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<u>*Business Valuation*</u>

<u>UNDERSTANDING THE IRS ASSAULT ON DISCOUNTS</u>

On August 2 the IRS released proposed regulations under Code Section 2704 to limit or deny the application of valuation discounts of minority interests in a wide variety of situations involving family members in family-owned or family-controlled entities. This has triggered a lot of recent commentary; mostly summaries of the proposed regs by various professionals with the conclusion something like … *the sky is falling, so you better do something by December 1*. (Actually, there is only a public hearing in Washington on December 1, and new government regs typically move very slowly). The American Society of Appraisers and the American Institute of Certified Public Accountants, among other organizations, are mobilizing task forces to respond to these proposed changes.

Calm down. Most of ink in the proposed regulations deals with real abuse situations – deathbed gifts, pseudo appraisers opining 50% discounts, clear tax avoidance situations, and unrealistic restrictions on transfers. The one-time exemption for value passing from any individual is $5.45 million, with a portability of spouses suggesting that up to $10.9 million can be passed to second (or third) generations without Federal taxes. (In Indiana the estate tax was repealed for individuals dying after December 31, 2012). So, if you are rich, then worry because the estate tax bite is often 40% of the fair market value <u>above</u> your $5.45 million (or $10.9 million). If you are only moderately rich (or less rich), this hoopla probably doesn't apply to you.

The IRS distaste and loss of patience for pure estate planning abuse has been around for decades, regularly arising in Greenbook proposals presented annually to Congress by the President. Yes, there are abusive situations, and the new regulations correctly call out these attempts of the unwary and sloppy transfers with only tax avoidance intentions and no clear business purpose. For example … *let's create a new limited partnership entity, fund it with $10 million in cash and securities, and write a restriction in the partnership agreement that limited partners cannot sell their equity without the approval of the controlling general partner! Better yet, let's restrict the limited partner to only being able to sell the equity after 99 years!* Much of the proposed regulations deal with these types of silly situations. The appropriate judgement usually allows the hypothetical buyer to be viewed as an assignee, with full benefit of the economic rights.

Unfortunately, the proposed regulations don't clearly distinguish between holding companies and operating companies with passive or active interests, where there is clearly a market basis for discounts. Even the IRS in Revenue Rulings 59-60 and 93-12 acknowledge the market reasonability of a haircut in pro-rata value of a minority interest within the definition of "fair market value." If you offer a 100% interest in a company for sale on the street corner, you may get, say, $100 as the highest and best price from among the throng of bidders. A 20% interest in the same company at the same time will not fetch $20, but something less because by owning this interest one cannot make policy, decide to liquidate, appoint management, and a whole host of other privileges that a *controlling owner* would have. The minority, fractional interest is also less desirable and harder to sell. Sometimes stock <u>in public corporations</u> sells for less than pro-rata book value, such as seen in the banking industry during the prior recession. So, does it follow that a minority interest owner can "put" or sell the interest to a fully-knowledgeable hypothetical buyer, not being under compulsion, for a "minimum" pro-rata book value? What is the difference between a fully family controlled business and one with shared control (e.g., 50% co-ownership) with outsiders? Who is family? These situations require more thinking and judgment with real life comparative evidence rather than formula regulations.

In these situations there is little chance of a binary outcome that *either* the proposed regulations will be adopted, *or* the regulations will go away. The most important component is business purpose of the entity in question. If the FLP or LLC or other corporate wrapper has only tax avoidance at its heart, be prepared for increased IRS scrutiny and challenge. If a transfer occurred changing the decedent's ownership from majority to a minority position within three years prior to death, the proposed regs outline a claw-back provision that would keep the value of a decedent's estate at a control level. Even older entities with careless discounted gifts made in the past with IRS acquiescence could come to haunt heirs by being ripped back into the estate after a triggering event (such as the death of the original donor). Manage your existing holding companies like a business, with proper risk sharing, asset oversight, economies of scale, and clear actions by the Board of Directors and management to respond to changing economic opportunities.

Trillions of dollars will pass from boomers to millennials over the next ten years. The IRS is putting wealthy Americans on notice that simple and stupid abuses will be challenged. Work with your attorney and advisor on these matters. Yet, don't behave like Chicken Little … there is a lot more to come.

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