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Major Components of New Section 2704 Proposed Regs

A brief summary of the three sets of new rules

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The new proposed Internal Revenue Code Section 2704 proposed regulations[1] contain three sets of new rules. Here's a brief summary of each of them. In a follow-up article , I'll discuss planning under the proposed regulations. In subsequent articles, I'll discuss the future of discount planning and other issues related to the proposed regulations.

Transfer Within Three Years Rule

The first set of new rules begins with an extension of the Tax Court's decision in *Estate of Murphy v. Commissioner*.[2] Rather than a subjective test relating to deathbed transfers of voting stock to achieve minority interest status, however, the Internal Revenue Service has chosen to impose a bright line "transfers within three years of death rule," similar to the rule for gifts of life insurance policies within three years of death of the lapse or release of a Section 2036-type retained interest within three years of death.[3] The only difference is that there doesn't appear to be an exception to the three-year rule for transfers for adequate and full consideration in money or money's worth.[4] If transfers within three years of death result in a lapse of a liquidation right in the transferor, the transferred shares will effectively be included in the transferor's gross estate for federal estate tax purposes.

Although one could argue it's questionable whether Congress granted the IRS authority to unilaterally add this new three-year rule, the IRS could just as easily argue that the new three-year rule represents nothing more than an easing of the already-imposed IRC rules, rather than an expansion of the same. IRC Section 2704(a)(2) provides:

(2) Amount of transfer For purposes of paragraph (1), the amount

determined under this paragraph is the excess (if any) of—

(A) the value of all interests in the entity held by the individual described in paragraph (1) immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing), over

(B) the value of such interests immediately after the lapse.

Thus, because the transferor would have possessed the valuable right to liquidate the entity before the transfer of the interest, but as a result of the transfer, the transferees no longer retain the same right, the value of the lapsed right may be considered an additional transfer under the IRC. See, however, the discussion at the end of my other article , which challenges the IRS' ability to have the lapse treated as occurring at the transferor's date of death versus at the date of the actual lapse.

The proposed regulations also clarify that 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 of liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest.[5]

Applicable Restrictions

Under the second set of new rules, state-imposed "applicable restrictions" on the ability to liquidate an entity that can be changed by family members are no longer excepted from the term. Thus, if state law provides that a

limited partner doesn't have a right to have the partnership purchase his/her limited interest for fair value, but this aspect of the state law can be overridden by agreement among the family members, then the state law restriction is ignored for valuation purposes, and it's assumed that each family member possesses this liquidation right.

Further, even if the restriction is mandated by state law and couldn't be removed, it still won't be given effect for valuation purposes if either: (1) the state law restriction is limited to family-controlled entities, or (2) the state law provides an optional provision or an alternative statute for the creation and governance of the same type of entity that doesn't mandate the restriction.

Disregarded Restrictions

The basic concept of the third set of new rules is to go beyond the *ability to liquidate* itself and look at the *value* of what the interest holder would receive if they did liquidate their interest. Thus, these "disregarded restrictions" cover any restriction that: (1) limits the ability *of the holder of the interest* to liquidate the interest (this is, the potential overlap section); (2) limits the liquidation proceeds to an amount that's less than a "minimum value"; (3) defers payment of the liquidation proceeds for more than six months; or (4) allows for payment of the liquidation proceeds in any form other than cash or other property, other than certain secured notes. The "minimum value" of an interest is the net value of the entity multiplied by the interest's share of the entity.

Significantly, the preamble to the proposed regulations provides that: "if a restriction is disregarded under proposed §25.2704-3, the fair market

value of the interest in the entity is determined assuming . . . any appropriate discounts or premiums," but also assuming the disregarded restrictions didn't exist, either in the governing documents or applicable law. Thus, it would appear that the proposed regulations haven't done away with lack of marketability and minority interest discounts in their entirety. The apparent overlap between the terms "applicable restriction" and "disregarded restrictions," as they each apply to restrictions on the interest's liquidation rights, can be resolved by focusing on the highlighted words from the proposed regulations: An "applicable restriction" is defined to mean "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."[6] A "disregarded restriction," on the other hand, is defined generally to include a restriction that's "a limitation on the ability to *redeem or* liquidate *an interest in an entity* . . . 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."[7] A disregarded restriction is therefore one that places restrictions on the *particular holder* of the interest in the entity, rather than on the holders of the entity generally.

For purpose of determining whether the restriction can be removed by the transferor or any member of the transferor's family . . ., either alone or collectively," the proposed regulations disregard an interest held by a non-family member that: (1) has been held less than three years before the date of the transfer, (2) constitutes less than 10 percent of the value of all of the equity interests, (3) when combined with the interests of other non-family members constitutes less than 20 percent of the value of all the equity

interests, or (4) lacks a right to put the interest to the entity and receive a minimum value.[8]

Similar to the applicable restriction rule, restrictions imposed under federal or state law won't constitute a "disregarded restriction" provided the law is one that may not be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) and isn't limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to what is described in Section 2704.

Endnotes

1. 26 CFR Part 25 [REG-163113-02].

2. 60 T.C.M. 645 (1990).

3. Proposed Regulation Section 25.2704-1(c)(1).

4. Internal Revenue Code Section 2035(d).

5. Prop. Reg. Section 25.2704-1(a)(5).

6. Prop. Reg. Section 25.2704-2(b)(1).

7. Prop.Reg. Section 25.2704-3(b)(1).

8. Prop.Reg. Section 25.2704-3(b)(4).

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