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An AALU Washington Report

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TOPIC: Proposed Section 2704 Regulations Published

CITES: *Restrictions on Liquidation of an Interest*, REG-163113-02, Proposed Rule, August 4, 2016; *Kerr v. Commissioner*, 113 T.C. 449 (1999), aff'd, 292 F.3rd 490 (5th Cir. 2002).

SUMMARY: On August 4, 2016, the Treasury Department and IRS issued long-awaited proposed regulations under Code Section 2704. Section 2704 describes how the Code values certain interfamily transfers of corporate, LLC, and partnership interests. Specifically, Section 2704 addresses the effect of certain lapsing rights and restrictions in the agreements governing transfers of those interests on the transfer tax value of those interests.

The Code Section's purpose is to prevent value from escaping the transfer tax system due to what the IRS considers an illusionary right or restriction. To accomplish this objective, Section 2704(b) requires that certain restrictions on liquidating an interest must be disregarded in computing the value of those interests for those purposes. This is meant to discourage the creation of artificial restrictions on the right to liquidate an interest which lapses soon after the interest is gifted, or that other family members with interests in the entity can remove after the transfer.

The proposed regulations expand the types of *inter vivos* gifts that would increase estate inclusion under Code Section 2704(a) and expand the scope of liquidation restrictions which are disregarded under 2704(b). Although the proposed regulations will substantially increase the transfer tax value of many closely-held business and investment entities by eliminating discounts for lack of control or minority interests, it is not clear whether these proposed regulations will affect discounts for lack of marketability.

NOTE: Because the proposed regulations will not be effective until finalized, there is a short-term opportunity to make gifts and sales under current law.

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RELEVANCE: Under current law, lapsing rights and restrictions can significantly affect the transfer tax value of an individual's estate, which include business interests. The proposed regulations are far-reaching and would largely eliminate estate tax discounts for lack of control or discounts taken because the interests transferred represent minority interests in the entity.

The bottom line is that the proposed regulations will eliminate many valuation discounts which planners (and their clients) have come to expect and rely on when planning with interests in business entities. The effective result will be to increase the estate tax rate for many clients.

There appears to be a short-term window of opportunity – from now until the regulations are finalized – during which clients may benefit from implementing an estate plan using one or more of the valuation discounting techniques that will be cut off by these proposed regulations if enacted as proposed. In the long-term, many clients will have an increased estate tax obligation and some of them will need additional sources of liquidity (e.g. life insurance) at death.

FACTS: Here is a brief synopsis of the proposed regulations.

1. **Expanded scope of a "lapse" under Code Section 2704(a).** Code Section 2704(a) is meant, in part, to prevent the value of lapsed liquidation rights from being non-taxable. The proposed regulations provide that if a transferor on his/her death bed loses the right to liquidate the entity due to the transfer, this would be treated as a lapsed liquidation right—and should not artificially decrease the estate tax value of the transferred interest.

There is, however, an exception that applies for transfers which cause the transferor to lose the right to liquidate the entity made *more* than three years before the transferor's death. Stated another way, there will be an *inclusion* period for transfers made within three years of the transferor's death during which any potential discount attributable to the loss of the right of liquidation of the entity will be ignored.

This change also prevents the transfer of a partnership or LLC interest to an assignee that does not have liquidation rights without triggering estate tax liability.

2. **Expanded scope of "applicable restrictions" under Code Section 2704(b).** Code Section 2704(b) is meant to cause certain restrictions on liquidation to be disregarded in the determination of value of a business interest for transfer tax purposes. The term "applicable restriction" describes the types of disregarded restrictions. The Treasury Department and the IRS believe the courts and state law changes have overly restricted what is included in the definition of applicable restrictions.

    a. **Restriction on the Ability to Liquidate an Individual Interest.** The court in *Kerr v. Commissioner* concluded that, as the current regulations are written, in order to be an applicable restriction, the restriction on the right to liquidate the entity must be at the *entity* level, rather than specific to a particular transferred interest. This allowed planners to restrict the liquidation rights of only certain interests, thereby capturing a valuation discount which the IRS and Treasury assert are divorced from economic reality. The proposed regulations therefore specifically *include* individual interest liquation rights in the definition of applicable restrictions.

    b. **State Law Standard.** State business entity laws generally require some restriction on liquidation, and therefore the current regulations exclude such restrictions from the definition of an applicable restriction. However, in response to this, several states made changes to their statutes which allowed planners to use this exception. The proposed regulations therefore provide that only liquidation restrictions under state law which are not effectively *elective* by the taxpayer are excluded from being applicable restrictions. Most states do not impose *mandatory* restrictions on liquidation, so the ability of planners and their clients to choose a favorable forum for valuation purposes has been severely limited.

c. **Non-Family Members.** Under the current regulations, Code Section 2704(b) does not apply to a taxpayer that transfers a nominal interest in the entity to non-family member, such as a charity, and structures the entity so the non-family member's consent is required to liquidate the entity. The proposed regulations seek to curtail this strategy by requiring the non-family member's interest to be more economically substantial if it is to be excluded from the definition of an applicable restriction. The proposed regulations include a four-part test which must be satisfied to allow the non-family member's liquidation restrictions to be considered.

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