

Proposed Changes to Regulations Under IRS Code Section 2704 Issued August 2, 2016

A Webinar Regarding the Proposed Changes
from Business and Valuation Perspectives

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Questions

- To ask a question, use the Question window in the control panel
- Because of time constraints, I may not have time to answer all questions during the webinar
- Any questions not answered during the webinar will be answered off-line after the webinar

Handouts

- Download this presentation deck as well as our recent whitepaper from the Download section of GoToWebinar
- Link to Proposed Changes:
<https://www.federalregister.gov/documents/2016/08/04/2016-18370/estate-gift-and-generation-skipping-transfer-taxes-restrictions-on-liquidation-of-an-interest>

Technical Difficulties and Other Problems

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Caveats at the Outset

I speak as an individual business appraiser from business and valuation perspectives

Our views on the Proposed Changes are evolving

There are many uncertainties and unknowns in the Proposed Changes. We reserve the right to change any views expressed today based on evolving interpretations and new information

The Proposed Changes

Represent an outright attack on family operating businesses in spite of what I call the so-called operating business exception

Represent a not-so-subtle attack on the business purposes of family asset-holding entities

Create a hypothetical world and hypothetical conditions that are not consistent with fair market value concepts

Create a world in which families are assumed to work and interact together unlike any family of size I have ever seen

A Bit of Irony

The purposes of the Proposed Changes include the prevention of undervaluation of transferred interests in family entities

Current valuation concepts for illiquid minority interests include consideration of minority interest and marketability discounts (DLOMs)

The terms “minority interest discount” and “marketability discount” are not mentioned in the Proposed Changes

The drafters of the Proposed Changes have these familiar and useful discounts in their cross-hairs

So What are Clients to Do?

Advice of Numerous Estate Planning Attorneys

1. Engage in transactions now where there is an existing intent to transfer interests
2. No one will know for probably three years whether the Proposed Changes pass judicial muster (assuming they are implemented as drafted)
3. Lock in the existing rules as much as possible
4. Better the devil you know than the one you don't know

Overview

1. Begin with a concept of control (could this be “complete control”?)
2. Define a class of entity “applicable restrictions” that are not applicable given presumption #1
3. Describe a class of “disregarded restrictions” that are to be disregarded if they limit the ability of a holder to redeem or liquidate an interest (given presumption #1) – so any holder can liquidate at any time
4. Provide for an impossible, commercially unreasonable put right to every interest holder
5. Require business appraisers to determine the fair market value of interests under assumptions that are known to be untrue and even commercially unviable
6. Create a hypothetical valuation environment that is not consistent with the standard of value known as fair market value and that requires business appraisers to assume hypothetical conditions and to render hypothetical appraisals


Control Defined

For purposes of section 2701, a **controlled entity** is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of section 307.7701-2(a) of this chapter, immediately before a transfer, **by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse.** (Proposed 2701-2 (i))


Other business entities. In the case of any entity or arrangement that is not a corporation, partnership, or limited partnership, control means the holding of **at least 50 percent of either the capital interests or the profits interests in the entity** or arrangement. In addition, control means **the holding of any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part.** (Proposed 2701-2 (iv))

Control in Words


Complete Control



A “controlled entity” is one where control is held by a **“family”** comprised of the any lineal descendants the parents of a transferor or a transferor’s spouse – very broad

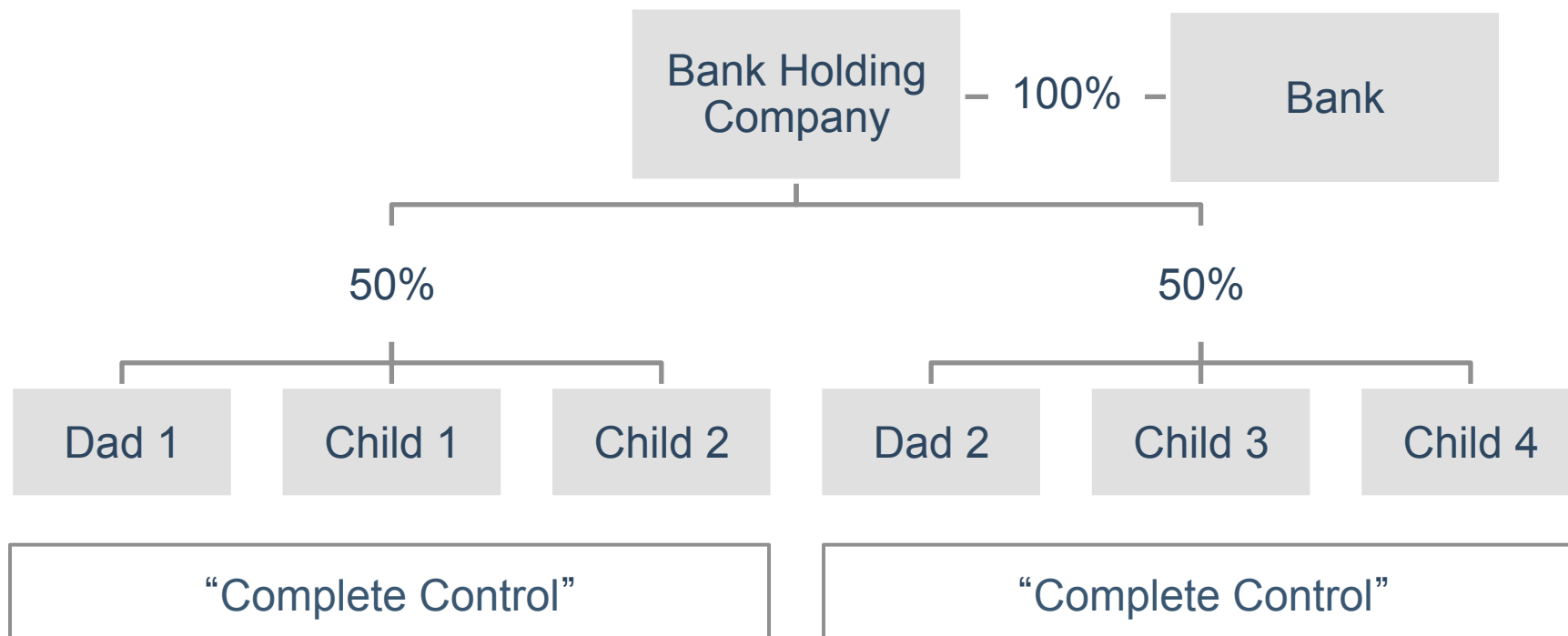


Control consists of **at least 50%** of the voting power within the broadly defined family (or has voting power to liquidate)



“Controlling families” are assumed to vote collectively to eliminate **“applicable restrictions”** and also any “disregarded restrictions”

One Potential Anomaly



Dad 1 and Dad 2 are Unrelated

Applicable Restrictions

(b) *Applicable restriction defined*—(1) *In general.* The term *applicable restriction* means a **limitation on the ability to liquidate the entity, in whole or in part** (as opposed to a particular holder's interest in the entity), if, after the transfer, that limitation either lapses or may be removed by the transferor, the transferor's estate, and/or any member of the transferor's family, either alone or collectively... (Proposed 2704-2 (b))

“Applicable” Restrictions “Not Applicable” if Family has Control

(a) *In general.* For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), if **an interest in a corporation or a partnership (an entity)**, whether domestic or foreign, **is transferred to or for the benefit of a member of the transferor's family**, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, **any applicable restriction is disregarded in valuing the transferred interest.**

(Proposed 2704-2 (a))

What are “Applicable Restrictions”?

Do include restrictions that are imposed under governing documents

Buy-sell agreements

Rights of first refusal

Restrictions on transfer

Restrictions on right to liquidate interests or entities

Put rights at less than minimum value

Other

Disregarded Restrictions

(b) *Disregarded restrictions defined*—(1) *In general.* The term *disregarded restriction* means a restriction that **is a limitation on the ability to redeem or liquidate an interest in an entity that is described** in any one or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to paragraph (b)(4) of this section), either alone or collectively.

Disregard Any Provision That:

1. Limits (or permits the limitation of) the ability of the holder of the interest to compel liquidation

Not realistic or commercially reasonable

Such limitations are placed in operating agreements to facilitate the operation of entities to achieve their business purposes

2. Limits the amount to be received by the holder of the interest on liquidation or redemption to an amount less than “minimum value”

Are family businesses money machines that provide instant cash on demand?

Don't you wish that you could be guaranteed “minimum value” on every investment you make?

Disregard Any Provision That:

3. Would defer payment (to the holder) if the full liquidation or redemption amount for more than six months after the holder gives notice

What happens with entities owning illiquid assets that are not divisible?

Would permit the payment of liquidation or redemption proceeds in any form other than cash or property

Cannot issue note to “liquidating” owner but must pay cash (or distribute property)

Not commercially reasonable

4. Authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property

Promissory notes are not acceptable payment

Cash only, which would force the liquidation of most partnerships to redeem any significant interests

What are the implications of disregarded restrictions for family members?

1. Creates a presumption that any holder (in the family?) can demand liquidation of his/her interest(s) at any time at minimum value and receive cash or property pro rata to the interest
2. Makes an implicit assumption (in the Proposed Changes) that there is no place or purpose for family asset holding entities
3. Would place all family operating companies at significant risk

Lapse or Removal of Limitation

(3) *Lapse or removal of limitation.* A restriction is an **applicable restriction** only to the extent that **either** the restriction by its terms **will lapse** at any time after the transfer, **or** the restriction **may be removed after the transfer by any one or more members, either alone or collectively**, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family.
(Proposed 2704-2(b)(3))

(3) *Lapse or removal of limitation.* A restriction is a **disregarded restriction** only to the extent that the restriction **either will lapse** by its terms at any time after the transfer **or may be removed after the transfer by any one or more members, either alone or collectively**, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family.
(Proposed 2704-3(b)(3))

Lapse or Removal of Limitation

(1) For purposes of subtitle B..., the lapse of a voting right in a corporation or a partnership (an entity), whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse (the holder) to the extent provided in paragraphs (b) and (c) of this section. (Proposed 25.2704-1(a)(1))

The “value” of a lapse (of control or liquidation right) is the fair market value of the interest before the lapse (minimum value) minus the fair market value of the interest after the lapse (presumably a discounted value)

Assignee Interests

A transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights. For example, the transfer of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest.

(Proposed 2704-1(a)(5))

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What is a Put Right?

A put option is an option contract giving the owner the right, but not the obligation, to sell a specified amount of a security at a specified price within a specified time (Investopedia)

A put provides a potential avenue to liquidity – if a business has the financial wherewithal to honor it

Put rights are considered to provide some downside protection for investors

Why would you put if the future looks bright?

The New Put Right

(iv) *Put right of each holder.* Any restriction that otherwise would constitute an applicable restriction under this section **will not be considered an applicable restriction if each holder of an interest in the entity has a put right** as described in § 25.2704-3(b)(6).
(Proposed 2704-2(b)(4)(iv))

(v) *Right to put interest to entity.* Any restriction that otherwise would constitute a disregarded restriction under this section will not be considered a disregarded restriction **if each holder of an interest in the entity has a put right** as described in paragraph (b)(6) of this section.
(Proposed 2704-3(5)(v))

Breaking the Put Right Down

Restrictions are **not considered** “disregarded applicable restrictions” or “disregarded restrictions” **if** “**each holder of an interest in an entity**” has a **put right**

- The put right apparently trumps other provisions in the IRS valuation book

It is **not commercially reasonable** to assume that each member of a family entity – or any entity – would have unlimited put rights to the entity

No so subtle attack on the business purposes of family entities

Going concern status of an entity where each holder has a put right to the entity?

Race to put first?

Pricing of the Put Right

(6) *Put right.* The term *put right* means **a right**, enforceable under applicable local law, to **receive from the entity or from one or more other holders**, on liquidation or redemption of the holder's interest, **within six months after the date the holder gives notice** of the holder's intent to withdraw, cash and/or other property with a **value that is at least equal to the minimum value** of the interest **determined as of the date of the liquidation or redemption**. (Proposed 2704-3(6))

The DOT/IRS seem to believe this put right is no issue at all, since families would simply vote to liquidate to honor a put if necessary, even if it destroyed their business

Minimum Value

(ii) The provision limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a minimum value

The term *minimum value* means the interest's share of the net value of the entity determined on the date of liquidation or redemption.

- Essentially, minimum value is the net asset value of an entity on a market value basis (on the date of liquidation or redemption – and not on the valuation date)
- Language attempts to exclude real liabilities like embedded capital gains in C corporations
- For asset holding entities, **minimum value is really maximum value**

Put Right Questions for Family Entities

The fictitious put right is apparently “enforceable under local law”

- How? It doesn’t exist
- What do the “words on the page” say as to how the put operates? They don’t. Appraisers will have to define?

Right to receive from the entity **or from one or more holders**

- How are the other holders involved? (One big happy family?)

Within six months after holder gives notice of intent to withdraw

- How can appraisers assume payment within six months if assets are illiquid?
- A securities-only entity might be able to honor a put by liquidating securities
- What about the business purpose of the family entity?

Cash or other property equal to “minimum value” – **No promissory notes**

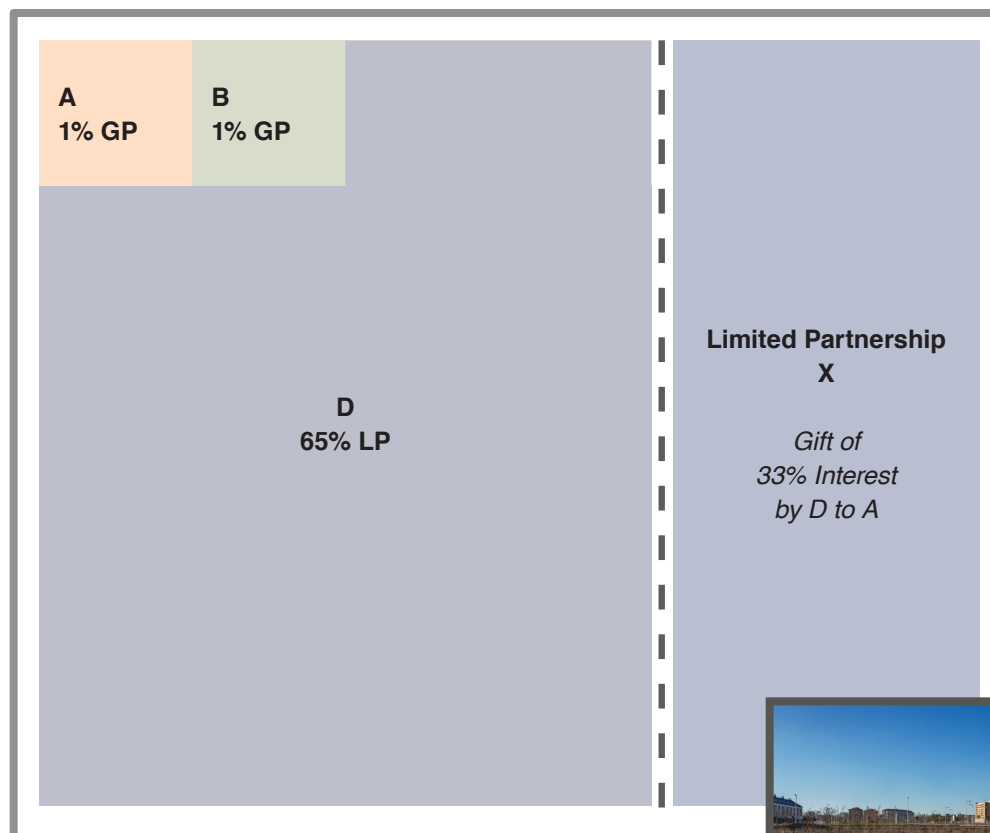
What If the Asset is an Apartment Building?

What good is a so-called six month put when it may take a year or more to liquidate the underlying asset?

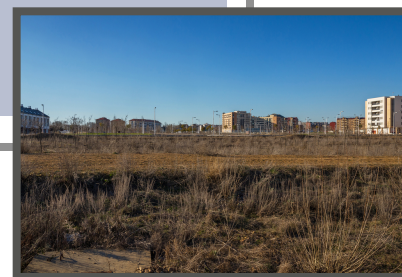


What If the Asset is Urban Dirt?

What good is a so-called six month put when it may take a year or two or more to liquidate the underlying asset?

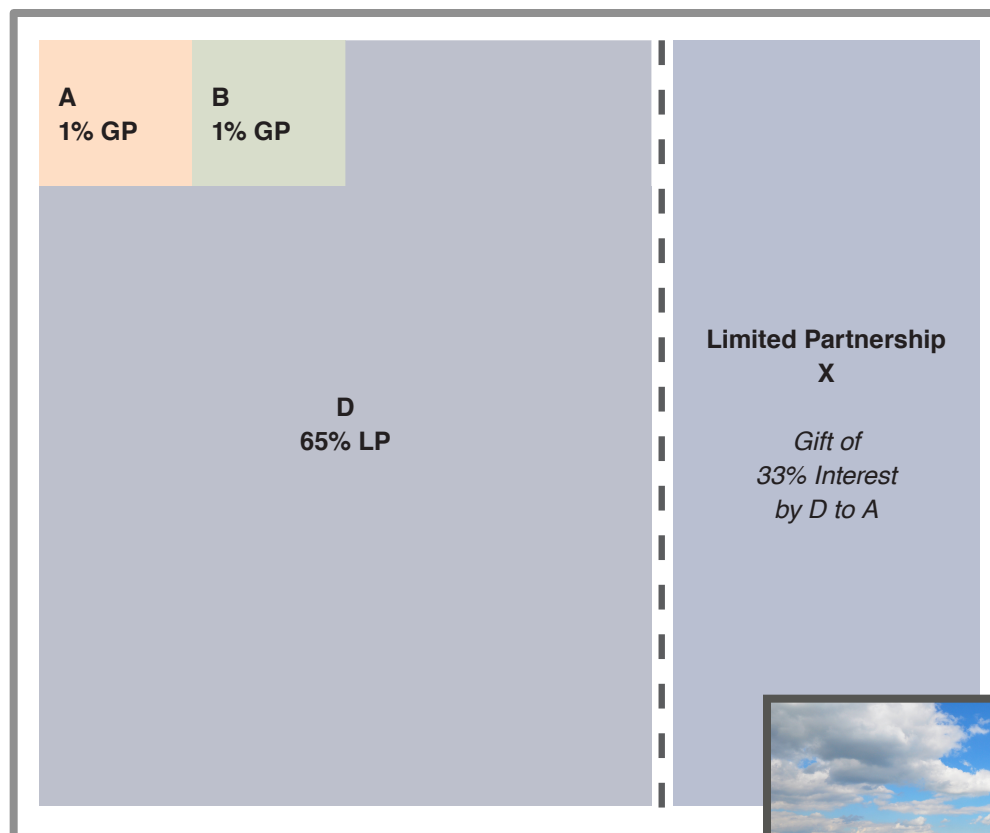


Concept of fractional interest discount part of fair market value of the interest?

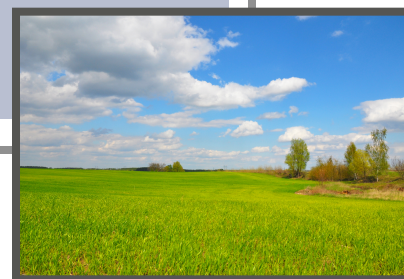


What If the Asset is Farmland?

What good is a so-called six month put when it may years to liquidate the underlying asset?



Concept of fractional interest discount part of fair market value of the interest?



More Put Right Questions for Family Entities

Does the put right flow to hypothetical willing buyers, who, in turn, would be able to put the interest at minimum value at any time?

- Would hypothetical willing buyers believe this, or is this a hypothetical condition that must be assumed by appraisers?
- Would hypothetical willing buyers even show up to negotiate?

What kind of investment is it when value is created by a hypothetical put rather than by the economics of an investment over a reasonable expected holding period?

Determined as of the date of the hypothetical liquidation or redemption

- What about risks between the “put” and the hypothetical liquidation?
 - Securities only?
 - Apartment building?
 - Urban dirt?
 - Rural land?
- What about liquidation costs?
- The put is at minimum value, but the proceeds will be less than minimum value?
 - Are liquidation costs to be shared or is the first to put a winner?

Summary Thoughts Regarding the Hypothetical Put Right

From Business and Valuation Perspectives

Non-economic

Would never be negotiated between arm's length parties (or families)

Would be subject to definition by appraisers

If deemed real, could have positive impact on value of interests in family asset holding entities

In the alternative, the riskiness of any operating entity where all holders have a put right is increased, so overall entity value could be diminished

Certainly does not “fix” value at so-called minimum value

The Operating Company “Exception”

The Company

A company with an “active trade or business” representing 60% or more of its value can issue a note

The Note

The note (or other consideration) must:

- Be adequately secured
- Provide for periodic payments of principal and interest with no deferral provision
- Provide a market rate of interest
- Have a **fair market value** equal to the liquidation proceeds

Interesting that the Proposed Changes recognize the risks inherent in a note issued by a family operating business, including illiquidity, but they do not recognize the same impediments to liquidity for operating business interests

The Operating Company “Exception”

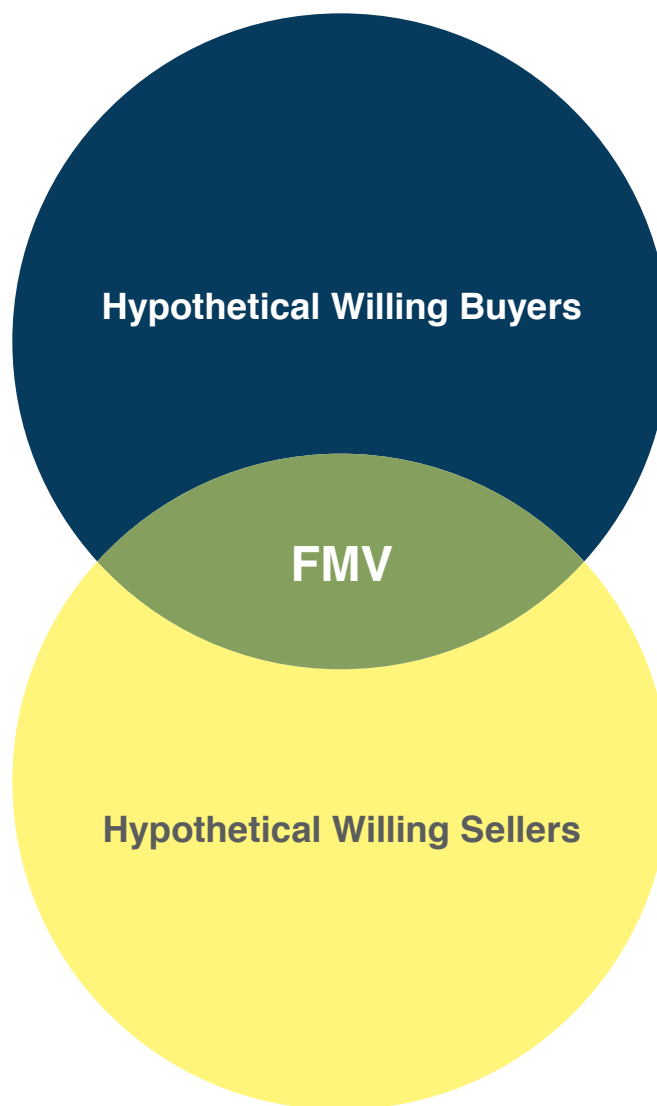
The Company

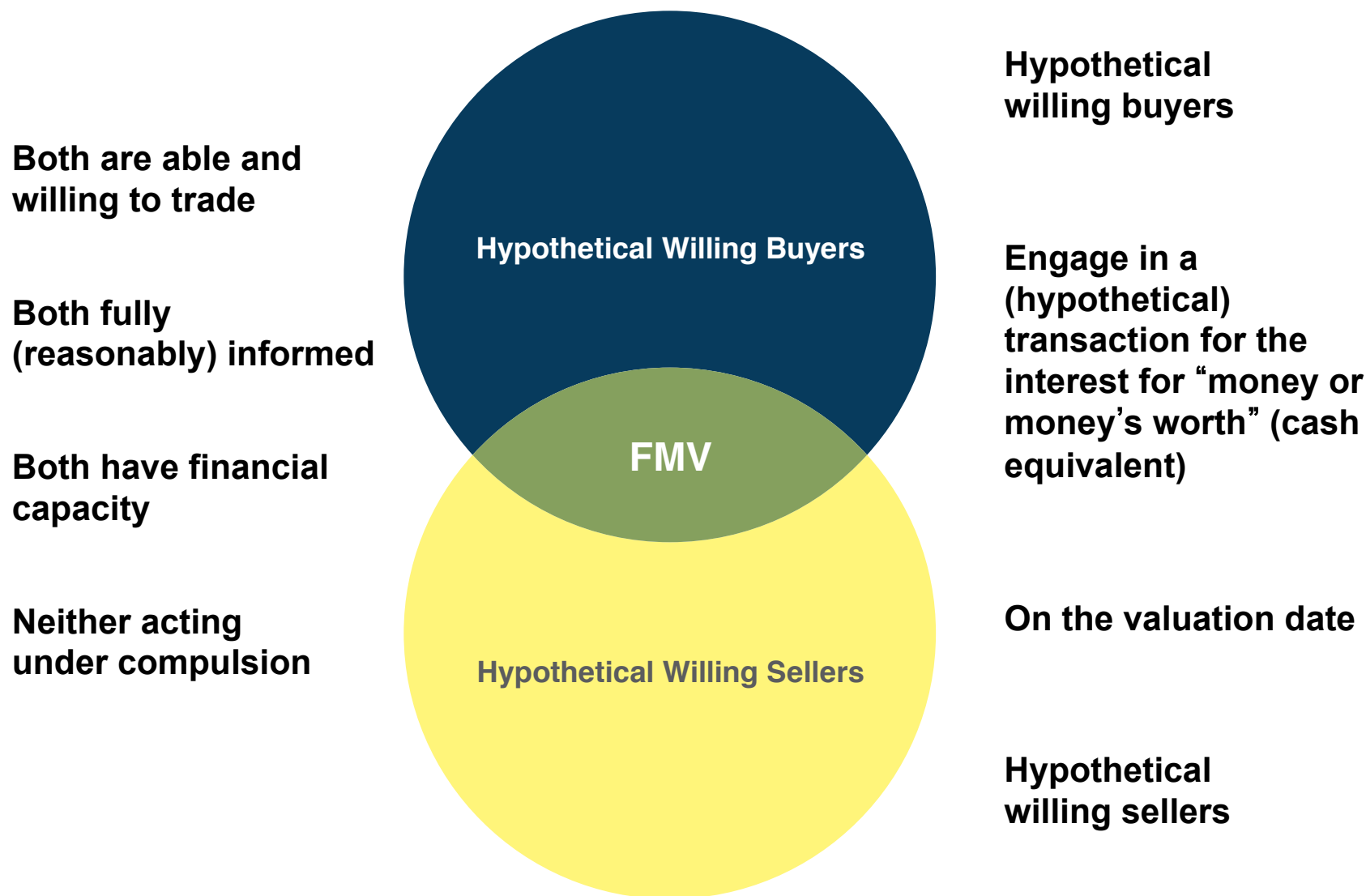
- Not really an exception at all
- Passive (or non-operating) assets cannot be used to honor a put
- Existence of hypothetical put rights increases risk and cost of capital, and depresses entity value?
- Ability to liquidate or redeem for all interests creates instability for operating companies
- Should appraisers increase cost of capital to reflect this risk and lower operating company value?

The Note

- Not feasible to secure a note if the company is already borrowing and pledging operating assets
- What is a “market rate of interest”?
- Leverage may increase the company’s debt costs
- What happens if the company cannot issue a note?

Talk About Fair Market Value

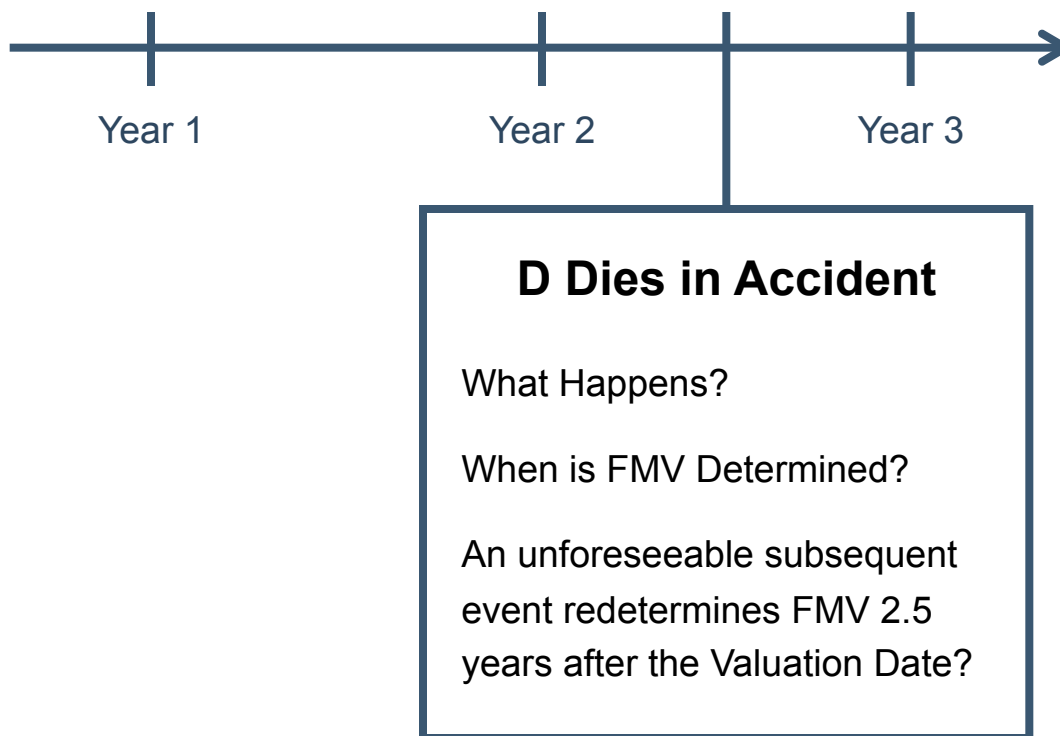




When is FMV Determined?

The “Death Bed” Transfer Solution

	Valuation Date
NAV	\$10,000
Interest	33%
Pro Rata NAV	\$3,300
Valuation Adj.	x (1-25%)
HWB Pays	\$2,475



Point to Paragraph (f)

For purposes of subtitle B ... , and notwithstanding any provision of section 25.2704-2, **if an interest** in a corporation or partnership (an entity), whether domestic or foreign, is **transferred to or for the benefit of a member of the transferor's family**, and the transferor **and/or members** of the transferor's family **control the entity** immediately before the transfer, any **restriction** described in paragraph (b) of this section is **disregarded**, and the **transferred interest is valued** as provided in paragraph (f) of this section. (Proposed 2704-3(a))

Fair Market Value Instructions per Paragraph 2704-3(f)

If a restriction is disregarded under this section, the **fair market value** of the transferred interest is determined under **generally applicable valuation principles... as if the disregarded restriction does not exist in the governing documents, local law, or otherwise.** (Proposed 2704-3(f))

Remember disregarded restrictions?

Essentially anything that would prevent liquidity for cash within six months

“Normal” Valuation for Family Asset-Holding Entity

Operating Agreement

- Restrictions on transfer
- Right of first refusal
- Buy-sell agreement
- Restrictions on liquidation
- Put right at less than minimum value
- Normal operating provisions

Entity/Interest Economics

- Net asset value
- Expected distribution yield
- Expected growth in value
- Expected holding period for investment
- Risks of the expected holding period
 - General illiquidity
 - Asset composition
 - Expected management policies
 - Limited market for interests
 - Restrictions on transfer
 - Acquisition and monitoring costs

Section 2704 Valuation

Operating Agreement

~~Restrictions on transfer~~

~~Right of first refusal~~

~~Buy-sell agreement~~

~~Restrictions on liquidation~~

~~Put right at less than minimum value~~

Normal operating provisions

Put right to all owners at minimum value

Entity/Interest Economics

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Expected management policies

Limited market for interests

~~Restrictions on transfer~~

Acquisition and monitoring costs

Put right at minimum value

Immediate Implications of Proposed Guidance

Appraisers are to use the standard of value known as **fair market value**

- The subject of the valuation upon transfer is the transferred interest
- The valuation date is the date of transfer
- The distinction between the transferred interest and the entity in which it represents ownership is also important

Appraisers are to employ **generally applicable valuation principles**

- USPAP
- ***ASA Business Valuation Standards*** and ***Principles of Appraisal Practice and Code of Ethics*** of the American Society of Appraisers
- Other relevant standards from other organizations

Now, appraisers are to assume that all disregarded restrictions or applicable restrictions do not exist in the governing documents or anywhere

- In disregarding actual restrictions, must appraisers assume hypothetical conditions and render hypothetical appraisals?

Hypothetical Appraisal (PAPCE)

A hypothetical appraisal is an appraisal based on assumed conditions which are contrary to fact or which are improbable of realization.

The Society [the ASA] takes the position that there are legitimate uses for some hypothetical appraisals, but that it is improper and unethical to issue a hypothetical appraisal report unless (1) the value is clearly labeled as hypothetical (2) the legitimate purpose for which the appraisal was made is stated and (3) the conditions which were assumed contrary to fact are set forth.

Hypothetical Condition under USPAP

Hypothetical Condition

a **condition**,
directly related to a specific assignment, which
is contrary to what is known by the appraiser to exist
on the effective date of the assignment results,
but is used for the purpose of analysis

Comment: Hypothetical conditions are contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property

Reporting Implications under USPAP

The content of an Appraisal Report must be consistent with the intended use of the appraisal and, at a minimum:
...clearly and conspicuously state all extraordinary assumptions and hypothetical conditions; and state that their use might have affected the assignment results;...
(Standards Rule 10-2(a)(x))

Fair Market Value Defined

(ASA Business
Valuation Standards)

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Fair Market Value Defined

(Revenue Ruling 59-60
Section 2.02)

.02 Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the 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 relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

“All Relevant Factors” of RR 59-60

Sec. 4. Factors to consider.

.01 It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, **all available financial data, as well as all relevant factors affecting the fair market value, should be considered.** The following factors, although not all-inclusive are fundamental and require careful analysis in each case

Question: Are the economics of an illiquid minority interest that is transferred among the “relevant factors” that should be considered? The Proposed Changes as written suggest, perhaps not

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An Example from the Proposed Changes

D and D's children, A and B, are partners in Limited Partnership X that was created on July 1, 2016

D owns a 98 percent limited partner interest, and A and B each own a 1 percent general partner interest

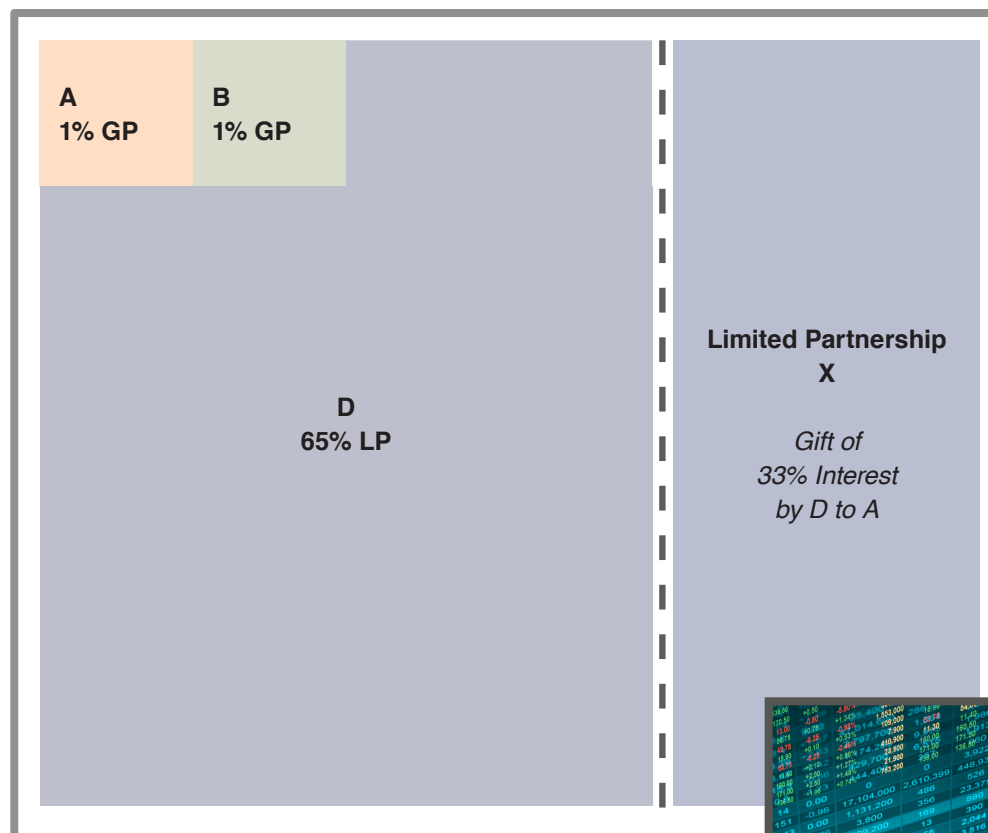
The partnership agreement provides that the partnership will dissolve and liquidate on June 30, 2066, or by the earlier agreement of all the partners, but otherwise prohibits the withdrawal of a limited partner

- Under applicable local law, a limited partner may withdraw from a limited partnership at the time, or on the occurrence of events, specified in the partnership agreement
- **Under the partnership agreement, the approval of all partners is required to amend the agreement**
- **None of these provisions is mandated by local law**

D transfers a 33 percent limited partner interest to A (*omit transfer to B for example*).
(Proposed 2704-3(g))

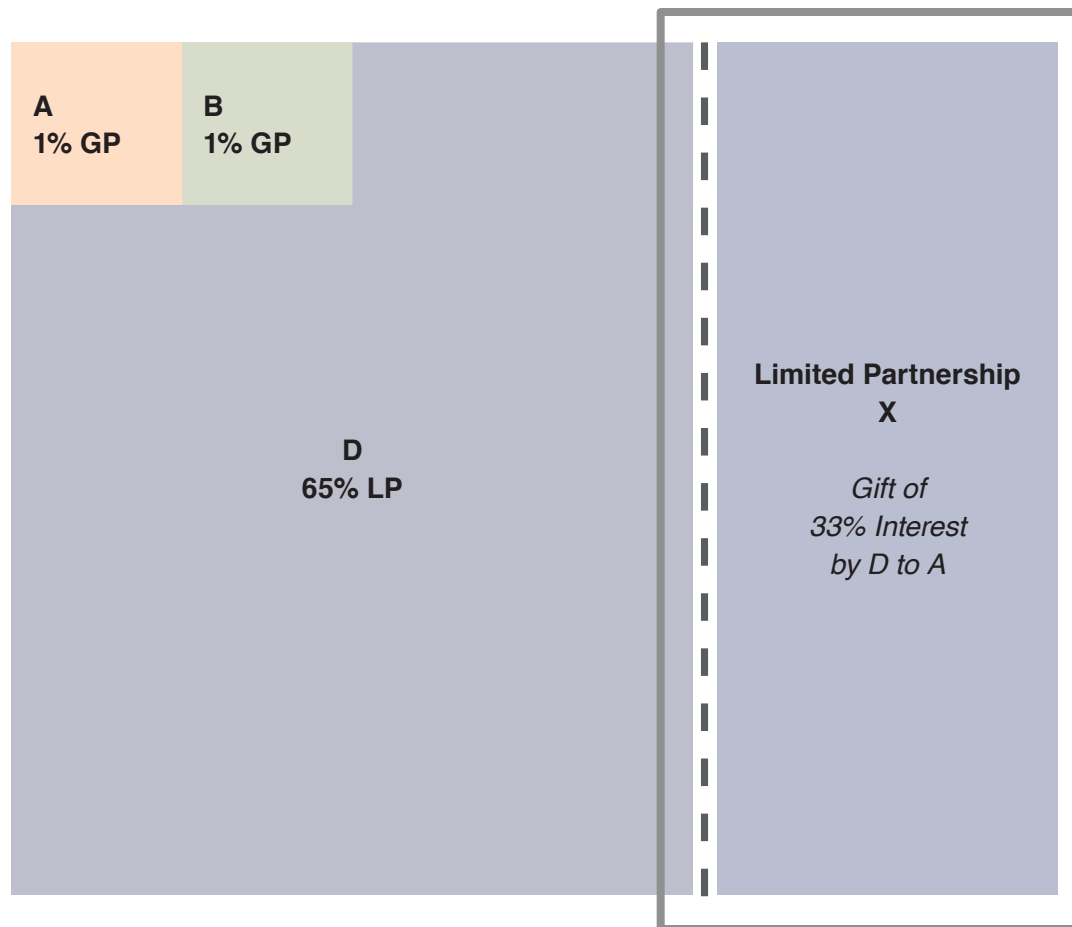
Limited Partnership X

The example is silent regarding the assets held by Limited Partnership X or how or when it came into being



Limited Partnership X After Transfer

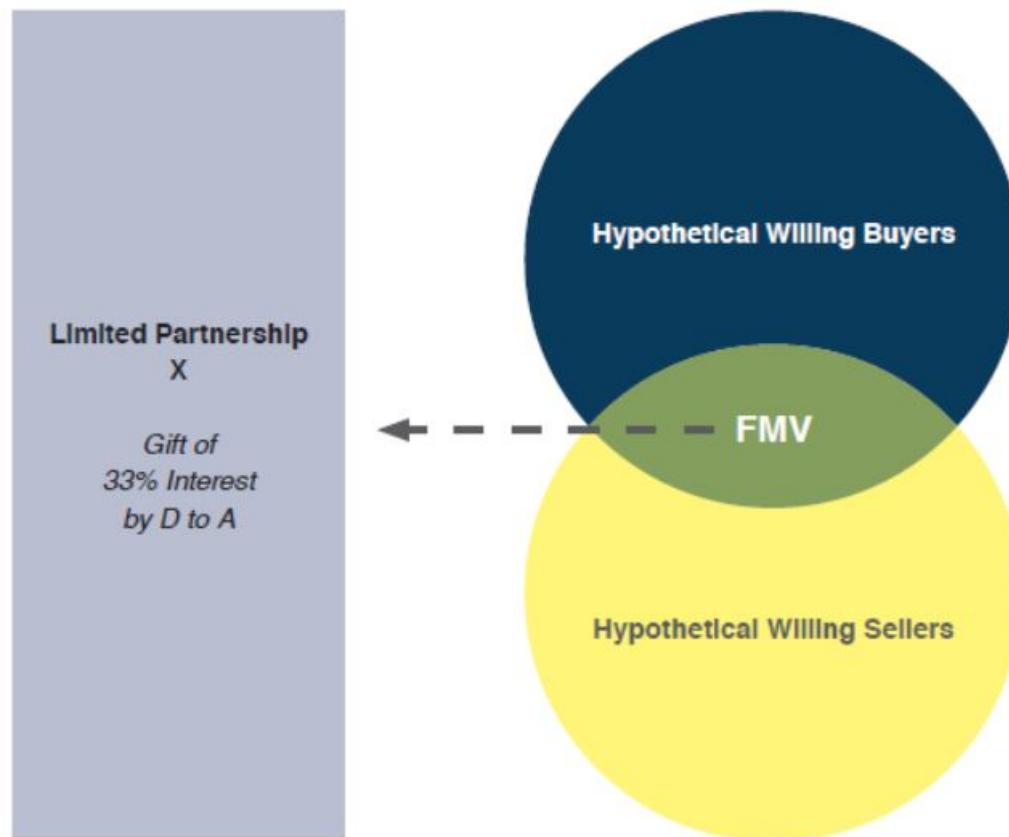
But as a
business
appraisers, we
have to value
the 33%
interest



Fair Market Value of the 33% Interest

Recall the definitions of Fair Market Value

They apply to the 33% interest of Limited Partnership X



Partnership Assumptions Regarding Limited Partnership X

1. Partnership agreement contains normal provisions providing for the right of general partners to manage the affairs of the partnership
2. Partnership will dissolve in 2066 or by earlier agreement of the partners
3. Otherwise, withdrawal by a partner is prohibited
4. Under local law, an LP **may withdraw** from a partnership as specified in the partnership agreement; however, approval of all of the partners is required to amend the partnership agreement
5. None of these provisions is mandated by local law
6. Likely there are certain restrictions on transfer to non-family investors and a right of first refusal provision in the event someone desires to obtain liquidity
7. Business purpose is to maintain, preserve and grow family wealth

Economic Assumptions Regarding Limited Partnership X

1. “Plain vanilla” large capitalization, securities only
2. Market values of securities total \$10.0 million **as of the date of transfer**
3. No liabilities
4. Net asset value (“minimum value”) is \$10.0 million
5. Expected annual return on the portfolio is 8.0%
6. Expected distribution is 2.5% of beginning asset value
7. Expected annual appreciation in value is 5.5% (8.0% - 2.5%)
8. D has life expectancy of 8 years and A and B plan to liquidate upon his death

Possible Valuation Methods Under the Proposed Changes

Method 1. Pro Rata Net Asset Value (Minimum Value) – **Hypothetical**

Method 2. Pro Rata Net Asset Value less a valuation adjustment pertaining to uncertainties regarding the ability of the entity to honor the put on a timely basis – **Hypothetical**

Method 3. DCF Value based on expected cash flows, expected growth and expected risks associated with receipt of the cash flows (“Normal” DCF method as hedge) – **Not Hypothetical**

Method 1 – Pro Rata Net Asset Value

Step 1

Determine market values of all assets of Limited Partnership X and subtract liabilities

That's \$10.0 million for Limited Partnership X (Minimum Value)

Step 2

“Fair market value” of the 33% interest in Limited Partnership X is therefore \$3.3 million (\$10.0 million x 33%) - **Hypothetical**

Method 1 – NAV / Minimum Value

Does not represent fair market value

Hypothetical willing buyer was not present for the hypothetical negotiations

No HWB would pay minimum value for the interest when there is immediate downside risk and lack of control following a put (if the HWB, who is not a family member, gets the put)

Many interpret this Method 1 as the goal of the DOT/IRS

- A number of attorneys have said this is not the right interpretation of the IRS goal based on conversations with IRS personnel
- However, many make this interpretation, so we show it, even though it ignores Proposed 2704-3(f)

Method 2 – NAV Less Uncertainties Regarding Liquidation

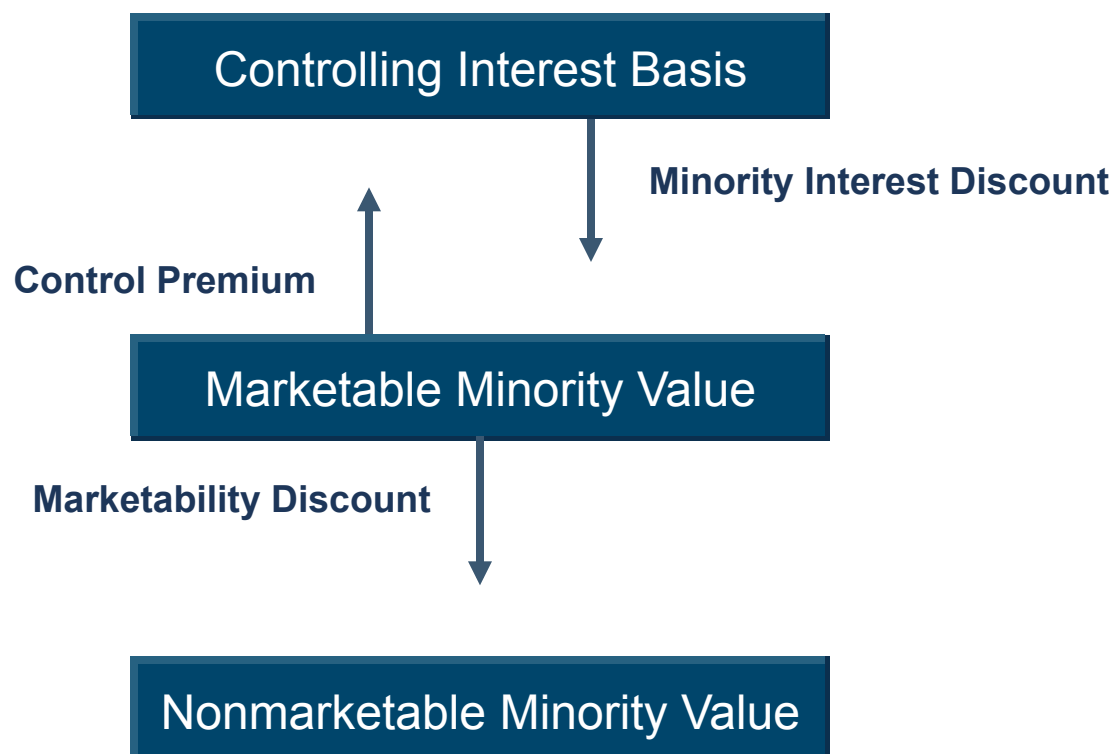
Examine hypothetical family entities holding four distinctly different asset classes

- Securities only
- Income producing property (an apartment building)
- Vacant urban dirt with little immediate potential
- Rural land with little immediate potential

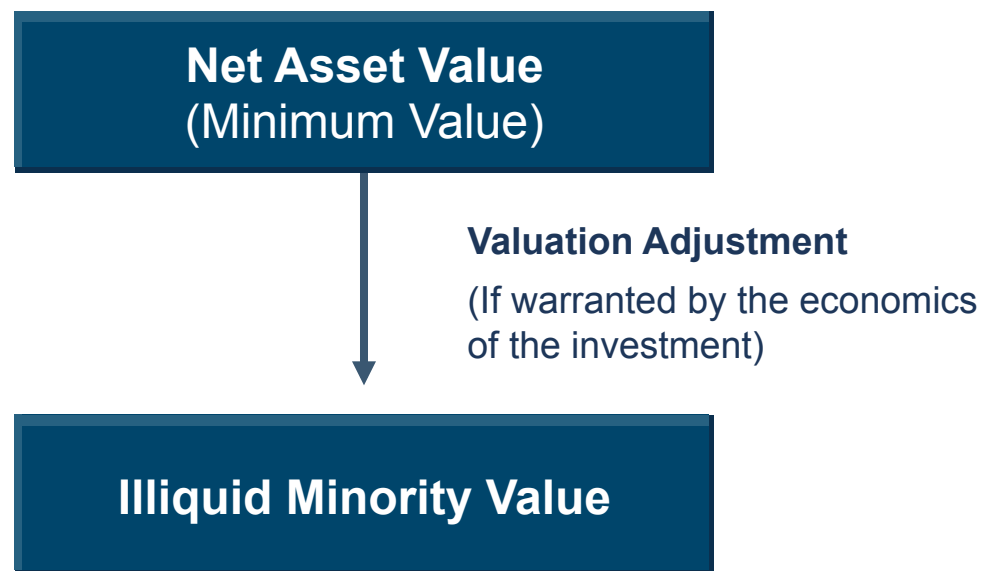
Make simplifying assumptions re basic economics of the partnerships

Make simplifying assumptions re the estimated time to liquidate the underlying assets of the partnerships

This Levels of Value Chart Will Likely Not Work Under Proposed Changes



Levels of Value Under Section 2704?



Method 2 – NAV Less Uncertainties Regarding Liquidation

Hypothetical Buyers Question the Expected Time to Liquidation of Assets

Discounting Factors	Assumed Base Return	Assumed Holding Period Premium to Base Return	Req'd Return	Estimated Time to Liquidation					
				6 Months	1 Year	1.5 Years	2.0 Years	2.5 Years	3.0 Years
				0.5	1.0	1.5	2.0	2.5	3.0
Expected NAV at Assumed Base Return				\$1.039	\$1.080	\$1.122	\$1.166	\$1.212	\$1.260
Asset Categories in Family Entities									
Securities Only	8.0%	5.0%	13.0%	5.9%					
Income Producing Property	8.0%	7.0%	15.0%			18.9%			
Urban Raw Land	8.0%	9.0%	17.0%					32.5%	
Rural Land	8.0%	11.0%	19.0%						40.7%

Implied Discounts Based on Differing Estimated Times to Liquidate Underlying Assets

All are Hypothetical

Method 3 – No Put (“Normal”) – A Hedge Valuation

Relevant Factors Pertaining to the 33% Interest for Methods 2a and 2b

1. Limited Partnership X has a specific portfolio that HWBs could replicate and maintain complete control – **Additional Risk**
2. HWB subject to future management decisions of A and B and their expected distribution policy – **Additional Risk**
3. HWB has information acquisition costs that can only be recouped in initial pricing – **Additional Risk**
4. HWB has ongoing investment monitoring costs that can only be recouped in initial pricing – **Additional Risk**
5. HWB has uncertainties of the expected holding period which is of unknown duration, even though assumed – **Additional Risk**
6. HWB would recognize that \$3.3 million pro rata NAV (or a discounted value from there) represents a significant investment that limits the market for the interest – **Advantage Buyer**

Method 3 – No Put (“Normal”)

Relevant Factors Pertaining to the 33% Interest for Methods 2a and 2b

7. HWB understands that, with no right to put or withdraw, that there is no market for the interest and it is quite illiquid – **Additional Risk**
8. All of above suggests that HWB accepts additional risk that requires compensation over the basic expected 8.0% return of the Partnership, which implies a valuation discount (of whatever name) from minimum value
9. The HWS, who is rational, capable and knowledgeable, would recognize the value-reducing impact of the factors above and **negotiate for the best possible price from his viewpoint, which he knows is not minimum value**

Method 3 – No Put (“Normal”)

Develop a Required Return for the 33% Interest

Remember the Economics of the 33% Interest

Required Holding Period Return (Shareholder-Level Discount Rate) - No Put

Components of the Required Holding Period Return		Estimated Range		Source/Brief Rationale
		Lower	Higher	
1	Base Holding Period Required Return	8.00%	8.00%	Expected annual return of the portfolio
Investor Specific Risk Premium(s) for This Investment:				
2	+ Uncertainties of Expected Holding Period	1.00%	1.00%	Hypothetical buyers face holding period risks
3	+ Information Acquisition Cost Premium	1.00%	1.00%	Only time for buyer to recoup these costs
4	+ Monitoring Costs	0.50%	1.00%	Only time for buyer to recoup these costs
5	+ Uncertainties Due to Risks of Future Investment Strategies	0.50%	1.00%	A & B's abilities and motivations are not known
6	+ Large Size(s) of the Investment Limits Market	0.00%	1.00%	Small number of qualified hypothetical buyers
7	+ General Illiquidity of the Investment	1.00%	1.00%	Cannot transfer or withdraw
8	+ Other	0.00%	0.00%	Depends on facts and circumstances
9	Total Investor Specific Risk Premium for This Entity	4.00%	6.00%	Sum of above
10	Estimated Range of Required Holding Period Returns	12.00%	14.00%	Enterprise discount rate plus shareholder risks
11	Rounded Range	12.00%	14.00%	To Nearest 0.3%
12	Mid-Point of Estimated Required Return Range	13.0%		For reference

Method 3 – No Put (“Normal”)

DCF Valuation Assumptions

Discounted Cash Flow Shareholder-Level Valuation Discount Model (QMDM)

DCF Assumptions		Corresponding QMDM Assumptions		Model Inputs	
Forecast Period	Range of Expected Holding Periods (Years)	Low High	6	Assumed eight year expected holding period (plus or minus)	
			10		
Projected Interim Cash Flows (during forecast period)	Expected Distribution / Dividend Yield Expected Growth in Distribution / Dividend Timing (Mid-Year or End of Year)	Yield Growth Timing	2.5%	A&B say that will distribute 2.5% yield	
			5.5%	Same as Gv	
			M	Expectation for quarterly distributions	
Projected Terminal Value (at end of forecast period)	Growth in Value over Holding Period Premium or Discount to Marketable Value	G _v Prem/Disc.	5.5%	8.0% expected return less dividend yield	
			0.0%		
Discount Rate	Range of Required Holding Period Returns	Low High	12.0%	From prior build-up	
			14.0%	From prior build-up	
		Base Value (Net Asset Value)	\$1.00	Minimum Value	

Method 3 – No Put (“Normal”)

Calculate Range of Expected Valuation Discounts

Concluded Range of Valuation Discounts											Lower	Upper	Average		
											18%	37%	27%		
Required Holding Period Return (Annual %)	Assumed Expected Holding Periods in Years														
	1	2	3	4	5	6	7	8	9	10	15	20	25	30	
	Implied Valuation Discounts														
	11.0%	3%	5%	7%	10%	12%	14%	16%	17%	19%	21%	28%	33%	37%	41%
	12.0%	3%	7%	10%	13%	15%	18%	20%	23%	25%	27%	35%	41%	46%	49%
	13.0%	4%	8%	12%	16%	19%	22%	25%	27%	30%	32%	42%	48%	53%	56%
	14.0%	5%	10%	14%	18%	22%	26%	29%	32%	34%	37%	47%	54%	59%	62%
	15.0%	6%	11%	16%	21%	25%	29%	33%	36%	39%	41%	52%	59%	63%	66%

PV=100%

PV=100%

Method 3 – No Put (“Normal”)

Examine the Implied Expected Returns for the Investment

Expected Returns Over Various Holding Periods Given Valuation Discount Selected

Discount Applied	1.5%	Selected Discount Increment													
		Subsequent Expected Holding Periods in Years													
		1	2	3	4	5	6	7	8	9	10	15	20	25	30
	24.0%	43%	24%	19%	16%	15%	14%	13%	12%	12%	12%	11%	10%	10%	10%
	25.5%	46%	26%	20%	17%	15%	14%	13%	13%	12%	12%	11%	10%	10%	10%
	27.0%	49%	27%	21%	17%	16%	14%	14%	13%	12%	12%	11%	10%	10%	10%
	28.5%	52%	28%	21%	18%	16%	15%	14%	13%	13%	12%	11%	10%	10%	10%
	30.0%	55%	30%	22%	19%	17%	15%	14%	14%	13%	13%	11%	11%	10%	10%

H.R. 6042

A BILL

- To nullify certain proposed regulations relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes.
- *Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

SECTION 1. NULLIFICATION OF CERTAIN PROPOSED REGULATIONS RELATING TO RESTRICTIONS ON LIQUIDATION OF AN INTEREST WITH RESPECT TO ESTATE, GIFT, AND GENERATION SKIPPING TRANSFER TAXES.

Regulations proposed for purposes of section 2704 of the Internal Revenue Code of 1986 relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes, published on August 4, 2016 (81 Fed. Reg. 51413), and any substantially similar regulations hereafter promulgated, shall have no force or effect.



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Follow Up

Questions: Any questions that I was unable to address during the webinar will be handled off-line.

CPE Credit: After exiting this webinar, a survey will pop up. Please record the CPE Code as instructed. CPE Certificates will be emailed within 2 – 3 days

Other: If you would like to further discuss the Proposed Changes to Section 2704, please contact any of us here at Mercer Capital.

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Chris Mercer is the founder and CEO of Mercer Capital, a national business valuation and financial advisory firm.

Chris began his business valuation career in the 1970s and has been involved with hundreds of valuations for purposes related to mergers & acquisitions, litigation, and estate and gift tax planning, among others.

Chris has extensive experience in litigation engagements including statutory fair value cases, business damages, and lost profits. He is also an expert in buy-sell agreement disputes.

Chris is a prior chair of the Standards Sub-Committee for the Business Valuation Committee of the American Society of Appraisers and a former member of the International Valuation Professional Board of the International Valuation Standards Committee (IVSC).

Designations held include Fellow Accredited Senior Appraiser (FASA) from the American Society of Appraisers, Chartered Financial Analyst (CFA) from the CFA Institute, and Accredited in Business Appraisal Review (ABAR) from the Institute of Business Appraisers.

Chris has written widely on business valuation-related topics and is a frequent speaker on business valuation issues for national professional associations, other business and professional groups, and business owners.

Recent books authored by Chris include *Unlocking Private Company Wealth* (Peabody Publishing, LP 2014), *Buy-Sell Agreements for Closely Held and Family Business Owners* (Peabody Publishing, LP 2010) and *Business Valuation: An Integrated Theory, 2nd Edition*, with Travis W. Harms (John Wiley and Sons 2008).

For a complete list of the books authored by Chris, as well as further information on his valuation-related experience, view his complete CV at www.mercercapital.com.

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