it is hard to imagine that the rules would be applicable to transfers prior to January 1, 2017. Once the Section 2704 Regulations are in place, it is reasonable to expect that a round of legal challenges from impacted taxpayers will ensue. Challenges to the Section 2704 Regulations include: (i) arguments that the rules exceed the scope of what the enacting legislation envisioned them to be, and (ii) do they constitute a violation of the Constitutional separation of the executive and legislative branches of government. However, most taxpayers will likely not want to "sign up" to test the new valuation rules for a variety of reasons. That being the case**, persons considering transferring interests in family-controlled entities or freezing the value of such interests should consider acting quickly – i.e., before the end of 2016, if they wish to avoid the impact of these Section 2704 Regulations, assuming they are finalized as proposed.**

Contact Us

As a reminder, persons considering transferring interests in family-controlled entities or freezing the value of such interests should consider acting quickly. If you have any questions regarding this subject or if we may be of assistance to you or your clients in any way, please call: Norm Lofgren at 469.320.6075, Greg Sampson at 469.320.6097, or Glen Eichelberger at 713.986.7154.

More Comments – An Historical Perspective

Article 1, Section 8 of the United States Constitution grants Congress the "power to lay and collect taxes." That power is not granted to the executive branch of our government.

In establishing the federal estate tax, gift tax and generation skipping transfer tax (GSTT), Congress specified that these taxes would be based upon the "value" of the asset being transferred (Internal Revenue Code Section 2031). Treasury Regulation Section 20.2031-1(b), enacted decades ago, defines "value" as "fair market value." Fair market value is basically the price at which property would change hands between hypothetical unrelated parties.

In the context of transfers of interests in business entities such as corporations, partnerships and limited liability companies, the fair market value of an interest in the entity is, in an economic sense, not equal to the underlying fair market value of the enterprise times the percentage ownership interest. Rather, in valuing non-publicly traded business interests, expert appraisals take into account such impairments to value as "lack of control" and "lack of marketability." In very round numbers, these valuation impairments are often in the 30 percent to 40 percent range AND the IRS and the Courts have routinely accepted these valuation discounts. Accordingly, if you own 30 percent of the stock of a private corporation worth $10 million, the value of your 30 percent interest is likely in the range of $1.8 million to $2.1 million – not $3 million (30 percent of $10 million value of the whole enterprise).

In the fall of 1990, the Democratic Party held a majority of both houses of Congress. Effective October 9, 1990, new Sections 2701 – 2704 ("Chapter 14") were added to the Internal Revenue Code. These provisions are titled "Special Valuation Rules." Chapter 14 created a set of artificial valuation rules for estate, gift and GST taxes – a departure from the general rule of utilizing fair market value.

Section 2704

Internal Revenue Code § 2704 specifically deals with (a) "lapsing" voting and liquidation rights restrictions and (b) intra-family transfers (e.g., death or gift) of corporation or partnership ownership interests where the family controls the entity and the ownership interest is subject to liquidation restrictions (an "Applicable Restriction"). An Applicable Restriction is one which limits the ability of an owner to liquidate the entity (in whole or in part) which the transferor or his family has the power to remove. However, an Applicable Restriction does not include a restriction "imposed, or required to be imposed" by state or federal law. On January 28, 1992, the Treasury Department issued regulations under Section 2704 (Treas. Reg. §25.2704-2(b)) which provide in relevant part an Applicable Restrictions is one "that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." The exception under the regulations is phrased differently from the statute. By ignoring Applicable Restrictions, the value reportable for federal estate, gift and GST taxes is increased above true economic fair market value.

In one of the landmark estate tax cases, *Estate of Strangi*, decided in 2000 and tried by Gray Reed attorneys Norm Lofgren and Tom Rhodus, the Chief Judge of the Tax Court observed:

"The new special valuation rules in Chapter 14 departed substantially from the hypothetical willing buyer-willing seller standard."

In *Estate of Strangi*, the IRS was unsuccessful in its attempt to convince the courts (Tax Court and Fifth Circuit) to expand the breadth of Section 2703 (a companion to Section 2704) in an effort to disregard the existence of a family limited partnership and also unsuccessful in its attempt to disregard that entity for lack of economic substance. Shortly before trial, the IRS abandoned its attack under Section 2704. A properly constructed partnership had successfully navigated the problems of Chapter 14.

Immediately following enactment of Section 2704, many owners of family-owned businesses, which routinely required unanimous consent of the owners to liquidate, gifted small interests in their business to public charities. This tactic conceptually destroyed the IRS' ability to classify liquidation restriction as an Applicable Restriction since the family no longer had the power to remove the liquidation restriction. The IRS unsuccessfully attacked this tactic in *Kerr v. Commissioner*. In 1997, the Texas legislature amended the law governing the ability of a limited partner to withdraw from a limited partnership (TRLPA § 6.03) and in 2003 amended the law governing withdrawal of a member of a limited liability company (TBOC § 101.107). Generally, a limited partner or limited liability company member can withdraw only as provided for in the governing documents of the entity. Other states enacted similar legislation. Kerr and the changes in state law provided a safe path to avoid the pitfalls of Section 2704. When coupled with the *Estate of Strangi* decision, taxpayers had a road map to avoid Chapter 14.

In light of the proliferation of family limited partnerships and their valuation discounts, President Bill Clinton attempted to curtail discounts, requesting legislation to curb these discounts. Congress was not receptive. On January 9, 2009, Congressman Earl Pomeroy

(Democrat - ND) introduced HR 436, to curb discounts. This Bill died in committee. In his first several budgets, President Obama requested legislation to eliminate valuation discounts of family entities and close down the perceived Section 2704 avoidance. Congress was not receptive to these requests. Similarly, the Courts repeatedly upheld well-planned taxpayer strategies following *Estate of Strangi, Kerr* and the new state laws.

Starting with his FY 2014 budget, President Obama abandoned pursuit of a legislative change to the tax law and the Treasury Department began work on what has now been issued as the proposed Section 2704 regulations. If the proposed regulations are finalized, this unilateral action by the Executive Branch, which greatly expands the reach of Section 2704 and seemingly departs from the statutory provisions of Section 2704, will likely be challenged by taxpayers in court as an unconstitutional usurpation of the power of the legislative branch of government. The "disregarded restrictions" portion of the proposed regulations, i.e., the look-through to underlying entity value is in essence an attempt to disregard the separate existence of the entity for valuation purposes, a tactic already rejected by the courts in *Estate of Strangi* and other cases in the context of IRS attacks under Section 2703 and "the lack of economic substance theory."

Query - Is this proposed unilateral action by the Executive Branch taxation by executive fiat? If the proposed regulations are finalized in their current form, litigation by impacted taxpayers will likely ensue.