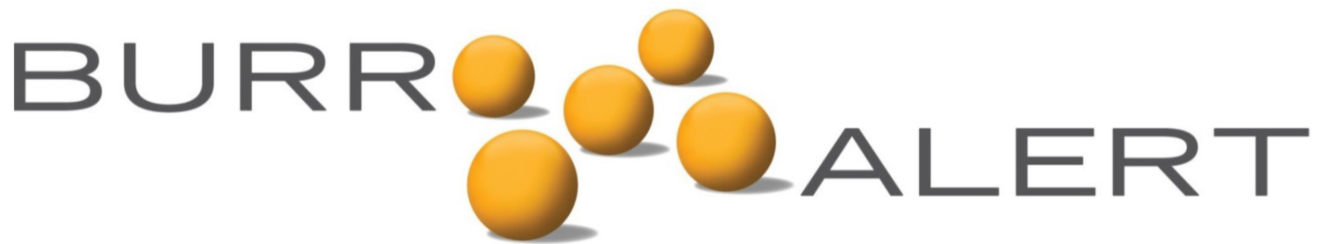

September 2016

It's Time For Your Buy-Sell Checkup!

*Shareholders, Partners and/or LLC members of any closely-held or family-held company should check the buy-sell formula contained in their Shareholder Agreement (sometimes called a Buy-Sell Agreement), Partnership Agreement or Operating Agreement to make sure that the formula still works for **all** of the owners following last month's release by the IRS of proposed regulations under Code §2704.*

By now, most owners of interests in family-controlled businesses have heard of or read about the regulations proposed by the IRS in early August specifically designed to reduce, if not completely eliminate, minority interest and lack of marketability discounts when a single family controls 51% or more of the ownership of the company. While there have been numerous articles and blogs explaining the proposed changes on how interests in a family-controlled business must be valued once these regulations are finalized, few of those articles have provided much detail on when, where or how closely-held business owners should start planning with respect to these proposed rules and what documents need to be reviewed.

Our suggestions for answering the "when, where, how and what" questions are pretty consistent. *When* should family-controlled companies seek advice on the impact of these rules? Before the end of 2016, but at the latest, before the proposed regulations become final (which most commentators expect will be sometime in mid-2017); in other words, soon. Obtaining advice this year becomes even more imperative if a family member has been discussing the possibility of making transfers of interests in the family business sometime in the near future (for example, sometime in the next 3 to 5 years). Why review now? Because odds are that it makes more sense tax-wise to transfer the interests now before the final regulations are published than to wait and make the transfer later. *What* documents need to be reviewed? Any buy-sell provisions as well as the company's organizational documents, which then need to be compared against applicable state law and any state law default restrictions (the reason for this comparison is discussed later in this article). *Where* questions relate to obtaining a careful review of buy-sell provisions; will they be respected by the IRS for valuation purposes? If not, the family should know whether any restrictions on liquidation or redemption exist and whether such restrictions constitute *applicable restrictions* under the proposed regulations. Finally, business owners should know the potential difference in tax value between the formula in the buy-sell and the value as determined under the proposed regulations.

If your business is a family business, whether your buy-sell agreement relies on the term *fair market value* ("*fmv*"), the phrase *fair market value as finally determined for estate tax purposes* or any other formula to set the *agreed price* when a transfer is made, it's time to bring your agreement in for a checkup. Both tax and non-tax issues need to be addressed and decisions made, and the window of opportunity for making such choices is a relatively short one. We therefore strongly advise that now is the time for a buy-sell formula checkup with your tax advisors!

BUY-SELL PROVISIONS: AN OVERVIEW. For many years now, one of the important business reasons that attorneys and CPAs have recommended that business clients use a buy-sell arrangement is to make sure that the amount received by a deceased's owner's heirs is not significantly less than the amount taxable in the owner's estate. Historically, even following the 1990 enactment of Chapter 14 and Code §2703(b) (which specifically exempts bona fide business arrangements which are comparable to agreements entered into by unrelated parties from being treated as disregarded restrictions), the phrases *fair market value* and *fair market value as finally determined for estate tax purposes* have often been treated by tax practitioners as rough equivalents of each other for purposes of drafting buy-sell provisions. No matter which term was used in the buy-sell, when Farmer Ed passes away holding a 35% interest in an LLC owning rental properties, both Ed's family and his partners, whether family members or unrelated individuals, would know, more or less, what to expect financially and what to expect from a transfer tax perspective. Ed's partners would know they were going to pay Ed's heirs the *fmv* of his interest, and Ed's heirs would expect to receive an amount equal to the interest's *fmv* (they would also know how much might be financed). More importantly, Ed's heirs could also reasonably expect the amount received from Ed's partners would be the same amount required to be reported on Ed's estate tax return. Using either of the above terms in a buy-sell thus allowed the family to determine, with relative certainty, the amount of any transfer taxes that might be due whether Ed gifted his interest or passed away holding his interest.

One of the reasons this practice continued to be favored by tax practitioners and their family business clients was the surprisingly narrow interpretations adopted by the IRS in its first set of regulations under Code §2704 with respect to when lapses in liquidation/redemption rights, lapses in voting rights and the family's imposition of applicable restrictions would result in changes to how an interest in the family business would be valued for transfer tax purposes. Those original regulations and subsequent changes by numerous states in the "default" provisions of their business statutes governing the rights associated with becoming a shareholder in a corporation, a partner or limited partner in a partnership or a member in an LLC made lawyers comfortable in "doubling down" and providing in a buy-sell that the value of an interest in a family business would be its *fmv* provided that violations of then current regulations under Code §2704 did not occur (so that no changes to *fmv* would be required). Further encouraging the use of *fmv* in buy-sell agreements was the fact that the original Chapter 14 regulations differentiated between the valuation effects of lapses in certain rights, the imposition of applicable restrictions and the binding nature of buy-sell agreements which meet certain requirements. Treas. Reg. §25.2704-2(b)(4)(iii) still provides that any buy-sell agreement meeting the requirements of Code §2703(b) is not an *applicable restriction*. However, many of the types of rights covered by Code §2704 and its regulations are often included as restrictions in buy-sell agreements. Because the original 2704 regulations focused on the rights associated with the interest transferred, not the bundle of rights originally held by the transferor, and because the original regulations respected state law with respect to voting rights limitations and liquidation rights limitations arising out of default statutes, *fmv* would often be the valuation result, even after working through Code §2704's rules.

However, with August's proposed 2704 regulations, the IRS now has a reason to more aggressively pursue the question of whether a buy-sell agreement qualifies for the Code §2703(b) safe harbor. Presumably, if the buy-sell does not qualify for that safe harbor, then any restriction on use, liquidation and/or redemption will be taken into account for valuation purposes under Code §2703(a) and/or Code §2704.

So what are the requirements set forth in the 2703 regulations for a buy-sell agreement to meet the safe harbor test? There are three (3) and each of them must be independently satisfied in order for the safe harbor to apply. One requirement is that the taxpayers must affirmatively prove that the buy-sell was comparable to similar arrangements entered into by persons in arm's-length transactions at the time the buy-sell was created. According to the regulations, a buy-sell restriction which conforms with the *general business practice* of unrelated parties in the same business will be treated as *comparable*. On the other hand, merely showing isolated examples does not meet the general business practice standard; while not expressly stated this way, in order to protect a buy-sell agreement, the taxpayer must demonstrate that it followed a general business practice in its industry when setting the buy-sell formula. The two other §2703(b) tests with respect to which the taxpayer will bear the burden of proof are (i) that the buy-sell is not a device to accomplish intra-family transfers for less than full and adequate consideration, and (ii) that the buy-sell is a bona fide business arrangement. Fail any of these three (3) tests and the rules under Code §2703(a) and/or Code §2704's proposed regulations will apply to the restrictions.

Now that the IRS has proposed revised §2704 regulations setting forth a new set of rules for determining whether liquidation, redemption and voting rights have been lost when transferring business interest to family as well as imposing a minimum value standard, the traditional approach of just assuming that the use of *fmv* in a buy-sell is sufficient to protect how interests in the business are to be valued for estate tax purposes is unlikely to control when applied to family-controlled businesses. These new 2704 regulations finally provide the IRS with a reason to look more closely at buy-sell agreements and whether they withstand scrutiny under Code §2703(b) and its regulations.

WHAT THE PROPOSED REGULATIONS DO: First, They Reject Valuation Discounts When Voting or Liquidation Rights Are Lost. The proposed regulations require practitioners and business owners to fundamentally re-focus the starting point of traditional valuation from the value of what the owner actually conveyed to a transferee (determined in a vacuum, so that gifts made to others around the same time are not considered or combined), to a starting point that takes into account the cumulative impact of all transfers of a business entity conveyed during any tax year (e.g., whether voting or liquidation rights were lost by the transferor due to the cumulative impact of gifts made). Fortunately, only losses of voting control or the right to force a liquidation which occur within three (3) years of the transferor's death are subject to inclusion in the transferor's estate under the proposed regulations.

An example from the proposed regulations provides an easily understood illustration of how the IRS anticipates that its new intra-family transfer valuation rules will operate. In that example, a parent owns 84% of the stock of a business. The by-laws require a vote of 70% in order to liquidate. When parent transfers 42% of the stock (e.g., 50% of parent's total ownership) equally between his/her three (3) children in the same tax year, each child receives 14% of the company's stock. As a result of the gifts, no single child has received a sufficient number of shares to constitute voting control. Neither has any child received an adequate number of shares to be able to cause the company to liquidate. Therefore, each child has only received an interest in the business which does not hold the two factors that when missing give rise to minority interest and lack of marketability discounts. Also note that prior to making the gifts to the three (3) children, parent held both voting control and the right to force a liquidation of the company. Prop. Treas. Reg. §25.2704-1(f), Example 4.

Before these new regulations, the focus under generally applicable valuation principals would be on the value of what the transferee received, and because each share of stock received by parent's children still carried the right to vote, no lapse of any voting or liquidation right occurred. Treas. Reg. §25.2704-1(c) (the current version). In other words, no right associated with the stock transferred to each child was eliminated or restricted when the gift was made, so no valuation adjustment was required under Code §2704 and the transfer tax value of each gift was the *fmv* of the business interest transferred to each child. Treas. Reg. §25.2704-1(f), Example 4 (current version).

In what feels like a complete 180° shift in policy, the proposed regulations force us to focus on the value of everything the parent has directly or indirectly given up, what was collectively conveyed away -- in the above example, in addition to having conveyed a number of shares equal to 52% of the company, parent, because of the cumulative number of shares transferred, also transferred away both voting control of the company and the right to unilaterally force its liquidation. Prop. Treas. Reg. §25.2704-1(f), Example 4. Another way to conceptualize the impact of the proposed regulations on parent is to understand that his/her estate will effectively be treated as if parent died still holding 84% of the business. Thankfully, this specific adjustment to traditional tax valuation methodology is only required if parent dies within three (3) years of conveying the stock to his/her children.

WHAT THE PROPOSED REGULATIONS DO: The Number and Types of Restrictions on Liquidation/ Redemption to be Disregarded Are Being Increased. According to its legislative history, the original purpose behind Code §2704(b) was to ensure that any limitation on the right to liquidate which is more restrictive than state law, whether imposed by the family or caused by the transfer of a business interest to a family member, is to be disregarded when valuing the asset for estate/gift tax determinations. The 2016 proposed regulations expand the types of restrictions to be disregarded beyond those covered in the original regulations by focusing on whether the transferee's ability to compel the liquidation or redemption **of the interest received** for cash or property within 6 months and receive the business interest's *minimum value* has somehow been limited by family action, actions which can include the family's original choice of law and/or original choice of the statute under which the entity was formed. These rules directly attack the valuation impact of so-called *default* rules which apply under state corporate/partnership/LLC statutes, provided the owners had the right to elect under those statutes to provide otherwise in the organizational documents.

The effect of how such other restrictions are now to be treated is perhaps best exemplified by the proposed regulation which will govern the value of a transfer to someone treated as an *assignee* under state law and/or the organizational documents. If a transferee is a mere *assignee*, the proposed regulations provide that no discount is to be allowed for estate/gift tax purposes. The transfer is to be treated as if the interest received still has all the voting, liquidation and/or other rights associated with it in the hands of the transferor.

While the proposed regulation addressing *assignees* is specific to that term, any other restriction which adversely impacts the ability of the transferee of an interest in a family-controlled business to compel the liquidation or redemption of that interest is treated in the same fashion; the restriction is ignored for transfer tax purposes. Said just a little differently, if the family could have chosen a structure when first organizing the business which provided subsequent transferees with the right to *put* the business interest to the business or to the other owners upon 6 months' notice and receive *minimum value*, any restriction on the right to liquidate that interest up to and including the total lack of the ability to do so is to be ignored for transfer tax purposes. As noted earlier, these proposed

regulations are the Service's response to default provisions in state laws added since Chapter 14 was first enacted which have the effect of allowing business owners to allegedly receive overly favorable transfer tax valuations even though the members/partners/owners could have chosen a different structure when first organizing the entity.

So what is this *put* value that must be met under the proposed regulations; what is the interest's *minimum value*? This new valuation standard for family-controlled entities is defined as the interest's pro-rata share of *the net value of the entity;* a definition which sounds very much like, but may not be exactly equal to the *fair value* of the interest under state law. Further confusing the valuation calculation is that *the net value of the entity* is defined as starting with the net *fmv* of the entity's assets, and then deducting the entity's liabilities, but only those liabilities "that would be deductible for federal estate tax purposes." So, will all liabilities on the entity's financial balance sheet be treated as reducing the value of the company for tax purposes? That is an issue that needs to be clarified when the final regulations are issued.

WHEN IS A COMPANY FAMILY-CONTROLLED? If these proposed regulations are adopted in the same form as published in August, whether an entity is *family-controlled* will be determined under rules which look to the percentage of ownership of the company held by an individual, his/her spouse, any ancestor or lineal descendant of such individual, any brother or sister of the individual and any spouse of an ancestor, a lineal descendant, or a sibling. If the ownership of the extended family equals or exceeds 51% of the total interests in the company, the company is *family-controlled*. Further complicating the analysis, attribution rules with respect to certain types of entities also apply under Treas. Reg. §25.2701-6. So, pick the individual making a transfer or deemed transfer and if 51% of the company is controlled by such transferor and his/her family, the company is *family-controlled* and these new valuation rules apply.

The proposed regulations then provide even more complexity with respect to determining whether the family members could remove a restriction on liquidation or redemption so that the restriction is disregarded for estate/gift tax purposes. To combat a practice which the IRS has long characterized as abusive, the use of transfers to or ownership by unrelated "straw" owners to allegedly create a legal obstacle to the family being able to, in fact, control the removal of a restriction, the proposed regulations provide that ownership in a family-controlled business by a third-party is to be disregarded unless (i) the interest has been held by the non-family member for at least three (3) years prior to the family transfer at issue, (ii) on the date of the family conveyance being valued, the interest held by the third-party constitutes at least 10% of the equity interests of the business, (iii) on the date of the family transfer, the total equity held by non-family members is at least 20% of the value of all equity interests of the company, and (iv) each non-family owner must have the clear and unequivocal right to have that business interest liquidated/redeemed within 6 months following notice for cash and/or other property at a value that is at least equal to the *minimum value* of the interest (determined as described above). Thus, both taxpayers and tax advisors must carefully analyze the identity of each and every owner of a corporation, partnership or LLC in order to properly draft or advise on any buy-sell arrangement or any transfer of an interest if looking to use non-family ownership to block the application of these proposed 2704 rules.

There is yet one more unexpected requirement which these *put rights* must meet in order to overcome the presumptions of the proposed regulations. Specifically, the amount due when the *put right* is exercised must be paid in cash or property, and the proposed regulations expressly state that

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a promissory note issued by the entity, its owners or any person related to the business or its owners will not qualify as property for this purpose. Fortunately, a safe harbor for certain promissory notes exists which requires: (i) that such note be issued by an entity engaged in an active trade or business (e.g., is the real estate business at issue an active business or a passive one?), (ii) that the note be adequately secured, (iii) that the note require periodic payments on a non-deferred basis, (iv) that the note require that market interest be paid, and (v) that the note has a *fmv* on the date of liquidation equal to the amount due (a present value calculation). This is the first time that ***market rate interest*** as opposed to the usual *applicable federal rate* has been imposed by the IRS for a related-party transaction.

BACK TO BUY-SELL FORMULAS. With all these valuation changes, is setting the buy-out price at the *fmv* of the interest or its *fmv as finally determined for estate tax purposes* still a reliable default rule? Unfortunately, it now appears to depend; are all of the parties to the agreement unrelated so that the entity is ***not*** a family-controlled business? If so, and assuming that none of the parties intends to own more than 50% of the new entity, *fmv* appears to still be a viable choice for setting the interest's value. Of course, if the parties are unrelated, the buy-sell formula can be whatever the owners negotiate between themselves. However, remember the example from the proposed regulations examined earlier? Presumably, the 16% of the company not owned by parent was owned by an unrelated individual or individuals and when the stock was transferred, the rules under the proposed regulations applied. So, should the choice of *fmv* or its cousin, *fmv as finally determined for estate tax purposes*, be advised as the formula for a buy-sell agreement, especially if a majority owner knows or expects that he/she ultimately intends to convey interests in the business to his/her family? Probably not, unless the practitioner is also comfortable advising the client that the agreement will qualify for the Code §2703(b) safe harbor. Finally, what about an entity which is already clearly family-controlled; does *fmv* as a default buy-sell value make sense? Maybe not; there is uncertainty here too.

The uncertainty of whether the buy-sell for a family-controlled business will control the valuation of an interest in the business is whether the arrangement meets the safe harbor requirements under Code §2703(b) discussed earlier: is the buy-sell a bona fide business arrangement, is it a device to transfer property to the family at less than full consideration and is it comparable to similar arrangements between unrelated parties at arm's-length? See, e.g., Holman v. Comm'r, 601 F.3d 763 (8th Cir. 2010), aff'g, 130 T.C. 170 (2008) (where the Courts found the arrangement failed the first two prongs of the 2703(b) safe harbor, but were fairly liberal in their approach to allowing the taxpayers to prove comparability through expert testimony), and Est. of Amlie v. Comm'r, T.C. Memo 2006-76.

While less of a problem for operating businesses than entities holding investment-type assets, the analysis under Code §2703(b) will be fact specific and subject to uncertainty until the issue has been raised by the IRS. Still, there are certain factors which can be reviewed by practitioners in order to know whether the buy-sell has a fighting chance of being upheld or whether it is more vulnerable to attack by the IRS than other such agreements. For any industry or investment do *comparable* terms include a *fmv* buy-out or the use of some other valuation method? How do you know? With the downside being the probable application of the proposed regulations, taxpayers should check and try to determine if Code §2703(b) might provide protection on the choice of how interests in a family-controlled business are to be valued when transferred.

In any event, if the buy-sell does not meet the requirements for safe harbor treatment, the new 2704 proposed regulations (along with Code §2703(a)) will clearly prevent the term *fmv as finally determined for estate/gift tax purposes* from being a clear and unambiguous description of how the value of an interest in a family-controlled business is to be determined for estate/gift tax purposes. So, what about the enforceability of a buy-out provision relying on that term? Consider first that *fmv* implies that all generally applicable valuation principles, including discounts for minority interests and/or lack of marketability, are to be applied. Yet those discounts are the very targets which these new regulations were designed to eliminate or reduce. Neither does *fmv* as a definition of value become any clearer by adding the clause *as finally determined for estate tax purposes*. A mere modifier, that clause should not be interpreted to somehow inherently incorporate the adjustments to generally applicable valuation principles required under the proposed regulations. Given these considerations, it seems clear that two individuals, much less different courts and/or different lawyers, would be unlikely to interpret the phrase *fair market value as finally determined for estate tax purposes* in the same fashion once the proposed 2704 regulations have become final.

Consider for a second, the potential for dispute when the second spouse of a recently deceased family member is told by the deceased's family that she must accept the *fmv* of a minority interest as the redemption price. Is that spouse likely to agree that the term *fmv* is without ambiguity as to the amount which the spouse, the spousal trust and/or that spouse's children are supposed to receive, especially after being informed by the tax advisor that the value to be used for estate tax purposes is more likely the interest's *fair value* or perhaps its *minimum value* because the IRS has applied the proposed regulations rather than the buy-sell formula?

Tax advisors, business lawyers and clients must also be conscious of the potential that an ownership structure which would not currently be treated as *family-controlled* can easily become so, thereby also making transfers of interests in the business subject to the new regulations if intra-family transfers occur at some point in the future (as in the example with "parent" discussed earlier). Should attorneys therefore consider drafting buy-sell agreements so that when these new regulations control the method for determining the value of a family-controlled business interest, that valuation method will also control the amount due the owner's heirs if the interest is to be purchased? Alternatively, is there a reason to use the term *minimum value* as defined in these new regulations in buy-sell agreements for non-family owners?

THE SECOND SPOUSE BUY-OUT PROBLEM. Let's look at a practical application of these new rules when a buy-sell agreement is in place. Phil is the family patriarch and started an operating business (e.g., not a passive business), eventually transferring 30% of the Company to each of his three (3) sons in 1995. Under these facts, there is little room for debate that the business will be a *family-controlled business* and that the proposed regulations could apply. Joel, one of Phil's sons, passes away after the proposed regulations become final at a time when the Company's enterprise value is $33 million. The buy-sell provision contained in the Company's Operating Agreement states that the agreed price for any member's ownership interest will be the *fair market value of the interest as finally determined for estate tax purposes*. If the family cannot successfully prove that a *fmv* buy-out is comparable to other buy-sell arrangements in their industry (or is unsuccessful in its position that the buy-sell is a bona fide agreement or that it is not a device), Joel's family is likely to be forced to use the proposed regulations and treat the value of Joel's interest as being $10 million for estate tax purposes (e.g., the ownership interest's *fair value*). What happens then if Joel's brothers insist that the terms of the buy-sell be enforced so that Joel's family is only entitled to $6.5 million ($10 million

less a 35% discount based on the interest being a minority interest and that lack of marketability applies because no liquidation and/or redemption rights exist)? If we assume the value of Joel's interest in this family-controlled business is fully includable in his taxable estate, the estate will pay 40% on $5 million (approximately) after using Joel's exemption amount. That results in the net cash received by Joel's family being $4.5 million (instead of $8 million net received if the estate tax value were used as the starting point). Is that the result Joel would, if he could, testify he had agreed to and anticipated before these regulations were proposed? Is there any doubt that family relationships are likely to deteriorate if the position initially expressed by Joel's brothers is enforced against his family? Is that a result which Phil, the family patriarch, will support? Isn't litigation a strong possibility?

CONCLUSION. All of the issues and questions raised in this discussion arise solely because the IRS has, in issuing these proposed regulations, effectively decoupled the transfer tax value of family-controlled businesses from the value which would be determined under generally applicable valuation principals. The result is that closely-held businesses which are, and even those which might later become, *family-controlled businesses* should carefully consider taking advantage of the window of opportunity provided in the proposed regulations (e.g., that they do not become effective until issued in final) to make transfers this year. Family-controlled businesses should also determine whether the formula used in the company's buy-sell will have the proper financial and tax impacts on the family once the proposed regulations are finalized; those family-controlled businesses without buy-sell agreements should decide what steps the family ought to take to protect the family and the business, should a buy-sell be considered and, if so, what formula should be imposed? These are just some of the questions which should be resolved by the family before these proposed regulations become final in 2017.

If you would like more information on these proposed regulations, their impact on buy-sell agreements or any other tax matter, please contact:

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