

New Treasury Valuation Rules & Family Businesses

September 13, 2016



Proposed Treasury Rules

What Did Treasury Do?

- Treasury’s proposed rules would largely eliminate “lack of control” and “lack of marketability” valuation discounts for family members receiving interests in a family-controlled business
- The proposed rule is an effort to reprise the old, failed concept of “family attribution,” this time using section 2704 as the underlying authority
- Left in place, the rule would increase estate and gift taxes by 30 percent or more on family-owned businesses, resulting in fewer family businesses surviving from one generation to the next:
 - This affects family businesses only
 - Public companies and businesses owned by unrelated parties are unaffected
- Here’s the background

Proposed Treasury Rules

Minority and Marketability Discounts

- How assets are valued makes a dramatic difference for gift and estate tax purposes
- For closely-held businesses, there are few if any comparable sales and no ready markets, so their value must be determined by estimating the likely sale price between two willing and unrelated parties
- A variety of factors are considered, but two key discounts often apply:
 - Lack of Control: If the interest being transferred is not controlling, it is worth less
 - Lack of Marketability: If there no ready market for the interest, finding a willing buyer may be difficult and the asset is worth less
- These discounts are often valued at 30 percent or more and they reflect the underlying economic realities -- non-controlling ownership interests and assets without ready markets are just worth less

Proposed Treasury Rules

Section 2704

- Section 2704 was adopted in 1990 to target certain “lapsing restrictions”:
“The Secretary may by regulations provide that other restrictions shall be disregarded... if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle **but does not ultimately reduce the value of such interest to the transferee.**”
- But minority and marketability discounts are real economic factors and do not lapse – ownership with control is always worth more than ownership without it
- Moreover, Congress made clear 2704 was not intended to affect minority and marketability discounts:
“The conference agreement modifies the provision in the Senate amendment regarding the effect of certain restrictions and lapsing rights.... **These rules do not affect minority discounts or other discounts available under present law.**” (Conference Committee Report)
- How does Treasury use Section 2704 to go after these discounts?

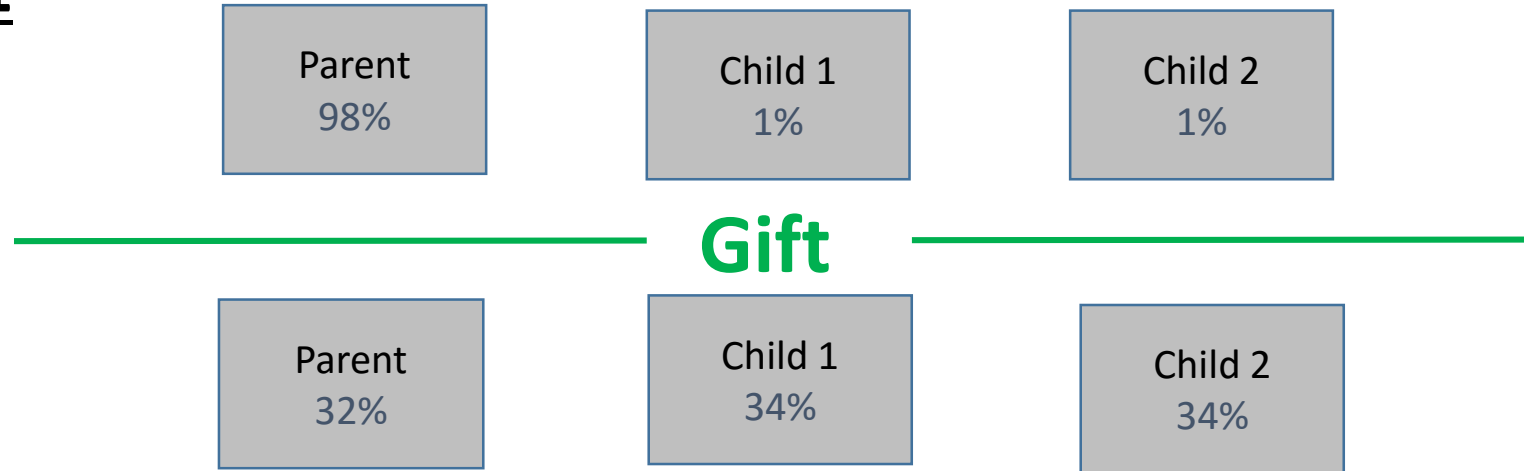
Proposed Treasury Rules

Under the Rule, “Family Control” Means “No Discount”

- Treasury attributes a family’s control of a business to any minority interest in the business held by a family member
- The key aspects of control at issue here are the ability to compel the liquidation or sale of the business and the ability to compel the business to redeem or liquidate an owner’s interest
- If the family controls the business prior to the transfer of a minority stake in the business, and controls the business after the transfer, then minority and marketability discounts of the interest passed on to a family member would either not apply or be significantly reduced
 - In some cases, they would not apply even if the family gives up control after the transfer
- The rule assumes families always act in concert and therefore any minority interest in a family-controlled business transferred to a family member should be valued as a controlling interest

Family Business Example

Example #1



Family Partnership Facts:

- Partnership Agreement requires the approval of all the partners to liquidate
- Partnership Agreement requires approval of all partners to amend the Partnership Agreement
- Parent gifts 33% interests each to two children
- Assumptions: If 100% of partnership is worth \$100, and minority interest discount is 30%, then:
 - Under current rules, FMV of the 33% gift would be \$23 and the gift tax would be \$9
 - Under New Rule, gift would be valued at par -- \$33 -- and the tax would be \$13 -- 43 percent higher and more than half the FMV of the gift

Challenges to the Rule

Challenge #1: Families Don't Always Agree

- For decades, the IRS sought to increase the estate tax on family-owned businesses by arguing that the family relationship made those assets more valuable:
 - Under Family Attribution, the transfer of a minority stake in a business would be valued at par if the person receiving the stake was a member of the family controlling the business
 - At its core, Family Attribution assumes that all families get along and always act in concert
- This approach was routinely rejected by the courts and, in 1993 the IRS conceded the point in Revenue Ruling 93-12:

In determining the value of a gift of a minority block of stock in a closely-held corporation, the block should be valued for gift tax purposes without regard to the family relationship of the donee to other shareholders.
- The new Rule is a backdoor effort to resurrect the old “Family Attribution” approach to valuing family-business interests differently from other business interests

Challenges to the Rule

Challenge #2: The Rule Would Create Two Competing Valuation Systems

- The Rule would create two competing valuation systems and is simply unworkable
- The reason valuation science starts with a hypothetical buyer and seller is because that is the only way to ensure a similar and balanced approach to all valuations
- Once you begin adjusting valuations based on who is receiving the asset, you create an unworkable mess (Example 4)
- As the IRS noted in Revenue Ruling 93-12:

*After further consideration of the position taken in Rev. Rul. 81- 253, and in light of the cases noted above, the Service has concluded that, in the case of a corporation with a single class of stock, notwithstanding the family relationship of the donor, the donee, and other shareholders, **the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest.***

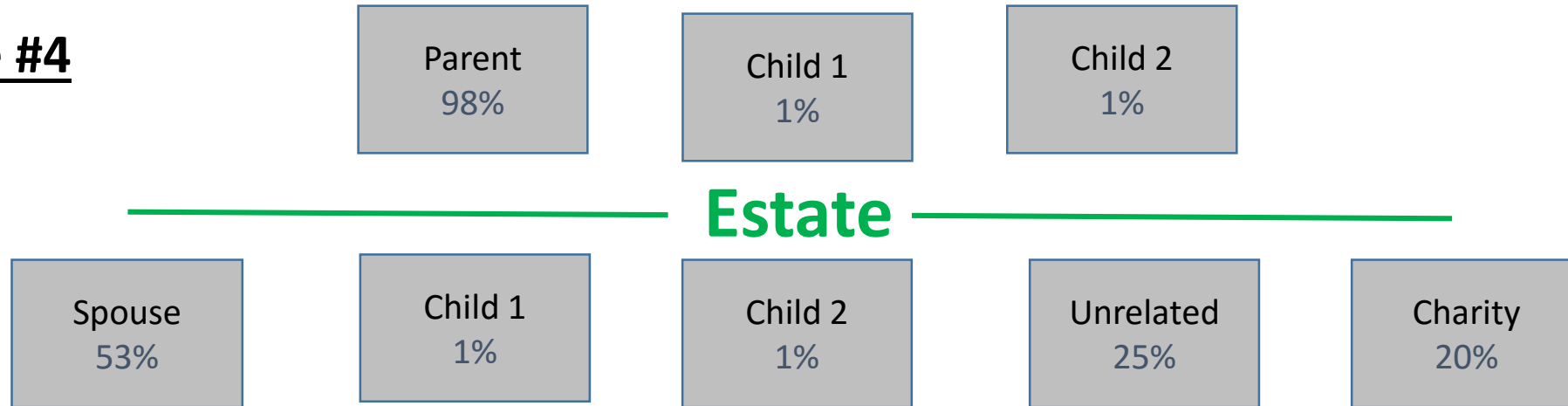
Challenges to the Rule

Challenge #3: Three-Year Lookback Means Families Without “Control” Will Pay More Too

- The Rule goes beyond “Family Attribution” by assuming that deathbed bequests are designed to avoid the estate tax
- For purposes of measuring control, the Rule disregards family business interests transferred to unrelated parties within three years of the death of the owner
- So in cases where an owner’s will transfers business interests to both related and unrelated parties, the business interests transferred to the unrelated parties will be disregarded for determining whether the related parties retain a controlling stake in the business – even if the governing documents say they no longer do!

Challenges to the Rule

Example #4



Facts:

- Partnership Agreement requires the approval of all the partners to liquidate
- Partnership Agreement requires approval of all partners to amend
- Parent's will transfers 53% interest to spouse, 25% to unrelated party, and 20% to charity
- Transfers to unrelated parties are disregarded for determining "family control"
- Spouse's interests valued as "controlling" even though, under the Partnership Agreement, the spouse lacks the ability to liquidate the partnership OR the ability to change the Partnership Agreement
- Results in two valuations of the SAME interests!

Challenges to the Rule

Bottom Line: Rule Would Mean Fewer Family Businesses

- As proposed, the Rule could raise effective estate tax rates on family-controlled, operating businesses to well over 50 percent:
A Parent gifts a daughter a 20 percent interest in the family business. The fair market value of the whole company is \$500, but the 20 percent share is not controlling, so it needs to be adjusted for lack of control and marketability. If those discounts are 30 percent, then the gift is worth \$70. Under current law, the tax would be \$28. Under the proposed Rule, the tax is \$40.
- Any buyer of the 20 percent interest is only going to pay FMV for this interest -- \$70 – which means the effective tax on this gift is almost 60 percent
- For non-liquid, capital-intensive family businesses that already have succession plans in place, the Rule creates an even higher hurdle to survival

Valuation Rule Timetable

Could Treasury Finalize These Rules Before the New Administration?

- Current Timetable:
 - ✓ August 2nd – Valuation Rule Proposed
 - ✓ November 2nd – Comment Period Closes
 - ✓ December 1st – Treasury Hosts Public Hearing
 - ✓ January 20th – End of Obama Administration
 - ✓ 30 Days After Publication – Rule takes effect
- Under normal circumstances, it would be extremely difficult for Treasury to wait until November, wade through all the comments, make the necessary changes, and work through their internal processes to finalize the rule by January 20th
- But are these normal circumstances?

Business Community Response

The Business Community Response: All of the Above!

- Educate business community and policymakers alike:
 - Briefings and other communications
 - Letters to Congress and the Treasury
 - Outreach to the press
- Coordinate comments into Treasury
- Identify the most favorable avenues for legal challenges:
 - If the Rule is finalized litigation is inevitable
 - But traditional litigation could take years
 - Need to identify a quicker means of reaching a final decision

What Can Congress Do?

Need an “All of the Above” Response from Congress too!

- This rule goes well beyond the underlying statutory authority granted in Section 2704 and Congress needs to defend its jurisdiction
- Possible actions include:
 - Additional correspondence from the Hill asking for clarifications and opposing the rule
 - Legislation to repeal the rule and/or strengthen the hand of litigants
 - Hearings, speeches and other communications making clear the intent of Congress when it adopted Section 2704
 - Congressional Review Act
- We understand the calendar is tight, but this Rule needs to be defeated!

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