



The IRS and Treasury release proposed regulations aimed to curb use of minority discounts in transfer tax planning with family entities

On August 3, 2016, the Internal Revenue Service (“IRS”) and the Department of Treasury (“Treasury”) issued proposed regulations under Internal Revenue Code (“Code”) Section 2704 after months of anticipation. This outline is intended to provide an overview of the background of Section 2704 and existing regulations and provide an initial summary of the key aspects of proposed regulations. A full analysis of the changes and potential effects on past and future transfers of interests in family businesses is ongoing.

Background of Code Section 2704

Section 2704 was enacted effective as of October 9, 1990 and generally applies in two different scenarios both in the context of closely held businesses (i.e. family businesses):

- Section 2704(a) generally provides that a taxable event occurs when liquidation or voting rights lapse.
- Section 2704(b) generally provides that in valuing property for estate and gift tax purposes, certain restrictions on the ability of an entity to liquidate are disregarded.

Section 2704(b) grants the Treasury the authority to issue regulations to cause certain other restrictions that reduce valuation to be disregarded.

Key initial takeaways from proposed regulations

- **Covered Entities Clarified.** The proposed regulations generally apply to corporations, partnerships, LLCs, and other entities and arrangements, regardless of (1) whether the entity or arrangement is domestic or foreign; (2) how the entity or arrangement is classified for federal tax purposes; and (3) whether the entity is treated as a disregarded entity for federal tax purposes.
- **Entity Classification Expanded in Certain Cases.** For purposes of determining control of an entity and whether a restriction is imposed under state law, in the case of an entity that is not a corporation, the form of the entity or arrangement will be determined under local law regardless of its classification for federal tax purposes and regardless of whether it is a disregarded entity for federal tax purposes. Thus, for purposes of applying the proposed regulations in these cases, LLCs that are not S corporations, for example, are an “entity”.
- **Elimination of Key Exception to Definition of “Applicable Restriction”.** As noted above, Section 2704(b) generally provides that in valuing property for estate and gift tax purposes, certain restrictions (“applicable restrictions” for purposes of the Code) on the ability of an entity to liquidate are disregarded. An exception to the general rule applies where a restriction on liquidation is no more restrictive than that of the state law that would

apply in the absence of the restriction. In recent years, many states have promulgated statutes which are designed to be at least as restrictive as the maximum restriction that could be imposed in a partnership agreement – which allowed partnership agreements with liquidation restrictions to fall within the exception to the general rule. The proposed regulations revise the current regulations by removing this exception.

- **Creation of New Class of “Disregarded Restrictions”.** The proposed regulations create a new class of restrictions which would be disregarded.
- **Coordination of Marital Deduction and Charitable Deduction Rules.** To the extent that an interest qualifies for the gift or estate tax marital deduction and must be valued by taking into account the special valuation assumptions of Section 2704(b), the same value generally would apply in computing the marital deduction attributable to that interest. The value of the estate tax marital deduction could be further affected, however, by other factors justifying a different value, such as the application of a control premium
- **Application to Transfers to Family and Nonfamily Members.** Although Section 2704 does not apply to transfers of an interest in an entity to nonfamily members, the proposed regulations provide guidance on situations where an interest is transferred in part to family members and in part to nonfamily members. Under the proposed regulations the fair market value of the part passing to the *family members* would be determined taking into account the special valuation assumptions of Section 2704(b), as well as any other relevant factors, such as those supporting a control premium. The fair market value of the part passing to the *nonfamily member(s)* would be determined in a similar manner, but without the special valuation assumptions of Section 2704(b).
- **Effective Dates.** The Proposed Regulations are proposed to be effective on and after the date the regulations are finalized and generally apply to lapses of rights and transfers of property subject to restrictions *created after October 8, 1990*, and in which, *the transfer occurs 30 or more days after* the date the proposed regulations are finalized.

A hearing has been scheduled to discuss the proposed regulations on December 1, 2016. The Treasury has stated that the final regulations will not become effective until at least 30 days after they are finalized. Although unlikely based on past trends in finalizing regulations by the Treasury and the IRS, the proposed regulations could be effective for lifetime and deathtime transfers soon after the close of this year. Because of their potential impact, taxpayers may want to consider taking action before year end if they hold interests in closely held (family) entities.