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QUARTERLY INSIGHTS

Section 2704 Proposed Regulation Coming Possibly in Fall 2015

Catherine Hughes, Office of Tax Policy of the US Treasury Department, recently spoke at the American Bar Association Conference. Part of her discussion indicated that proposed regulations under IRC section 2704 will likely be introduced in the fall of 2015. Those regulations may limit the availability of lack of control and lack of marketability discounts for transfers of closely held interests among family members. Accordingly, clients contemplating the transfer of closely held business interests should consider making those gifts as soon as possible, prior to the issuance of the proposed regulations.

Details

IRC Section 2704 & Applicable Restrictions

IRC Section 2704 was enacted in 1990 to eliminate perceived valuation abuses concerning certain lapsing voting and liquidation rights as well as certain restrictions on liquidation. Specifically, the statute addresses transfers of interests in controlled corporations or partnerships among family members. In valuing those transfers "applicable restrictions" are to be disregarded. An "applicable restriction" is any restriction that effectively limits the ability of a corporation or partnership to liquidate and, (i) where either the restriction lapses, in whole or in part, after the transfer, or (ii) the transferor or family members can remove the restriction, in whole or in part.

An applicable restriction, however, does not include any restriction imposed by federal or state law, nor any reasonable restriction which arises as part of financing to the corporation/partnership with a person who is not related to the transferor or transferee, or a member of the family of either. Many states enacted statutes that caused a restriction to be imposed by state law such that discounts for those restrictions were still permitted.

Section 2704(b)(4) provides that the IRS can issue regulations that would disregard other restrictions if the restriction has the effect of reducing the value of the transferred interest, but does not ultimately reduce the value of such interest to the transferee. Under this provision, the IRS intends to issue proposed regulations.

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When Will the Regulation Take Effect?

It is not known if this Regulation will be effective as of the date of the Proposed Regulation, or as of the date of issuance of the Final Regulation. If gifts, as described above, are contemplated, the safest approach is to make them prior to issuance of the Proposed Regulation in late summer or early fall of 2015.

U.S. IPOs to Maintain Pace Over Remainder of Year

Initial public offerings (IPOs) on U.S. exchanges finished the first half of the year with a flurry of activity. In fact, the 33 offerings that priced in June represent the highest number of deals since July of last year. Yet, despite this strong finish, the number of U.S. IPOs and proceeds raised through six months are down significantly when compared to 2014.*

According to the ***2015 BDO IPO Halftime Report***, a survey of capital markets executives at leading investment banks, IPO activity on U.S. exchanges during the second half of the year should mirror the first six months of 2015. A majority (54%) of bankers predict IPO activity will remain at the same level as the first half of the year. Just over a quarter (26%) anticipate the pace of U.S. IPO activity will increase in the second half of 2015, while one-fifth (20%) forecast a decrease in offering activity. Overall, capital market executives are predicting virtually no net change (under 1%) in the number of U.S. IPOs during the second half of the year.

Bankers anticipate these offerings will average just $174 million in size for the remainder of 2015, approximately the same as the first half of the year. This projects to less than $36 billion in total IPO proceeds on U.S. exchanges in 2015, the lowest level of proceeds since 2009 when the market was still reeling from the financial crisis.

"It was almost inevitable that the 2015 U.S. IPO market was going to experience a slowing of growth given the impressive increases achieved in 2013 and 2014, however the drop-off in offerings this year has been significant. While there are always multiple contributing factors for such a dramatic change, the capital markets community clearly believes the wide availability of private financing at favorable valuations is playing the leading role," said Brian Eccleston, a partner in the Capital Markets Practice at BDO USA. "If this access to private funding continues, bankers believe it will lead to fewer IPOs moving forward. Certainly, this is a trend that bears watching."

When compared to 2014, when 275 IPOs generated more than $85 billion in proceeds*, the number and size of U.S. IPOs have dropped considerably this year. A majority (56%) of capital markets executives believe the widespread availability of private funding at attractive valuations is the main factor in the dramatic drop in the number of initial public offerings (IPOs) on U.S. exchanges in 2015 when compared to 2014. A cooling stock market (22%), fewer offerings from private equity firms (14%) and the collapse of oil prices (8%) are cited as the main factor by much smaller proportions of the bankers.

When asked about the impact of companies putting off their IPOs due to the availability of late-stage financing in the private sector, a majority (61%) of the bankers feel it will lead to fewer offerings going forward, while more than a quarter (29%) predict it will result in better IPOs in the future. Two-thirds (66%) of the capital markets executives believe the recent trend of mutual fund companies investing in popular, private technology businesses is a further disincentive to companies considering an IPO.

In addition to the drop in the number of IPOs, the size of the average offering - even absent last year's massive Alibaba offering - has decreased significantly in 2015. A large proportion of the capital