Understanding the Impact, Proactive Planning Opportunities, Traps and Uncertainties of Proposed Section 2704 Regulations and Recent Tax Changes Affecting Closely Held Businesses

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Key PATH Act Changes Affecting Business Owners

- Section 179 expensing at $500,000 made permanent
- Bonus depreciation (more important for larger companies) extended through 2019, but *not* made permanent.
- Reduction in S corporation recognition period for built-in gains tax 5 yrs is made permanent (for C to S conversions).
- Exclusion of 100% of gain on qualifying small business stock held at least 5 years is made permanent.
- Lower shareholder basis adjustment for charitable contributions by S corporations (including to CRTs) is made permanent.
- Small captive insurance companies expanded, with safe harbor deductible contributions under §831(b) expanding from $1.2 to $2.2 million (adjusted for inflation) in 2017

Key PATH Act Changes Affecting Business Owners

- The credit for increasing **research** activities was made permanent. Particularly relevant to small businesses starting in 2016, it can also offset the AMT as well as regular tax, effective for credits determined for tax years beginning after Dec. 31, 2015. An eligible small business may instead elect to apply a portion of its research credit against the 6.2% payroll tax imposed on the employer's wage payments to employees.
- **Qualified improvement property** placed in service on or after Jan. 1, 2016 qualifies for bonus depreciation. "Qualified improvement property" is any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was "first placed in service."

Background on Valuation of Business Interests for Tax

- "Willing buyer, willing seller test" outlined in Rev. Rul. 59-60 and in Treas. Reg. §25.2512-1 - fair market value is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or sell
- Minority interest discount allowed for intra-family transfers
- Upheld in numerous rulings and cases

Gifts/Sales of Lack of Controlling Interests in Background on Valuation of Business Interests – pre-Chapter 14ty and Family Attribution

- Estate of *Bright v. Commissioner* , 658 F.2d 999, 5th Cir. 1981 (minority interest discount allowed for intra-family transfers)

  Estate of Harrison v. Commissioner, T.C. Memo 1987-8, 52 TCM 1306 (involved a partnership that parent and two children controlled as the GPs. The parent also held all of the LP interests. At death, parent's GP interest became a LP interest. The value of a LP interest (which is all the decedent owned) was considerably less, because there was no ability to liquidate the partnership. The GPs could liquidate at any time.

The Original §2704 Regulations and Aftermath

- Chapter 14, including IRC §§ 2701-2704, enacted 11/5/90
- Initial regulations proposed in 1991, finalized 1/28/92
- These curbed a few strategies, but still left open plenty of creative (or, abusive, depending on perspective) techniques
- Revenue Ruling 93-12 (sole stockholder of a corporation who gave a 20% interest to each of his five children would permitted a minority discount in valuing those shares)
- "Modify Rules on Valuation Discounts" in Obama Administration budget proposals (aka "Greenbooks") for several years, with no law passed
- Proposed regulations were expected by 9/18/15, delayed.

Discounts

- The Conference Report to Chapter 14 (H.R. Conf. Rep.101-964 (1990)) is instructive
  - The government acknowledged that Code § 2704(b) was not intended to affect minority and lack of marketability discounts

"The conference agreement modifies the provision in the Senate amendment regarding the effect of certain restrictions and lapsing rights upon the value of an interest in a partnership or corporation. These rules are intended to prevent results similar to that of Estate of Harrison v. Commissioner, 52 T.CM. (CCH) 1306 (1987). These rules do not affect minority or other discounts available under present law."

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Highlights of the Proposed Regulations and the Heated Debate Over How Broad (or Narrow) They Are

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The Newly Proposed Treasury Regulations

- Section 25.2701-2 (expansion and clarification of definition of controlled entity, not the most groundbreaking change)
- Section 25.2704-1 (lapse of certain rights, includes 3 yr rule)
- Section 25.2704-2 (transfers subject to applicable restrictions)
- Section 25.2704-3 (transfers subject to disregarded restrictions – the most controversial and confusing) – all the others are amendments, this one is completely new
- Section 25.2704-4 (effective date)

These are uploaded as downloadable handout – pages 1-22 of pdf are the preamble, pages 23-50 are the proposed changes. I highlighted portions that will be discussed today and will reference page numbers of these (more readable than slides).

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Who Wins and Who Loses if Proposed Regulations Become Law

Who is potentially negatively impacted? Anyone with a taxable estate ($5.45 /$10.9 million married, increasing to $5.49/$10.98 million in 2017), who owns a business entity or arrangement, which the family could control if aggregated together (*control* meaning 50% or more).

Who Wins? Potentially, anyone with a *non*-taxable estate with affected business entities (since they may *benefit* from higher valuations, which would increase basis - but this is very uncertain, especially for non taxable estates – see Morrow article). *Indirectly*: valuation, law and accounting firms, maybe even life insurers to cover a three year lookback!

Who is unaffected? Those who do not own closely held business interests nor would ever establish one, or those families with non-controlling (<50%) interests in a closely held business (aggregated).

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Prop. Reg. §25.2701-2: Clarifying Application to Various Entities

- Addresses what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership, or limited partnership and clarifies what entities the regulations apply to.

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Prop. Reg. §25.2704-1: New "Assignee" and "Three Year Rule"

- Prop. Reg. §25.2704-1 "Lapse of Certain Rights" (Discussion in preamble at p. 3-5, page 26-28 of the pdf file containing regs, page 29-30 for Examples) first clarifies the scope of affected entities and application to assignees (e.g. if I transfer LLC interest but donee is mere assignee, it's a lapse), but (c) is the most far reaching – it is clarifying and creating a bright line test in lieu of the *Murphy* case (which denied discounts where owner of 51.41% of business gifted 1.76% 18 days before death), and superseding Rev. Rul. 93-12 (where IRS permitted non-aggregated minority interest discounts where donor gifted five 20% shares of business) for transfers within 3 years.

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Three Year Rule – Prop. Treas. Reg. §25.2704-1(c)

- The proposed regulations would create a valuation penalty for transfers occurring within three years before the transferor's death if the entity is controlled by the transferor and members of the transferor's family immediately before and after the lapse. They "*apply to transfers of property**** *occurring on or after* [date regulations are final]"
- Is the "transfer" the original transfer or the deemed lapse/gift at death? E.g. if owner gifts shares in 2016 but dies in 2018, assuming this is after similar regs are made final, when is the "transfer"?

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Three Year Rule – Prop. Treas. Reg. §25.2704-1(c)

- *This could affect transfers made pre-final regulation if the transferor dies within three years.* Treasury will very likely clarify this and may ultimately resolve the uncertainty with a more taxpayer-favorable interpretation. Nonetheless, **we have to warn clients of "clawback" possibility, even if regs take 2 years to finalize.**
- WORSE: it may lead to phantom inclusion that does NOT qualify for the marital deduction (there is a *marital deduction valuation symmetry* in proposed §2704(b) regulations (see highlighted portion of preamble on page 20 of pdf and §25.2704-3(g) Ex 4, but this is ***not*** mentioned anywhere in §25.2704-1.

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Three Year Rule – Prop. Treas. Reg. §25.2704-1(c)

- Calculating the value of the lapse under the three year rule is uncertain. The regulations state that the value is calculated by comparing the value of the interests before and after the lapse (see current Reg. §25.2704-1(d)).
- But, is this at the time of the gift, or at the time of death when the deemed lapse occurs? I believe the latter.

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Three Year Rule – Prop. Treas. Reg. §25.2704-1(c)

- Practical example of what would change:

Dad Donor owns 100% of DonorCo, worth $10 million. He gifts three 20% full membership/voting shares to his children. *Let's assume for now that 2704(b) does not apply*– at 30% discount this is a $4.2 million gift. If Dad Donor dies two years later, the proposed regulation would cause a taxable lapse of Dad's previously held right to redeem/liquidate DonorCo, the value of which would be added to Dad Donor's estate. Let's say in 2 years DonorCo is now worth **$11** million. So, Dad Donor's 40% share that might have been $3.08 million discounted will now have §2704(a) additional inclusion of $1.32 million for a total of $4.4 million. However, if Dad Donor leaves this to his wife, the *marital deduction may only be $3.08 million.* Basis to wife?

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Three Year Rule – Prop. Treas. Reg. §25.2704-1(c)

But wait, there's more – it's not just the value of the retained portion of the stock that is increased!

- What about the value of the three gifts of 20% of DonorCo two years earlier? The value of the inclusion would be calculated by comparing the value at the time of death with or without the lapsed control. This may cause more inclusion than the prior discount! For example, in our previous slide, gifts were 3x$1.4 million=$4.2 million. But the proposed §2704(a) inclusion would likely be based on the value 2 years after the gift, at death -10% higher. Not $6 million minus $4.2 million (the $1.8 million "discount" valued two years earlier at time of gift), but $6.6 million minus $4.62 million (amounts two years later at death)=$1.98 million. In other words, you don't get the two years growth removed from the estate either (at least, not all of it)!

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Three Year Rule – Authority???

- Unlike the three year rule in IRC § 2035, which Congress added specifically by statute, there is nothing in §2704(a) remotely hinting at any three year rule, and unlike 2704(b), there is no specific statutory delegation on this point.
- Maybe a three year rule is reasonable to prevent abuse, but shouldn't this be Congress?
- Is this creation of a bright line 3 year rule out of thin air within the Treasury's power to ***interpret*** the statute? Note, it does not create a rebuttable presumption but it is a bright line test that could apply to a healthy 40 year old who dies unexpectedly within three years exactly the same as transfers by a 95 year old.

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Effect of 2704 Application on Income Tax Cost Basis

- It is unclear whether any increased valuation resulting from §2704 or the proposed regulations leads to an increased income tax basis pursuant to §1014, because the statute and regs specifically limit application "for purposes of this subtitle", which is estate, gift and GST tax, ***not*** income tax.
- See attached LISI article. Estates that are *required* to file estate tax returns pursuant to Section 6018 (which would be most of the people we are trying to actively do estate tax planning for) have a good argument that basis should symmetrically follow estate tax valuations. However, even this is uncertain for "phantom" inclusions (e.g., in our prior example, the amount added to the three 20% gifts, not the 40% retained, which is clearer) – the basis could be reduced by depreciation taken post-transfer per §1014(b)(9)

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Prop. Treas. Reg. 25.2704-2 and Applicable Restrictions: Attacking State Laws Causing Higher Discounts by Prohibiting Withdrawal

- Section 25.2704-2(b) provides, in part, that an applicable restriction "is a limitation on the ability to liquidate the entity (in whole or in part) 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."
- This regulation amends §25.2704-2 to refine the definition of the term "applicable restriction" by eliminating the comparison to the liquidation limitations of state law (sorry Nevada!), if there are comparable state law alternatives that would not have such limitations – see highlighted portion on page 33 of pdf.

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Prop Reg. §25.2704-3: "Disregarded Restrictions"

- In explaining the three year rule, we assumed that the traditional discounts were still in place. In explaining the three year rule, the §25.2704-1 regulations do not mention any application of §2704(b) or proposed §25.2704-3 in the examples to such transfers in the first place.
- Back to our earlier example, if I gift three 20% interests and retain 40%, are these three gifts entitled to the same discounts as previously in most cases, **or** do the proposed §25.2704-3 regulations only apply to a narrow subset of restrictions and less common situations? This is the big debate. If discounts are mostly removed by 2704(b) anyway, then the proposed three year rule is close to meaningless.
- I will refer to the two interpretations as "weak" (not having much valuation effect at all) or "strong" (profound effect).

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"Disregarded Restrictions" in §25.2704-3 – the Debate

- Does this, as some argue, create a minimum value, a "put right"? This "strong" interpretation would ***effectively eliminate*** most of a discount for lack of marketability or lack of control, because someone would be deemed to have access to the underlying assets for valuation (with a mere 6 month delay). This interpretation has caused the huge uproar in the business owner community, and has been widely disseminated by many noted experts.
- Or, is 2704-3 just an awkwardly worded and confusing provision that has very little effect on traditional discounts at all? Informal comments by Treasury officials are indicating this is the more likely interpretation that should be clarified upon finalization.
- If this "weak" version holds, §25.2704-3 is a big yawn.

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"Disregarded Restrictions" in §25.2704-3 – the Debate

Prop. Reg. §25.2704-3 "The term disregarded restriction **means a restriction that is a limitation on the ability to redeem or liquidate *an interest* in an entity** that is described in any one or more of paragraphs b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to paragraph (b)(4) of this section), either alone or collectively."

If you stop reading here, you see why the effect may be mild – if you don't restrict someone from selling their interest, no big deal, this is not triggered, keep your discounts. What has unfortunately led to the confusion is how Treasury described the restrictions in paragraphs i-iv.

See p. 16 of pdf for preamble's discussion, p. 36 for reg's definition.

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"Disregarded Restrictions" in §25.2704-3 – the Debate

(i-iv), on page 36-37 of the uploaded pdf, are too long to paste in a slide, but summarized, includes provisions that:

i) limit the ability to sell (easy to understand)
ii) limit the ability to sell for less than a "minimum value" (OK, sounds easy, just avoid adding any such restriction, but it is very convoluted the way they word it because they imply there is a minimum value of the interest based on pro rata value of the entity)
iii) limit the ability to get payment for more than 6 months
iv) limit the ability to get cash/property for interest (no notes)

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"Disregarded Restrictions" in §25.2704-3 – the Debate

Ed's take: the restrictions that are disregarded only pertain to the ability to redeem or liquidate an interest in an entity, *not* the ability to liquidate the entity itself. In a typical situation, you do not limit or prevent an owner from: i) selling; ii) selling for more than $X; iii) getting paid immediately; or (iv) getting cash/property for sale.

The examples in the regulations imply that the same discounts apply, except for the effect of disregarding the specific provision, valued under "generally accepted valuation principles" (e.g. in Ex. 1-5 on page 44-46 of the attached regs, the 33% share is still valued as a 33% share, but just with the right to sell it on open market. **If they had meant to force valuation based on put right, wouldn't they simply say *directly* that the 33% is valued at "minimum value" in the examples?)**

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"Disregarded Restrictions" in §25.2704-3 – the Debate

Here are examples of provisions that might still be disregarded for valuation, even under the "weak" interpretation of the regs (i.e. no big effect):

- prohibition on withdrawal (obvious from examples);
- party receives or can only receive assignee interest (also covered in §25.2704-1), or
- the right of first refusal allows the company to purchase but only pay with issuance of a note.

Treasury could have avoided a lot of controversy with clearer examples! The key question: if a party cannot withdrawal and demand pro rata purchase, yet can sell interest on open market, is the inability to instantly redeem for "minimum value" a "disregarded restriction" (aka "strong interpretation")?

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"Disregarded Restrictions" in §25.2704-3 – the Debate

Argument for the 6 month put right ("strong" interpretation): What if documents are merely *silent* on restrictions (in some cases you may not even HAVE an operating agreement)? For instance, a document might restrict an owner from having the ability to withdrawal and be paid for the interest, or dissolve the company and receive a pro rata share, but these are usually baked into state law without needing to be drafted into an operating agreement. Are the *lack of such powers* "disregarded restrictions"? Is the fact that state law or document does not grant liquidation or dissolution rights a "limitation on the ability of the holder of the interest to compel liquidation or redemption of the interest"?

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"Disregarded Restrictions" in §25.2704-3 – the Debate

Would Treasury go to all the trouble of the regulations to merely bite at the periphery attacking only extreme state law effects or outright prohibitions on sale or withdrawal that are not often used?

Perhaps. "The term disregarded restriction **means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity"** – this phrase should not be interpreted to ***impose a right*** to redeem or liquidate an interest in an entity for a minimum amount.

That said, *many more distinguished practitioners than I* think otherwise, so I'm going to warn clients anyway until clarified.

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"Disregarded Restrictions" in 25.2704-3 – if the "strong" interpretation applies

Obviously the "strong" interpretation of 2704-3 would have extremely profound valuation effects!
The "minimum value" is the net value of the entity multiplied by the interest's share of the entity. (see page 17 (preamble), page 36 of handout).
The "put right" is a right, enforceable under applicable local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption (page 42 of handout)

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Contrasting Effect - Related and Unrelated Parties

Example: Francis, Tim and Jeff own an LLC worth $12 million. *They are **unrelated.** Their 1/3 share should still be valued under the old "fair market value" principles for gift/estate tax – perhaps a 20-40% discount- perhaps $ 3 million value.*

However, if a funded buy-sell agreement formula mandates the buyout of a deceased owner for a pro rata value of $4 million (not uncommon for unrelated parties), it would be valued at $4 million regardless.

Beware: if Jeff retires or dies and Francis and Tim buy him out (regardless of whether it is for $3 million or $4 million), ***2704 may now be triggered*** because they own 50% (again, the remaining "discount" after §25.2704-3 application is unclear, but the three year rule application could still be quite impactful)

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Contrasting Discount - Related and Unrelated Parties

Contrast, if Francis, Tim and Jeff in our prior hypothetical were **brothers,** each of their interests ***may be*** valued closer to $4 million for estate tax purposes under the proposed regulations, even if there is no buy sell agreement, even if they hate each other and always litigate, even if the widow/estate of owner is later bought out for **$3 million!** (again, this effect is debated)

In most families, siblings control each other as much as we control the wind, moon and tides, yet the IRS may attribute collusion regardless. Similarly, 50% ownership of a company is hardly control, yet the regulations force higher valuation, especially if three year rule to apply (e.g. if 51% owner gifts 2% and retains 49%).

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Contrasting Discount for Non-Entities, Tenancies in Common

Example: Francis, Tim and Jeff are brothers and own real estate or artwork ***as tenants-in-common*** worth $12 million. Their 1/3 interest should still be valued under the old "fair market value" principles for gift/estate tax – perhaps a 15-30% discount (less "discount" typically than an LLC/LP)- perhaps $ 3.2 million value, unaffected by the proposed regulations. The new regulations only affect *entities.*

However, except for the rare case of siblings inheriting property from a parent, most people will co-own real estate through a limited liability entity for superior ease of transfer and asset protection. But, consider, what about Francis, Tim and Jeff contributing their 1/3 tenancy in common to their own ***three separate LLCs?*** *Potential IRS attack: depending on the level of cooperation and coordination, the IRS might find such joint ventures/TICs to be de facto partnerships for tax purposes. See Rev. Proc. 2002-22 for discussion. While tenancy in common agreements are recommended, a restriction on partition may be disregarded. IRC §2703*

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Effective Dates

- Some of the regulations become effective upon Immediately after the regulations are published as final, but the most substantial and far-reaching rules will not take effect until 30 days after that. Prop. Reg. §25.2704-4 (page 49-50 of pdf). They could be made final in December, January, or likely months later (it could take years). The important point is that we have ***time*** to plan.
- There is a strong possibility that regulations may be modified or even overturned (more likely if the "strong" 6 month put right interpretation applies), but it may take years – safest to plan for the worst.

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Planning Opportunities and Strategies

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Planning Opportunities that Will *Remain* Effective

- Short Term GRATs often use non-family entities for funding anyway (because distributing in kind with a discount going out as necessary for 2-3 year GRAT removes most benefit of discount anyway) - these will not be affected
- Even if the proposed regulations are made final (and the more stringent "deemed 6 month put" interpretation valid), many gifting strategies will still be highly effective and continue to be used, especially over the longer term, because grantor trust status permits tax-free gift by paying the tax, and growth is still outside of estate. **Over time, these two factors dwarf the value of the discount.**
- Volatile assets may be well suited to GRATs, whereas more stable ones to IGTs, since GRATs do not waste any seed gift if the value of the asset decreases. GRATs can adapt to increased valuation uncertainty!

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Old Buy-Sell Agreements – a *Ticking Time Bomb?*

- If the estate tax value increases due to §2704, is the buy-sell agreement buyout tied to that number in any way?
- If it is not, should it be (if so, when)? Phantom estate value occurs if $X is in estate, but estate receives $.64X (non-family buy-sells usually do not discount).
- There is no obvious answer, it depends on the situation, but parties should make sure they agree on result - the three year rule may create the nastiest valuation difference
- The difference between estate tax value and "fair market value" could be significant and may lead to expensive non-tax litigation!
- Buy-sells where other family members are or may become owners should be reexamined. Buy-sells with non-related parties are not as likely to be affected, but verify.

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Other Factors Impacting the Decision to Plan in 2016

- The election – Secretary Clinton has proposed estate/gift tax changes that would decrease the estate/gift tax exclusion from $5.45 million (current) to $3.5 million, and increase the gift/estate tax rates from 40% to 45%, with 50% rate > $10 million, 55% rate >$55 million, 65% rate bracket for estates > $500 million
- Current historically low applicable federal rates – August 2016 is only 0.56% (short term), 1.18% (mid-term) and 1.9% (long-term) – 7520 rate only 1.4% - these favor techniques that include loans
- Many taxpayers made large gifts in 2012 before the "cliff" and the *statute of limitations on the gift tax return has safely passed*, giving them more comfort level to make additional gifts

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Tax Apportionment Traps; Adapting to Three Year Rule

- Tom Clancy's estate just had a nasty estate tax apportionment battle causing years of litigation (see short article posted on LinkedIn by Ed Morrow)
- The "phantom inclusion" of §2704, especially more likely for gifts within three years of death, could cause nasty tax apportionment battles – if I get stock worth $X, but the estate has to pay combined state and federal tax of 50% on a higher value of $1.5X, who pays the additional tax cost? If there is only one residuary beneficiary, that's easy, but many estates with business interests will have specific bequests and blended families.

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