BURR ALERT

August 2016

Family-Controlled Businesses -- Tax Targets Again:

Newly Proposed 2704 Regulations and Presidential Candidates' Positions

It's August of an election-year, and not just any election-year, a presidential election year. So, in less than 80 days, we'll all go to the polls and elect a new president. While Benjamin Franklin might have been right that nothing in life is more certain than death and taxes, long experience has taught us that even death and taxes change with time. For example, as medical science improves, our collective life expectancies get longer. Taxes, though, just seem to increase and become more complex whether the changes are initiated politically (following turnover in elected offices) or administratively (by the IRS). Both types of changes are being proposed this year and therefore, both deserve our attention. Especially since each of the proposed changes will have a significant impact on existing estate plans, so much so that many family businesses and their owners should already begin planning how they intend to react to such changes.

The Candidates' Positions On Estate Taxes. If the only difference between the candidates was their position on estate taxes, the weekly poll results might be different. Mr. Trump is clearly estate tax adverse. He has made it clear that he believes that all so-called "death taxes," including their cousin, the gift tax, should be eliminated. If adopted, Mr. Trump's proposal will put much more focus on income tax planning while simultaneously making the preparation of wills and other testamentary documents much simpler.

Mrs. Clinton, on the other hand, has indicated that she would like to see the estate and gift tax rates and exemptions rolled back to 2009 levels. According to her campaign, the estate tax rate should be increased from 40% to 45% and it should begin to apply to estates at $3.5 million, $7 million for a married couple. That is substantially less than the $10,900,000 allowed married couples under current law. Further complicating estate planning, Mrs. Clinton would also re-impose the $1 million limit on lifetime gifts.

While this is a presidential election, neither Mr. Trump nor Mrs. Clinton would be able to implement their preferred tax policy unless his/her party controls both the House and the Senate. While not impossible, most political pundits rate the likelihood of that occurring as very low. So, once again, taxpayers and their advisors are in the position of having to wait to see what compromises our newly elected officials might strike during the next four years in order to know for certain what tax rules are going to apply and for how long. As these two very different policies continue to battle, taxpayers are likely to again experience estate planning as more short-term than long-term, requiring every other year reviews and revisions.

Proposed Regulations Impact Transfers of Interests In Family Businesses. As important a voice as the next president will have in our national tax policy, we should not overlook that the tax administrator, the IRS, also has an important say in our tax rules and regulations (since the IRS writes them). For almost as long as I can remember, the IRS has fought how family businesses are valued for estate and gift tax purposes. Regrettably, the IRS' animosity against treating transfers of interests in family-controlled businesses in the same manner as transfers of business interests between unrelated parties was elevated to a new level earlier this month with the release of a new set of proposed regulations under Section 2704.

While there are many different aspects to these regulations, this introduction will only cover a few of the more important changes. But if you and/or your family own and control a business, whether it be an automobile dealership, a manufacturing concern, a logistics company, a professional practice or a retail establishment, these regulations will almost certainly impact the estate or gift tax value of any interest in the business being transferred between family members. Taxpayers owning investment holding companies, including real estate entities, should also expect that transfers of interests in those will be significantly impacted by these new rules.

How Important Are These Rules? When finalized, these new regulations will play a very important role in the cost of successfully transitioning the business from one generation to the next. Let's take an easy example. Doyle is a single individual who owns 1/3 of a family-controlled business. His sister, Libby, owns another 1/3, and their father's best salesmen each own 1/6th of the company. The *minimum value* (see discussion below) of Doyle's interest is $10 Million and, to make our math easy, he owns nothing else of significant value. If Doyle were to die today leaving his business interest to his only son, the estate tax due, after taking into account reasonably conservative minority interest and lack of marketability discounts (at 35%), is roughly $425,000. Now, if these new regulations were to apply to this transfer, the estate tax bill for Doyle's estate increases to $1,820,000, a jump of over 400%. If Mrs. Clinton's estate tax proposals are then included in the calculation (on top of the newly proposed regulations), the estate tax due at Doyle's death increases again, this time to just under $3 Million, an increase of almost 700% from the same calculation made under today's laws and an increase of more than 150% from the tax increase solely associated with the Section 2704 proposed regulations. Ultimately, the most important question for Doyle's son and the business is how will those taxes be paid?

A Small Window of Opportunity. These new IRS rules are only *proposed* regulations right now. They do not become effective until finalized by the IRS; an action which cannot occur until the close of the 90-day comment period, followed by a public hearing. Those two requirements make mid-to-late December the earliest that these regulations could be finalized. However, because the IRS and the Treasury Department almost always review and give serious consideration to suggestions for making proposed regulations less confusing and/or easier for taxpayers or the IRS to implement, it is more likely that these regulations will not become final until sometime during the first part of 2017. So, there is your planning window; it begins today and runs through the ultimate effective date.

There is, of course, a "but" that goes along with that estimate of time available to taxpayers to take action. The regulations are clear that in the case of any transfer of a family business interest before the *effective date*, where the transferor dies after the *effective date* but within 3 years of the initial transfer, the transferor will be required to report, on the transferor's estate tax return, the value of that transferred interest as if the new regulations had applied to the original transfer. Therefore, beware of making transfers without adequately analyzing the potential application of these new rules.

Since the window of opportunity for planning is only open until these regulations become final, wise business owners are already making arrangements to meet with their tax advisers to determine whether additional planning ought to be undertaken before 2016 comes to an end. Furthermore, most, if not all, Shareholder Agreements, Operating Agreements, Partnership Agreements and business succession plans for family-controlled businesses must be reviewed in light of these new valuation rules; few businesses and fewer families can afford to be taxed on a value greater what was actually paid for a business interest under an agreed buy-sell formula or the discounted value the family has been relying on from year-to-year. Finally, the liquidity of each owner's estate must be analyzed to ensure that the impact of these new valuation rules have been considered; can a 400% tax increase be paid?

What Do These Proposed Regulations Do? According to their preamble, these newly proposed regulations are intended to eliminate minority interest and lack of marketability discounts for transfers of interests in any entity which is family-controlled (a 50% or greater standard) and it certainly appears that most, but perhaps not all, of the discounts that have traditionally been available when an interest in a family business is transferred, whether during life or at death, will no longer be available once these regulations are finalized. The IRS generally went about accomplishing its stated goal by adding additional types of restrictions to the list of *applicable restrictions* which are to be disregarded when valuing a family business interest. Among others, those now-to-be disregarded restrictions include those which are imposed or are required to be imposed by State or Federal law ***unless*** the restriction is mandatory and cannot be overridden by the family and/or other parties in the entity's organizational documents.

Some of the other important aspects of the proposed regulations:

- Any limitation on the ability of the holder of the ***interest*** to liquidate the interest, not just the entity, but the interest, through a "put"-type of right also becomes a ***disregarded restriction***;
- Any provision reducing the liquidation value of the interest below a ***minimum value***, defined in the proposed regulations as a pro-rata share of the net value of the entity's assets less only those liabilities that would be deductible for federal estate tax purposes (which could have a larger than intended impact), becomes a ***disregarded restriction***; and
- Any payment obligation which exceeds 6 months or is not from an entity engaged in an active trade or business, is not adequately secured, does not bear market interest (note

here, market interest is required, and that is not the same as the ***applicable federal rate*** ("AFR") published by the IRS as the minimum required rate of interest), is not attributable to passive assets and has a FMV (when discounted to present value) equal to the liquidation proceeds, is likewise a problem.

Conclusion. One thing from these newly proposed regulations (and the political tax proposals) which is crystal clear, family-controlled businesses are again one of the prime targets for raising tax revenues to fund other government programs. Recognizing that fact now and updating or beginning to develop a plan for protecting your family's business are action items Burr strongly recommends be included as part of your September and/or October business plans.

If you would like more information on these newly proposed regulations or any other tax matter, please contact:

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