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Featured Article

Potential Changes in Valuation relative to Estate Tax

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According to the *Wall Street Journal* publication, the August 3, 2016 issue, the article titled, “U.S. Targets Tactic

to Avoid Estate Tax,” written by Richard Rubin, *Rules would limit practice of discounting value of stocks in family business*, the following is outlined:

1. The plan from the Treasury Department and Internal Revenue Service would place new limits on a common technique used to transfer interests in a family owned business and limit the potential of discounting value of stocks in family owned business.
2. The regulations address the practice of discounting the value of ownership stocks in a closely-held business or land. The discounts are permitted because some stocks are worth less since they are harder to sell or represent a minority interest.
3. Mark Mazur, the assistant secretary for tax policy said in a state-

ment, “Treasury’s action will significantly reduce the ability of these taxpayers and their estate to use such techniques.”

4. The government’s proposal would make it harder for taxpayers to claim valuation discounts typically used to reflect the diminished value of minority interests, according to Richard Dees of McDermott Will and Emery in Chicago.

5. Estate and gift tax apply at a top rate of 40%, above the \$5.45 million per person exclusion, meaning the estate tax affects about 0.2% of those who die each year. In 2014, about 5,200 estates filed taxable returns according to IRS data.

6. The Republican presidential candidate, Donald Trump, wants to eliminate the estate tax, while the Democratic presidential candidate, Hillary Clinton, says that she would make the estate tax apply to about twice as many people. She proposes returning to the law in effect in 2009, when there was an estate-tax exclusion of \$3.5 million per person, a \$1 million per person gift tax exemption and a 45% tax rate.

The following comments are taken from the proposed regulation by the Internal Revenue Service:

Summary of Proposed Regulation

1. The proposed regulations treat transfers occurring within three years of death and result in the lapse of a liquidation right as transfers occurring at death for purposes of Section 2704(a).

The proposed regulations disregard the interest held by a non-family member that has been held less than three years before the date of the transfer, and constitutes less than 10 percent of the value of all of the equity interests, when combined with the interests of other non-family members less than 20 percent of the value of all of the equity interests or lacks a right to put the interest to the entity and receive a minimum value.

2. The proposed regulations would clarify in 25.2704-1 through 25.274-3 that section 2704 applies to corporations, partnerships, LLCs and other entities and

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arrangements that are business entities. The proposed regulations would provide in cases where the business entity or arrangement is not a corporation, the form of the entity or arrangement would be determined under local law. Thus there would be three types of entities: corporations, partnerships (including limited partnerships) and other business entities (which would include LLCs that are not S corporations) as determined under local law.

3. The proposed regulations would further clarify that control of an LLC or of any other entity or arrangement not a corporation, partnership, or limited partnership would constitute the holding of at least 50 percent of either the capital or profit interests of the entity or arrangement or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement.

4. The proposal regulations also would revise 25.2704-2 (b) to provide an applicable restriction to include a limitation that is imposed under the terms of the governing documents as well as a restriction imposed under a local law regardless of whether or not it may be suspended by or pursuant to the governing documents or otherwise. In applying this particular exception to the definitions of an applicable restrictions, this proposed rule is intended to ensure that a restriction that is not imposed or required to be imposed by Federal or State law is disregarded without regard to its source.

5. The proposed regulation would explain that the terms “Federal”

and “State” infer only to the United States or any state including the District of Columbia but do not include any other jurisdiction.

6. If an applicable restriction is disregarded, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction does not exist (that is, as if the governing documents and the local law are silent on the question) and thus, there is deemed to be no such restriction on liquidation of the entity.

7. Under 25.2704-3 of the proposed regulations, in the case of a family-controlled entity, any restriction described below on a shareholder’s, partner’s member’s or other owner’s right to liquidate his or her interest in the entity will be disregarded, if the restriction will lapse at any time after the transfer, of if the transferor or the transferee and family members, without regard to certain interests held by non-family members, may remove or override the restrictions. Under the proposed regulations, such a disregarded restriction includes: (a) limiting the ability of the holder of the interest to liquidate the interest; (b) limiting the liquidation proceeds to an amount that is less than a minimum value; (c) deferring the payment of the liquidation proceeds for more than six months; or (d) permitting the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.

The minimum value of the interest is in the net value of the entity multiplied by the interest’s share of the entity. For this purpose, the

interest’s share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity.

8. If a restriction is disregarded under proposed 25.2704-3, the fair market value of the interest in the entity is determined assuming that the disregarded restriction did not exist, either in the governing documents or applicable law. Fair market value is determined under generally accepted valuation principles, including any appropriate discounts or premiums.

9. Section 2704 (b) does not apply to transfers to non-family members and has no application in valuing an interest passing to charity or to a person other than a family member.

The amendments to 25.2701-2, 25.2704-1 and 2 are proposed go into effective on and after the date of publication if the Treasury decided to adopt these rules as final regulation in the Federal Register section 25.2704-3 (proposed to be effective 30 days after published as final regulations in the Federal Register.) A public hearing on the proposed amendment is scheduled for December 1, 2016.

In summary, it appears that the proposed regulations will put a big damper on family limited partnerships and also on family owned and controlled entities. The IRS appears to be reversing RR 93-12 (attribution). The primary focus is on liquidation rights, a key factor in the magnitude of the discounts (LOC + LOM). The proposed regulations will not affect entities that are not family owned or controlled. □

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8/25-26/16 – Booth, Missouri Bar Annual Estate, Trust & Edler Law Institute, St. Louis, MO

9/14/16 – Luncheon Meeting – St. Louis Business Valuation Roundtable-“The Section 2704 Proposed Valuation Regulations,”—James G. Blase, Esq., Blase & Associates



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Please contact Mr. John A. Thomson, Secretary for the ASA Chapter of Los Angeles, for any questions at 562-437-6000.



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