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Proposed 2704 Regulations: Significant Impact on Valuation Discounts for Family Businesses

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Background: On August 4, 2016, the Treasury Department and Internal Revenue Service issued proposed regulations addressing the valuation of certain business interests for federal estate, gift and generation-skipping tax purposes. (Reg. 163113-02, 81 Fed. Reg. 51413-02 (August 4, 2016)). These long-anticipated regulations target what are perceived abuses in discounts applied in connection with gifts or transfers of interests in family entities. In the Preamble to the proposed regulations, the Department states the regulations are "necessary to prevent the undervaluation of such transferred entities," and further that "[t]he Treasury Department and the IRS have determined that the current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws and by other subsequent developments."

The new regulations, in effect, will greatly limit the availability of valuation discounts on transfers of family business interests where the family maintains control. This will serve to create a major shift in estate and business succession planning, and may very well have a chilling effect on the beneficial implementation of family limited partnerships (FLPs) and limited liability companies (LLCs) for other non-tax objectives.

Timing and Effective Dates: As of the date of this article, we are in the 90-day comment period, which extends through November 2, 2016. Thereafter, public hearings will be held beginning December 1, 2016, with the enactment of final regulations being perhaps as early as January, 2017. Final regulations should be expected sometime in 2017. Importantly, the new regulations will only apply to transfers that occur after their effective date. However, if a transferor of a family business interest dies after the effective date, the death will presumably be subject to the new 3-year lookback rule, discussed below, in determining the value of shares in his or her estate. In other words, valuation discounts presently would be effective, but if the transfer(s) are designed to bring the original owner's stake down to a minority stake, and if the owner dies within 3 years, then his or her estate could fail to obtain a lack-of-control discount at that time. The value, but not the equity, is effectively recaptured for valuation and estate tax purposes.

Overview of Key Provisions of the Proposed Regulations:

1. Expanded Entities:The original section 2704 regulations passed in 1992 and they historically dealt with corporations and partnerships. With the growth in LLCs since that time, the new regulations move beyond these forms to expressly include LLCs, corporations, partnerships (including limited partnerships), and any other "business entities", domestic or foreign, regardless of classification for federal tax purposes (e.g. disregarded entities).

The regulations will apply to all of these business entities in form, regardless of whether, in substance, the family business is an active, operating business, or a passive company in the nature of a holding company.

2. Definition of "Control": The proposed regulations (25.2701-2(b)(5)(iv)) set forth a definition of a controlling interest in certain entities identified above. For an LLC or other entity that is not a corporation, partnership or limited partnership, control requires the holding of at least 50% of either the capital or profits interests of the entity or arrangement. For purposes of determining control, an individual, the individual's estate, and the individual's family members are treated as holding interests held indirectly through a corporation, partnership, trust or other entity.

3. Three-Year Look-Back: In an effort to avoid deathbed transfers, in proposed regulation 25.2704-1(c)(1), any lapse of a voting right or liquidation right by reason of a transfer within three (3) years of the transferor's death is treated as a lapse

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occurring on the date of death, resulting in inclusion in the transferor's gross estate under 2704(a). In other words, changes in ownership designed to create a minority or lack-of-control discount at death might not occur if the transferor dies within three years. (The valuation is performed as if the deceased owner still owned the interest transferred, even though the transfer validly occurred and the owner, in fact, only owned a minority interest at death. No minority discount is available).

4. Disregarded Restrictions: A new category of restrictions, called "disregarded restrictions" essentially provides that certain restrictions are ignored if the family has aggregate control to eliminate the restriction after the transfer. These include: (i) limits on the ability to liquidate; (ii) payment deferrals of liquidation proceeds beyond six months; (iii) payment alternatives in a manner other than cash or property; or (iv) limits on the valuation the amount to less than "minimum value." Minimum value is essentially fair market value less debt. Two exceptions are: (i) transfers to non-family members under certain conditions; and (ii) if each owner has an enforceable "put" right to obtain minimum value (minimum value * pro rata share) within six months.

Potential Challenges Ahead?: Several commentators believe portions of the proposed regulations overreach, and will inevitably result in challenges through the comment period, and in addition, through the Courts if they become final in substantially their present form. They believe that the regulations are ripe for challenge on the grounds that: (i) the regulations fail to align with the legislative grant of regulatory authority by Congress; and (ii) the regulations are inconsistent with the statute and legislative history. See Cmmentary, Business Valuation Resources, LLC (Aug. 31, 2016) See also James G. Blose, *Portions of Proposed 2704 Regulations Exceed IRS' Authority*, Trusts & Estates (Aug. 18, 2016).

Interestingly, the IRS states in the Preamble to the proposed regulations that a regulatory impact assessment was not required, because the IRS certified on its own accord that the proposed regulations "will not have a significant economic impact on a substantial number of small entities. The proposed regulations affect the transfer tax liability of individuals who transfer an interest in certain closely held entities and not the entities themselves." This author believes this is a fundamental misunderstanding of economic reality. Among other concerns, the net effect of these regulations is that there will be larger estates and in turn additional estate and/or gift tax, which, absent adequate liquidity, from other sources, could have grave consequences for business succession and continuity of the enterprise upon the death of an owner.

Take Action Today: Taken together, it is clear that the new regulations, once final, will drastically reduce the availability for planning and the use of valuation discounts. It is critical for family business owners who have taxable federal estates to be mindful of the closing window for valuation discounts and strongly consider moving forward with business succession, estate planning, and general wealth and legacy transfer planning opportunities. The time to plan — or implement an existing plan — is now.

If you are involved in a family business, or provide professional advice to these businesses and/or the entrepreneurial families themselves, it is critically important that you consider the impact of these regulations on your particular circumstances and how they could foreclose potential planning opportunities if no action is taken.

Please contact a member of the Tucker Arensberg Business Succession or Estate and Trust Practice Groups or Brian Kahle today if you have questions about these proposed regulations, or are concerned about how they could impact your family business.

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