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# IRS Issues Proposed Regulations That Restrict Marketability and Control Discounts


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The IRS issued long-anticipated Proposed Regulations on Aug. 4, 2016, that are aimed at restricting discounts for lack of marketability and lack of control on estate and gift-related transfers of ownership interests. A hearing is scheduled in Washington, DC, on Dec. 1, and some believe there is a possibility the regulations could become effective soon after that date. Due to an understanding that the Obama Administration has targeted this area for changes and given the upcoming change in the White House, it is possible these regulations may get "fast-tracked."

Comments are due on or before Nov. 2, and the AICPA has a task force assembled to provide a detailed response. This task force has broad representation from the tax and valuation sections, including the two authors of this article. Comments are also being developed by other appraisal organizations, including the American Society of Appraisers and the National Association of Certified Valuators and Analysts. Key family business advocates strongly oppose the Proposed Regulations.

What does this all mean for business appraisers? If the Proposed Regulations are implemented as written and without successful injunctive challenges, the valuation community will be critically affected due to the restrictive ability to apply discounts on traditional estate planning structures. Major areas of change affecting business appraisers include the following:

- **Redefining fair market value —** The Treasury definition of fair market value on which business appraisers have always relied assumes both a hypothetical willing buyer and seller, dealing at arm's length (Regulation Section 20.2031-1[b]). The effect of the Proposed Regulations is to replace these key elements because there would no longer be a presumption of an arm's length transaction between such assumed parties. The Proposed Regulations essentially require the business appraiser to ignore governing documents and local law when certain restrictions on liquidation rights exist for business interests in family-owned entities. Business appraisers, therefore, will be forced to make hypothetical assumptions that are contrary to fact or unlikely to occur. In addition, the Proposed Regulations introduce the new term "minimum value," which includes limitations on debt deductions under Section 2053 that business appraisers will have to either make determinations on themselves or seek guidance from a tax specialist.
- **Redefining family control —** Under the Proposed Regulations, all applicable family members, or any lineal descendants of the parents of the transferor or the transferor's spouse, fall under the definition of control. This lower threshold aggregates family members who have not historically been included in family attribution considerations. Under the proposal, a 50% ownership interest or a general partner position could constitute control, even if the overall equity in the enterprise is small. In addition, the Proposed Regulations provide stringent requirements before ownership interests held by unrelated third parties become relevant to the analyses. An unrelated equity holder must have at least 10% interest, the aggregate interests of all third parties must be at least 20%, and those interests have to have been held for three years in order to be considered.

This aspect was the focus of a large amount of contested estate and gift matters in the 1970s and '80s and resulted in the IRS acquiescing with the issuance of Revenue Ruling 93-12, which, simply put, does not allow family attribution to be considered for tax-related matters. A bit more background on this history is informative with regard to this aspect of what is being proposed in the new regulations.

In Jan. 1993, the IRS issued Revenue Ruling 93-12, holding that a sole stockholder of a corporation who gave a 20% interest to each of his five children would not be denied a minority discount in valuing those shares solely due to the factor of corporate control in the family. This ruling represented a retreat from the IRS's previous position and created a significant window of opportunity for small business owners seeking to pass their businesses to their designated successors while minimizing transfer tax consequences. In effect, under Revenue Ruling 93-12, a controlling shareholder who chooses to give away minority ownership interests in a family-owned business can claim the total of his or her values is less than the value of the control block for transfer tax purposes. Also, the estate of a shareholder who dies owning a minority interest can obtain a minority discount for that interest, notwithstanding the fact that the decedent's estate and family members together may own a controlling interest.

Understanding the ruling requires understanding how the IRS values closely held shares in order to apply transfer tax. To calculate transfer gift taxes, the IRS taxes gifts based on their value on the date of the transfer. For estate tax purposes, stock is valued the moment of the decedent's death. When there are no sales prices or bonafide bid and asked prices for stock, the IRS had previously considered the degree of control represented by the block of stock to be valued; this is among those factors that must be considered.

In Revenue Ruling 81-253, the IRS took the position that when the stock owned by the family unit constituted a controlling interest, no minority discount would generally be available for intra-familial transfers of blocks constituting less than a controlling interest. The ruling did leave open the possibility that family attribution would not be applied when there was evidence of discord within the family unit that would suggest that the stockholders would not act cohesively in controlling the corporation. The ruling specifically rejected, among other cases, a 1981 Fifth Circuit case, *Estate of Bright v. Commissioner*, 658 F.2d 999, (5th Cir. 1981), in which a minority discount was allowed in an estate tax context. The IRS's position subsequently fared poorly in court, and it is the Estate of Bright case that the IRS ultimately cited again when it abandoned its former position in issuing Revenue Ruling 93-12, which is now essentially contradicted with the Proposed Regulations.

- **Redefining marketability —** The Proposed Regulations include what appears to be a mandatory put right. Under the proposal, the right to liquidate any interests in six months will be imputed even if the right to liquidate does not exist and never will exist. Furthermore, the liquidation must be in cash or other property with a value that is at least equal to the minimum value of the interest, or both, and cannot include a note or other obligation issued directly or indirectly by the entity or by one or more holders of interests. Business appraisers will likely need to consider alternative methods for determining lack of marketability discounts, such as comparable put right methods.
- **The 3-year rule —** The Proposed Regulations include a bright-line three-year test, which would require recapture in the transferor's estate of the value of a lapse right that gave rise to discounts, if the transferor dies within three years of the transfer. It is unclear when this three-year test would begin, but it appears transfers occurring prior to implementation of the Proposed Regulations may be tainted upon the death of the transferor after the effective date of the Proposed Regulations but within three years of the original transfer. If correct, this would apply the restrictions of the Proposed Regulations retroactively and to transfers occurring before these new rules were drafted. For business appraisers, this means different valuations and even different methodologies (control vs. minority-based) may be required for assets affected by the proposed rules, depending upon whether the asset was transferred to family donees or heirs, third parties (non-family members) or charities. Different valuations may also be needed for income tax or employee stock ownership plan purposes because the definition of fair market value may now differ from those related to gift and estate transfers.

## ON THE BRIGHT SIDE

On Sept. 15, Congressman Jim Sensenbrenner (R-WI) introduced legislation (H.R. 6042), and on Sept. 21, Congressman Warren Davidson (R-OH) introduced a similar bill (H.R. 6100) that would block the IRS from implementing the Proposed Regulations. Both Congressmen called them unnecessary and burdensome on family-owned businesses due to the elimination of valuation discounts, forcing many family-owned businesses to be sold. Both noted the regulations would be particularly damaging to family-owned farms, many of which often have large assets due to land holdings, but maintain relatively modest incomes. According to Sensenbrenner:

> *"The IRS should not be in the business of making it difficult for family-owned businesses to keep their doors open, especially during a difficult time such as the loss of a loved one. At a time when the economic outlook is precarious and full of uncertainty, it's critical we do everything we can to keep our nation's small and family-owned businesses well and flourishing."*

## WHAT'S NEXT?

The AICPA task force is working diligently to compile a response from the tax and valuation perspective and expects to provide testimony at the Dec. 1 public hearing. Depending on what happens with the regulations, the AICPA task force will likely consider legislative recommendations as well. The Forensic & Valuation Services Section will continue to keep members updated as things progress, and additional insight will be provided in a session at the AICPA Forensic & Valuation Services Conference in Nashville, TN, from Nov. 6–8.

The authors suggest an active campaign to engage our elected officials and small business clients. It is clear that the community of closely held family businesses will be harmed by these proposed regulations due to the increased burdens associated with the orderly succession of the enterprise. The Family Business Coalition is against the proposed regulations, and we understand that other organizations focused on the well-being and support of family-owned enterprises are also coming out against these rules. The authors advocate a vigorous campaign to reach out to members of both the U.S. Senate and House and, in particular, members of the Senate Finance Committee and House Ways and Means Committee, to voice opposition to the Proposed Regulations in the current form.

To date, the following legislation has been introduced to prevent the Proposed Regulations from taking effect:

- H.R. 6042 — Sponsored by Rep. James Sensenbrenner (R-WI)
- H.R. 6100 — Sponsored by Rep. Warren Davidson (R-OH)
- S. 3436 — Sponsored by Sen. Marco Rubio (R-FL)

The proposed regulations can be found in their entirety at regulations.gov/document?D=IRS_FRDOC_0001-1487


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