STOUT

The Future of Estate Planning

A new political landscape has hindered proposed IRS regulations; we examine these developments and address several possible scenarios involving estate taxes.

Since the release of the proposed changes to Internal Revenue Code Section 2704 on August 2, 2016 (the proposed regulations) and until the election of Donald J. Trump on November 8, wealthy taxpayers, family businesses, estate planners and business appraisers thought and talked about little else other than the possible valuation ramifications of these changes to the regulations. Many read the complicated and confusing document as a thinly disguised proscription of valuation discounts. Some interpreted the document as relatively benign. Others simply weren't sure what the Internal Revenue Service was driving at and why this was even needed.

Unexpectedly, the proposed regs didn't exempt U.S. farms and family businesses. This was a great surprise to taxpayers and the estate-planning community. It was well-known that the proposed regs might be forthcoming, but it was generally understood that any regulatory change would exempt family businesses. That it didn't was a huge miscalculation by the Treasury Department, as this allowed the opponents of the proposed regs to tap into the same populism that swept Trump into office. Many perceived the proposed regs as a message that the IRS was unfairly targeting U.S. farms and family businesses, which were already challenged by foreign competitors and beleaguered by government regulations. The IRS received over 10,000 comment letters, an unprecedented amount. Almost all of the letters were negative, and almost all cited the attack on the family business as justification for the nullification of the proposed regs.

Also contributing to the strong reaction from tax- payers and their advisors were two terms appearing in the document that, on even a relatively careful reading, indicated that the IRS was unleashing a novel and malevolent valuation construct that would eviscerate almost all forms of estate and succession planning. "Minimum value" was a new term coined by the IRS that essentially meant "enterprise value" for (the equity of) an operating business or net asset value for an investment or holding entity. "Disregarded restriction" meant any restriction that limited the ability of the holder of the interest to liquidate at less than minimum value in less than six months for cash. So, the first impression of the proposed regs was that it eliminated all valuation discounts. This belief was made more widespread by the publication of articles by well-known estate planners and appraisers stating that, under the proposed regs,

the valuation of an equity interest of any member of a family control group must be made as if it had a "deemed" put right at minimum value.

Different Meaning?

Eventually, most came to realize that these terms were meant as tests to determine if IRC Section 2704 applied to the interest being valued or not. These terms weren't intended to dictate how the interests were to be valued. In fact, the regulations instructed that the interests were to be appraised subject to generally accepted valuation principles. Unfortunately, by disregarding virtually all restrictions, including those imposed by state law, the characteristics of the subject interests become so altered that there may be no market comparisons or empirical studies that might be employed for valuation purposes. For example, some believed that, under the proposed regs, a selling limited partner would have no restrictions preventing his withdrawal from the partnership, but he would have no explicit right to do so. This metaphysical predicament might well have its place in divinity school, but it's hardly the stuff of a valuation analysis. If anything, such great uncertainty might serve to increase discounts. Furthermore, a central element of the valuation construct under the proposed regs is that the hypothetical seller would negotiate a price with the other family member equity owners. Many would see this as clearly outside the bounds of "fair market value." Despite the misapprehensions about terminology found in the preamble to the document, many significant uncertainties remain.

The Hearing

The hearing on the proposed regs that took place on December 1, 2016, was a bit anti-climactic. The unexpected victory of Trump and the Republicans, who now hold majorities in both houses of Congress, meant the repeal of estate taxes had become very real. Furthermore, the "Protect Family Farms and Businesses" bills[1] pending in the House and the Senate and seen previously as largely symbolic gestures had suddenly become powerful threats to the proposed regs.

Even though some thought the hearing might be canceled, it went on as scheduled. To their credit, the three Treasury and IRS panelists paid careful attention to all 36 speakers in a seven-hour hearing punctuated by very few breaks.[2] Catherine Hughes, attorney-adviser at the Treasury office of Tax Legislative Counsel, provided some useful verbal confirmation of statements she'd previously made to select groups. First, she stated that the proposed regs don't provide for nor anticipate that there's to be a put ("deemed" or otherwise) in the valuation rules. Second, she let it be known there was no possible way the proposed regs could become finalized before the change in administrations. Last, she stated that the three-year rule wouldn't be imposed retroactively.

All of the speakers, save one, were critical of the proposed regs, although the tenor and intensity varied widely. Many speakers, who either owned family businesses or represented them, bemoaned how the "loss of valuation discounts" would negatively impact the ability of family businesses to operate or effect succession planning. The several appraisers who appeared all stated their beliefs, in one way or another, that the valuation assumptions embedded in the proposed regs are contrary to the definition of "fair market value." Most attorneys who spoke offered more technical comments or criticisms. A few suggested that minor changes to other regulations tying into Section 2704 might be changed, obviating the need for some, if not all, of the proposed regs.

Many speakers asked that the Treasury consider the comments and suggestions submitted and, later, re-propose changes based on this input. Until that might occur or the proposed regs are issued as final, very little is to be gained by further dissecting them. The comments have been submitted, and the hearing has been held.

Even if repeal weren't to occur, once finalized, the changes to Section 2704 would likely be struck down by the Protect the Family Farms and Businesses bill, which, like a missile in a silo, stands ready to be launched.

In the aftermath of the hearing, one wonders why the Treasury and the IRS would spend any more time on the proposed regs for the foreseeable future. First, if estate and gift taxes were repealed, Section 2704 and Chapter 14 would become moot. Second, even if repeal weren't to occur, once finalized, the changes to Section 2704 would likely be struck down by the Protect the Family Farms and Businesses bill, which,

[1] H.R. 6100; S. 3436.
[2] The Treasury was represented by Catherine Hughes with the Office of Tax Policy. The Internal Revenue Service was represented by John MacEachen (author of the proposed regulations), Leslie Finlow, and Charlotte Chyr, all with Passthroughs and Special Industries.

like a missile in a silo, stands ready to be launched. In fact, Ronald Aucutt, a nationally recognized estate planner and a speaker at the December 1 hearing, has stated that he believes it may be three years or more before the proposed regs might be ready for finalization.[3] Of course, this would still depend on the political climate.

From an appraiser's standpoint, with the "threat" of the proposed regs neutralized (for now, at least) what's the outlook for 2017? The crystal ball is clouded by a fog of what-ifs, Washington politics and budgetary constraints. The best that can be done is to enumerate the most likely scenarios.

4 Key Questions

1 Is estate tax repeal a certainty?

No. Unquestionably, the Republicans have the votes to make this happen through the use of the budget reconciliation process. Much lip service has been paid to the notion that this is a "done deal." But, in the category of the "devil is in the details," there are a couple of important budgetary details standing in the way – the $600 billion budget deficit and the $20 trillion national debt. The last serious attempt at repealing the estate tax came under the George W. Bush administration, which, in 2003, enacted the now famous "Bush Tax cuts." While the Republicans controlled both houses then too, the 2002 deficit was $158 billion, and the national debt stood at just a little over $5 trillion. While estate taxes were cut and exemptions raised, outright repeal failed.

To be sure, Republican leaders like Speaker of the House Paul Ryan and Chairman of the House Ways and Means Committee Kevin Brady are dedicated to tax reform, but corporate and individual tax reform are far more important to them than estate and gift taxes that generated only $20 billion dollars for the U.S. Treasury in 2016.[4] It's possible that, to gain some bipartisan support for tax reform, again outright estate tax repeal may morph into simply a lowering of estate tax rates.

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2 If estate taxes are repealed, will we still have the gift tax?

Very little has been said about this. Most pundits believe the gift tax will remain. "I want to give" doesn't have the same political caché as "Repeal the death tax!"

3 Will there be a capital gains tax at death if estate taxes are repealed?

Without any doubt. If this is the case, then, since capital gains taxes aren't governed by the IRC sections related to Chapter 14, it would seem that such valuations wouldn't consider IRC Sections 2701-2704. Essentially, the valuation rules would be reset to 1989 – without the estate-planning restrictions of IRC Section 2036(c). That is, discounts would be affected by special restrictions in the entity's governance documents, and state law would matter. Much of the estate and gift tax valuation case law developed since the inception of Chapter 14 would be off point. One wonders if we would see a revival of the preferred stock freezes of the 1980s. If so, one would assume the IRS would attempt to reintroduce Section 2036(c). We've seen this movie before.

If gift taxes aren't repealed, Chapter 14 would continue to govern the valuation of such transactions. This would mean two very different sets of valuation rules for estate and gift taxes. Very confusing, complicated, and expensive for the taxpayer.

4 What estate planning techniques might appraisers see more of?

Split-dollar insurance arrangements. These should be gaining in popularity with the taxpayer favorable result of the *Estate of Morrissette v. Commissioner*[5] Here, the Tax Court ruled that the decedent's revocable trust was treated as the owner of the policies and that dynasty trusts, the beneficiaries of the life insurance policies, received no economic benefit beyond the life insurance protection. However, not addressed in this decision was the value of Mrs. Morrissette's revocable trust's right to repayment that will presumably be determined in a second trial or settlement.

Note valuations. The dual Woelbing cases (*Estate of Donald Woelbing v. Comm'r*,[6] and *Estate of Marion Woelbing v. Comm'r*,[7] Docket No. 30260-13) settled in the Spring of 2016. There were several important issues in these cases. The valuation of notes was one of them. That the IRS intended to make an issue of the subject of note valuations was apparent in *Davidson v. Comm'r*,[8] which also settled in 2016. Many in the estate planning and valuation communities were hoping for a decision in Woelbing that would shed more light onto the thorny issue of note valuation in the context of an intra-family sale of equity

[3] In an answer to a question following his luncheon speech at the 2016 Mo-Kan Meeting (Kansas City, Mo.), Dec. 3, 2016.
[4] With $20 trillion in debt, a 100 basis point movement in U.S. Treasury interest rates equals $20 billion.
[5] *Estate of Morrissette v. Commissioner*, 146 T.C. No. 11 (April 13, 2016).
[6] *Estate of Donald Woelbing v. Comm'r*, Docket No. 30261-13.
[7] *Estate of Marion Woelbing v. Comm'r*, Docket No. 30260-13.
[8] *Davidson v. Comm'r*, Docket No. 13748-13.

interests. For example, how are the expected distributions from the business or partnership to the purchaser to enter into the question of the solvency of the purchaser? To what extent are personal guarantees significant? Is a guarantee of 10% of the purchase price a "bright line" that assures adequate protection for the lender? What about the financial ability of a borrower (usually a trust) to repay? What sort of recourse does the lender have in the event of a default? Because of the private nature of tax settlements with the IRS, we'll have to wait for another case to gain more understanding of the IRS viewpoint on these components of note valuation.

S Corporation valuations. This will continue to be a "hot button" issue with the IRS, which adamantly holds to the view that "tax affecting" is unacceptable. In 1999, *Gross v. Comm'r*[9] rejected the idea of ignoring S corporation tax benefits and valuing the company as if it were a C corporation. This argument has been persuasive in at least four other Tax Court cases.[10] The IRS hasn't yet lost this argument in Tax Court. The appraisal profession has, for years now, used credible valuation methodology that takes into account the tax attributes of the S corporation relative to what would be the case if the company were a C corporation. Tax affecting (assuming a C corporation tax regimen) is required in the valuation because all of the valuation metrics come from the C corporation-dominated public marketplace.

In 2016 the Tax Court trial of *Cecil v. Comm'r*[11] was held. In that trial, both the taxpayer's and the IRS' expert used the S Corporation Economic Adjustment tax affecting model.[12] After the trial, the IRS tried to disavow its support for their expert's conclusion by this methodology. The appraisal community anxiously awaits the decision in this case.

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[9] *Gross v. Comm'r*, T.C. Memo. 1999-254.
[10] *Estate of Heck v. Comm'r*, T.C. Memo. 2002-34; *Dallas v. Comm'r*, T.C. Memo. 2006-212; *Estate of Natale B. Giustina v. Comm'r*; T.C. Memo. 2016-114; and *Estate of Gallagher v. Comm'r*, T.C. Memo 2011-148.
[11] *Cecil et al. v. Comm'r*, Docket Nos. 14639-14, 14640-14 (2014).
[12] Also known as the "Van Vleet Model," the S Corporation Economic Adjustment Model (SEAM) calculates the value of the S corporation benefit by a formula that compares total tax expense for a company and its shareholders on C corporation and S corporation bases.