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TYPES NOT MAPPED YET September 15, 2016 | TTR not mapped yet | Steve B. Gorin

Proposed changes to Section 2704 could spur tax increase for owners of closely held businesses

Controversial proposed regulations issued by the Treasury and the IRS on August 4, 2016, would change rules for valuing interests in business entities of which a person or a family owns at least one-half. The regulations would require using values for gift and estate tax purposes that ignore some of the parties' legal rights and liabilities. Thus, the regulations would inflate the value of business interests beyond their true values and constitute a back-door tax increase.

Background

For years, taxpayers have been placing nonbusiness assets in business entities. Because closely-held business entities are illiquid and owners of certain interests lack control, the ownership interests are often worth much less than a pro rata share of the entities' assets. The IRS has had only limited success trying to increase the value of closely held business interests to a pro rata share of the entities' assets.

Fourteen years after losing a case in which the court suggested that the government consider changing the regulations, the government took action. Most practitioners assumed that the regulations would attack entities specifically formed to hold nonbusiness assets. However, the proposed regulations apply to operating businesses as well.

They would ignore most restrictions limiting an owner's ability to cash out in six months or to cause the business to liquidate if and to the extent the owner or the owner's family could remove those restrictions. Furthermore, they do not distinguish between restrictions under the entity's governing documents and restrictions imposed by state law. They respect "a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity." However, the regulations would not allow consideration of contingent liabilities or draw a line between business risks that affect the business' going concern value and contingent liabilities.

Who will be affected?

Any person who owns, or whose family owns, at least half of the entity would be subject to these rules. The proposed regulations seem to imply that a person who owns (or whose family owns) at least half of the entity will have his or her business interest valued as if he or she could cash out.

The proposed regulations also includes in a decedent's estate any level of control, part or all of which was transferred within three years of death. However, the estate would not receive a marital or charitable deduction reflecting that level of control, because that level of control does not pass to the surviving spouse or charity.

The proposed regulations apply to restrictions created after October 8, 1990, occurring either the day after or at least 30 days after the proposed regulations are finalized, depending on the particular restriction. Written comments are due November 2, and on December 1 the government will hold a hearing, granting each speaker 10 minutes. Whether the government will finalize the regulations quickly or take its time is anybody's guess. Given that a political announcement accompanied the proposed regulations, the prospect of a change in Administration might affect the timing.

Action items to consider in consultation with a qualified attorney include:

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1. Consider making transfers before the proposed regulations become final. These transfers might be gifts, sales, or perhaps using other estate planning tools.

2. Review buy-sell agreements to consider whether any additional estate tax would apply under these rules and plan for who should pay that tax. Exercise caution in changing any provisions that existed on October 8, 1990.

3. When reviewing commercial loan agreements, carefully review any covenants that affect the owners' ability to cash out and document the extent to which these covenants require buy-sell provisions to prevent cashing out.

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