

IRS Targets Eliminating Discounts with Proposed Regulation



On August 2, 2016, the Internal Revenue Service released its long awaited proposed regulations that would make substantial changes to the valuation of privately held, minority interests that are controlled by one family. While many advisors expected the regulations to target partnerships with liquid assets, the regulations appear to be far more reaching than initially believed. Proposed changes to Internal Revenue Code 2704 would disregard restrictions on the right to liquidate when determining fair market value.

This change, if implemented, would contradict economic reality. Minority interests in privately held entities do trade at discounts due to lack of control and lack of marketability. Some key points we noted are:

- **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 in aggregate own a controlling interest in a privately held entity, the IRS would require the interest to be valued as if it has the right to liquidate.
- **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 seller. This proposal would assume that the seller is a particular person because family attribution would be considered.
- **Broadened Scope** - When IRC 2704 was written, it was meant to cover partnerships and corporations. If allowed to stand, this proposal would extend coverage to all business relationships including limited liability companies.

We expect there to be significant push back from the appraisal community because of the confusion this regulation would cause and its conflict with economic reality. Task forces are being formed by the AICPA, ASA and NACVA to prepare comments and the public hearing is set for December 1, 2016.

The proposed regulations would significantly impact discounts and deserve careful study. However, it appears the proposal is primarily targeting partnerships that own liquid investments like marketable securities and insurance policies (see Kerr v. Commissioner). From a valuation standpoint, the right to liquidate is not the same as a right to sell so, for entities that have real estate or for operating companies that are difficult to subdivide, discounts may still be applicable. We will comment further as things develop and we learn more about whether these proposals will be approved and how they would be implemented.