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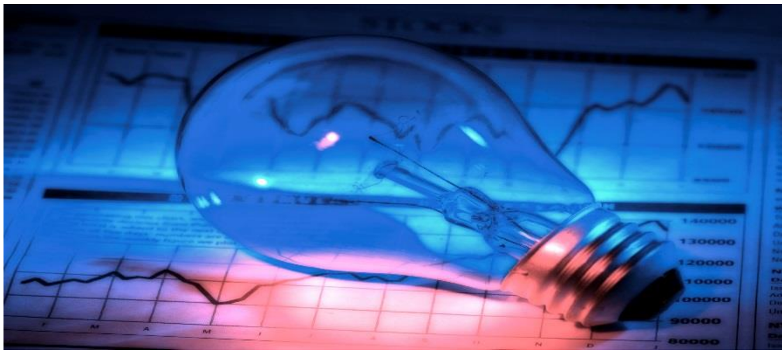

When Value Counts…

4th Quarter 2016

We hope that you enjoyed the summer. In the 4th Quarter 2016 newsletter, you will find the following short articles:

- Experts Size Up Controversial IRS Estate Valuation Regs
- Do the New Sec. 2704 Regs Redefine Fair Market Value?
- Multiple Grounds Exist to Challenge IRC Section 2704 Regs, Lawyers Say
- Key ESOP Ruling Zeroes in on Valuation and Remedies Issues
- Economic Update at a Glance

As you can tell by the articles listed above, the topic of the proposed regulations under section 2704 of the Internal Revenue Code has been the biggest focus in the valuation and gift/estate tax world for the past couple of months. We hope that you find the articles to be both enjoyable and informative. As we approach the year-end busy cycle (and the looming potential changes in the gift/estate tax regulation that might impact valuation discounts for family-owned entities), please feel free to call us if you need any assistance with valuation matters. Thank you, and we look forward to working with you.

Experts Size Up Controversial IRS Estate Valuation Regs

Valuation experts were anxiously awaiting the proposed IRC Section 2704 regulations designed to crack down on estate valuation discounts. Now that they have been released, they have triggered strong reactions from the valuation community, the legal profession, and others.

The IRS wants to eliminate the technique of putting valuable property into entities such as family-owned partnerships or corporations just to reduce the value in the property to avoid estate and gift tax. To do this, the proposed regs address the treatment of some lapsing rights and restrictions on liquidation in determining the value of transferred interests in corporations and partnerships. Liquidation restrictions would be disregarded for valuation purposes. Overall, it appears that the proposed regulations eliminate almost all minority discounts for closely held entity interests, including operating businesses owned by a family.

Redefining FMV. “The recently released IRC Section 2704 family limited partnership (FLP) discounts proposed regulations include much of what appraisers had been dreading for the past year,” says Carol Carden, chair of the AICPA FVS executive committee. “The proposed regulations provide new rules and limits that (if included in the final version) will impact estate planning with FLPs,” she says. “This is indeed a very significant issue for business appraisers, notwithstanding the impact the higher exemption limits have had on the number of taxpayers exposed to estate taxes,” says Ronald Seigneur. “In my opinion, this is a legislative attempt to redefine the fundamental premise of fair market value.”

Michelle Gallagher agrees. “They are changing the definition of fair market value,” she says, pointing to the Federal Gift Tax Regulations (Treas. Reg. Sec. 25.2512-1), which define fair market value as:

[T]he price at which property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.

“Seems to me, the proposed regs carve certain types of transfers completely out of the FMV definition,” she says, referring to transfers:

- Within three years of death;
- Between family members;
- Resulting in the lapse of liquidation rights; and
- Eliminating comparison to the liquidation rights of state laws.

The proposed regs are typically complex and difficult to understand, but Gallagher says there are some good examples at the end of the document that help sort them out.

“I view it as a full frontal assault on economic reality, but that really isn't anything new for the current Administration,” says Donald DeGrazia. “The IRS has long been hostile to the concept of discounts for lack of marketability and control despite losses in court and their own previous rulings. These discounts merely recognize that an interest in an entity, active or passive that doesn't enjoy the prerogatives of control is not proportionately equal in value to an interest that does enjoy control. That hostility is manifested in these proposed regs.”

“The regs seem to be an attempt to ignore economic reality through use of attribution rules (despite IRS Revenue Ruling 93-12) and non-recognition of succession planning restrictions on transfer of ownership interests in entities,” observes DeGrazia. “It is an attempt to invalidate discounts that reflect the economic impact on value of minority ownership interests in entities.” Legal observers feel that this is an attempt by the IRS to overturn many years of settled law. Richard Dees, an attorney and partner at McDermott Will & Emery LLP in Chicago, who last year sent a 29-page letter to the government critiquing the proposal as beyond the scope of its powers, says the proposed regs appear to eliminate all valuation discounts. "Liquidation restrictions and minority and marketability discounts are flip sides of the same coin; you can't separate the two," he says.

Other stakeholders are also weighing in, such as the Family Business Coalition, which issued a document explaining the proposed regs and warning that they would pose a big problem for family firms. Also, estate planners have been advising clients to complete transfers before the new rules take effect, so those efforts will now likely gain steam.

“Hopefully the valuation, accounting, legal and business communities will come together to challenge these proposed regs before they are made final,” says DeGrazia. Those efforts are now underway.

Do the New Sec. 2704 Regs Redefine Fair Market Value?

The IRS is attempting to eliminate discounts for lack of marketability (DLOM) and discounts for lack of control (DLOC) for the vast majority of family-controlled entities for estate, gift, and generation-skipping transfer (GST) tax purposes. To do this, its proposed IRC Section 2704 regs would treat the lapse of voting or liquidation rights as an additional transfer and disregard certain restrictions on liquidation in determining the fair market value of a transferred interest.

Different perspectives: “In my opinion, this is a legislative attempt to redefine the fundamental premise of fair market value.” says Ronald Seigneur, in an article in the September 2016 issue of Business Valuation Update. Michelle Gallagher agrees. “They are changing the definition of fair market value,” she says, pointing to the Federal Gift Tax Regulations (Treas. Reg. Sec. 25.2512-1).

It seems that the proposed regs carve certain types of transfers completely out of the FMV definition, she observes. These transfers include those made within three years of death, between family members, and resulting in the lapse of liquidation rights. Gallagher and Seigneur are on the AICPA task force studying the regs in order to prepare and submit formal comments to the IRS by the due date of November 1.

“The IRS is not proposing changing the definition of fair market value,” says Bryce Erickson. “However, when applying fair market value under the constructs as contemplated in the proposed 2704 changes, there would be a smaller (or perhaps no) value delineation for minority interests as compared to enterprise value of an entity.” This would support the IRS’s goal of preventing taxpayers from “undervaluing” transferred interests among family members, Erickson points out. “This, of course, runs in stark contrast to the marketplace, of which fair market value is supposed to be a reflection,” he says. “The marketplace’s long track record on this is abundantly clear—it differentiates for minority interests as compared to the value of entire enterprises." He sees the proposed regulations as essentially circumventing the levels of value for family members as defined in a "controlled entity."

There will be a public hearing December 1 at the IRS.

Multiple Grounds Exist to Challenge IRC Section 2704 Regs, Lawyers Say

"An overarching attack on discounts in family limited partnerships" is how attorney John Porter (Baker Botts) characterized the Treasury Department's proposed regulations under Section 2704 in a recent Bloomberg BNA webinar. Will there be a challenge to the regs? "You betcha," he says.

Unreal world: Porter and his co-presenter, attorney Stacy Eastland (Goldman Sachs), agree that in the real world owning a minority interest in a family limited partnership or an LLC more often than not is onerous and justifies the use of minority and lack of marketability discounts. Eastman goes as far as describing it as a "phantom asset" because the interest holder often can't dispose of it. Discount abuses on the magnitude the IRS claims to need to rectify by way of the regulations don't occur in real world, the speakers say.

Aspects of the regulations themselves are imaginary. Take, for example, the construct of a "put right," that is, the ability of each member of the entity to force the company to buy back his or her interest for cash equal to a minimum value (a pro rata portion of the fair market value of the entire entity) within six months of exercising the right. No such right exists in the real world, both speakers emphasize.

Porter says the regulations are an overreach by the IRS because Congress did not intend the Chapter 14 valuation rules to target minority discounts and DLOMs; rather it sought to address artificial restrictions. As Porter sees it, the IRS is trying to apply a family attribution test.

Grounds for the challenge: Porter says that there are at least two grounds for challenging the proposed regs: (1) The regulations don't align with the legislative grant of regulatory authority; and (2) they are inconsistent with applicable statutes and legislative history.

Right now there is uncertainty as to what might happen if the regulations became law. Take, for example, the new contemplated three-year rule under 2704(a), which would nullify discounts taken for certain transfers that occurred within three years of the transferor's death. Would it apply to transfers that occurred prior to the regulations being finalized? "Unclear," Porter says.

But both speakers also stressed that, even if the regulations became law, "the sky wouldn't fall." Good lawyers will come up with structural solutions to minimize the regulations' negative effect.

Key ESOP Ruling Zeroes in on Valuation and Remedies Issues

Perez v. Bruister, 2016 U.S. App.LEXIS 8046 (May 3, 2016) (Bruister II)

In a gnarled ESOP case, the 5th Circuit Court of Appeals recently issued an important decision on fiduciary liability and remedies in case of breach. The trial court had found the trustees violated their duties of loyalty and prudence and engaged in a prohibited transaction assisted by a disreputable appraiser. It expressly noted the remedy questions were harder to resolve than the liability questions, and it suggested its valuation-related findings might be "vulnerable" on appeal. It need not have worried.

Overpayment: When the owner of a closely held company wanted to divest himself of the company, he orchestrated a series of transactions to sell 100% of the company's shares to its employees by way of an employee stock ownership plan. In each transaction, the plan bought stock through an employee stock ownership trust for which the owner-seller and two persons with whom he had a close working relationship served as trustees. The trustees based the share price on valuations an appraiser had performed.

Subsequently, the Department of Labor (DOL) and two plan participants filed separate lawsuits alleging the trustees overpaid for the stock because the appraiser's valuations did not reflect the fair market value (FMV) of the stock. The district court, which consolidated the suits, found that neither the appraiser nor the trustees were truly independent and looking out for the interests of the ESOP and that it was not reasonable for the trustees to rely on the appraiser's valuations.

The court rejected the DOL's demand to rescind the transactions and instead awarded over $4.5 million in equitable restitution in the amount the ESOP overpaid. Overpayment was a function of the contract price and the stock's fair market value on each transaction date. To calculate FMV, the court considered the testimony of three noted valuation experts retained by the plaintiffs, the DOL, and the defendants, respectively. The experts were equally credible, the court said. Different experts used different methods, different assumptions, different estimates, and they reached different conclusions. To arrive at a final value determination, they all averaged the results. “This method tempered the outliers that some methods produced,” the court observed with approval. For its part, the district court averaged the experts’ valuations but weighted the results the defendants’ expert achieved at 50% and the much lower valuations the DOL’s expert and the individual plaintiffs’ expert proposed at 25% each. It dismissed the appraiser’s valuations as “not credible.”

‘Thoughtful approach’: The defendants appealed the liability and remedy findings with the 5th Circuit, and the DOL cross-appealed on the remedy. The appeals court largely affirmed. It noted that the parties “fought bitterly” over valuation and remedies issues. On appeal, the defendants and the DOL particularly objected to the district court’s averaging process. (The plaintiffs defended it.) Their arguments had no traction.

Prior decisions “have frequently accepted an average of expert valuations or estimates falling within a range of evidence offered,” the 5th Circuit pointed out. Here, the district court “carefully” set forth its findings and explained their basis in the record. The district court acknowledged its approach would be wrong if one expert were more credible than another, and it reached a reasonable average supported by evidence, the appeals court said. The district court’s “thoughtful approach to a complex question was founded in established valuation methodology,” the appeals court concluded.

Takeaway: In a complex ESOP case in which valuation and remedies issues were paramount, the 5th Circuit upholds the district court’s decision to grant equitable restitution based on the lower court’s computation of how much the ESOP overpaid.

Economic Update at a Glance

The U.S. economy—as indicated by GDP—grew at an annual rate of 1.2% in the second quarter of 2016. This rate was about half of economists’ expectations, as GDP was dragged down as businesses reduced their inventories and held off on major business investments. The decline in inventories was the most since the third quarter of 2011. Excluding inventories, GDP rose at a 2.4% rate in the second quarter. Private fixed investment, which includes residential and business spending, dropped 3.2% in the second quarter, the largest decline in seven years. Total government spending declined in the second quarter, with federal nondefense spending being the only subcategory that rose. Consumers were resilient in the second quarter, with consumer spending growing at its fastest pace in the past six quarters, driving the second-quarter GDP into positive territory. The trade deficit narrowed and contributed somewhat to the second-quarter growth in GDP.

Data analyzed by the Conference Board continue to indicate moderating economic growth through the end of 2016. Further, the weaknesses among the leading indicators have become somewhat more widespread than the strengths in recent months. However, the report noted that the economy still appears resilient enough to weather volatility in the financial markets and a moderating outlook in the labor markets.

After weak growth in May, job creation surged in June, rising by 287,000 new jobs. This marked the strongest month for jobs since October 2015 and was far greater than economists’ forecast. Job growth so far this year has average 172,000 jobs per month, which is well above the pace the White House Council of Economic Advisers has stated is necessary to maintain a low and stable unemployment rate. The unemployment rate crept up 0.2 percentage point in June, though some of the rise was attributed to more workers entering the workforce, as the labor-force participation rate also edged up.

While job growth rose significantly in June, wage growth only improved modestly. Average hourly earnings for all private-sector employees increased only two cents in June. Regardless, the White House Council of Economic Advisers drew attention to the fact that nominal hourly earnings for all private-sector workers have increased 2.6% over the past 12 months while consumer prices have risen just 1.0%. It found that nominal hourly wages have generally been rising faster than inflation since mid-2012, translating into real wage gains for American workers.

The Federal Open Market Committee made the decision to maintain the target range for the federal funds rate at 0.25% to 0.5%. In making its decision to leave the target for the federal funds rate unchanged, the FOMC stated that it wishes to maintain an accommodative policy in order to further support improvement in labor market conditions and a return to 2.0% inflation, which has been running low due to past declines in energy prices.

Readings for consumer confidence were mixed in June. The Consumer Confidence Index rose to an eight-month high, while the Consumer Sentiment Index retreated slightly. The Consumer Confidence report found Americans becoming more optimistic about the economy. The Consumer Confidence report found that consumers' impression of current situations reached its second-highest reading since September 2007, and their optimism toward their short-term outlook was the highest in five months. On the other hand, the Consumer Sentiment report found that Americans had greater concerns about prospects for the economy. The survey found that consumers do not anticipate there will be a recession but have increasingly come to expect that the pace of economic growth will slow in the next year.

Business-owner optimism improved for middle-market businesses but was not significantly better for small businesses. The Small Business Optimism Index edged up slightly, but the National Federation of Independent Business called the increase "negligible." The component that improved the most was the one that measures whether business owners believe the economy will improve. Regardless, more owners believe the economic conditions will worsen rather than improve, with a net -9.0% of owners expecting improved conditions. The 2Q 2016 Wells Fargo/Gallup Small Business Index moved down, marking the fourth decline in the past five quarters. The report found that, while business owners remain cautious, small-business optimism over the past year has been higher than at any point since 2008. The RSM U.S. Middle Market Business Index increased and indicated that the U.S. middle market is expanding. The results also indicated that the middle market is outperforming large corporations, which have more broad exposure to the global economy.

Growth in the manufacturing sector, as measured by the Institute for Supply Management's manufacturing index, rose in June. The index showed that the manufacturing sector expanded for the fourth consecutive month, following five months of contraction. Industrial production also advanced in June, with the component that measures manufacturing advancing 0.4% in June and 0.4% over the past 12 months.

The services sector continued to expand in June, as measured by the Supply Management's services index, and the pace of expansion quickened. The comments from respondents were mostly positive about business conditions and the economy. The report also found that there was a strong rebound from the "cooling-off" that occurred in May.

Most of the major stock indexes recorded gains in the second quarter, though there was some volatility toward the end June as a result of Britain's vote to exit the European Union. Performance among the sectors within the S&P 500 varied. A partial rebound in oil prices helped the energy sector gain nearly 12.0%, while the information technology and consumer discretionary segments recorded losses for the period.

Amid concerns over Britain's exit from the European Union, yields on intermediate- and long-term U.S. Treasury yields retreated as investors sought out haven debt, causing prices to rise. Britain's exit also caused yields in Japan, Germany, Switzerland, the U.K., Sweden, and Denmark to all reach record lows. This drove investors into U.S. Treasuries, which were offering more attractive yields at the time, sending U.S. yields down to near record lows.

Housing starts and building permits both rose in June, though they remained below their levels from a year ago due to decreased activity in the multifamily home sector. Existing-home sales continued their upward trajectory in June, rising for the fourth consecutive month to their highest annual pace since February 2007. Home prices continued to climb in June, rising for the 52nd consecutive month to their highest prices on record.

The National Association of Realtors Confidence Index for current conditions improved but was unchanged for single-family homes and townhouses, though it improved slightly for condos. Regardless, it was up for all three housing types compared to a year ago. Builder confidence, as measured by the National Association of Home Builders/Wells Fargo Housing Market Index, improved in June and remained at a level indicating homebuilders continue to be positive about the housing market.

The National Association of Realtors' most recent Commercial Real Estate Market Survey, analyzing the first quarter of 2016, found that commercial real estate investments continued to keep a positive pace. The report found that 58.0% of Realtors closed a commercial sale and sales volumes rose 8.5% from the same period one year ago. The members surveyed were positive about the general direction of business opportunities.

NOTE: *This newsletter does not constitute legal, valuation, tax or any other type of consulting advice. It is offered as an information service to our clients and friends. For specific legal and accounting issues, it is advisable to seek professional advice. We welcome the opportunity to discuss any specific valuation issues that you may have.*

Valuation Services, Inc. (VSI) is one of the premier business valuation firms based in the Washington, DC area that specializes in valuing private, closely-held businesses. We have valued private entities owning real estate and operating businesses with hundreds of thousands to billions of dollars of asset value. In addition, VSI has valued other assets like intangible assets, notes receivables, law suit claims, tenant-in-common interests, and large blocks of publicly traded stock.

VSI has a staff of professionals that prepares and supports valuations on a full-time basis. Our team of professionals handles various types of valuations and has a history of successfully defending as expert witnesses before the IRS and in many different courts. Our valuations are used for a variety of reasons—i.e., estate planning and administration, ESOPs, litigation support, succession planning, mergers and acquisitions, bankruptcy, financial reporting, and Section 409A.

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