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Family-Owned Business Discounts May End Under Proposed IRS Regulations

BY BRUCE A. JOHNSON

The Internal Revenue Service released proposed regulations on August 2, 2016, that would modify and expand Internal Revenue Code § 2704, which affects the valuation of privately held minority interests that are controlled by the same family. Since the tax court decision of *Kerr v. Commissioner*,¹ the IRS has been concerned that certain loopholes exist in § 2704 that allow taxpayers to gift interests to family members in entities that have no business purpose and allow the transfer of wealth without due consideration of the value

to the transferor.

While many attorneys, accountants and business advisers expected the regulations to target partnerships with liquid assets, the ramifications of the regulations appear to be more far-reaching than initially believed. In fact, they may have unintended consequences for valuation discounts for intrafamily interest transfers.

The effect of the amended and expanded regulations could eliminate discounts for lack of control and lack of marketability for privately held businesses and partnerships that are family



Family-Owned Business Discounts

controlled. Therefore, it may be advisable to review your clients'

personal situations and estate plans and, if such transfers were being considered or planned, implement them before these proposed regulations are issued.

How Valuation Occurs

Valuation theory is based on risk and return that is observable in the financial marketplace. Certain valuation principles have long been established, demonstrating that noncontrolling, nonmarketable interests in privately held businesses are worth less than controlling interests and equity interests in publicly held companies. Accordingly, certain adjustments are made when valuing noncontrolling interests in privately held entities, because the data used in the valuation process is based on publicly traded stock information.

The two most common adjustments are known as the *discount for lack of control* and the *discount for lack of marketability*. A discount for lack of control adjusts the value of a business interest because the owner does not have the ability to manage the operations of the business and also does not have the ability to control the sale and liquidation of the business, including the underlying assets. The discount for lack of marketability adjusts the value of a business interest because the interest cannot be sold and converted to cash as quickly as a publicly traded stock. These adjustments reduce the value of a noncontrolling interest in a privately held business or partnership to compensate for the increased risk of owning an interest that has no control and cannot be quickly converted to cash.

Rule-Making and Congress

IRC § 2704 was originally enacted by Congress in 1990 to curb valuation discounts that were based on restrictions limiting the liquidation of an interest. In addition, Congress gave the Department of Treasury the right to issue new regulations to limit restrictions included in the partnership agreement that reduced the value of an interest for the transferor but did not have the same

impact on the value for the transferee. However, the IRS and Treasury have not been successful in getting congressional support for these changes since § 2704 was enacted. The new § 2704 proposed regulations appear to directly implement what formerly had not gained congressional support and have not been successfully adopted in tax court decisions over the past 20 years. If officially finalized, as proposed, the regulations would impose special valuation rules for family-owned entities, which include the following:

- **Disregarding Restrictions**—The proposed regulations would disregard restrictions on liquidation that are not mandated by federal or state law in determining the fair market value of the transferred interest in a family-owned business.
- **Elimination of Assignee Interest**—The proposed regulations would eliminate any discount based on the transferee's status as an assignee and not a full voting owner in the entity for an interest being transferred in a family-owned business.
- **Three-Year Lookback**—If a transfer of an interest occurs within three years prior to the transferor's death, the proposed regulations would stipulate that an additional transfer occurred at the transferor's death if a lapse of the transferor's voting and liquidation rights occurred. This additional transfer is subject to taxation but not eligible for the marital deduction.
- **Assumed Put Option**—The proposed regulations would assume that the transferee in a family-owned business has a put option to sell their interest back to the entity for cash or equivalents within six months at a nondiscounted value.
- **Broadened Scope**—When IRC § 2704 was originally written, it was meant to cover partnerships and corporations. The amended proposal would extend coverage to all business relationships, including limited liability companies.

Effects of Proposed Changes

If the proposed regulations are accepted,

If the proposed regulations are accepted, family-owned businesses may lose an important estate planning tool for entities that have a valid business purpose.

they will close the perceived loopholes, but family-owned businesses also may lose an important estate planning tool for entities that have a valid business purpose. From a taxpayer standpoint, the implementation of the proposed regulations will result in increased tax costs for transferring interests in family-owned entities. From a valuation standpoint, the change would contravene the historical methodology accepted by the IRS and tax court for valuing minority interests in privately held entities.

Some key points from an appraisal standpoint include the following:

- **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 particular seller." This proposal would assume that the buyer and seller are a particular person and require certain valuation assumptions if they are family members.
- **Family Attribution**—The proposed regulations seem to contradict *Estate of Bright v. U.S.*,² which ended the aggregation of interests owned by the same family. Under the new proposal, if family members own a controlling interest in a privately held entity in aggregate, the IRS would require the interest to be valued as if it has the right to liquidate.
- **False Economic Reality**—The proposed regulations would establish a false economic reality because privately held businesses do not typically offer "put provisions" that can be exercised at any time. Privately held businesses do not grant put provisions in the real world because they could cause liquidity prob-

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lems that would jeopardize the operations of the company, because shareholders could withdraw and demand cash at any time.

- **Uncertainty**—The proposed regulations would complicate an established methodology for the valuation of privately held interests that has a 60-year history of court case precedent. In addition, the proposed regulations introduce new terminology, such as “minimum value,” which are not financial terms and could cause confusion for taxpayers and their advisers.


The proposed regulations are subject to a 90-day public comment period, which ends November 2, 2016. A public hearing is set for December 1, 2016, after which the regulations will be evaluated. If approved by the Treasury, they could be issued and implemented as soon as 30 days after the public hearing. A significant pushback is expected from the appraisal, accounting, and legal community due to the potential confusion caused by these proposed regulations and concern over higher tax levels for certain taxpayers whose family members own interests in the same entity.

If the proposed regulations are upheld, gifts made before the actual implementation will not be subject to the new restrictions, because they won't be retroactive. However, if entities are formed now but gifted after the potential new regulations are enacted, they will be subject to the new restrictions. The American Society of Appraisers (ASA) has formed a task force to prepare comments that might shed light on some of the unintended consequences of these proposed regulations.

Ultimately, the proposed regulations deserve careful study and consideration, as they appear to have significant repercussions for valuation discounts. While their full impact is uncertain, they do appear to substantially limit and in some cases eliminate discounts for lack of control and lack of marketability in entities that are owned by the same family. It would be prudent for owners of family-controlled businesses to seek counsel from their advisers to examine whether this proposal would affect their plans to transfer interests, in the event the proposed regulations become effective. [AF](#)

endnotes

1. 113 T.C. 449 (1999).
2. 658 F.2d 999 (5th Cir. 1981).



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