

Treasury Prompts Planning Opportunity for Families

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How do the recently released Proposed Regulations for §2704 impact you?

The past month has brought about a number of concerns from those in the estate planning world after the Treasury Department released new proposed regulations for Section 2704 of the Internal Revenue Code. These regulations seek to limit discounts commonly applied to transfers of family controlled, entity interests (including corporations, limited partnerships and LLCs). The use of such discounts has given tremendous leverage to the value of assets transferred for estate planning purposes. For example, a transfer of a family limited partnership interest from a parent to a child may have received a 40% combined discount (including the lack of marketability discount and the lack of control discount). Gifting such interests could have theoretically increased the lifetime exemption amount for a married couple from \$10,900,000 to over \$18,000,000! Said differently, an estate could pass along nearly 8 years of organic growth *today* (assuming a 7% annual rate of return) without using the lifetime exclusion amount for transfer purposes all because of the power of the discounts applied.

The proposed §2704 regulations would significantly restrict the use of popular discounts but should not eliminate them entirely. There are many questions outstanding regarding the application of the proposed regulations and how future federal/state/local law could impact their application. Further, the time table to complete planning prior to possible enactment remains a question mark. Within the first month of releasing the proposed regulations, 30 comments had already been submitted to Treasury for consideration and there are still nearly two months remaining for industry organizations or other professionals to make comments. If history is a guide, enactment would not likely occur before the first quarter of 2017. However, we cannot ignore that the election cycle could impact this timeline. We encourage any families who may be considering intra-family transfers (or who have recently completed such transfers) to set up meetings with their tax advisory teams between now and the end of the year to discuss how the proposed regulations may impact their specific circumstances. The proposed regulations are not retroactive but there are provisions that could impact the discount applied to a completed transfer if the transferor dies within three years of the gift.

For those of you who are interested, we will outline the proposed regulations and possible implications in more detail below. For those of you who have had enough tax talk for one day but feel that you may be impacted by the new regulations, please do not hesitate to contact members of your client team who can help arrange a discussion among your trusted tax advisors.

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History of §2704

§2704 was enacted in 1990 to curb excessive valuation discounts taken when determining estate and gift tax value of intra-family holdings of partnership interests or corporate stock.

- §2704(a) “Treatment of Lapsed Voting or Liquidation Rights”: states that a transfer has occurred if there is a lapse of voting or liquidation rights if a family controls the entity before and after the lapse. Control is important here. This section is only applicable if the family owns more than 50% of the value of the corporate stock/capital of the partnership or has 50% of the voting rights/GP of the limited partnership.
- §2704(b) “Certain Restrictions on Liquidation Disregarded”: disregards “applicable restrictions” (defined as restrictions that can be removed or lapse post transfer) when calculating the tax value of the transfer assuming a family controls the entity before the transfer.

After President Obama’s first year in office, his proposed 2009 budget actually placed further limitations on intra-family transfers similar to the proposed regulations; however, the budget was not approved and the language was eventually removed in 2013. §2704 itself gives Treasury and IRS the power to expand the applicability of §2704 through proposed regulations which likely drove the rationale for removing the related changes from the President’s Budget which needed Congressional approval. Due to the scope of the changes discussed below, expect to see challenges questioning the Treasury’s ability to enact such changes.

In its current form §2704 still allowed practitioners to use discounts in the tax valuation of family controlled entity transfers because the minority interests gifted are able to be valued independently. The proposed regulations seek to limit various minority discounts including discounts for lack of control and lack of marketability.

First, a lack of control discount (DLOC) is based on the premise that an investor would pay less for a security that did not have the ability to influence major entity related functions (liquidation, management appointment, dividend declaration, acquisitions, recapitalizations) than a similar security who had those rights. A common lack of control discount applied to transfers could be 15% but as displayed in the table below, the ranges could indicate even higher discounts.

Next the lack of marketability discount (DLOM) applies to stock or interests that exist where there is no public market. Therefore, the holder of the asset is not able to easily liquidate the position and would likely sell it at a discount in order to complete a transaction. The marketability discount applied to transfers could be as high as 30-35%.

When the two discounts are combined (multiplied), a total discount not uncommonly seen for a minority interest, private transfer is approximately 40%.

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Interestingly, valuation experts at Ernst and Young point out that even publically traded funds often trade at discounts to fair market value (Net Asset Value). Therefore, the discounts in the private market may not be as aggressive as some argue especially if the underlying entity does not hold publically traded investments. See below from EY for empirical evidence that discount ranges appear to consistently be in the 20-35% range for illiquid underlying assets even in public markets:

DLOC: closed-end funds and real estate limited partnership (RELPs)

Measures the discount between the current price and current net asset value (NAV) of similar, publicly traded funds.

Type of fund	Average price/NAV	Average discount
Corporate bond closed-end fund	0.91	9.2%
Diversified equity closed-end fund	0.88	12.9%
RELP – Distributing (low or no debt)	0.82	17.6%
RELP – Distributing (moderate to high debt)	0.79	21.2%
RELP – Non-distributing	0.64	35.7%

DLOM: studies and quantitative models

Academic studies attempt to quantify discounts on sales of restricted shares.

Marketability studies	Date	Average discount
Various	1969-1997	15.0% - 35.0%

Quantitative models	Time	Average discount
Put options	2-5 years	10.0% - 35.0%

While some valuation discounts taken on intra-family transactions may have been too aggressive in the past, the proposed regulations, which basically eliminate control discounts, are not consistent with basic market behaviors observed in publically traded markets among unrelated parties. As seen in publically traded closed in funds, the discounts to NAV may be extreme depending on the underlying assets (i.e. – raw land) and the thought that a reasonable buyer would pay full market value for a fractional interest in such an entity is unlikely. Certainly, this point is likely to be raised during the public hearings in December.

Proposed Regulations and Possible Impact to Family Planning

Within the proposed regulations, the ability to take discounts for lack of control or lack of marketability could be eliminated when transfers fall under §2704(a). Specifically, the lapse of a liquidation or voting right would not qualify for a discount if specifically made as a deathbed transfer thereby reducing a controlling interest to a non-controlling one just before death. Further for completed transfers including those recently made, the liquidation value of the transfer could be included in the transferor's estate (basically the discount would be disregarded) if the transferor dies within three years of the gift assuming the regulations are finalized.

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Proposed regulations for §2704(b) become more complex as they seek to limit the restrictions commonly placed on transfers thus reducing the DLOC and DLOM that could apply to future transfers. The thought is that certain restrictions placed on interests/shares would minimize the value of that asset. The regulations further impose an assumed put right on the transferred interest which is generating a lot of discussion. A transferred interest under §2704(b) would be valued as if the interest had the right to force a sale/redemption back to the entity within six months after the right was exercised regardless of what is defined within the ownership agreement of the entity. This put option assumption will still likely allow planners to justify a lack of marketability discount, albeit at a significant reduction to current discounts. EY valuation experts estimate that this right could justify a 6% discount. The proposed regulations also highlight the transfer of an insubstantial interest of a family controlled entity to a nonfamily member. The Treasury believes that the inclusion of such nonfamily members should not allow a family to therefore reduce the transfer tax value of the remaining family held interests. Unless the nonfamily member interest is an “economically substantial and longstanding one that is likely to have a more substantive effect”, the inclusion of such an interest should not be considered for valuation purposes. The regulations outline specific ownership targets and holding periods for nonfamily member interests that must be met for the interests to be considered for valuation discounts.

Overall, the impact of the enacted regulations would require that transfers of family controlled interests be valued using a new form of market value which will likely increase the cost of valuation services as appraisers adjust their models to value a transferred asset using the net value of the entity, or the value of the assets held by the entity reduced by their liabilities multiplied by the percentage of the interest transferred.

Finally, it is important to note that the proposed regulations treat all family controlled entities the same and do not look through to underlying assets when determining transfer values. A portfolio of stocks held in a family limited partnership and an operating business held in a family limited partnership would essentially be treated the same from a valuation perspective if interests are transferred.

Effective Dates and Remaining Ambiguity

The proposed regulations released on August 2, 2016 are not retroactive as written. Further, the disregarded restrictions provisions would not be effective until 30 days after the regulations are finalized. The hearing date for the regulations is December 1, 2016. After the hearing date, regulations could be finalized as soon as the Treasury responds to the received comments and approvals take place to enact them. Again, enactment in the first quarter of 2017 is plausible.

In addition to remaining ambiguity surrounding the definition of the net value of an entity for future transfers, the impact state and local law may have on disregarded restrictions, the starting point for the 3-year look back to include liquidation value on completed transfers in the estate of the deceased, there are remaining questions about how the proposed regulations may impact other transfer planning

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techniques most notably transfers to Grantor Retained Annuity Trusts (GRATs) and sales to Intentionally Defective Grantor Trusts (IDGTs). Such transfers could be affected if the transfers for the annuity or note payments are made in kind and are still occurring after the effective date of the proposed regulations.

What Next?

We have only touched the surface of the many considerations that will go into analyzing personal facts and circumstances regarding future and recently completed transfers that fall under §2704. We can say that the proposed regulations will likely impact the cost of planning as complication has increased and they will certainly limit previously available discounts commonly used today for intra-family transfers. If enacted, the proposed regulations should motivate those considering a transfer strategy to meet with their team of advisors in the near term.

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Elizabeth Mackie is a Director and member of the Research Team at Edge Capital. Since joining Edge in 2007, she has been instrumental in working with some of our largest clients to build customized portfolio solutions, solve the unique challenges of multi-generational families, and build relationships with clients' trusted advisors. Elizabeth now focuses her time on building long-term client relationships as well as capital markets research, strategy due diligence, and idea generation that is implemented across Edge client portfolios.

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