ANALYSIS: Analysis of the New Proposed Regulations Under Code §2704

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On August 4, the Treasury Department issued long-awaited Proposed Regulations (*Proposed Regulations*) on valuation discounts for family-owned businesses under §2704 of the Internal Revenue Code (*Code*). The Proposed Regulations are out for comment until a public hearing on December 1, 2016, and will become effective on or after the date of publication of a Treasury decision adopting the Proposed Regulations as final regulations.

Many practitioners feared that the Proposed Regulations would completely eliminate all valuation discounts in all contexts. Although the Proposed Regulations did not go that far, they did introduce significant changes that eliminate almost all valuation discounts in the family context. These changes clarify the application of Code §2704 and curb transfer tax valuation discounts used by family-owned businesses. The Proposed Regulations:

- Apply to limited liability companies (LLCs) and address what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership, or limited partnership.
- Restrict "deathbed transfers" that result in the lapse of a liquidation right and clarify the treatment of a transfer that creates an assignee interest.
- Refine the definition of the term *Applicable Restriction* by eliminating the comparison to state law liquidation limitations.
- Add a new section to address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interests held by persons who are not members of the family.

This paper analyzes each of these changes in light of prior law. It concludes with a list of practical takeaways to help your family-owned business clients navigate the new rules.

Clarifications About LLCs and Other Entities That Are Not Corporations or Partnerships
When the current §2704 regulations were issued, corporations and partnerships were the dominant forms of business. Since then, the check-the-box regulations have been promulgated, allowing a business entity's tax status to differ from its classification under local law. LLCs have also become increasingly popular, overtaking corporations and partnerships as the go-to entity choice for small businesses. These new developments were not contemplated by the existing regulations.

The Proposed Regulations address these changes in two ways. First, they clarify that §2704 applies not only to corporations and partnerships, but also to LLCs and other business arrangements. The Proposed Regulations also clarify that §2704 applies regardless of how the entity is classified for other federal tax purposes and regardless of whether the entity is a disregarded entity.[1]

Second, the Proposed Regulations specify how to determine control of LLCs and other entities that are not corporations or partnerships. Control of an LLC or other entity that is not a corporation or partnership means either (a) holding at least 50 percent of either the capital or profits interests of the business or (b) holding any equity interest with the ability to cause full or partial liquidation.[2]

Restriction on Deathbed Transfers that Result in Lapse of Liquidation Rights and Clarification of Treatment of Assignee Interests

Section 2704(a) was enacted in response to a Tax Court ruling that liquidation rights that lapse at death were excluded from the decedent's gross estate.[3] Code §2704(a) prevents this result by applying special rules to value lapsing rights in closely-held businesses. Under these rules, a lapse of rights is treated as a transfer for federal gift and estate tax purposes. If the rights lapse during a person's lifetime, the lapse is treated as a taxable gift. If the lapse occurs at death, the gross estate of the deceased taxpayer includes the value of the lapsing rights.

> *Assume that Father and Daughter own controlling interests in a corporation. If Father's stock has voting rights that lapse on Father's death, §2704(a)(1) would include the value of the lapsed rights in Father's estate. If Father's stock has voting rights that lapse prior to Father's death, Father will be treated as having made a taxable gift on the date of the lapse. Either way, the lapse of the voting rights is a taxable transfer for federal gift and estate tax purposes.*

Section 2704(a) applies only if the entity is controlled by the individual holding the lapsing right and members of that individual's family. The transfer tax value of the lapsed rights equals the difference between the value of the interests held by the person before the lapse (including the lapsed right) and the value of the interest after the lapse (excluding the lapsed right).[4]

Section 2704(a) applies to both voting and liquidation rights. The Treasury Regulations define *liquidation right* as follows:

> Liquidation right means a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity.[5]

As a general rule, a liquidation right is considered to lapse when it is restricted or eliminated.[6] But the regulations contain an important exception: A transfer of an interest that results in the lapse of a liquidation right is *not* treated as a lapse if the rights with respect to the transferred interest are not restricted or eliminated.[7] This exception allows taxpayers to transfer liquidation rights during lifetime without having the liquidation rights treated as a taxable gift.

The IRS believes that the exception for transfers of interests with lapsing liquidation rights should not apply to deathbed transfers. Specifically, the IRS believes that deathbed transfers create a disparity between the economic effect of the transfer and the tax effect of the transfer. These transfers have minimal economic effects on the value of the interest, but result in a transfer tax value that is lower than the value of the interest both before and after the decedent's death.

To address this disparity, the Proposed Regulations apply a three-year rule to transfers of interests subject to lapsing liquidation rights. If a taxpayer transfers an interest with a lapsing liquidation right within three years of the taxpayer's death, the liquidation rights are considered to lapse at the taxpayer's death and the value of the lapsed rights are included in the taxpayer's gross estate.[8]

This new rule adopts the approach of *Murphy v. Commissioner*.[9] That case involved a gift of .88 percent of stock in a family-owned corporation to each of the decedent's two children shortly before her death.The gift had the effect of reducing the decedent's 51.41 percent interest in the corporation to 49.65 percent. As stated by the Tax Court:

The sole purpose of bifurcating the transfer of control to her children was to obtain a minority discount for the stock. Transfer of the gift fragments did not appreciably affect the decedent's beneficial interest except to avoid Federal transfer taxes on the control premium.[10]

Based on this finding, the Tax Court denied the minority discount for the value of the gift. The Proposed Regulations take the same approach, but apply a bright-line rule: If a deceased taxpayer makes a gift to a family member that creates a minority interest and the gift occurs within three years of death, the value of the gift will not be discounted to reflect the minority interest.

The new three-year rule under §2704(a) is overshadowed by the more drastic changes to the Proposed Regulations under §2704(b). As discussed below, the Proposed Regulations under §2704(b) create new categories of Disregarded Restrictions that reduce—and perhaps eliminate—minority interest and marketability discounts for transfers to family members, regardless of whether those interests are transferred within three years of the decedent's death. Because of the broad reach of the Proposed Regulations under §2704(b), the three-year rule under §2704(a) may have little practical effect.

The Proposed Regulations also clarify the treatment of transfers that create an assignee interest. Under state law, an assignee is a person who receives an interest but is not admitted as a partner or member. State statutes provide that an assignee may receive items of income and loss, but has no rights to participate in management. As a result of this loss of management control, the transfer of an interest from a partner to an assignee eliminates significant rights and powers associated with the interest.

Under the Proposed Regulations, if a transfer results in the restriction or elimination of any of the rights or powers associated with the interest, the transfer is treated as a lapse under §2704(a).[11] As a result, a transfer of an interest to an assignee may be treated as a lapse of liquidation rights associated with the interest and thus be treated as a taxable gift.

Changes to Treasury Regulations Regarding Liquidation Restrictions Under §2704(b)

The valuation of an owner's interest in a business may depend on the owner's power to force liquidation of the business. Without the ability to force a liquidation, the owner has no means to obtain his or her *pro rata* portion of the underlying business assets. In these circumstances, the owner cannot realize the full value of his or her interest without cooperation of the other business owners.

Any reasonable buyer of the owner's interest in the business would consider the lack of ability to force a liquidation to be a detriment. All else being equal, a reasonable buyer would pay less for a business interest without liquidation rights than it would for an interest with liquidation rights. In recognition of this, the value of interests that do not include liquidation rights have historically been discounted to reflect the realities of the marketplace.

Taxpayers have long benefitted from valuation discounts associated with lack of liquidation rights. One common strategy involves creating artificial restrictions that limit liquidation of the business. When the business owner dies, the value of the interest is discounted to reflect the fact that a buyer would take the inability to compel liquidation into account in determining a purchase price. These discounts allow the business owner to transfer assets at a lower transfer tax value and thereby save estate and gift taxes.

§Section 2704(b) was enacted to curb the use of discounts to reduce transfer tax value in the family-owned business context. It applies when:

- the transferor and her family hold at least 50 percent, by vote or value, of equity in the entity;
- there is a transfer of a business interest to (or for the benefit of) a member of the transferor's family; and
- immediately before the transfer, the transferor and members of the transferor's family hold control of the entity.[13]

If §2704(b) applies, any Applicable Restriction (defined below) is disregarded for purposes of determining the value of the transferred interest for transfer tax purposes.[14] If an Applicable Restriction is disregarded, it is not taken into account in determining valuation discounts. Stated differently, the disregarding of an Applicable Restriction will prevent the taxpayer from using the restriction to transfer value at a lower tax cost.

Because the identification of a restriction as an Applicable Restriction can result in loss of tax savings, much depends on whether a given restriction qualifies as an Applicable Restriction under §2704. Section 2704(b)(2) defines *Applicable Restriction* to mean any restriction that effectively limits the ability of the business to liquidate, provided that the restriction lapses after the transfer or can be removed by the transferor's family after the transfer.[15] Significantly, §2704(b)(3)(b) excludes from the definition of applicable restriction "any restriction imposed, or required to be imposed, by any Federal or State law."

The current Treasury Regulations went beyond the explicit language of the statute to exclude not only state law restrictions, but also any "limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."[16] Under the current regulations, restrictions that are no more restrictive than those that would apply under state law are not applicable restrictions under §2704(b) and thus do not adversely affect valuation discounts.

The restrictions defined in §2704 are not exhaustive. Section 2704(b)(4) allows the Treasury to issue regulations that disregard other types of restrictions for tax purposes if the restrictions reduce the transfer tax value without reducing the actual value to the transferee. This significant grant of discretion gives the Treasury expansive authority to promulgate regulations to identify restrictions that are not explicitly covered by §2704(b) but should be disregarded for valuation purposes.[17]

The IRS believes that the current regulations do not fulfill the intended purposes of §2704(b). The Summary of the Proposed Regulations identifies several reasons for this deficiency. First, courts have applied the current regulations to restrictions on the ability to liquidate the entire entity, not to restrictions on the ability to liquidate a transferred interest in the entity.[18] Because of this interpretation, a restriction on the ability to liquidate an individual interest is not considered to be an applicable restriction under the current regulations.

Second, the current regulations provide that a restriction on liquidation is *not* an Applicable Restriction if it is no more restrictive than restrictions imposed by state law.[19] Since the enactment of §2704(b), many states have revised their limited partnership acts to allow liquidation only with the unanimous vote of the partners (unless provided otherwise in the partnership agreement) and to eliminate the statutory default provision that allowed limited partners to liquidate their limited partnership interests. Most state partnership and LLC statutes now prohibit withdrawal from the partnership unless the partnership agreement provides otherwise.

Because of these broad state law restrictions, most provisions in partnership and operating agreements that restrict liquidation are less restrictive than those that apply under state law. As a result, most restrictions in partnership and operating agreements are not applicable restrictions under §2704(b) and thus do not adversely affect valuation discounts.

Third, the IRS recognizes a common strategy of transferring partnership interests to assignees instead of partners. Under state law, assignees are typically allocated items of partnership income, gain, and loss, but do not have the controlling rights of a partner. This allows taxpayers to argue that an assignee's inability to cause the partnership to liquidate his or her interest is no more restrictive than state law and thus should not be considered an Applicable Restriction.

Fourth, some taxpayers avoid the application of §2704(b) by transferring a nominal interest in a business to a nonfamily member (including a charity or employee) and requiring all owners to approve liquidation. This creates a situation where liquidation restrictions cannot be removed by the transferor's family after the transfer and arguably removes the restriction from the definition of Applicable Restriction.[20]

The IRS believes that the combined effect of these developments has eviscerated §2704(b).

Changes to the Definition of Applicable Restriction to Eliminate Comparison to the Liquidation Limitations of State Law

As stated above, the Treasury Regulations go beyond the language of the statute regarding federal or state law restrictions. Where the statute disregards any restrictions required by state or federal law, the current Treasury Regulations disregard any limitation on the ability to liquidate the entity that is more restrictive than state law limitations. The Proposed Regulations take a more restrictive approach by removing the exception that limits the definition of *Applicable Restriction* to limitations that are more restrictive than state law restrictions.[21] The IRS believes this exception contradicts the intent of §2704(b) to the extent that it allows the transferor and family members to avoid any statutory rule.

The Proposed Regulations also provide that an Applicable Restriction includes both a restriction imposed under the governing documents and a restriction imposed under local law, regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise.[22] This regulation is intended to ensure that a restriction that is not imposed or required to be imposed by federal or state law is disregarded without regard to its source.

The Proposed Regulations also define the terms “federal” and “state” for purposes of determining whether a restriction is “imposed, or required to be imposed, by any Federal or State law” under §2704(b)(3)(B). The terms “federal” and “state” refer only to the United States or any state (including the District of Columbia), but do not include any other jurisdiction.

The Proposed Regulations also clarify which restrictions will be considered to be “imposed, or required to be imposed” under state or federal law. A restriction is imposed or required to be imposed by law if the restriction cannot be removed or overridden and it is mandated by the applicable law, must be included in the governing documents, or is otherwise made mandatory.

Even restrictions that may not be removed or overridden may be considered Applicable Restrictions in two circumstances. Both of these circumstances involve situations where the statute is mandatory, but other statutes may be used that would effectively make the mandatory statute elective. The two situations are:

1. When state law is limited in its application to a narrow class of entities like family-controlled entities that would otherwise be subject to §2704; and
2. When state law imposes a mandatory restriction but provides an optional provision or alternative statute for the creation and governance of the same type of entity and the optional provision or alternative statute does not mandate the restriction.

If an Applicable Restriction is disregarded, the fair market value of the transferred interest is determined under general valuation principles as if the restriction does not exist (i.e., as if the governing documents and the local law are silent on the question).

New Disregarded Restrictions on Transfers of Individual Interests

The most devastating change introduced by the Proposed Regulations is the introduction of a new category of Disregarded Restrictions. The Proposed Regulations use the broad authority given to the Treasury under §2704(b)(4) to close valuation loopholes by issuing regulations that define new restrictions that should be disregarded for transfer tax purposes in the family-owned business context.[23]

Section 25.2704-3(b)(1) of the Proposed Regulations creates four categories of Disregarded Restrictions (*Disregarded Restrictions*):

1. Provisions that limit or permit the limitation of the holder’s ability to compel liquidation or redemption of the interest.
2. Provisions that limit or permit 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 minimum value.[24]
3. Provisions that defer or permit the deferral of the payment of the full liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder’s intent to have the holder’s interest liquidated or redeemed.
4. Provisions that authorize or permit the payment of any portion of the full liquidation or redemption proceeds in any manner other than in cash or property.[25]

These restrictions are in addition to the Applicable Restrictions and are evaluated at the individual interest level. The inquiry is not whether the individual can cause a liquidation of the entity, but whether the individual can redeem or liquidate his or her interest in the entity.[26] For each of the four categories, the restriction will be disregarded 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, either alone or collectively.[27]

The practical effect of the new categories Disregarded Restrictions is to create a fictional put right for all interests in the family-owned business context unless there is a mandatory state law that precludes the put right. This is illustrated by Example 1 of §25.2704-3 of the Proposed Regulations, which posits a scenario where a parent with a 98-percent interest in a limited partnership makes gifts of 33 percent limited partnership interests to her two children. In the example, the partnership agreement prohibits withdrawal of a limited partner prior to dissolution of the partnership on June 30, 2066, and requires all partners to approve amendment of the partnership agreement. The example concludes:

> *By prohibiting the withdrawal of a limited partner, the partnership agreement imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor's family, acting collectively, by agreeing to amend the partnership agreement. Therefore, … the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of each transferred interest.*

In other words, the restriction on withdrawal of a limited partner is disregarded and all partners are treated as if each partner had the ability to liquidate his or her interest. Each partner is treated as though he or she has the right to be redeemed for full value. This would reduce—and perhaps eliminate—any minority or marketability discount.

Effect of Insubstantial Ownership by Nonfamily Members

The IRS also believes that the grant of an insubstantial interest in the entity to a nonfamily member should not preclude the application of §2704(b). The IRS believes that transfers to nonfamily owners in these circumstances creates a "friendly" environment that does not actually prevent the family from removing the liquidation restriction.

In determining whether the transferor or the transferor's family can remove a restriction included in this new class of Disregarded Restrictions, any interest in the entity held by a nonfamily member is disregarded if, at the time of the transfer, the interest:

- has been held less than three years before the date of the transfer;
- constitutes less than 10 percent of the value of all of the equity interests;
- when combined with the interests of other nonfamily members, constitutes less than 20 percent of the value of all of the equity interests; or
- lacks a right to "put" the interest to the entity and receive a minimum value.[28]

If an interest is disregarded, the determination of whether the family can remove the restriction will be made assuming that the remaining interests are the sole interests in the entity.[29]

If a restriction is disregarded, the fair market value of the interest in the entity is determined assuming that the Disregarded Restriction did not exist, either in the governing documents or applicable law. Fair market value is determined under general valuation principles, including any appropriate discounts or premiums.[30]

Practical Takeaways

The Proposed Regulations will significantly impact planning strategies that involve the use of restricted interests to achieve valuation discounts for family-owned business entities. The IRS has scheduled a hearing on the Proposed Regulations for December 1, 2016. The Treasury has stated that the final regulations won't be effective until at least 30 days after they become final. Taken together, these two statements indicate that the Proposed Regulations could apply to all lifetime and death transfers after December 2016.

Clients that hold interests in family-controlled businesses should take action by year end if they want to achieve valuation discounts under the current rules. The Proposed Regulations will dramatically curtail and possibly eliminate discounted transfer opportunities for transfer tax purposes. Attorneys and advisors who have clients with discounted transfer strategies in place must work quickly to take advantage of the limited time remaining before the Proposed Regulations become finalized.

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1. Prop. Reg. § 25.2704-1(a)(1).
2. Prop. Reg. § 25.2701-2. For purposes of determining control, under the attribution rules of existing §25.2701-6, an individual, the individual's estate, and members of the individual's family are treated as holding interests held indirectly through a corporation, partnership, trust, or other entity.
3. Estate of Harrison v. Commissioner, T.C. Memo 1987-8.
4. I.R.C. § 2704(a)(2).
5. Treas. Reg. § 25.2704-1(a)(2)(v).
6. Treas. Reg. § 25.2704-1(c)(1).
7. Id.
8. Prop. Reg. § 25.2704-1(c)(1). ("The lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to §2704(a).").
9. T.C. Memo 1990-645.
10. Id. at 645.
11. Prop. Reg. § 25.2704-1(a).
12. I.R.C. § 2704(c)(1); § 2701(b)(2).
13. I.R.C. § 2704(b)(1).
14. Id.
15. I.R.C. § 2704(b)(2).
16. Treas. Reg. § 25.2704-2(b).
17. See Kerr v. Commissioner, 113 T.C. 449 (1999), aff'd 292 F.3rd 490 (5th Cir. 2002).
18. Id. at 473.
19. Treas. Reg. § 2704-2(b).
20. See I.R.C. § 2704(b)(2).
21. Prop. Reg. § 25.2704-2(b).
22. Id.
23. Prop. Reg. § 25.2704-3(b).
24. Prop. Reg. § 25.2704-3(b)(1)(ii) provides: "The term minimum value means the interest's share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under §§2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under §2053 if those obligations instead were claims against an estate."
25. Prop. Reg. § 25.2704-3(b)(1)(ii) provides that the term "property" does not include a note or other obligation issued directly or indirectly by the entity, other holders of an interest in the entity, or persons related to either. There is an exception for notes of an entity engaged in an active trade or business in some circumstances.
26. Prop. Reg. § 25.2704-3(b)(1)(i) ("The term disregarded restriction means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity ….").
27. Prop. Reg. § 25.2704-3(b)(1).
28. Prop. Reg. § 25.2704-3(b)(4)(i).
29. Prop. Reg. § 25.2704-3(b)(4)(ii).
30. Prop. Reg. § 25.2704-3(f).

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