*Thought Leadership*

# Proposed Section 2704 Regulations: Issues and Implications

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*On October 2, 2016, the Internal Revenue Service released its anticipated proposed regulations concerning the valuation of interests in corporations and partnerships for gift, estate, and generation-skipping transfer tax purposes. Specifically, the proposed regulations concern the treatment of certain lapsing rights and restrictions on liquidation in determining the value of the transferred interests. Further, the proposed regulations affect certain transferors of interests in corporations and partnerships, and the proposed regulations are intended to prevent the alleged undervaluation of such transferred interests. This discussion outlines the proposed regulations. And, this discussion describes the implied business and security valuation issues and implications if the proposed regulations are finalized in their current form.*

## Introduction

The Internal Revenue Service (the "Service") has weighed into the long-running battle over the valuation of family-owned business interests for transfer tax purposes by issuing proposed regulations under Internal Revenue Code Section 2704.

The proposed regulations are supposed to close "loopholes" that, from the Service's point of view, have eroded the effectiveness of Chapter 14 of the Internal Revenue Code by preventing unjustified valuation discounts from the underlying control value of family-owned businesses.

The proposed Section 2704 regulations tighten up the conditions under which business valuations can recognize restrictions over the family's ability to control:

1. the redemption of interests or
2. the liquidation of the closely held company.

This discussion describes (1) the extent of these proposed changes and (2) the implications of this proposed authority regarding the valuation of noncontrolling ownership interest transfers among family members for gift and estate planning purposes.

## Background and Historical Context

Briefly (due to coverage in several other discussions in this *Insights* issue), the Service has historically taken the position that interests in family-owned businesses passing from one family member to another family member should be valued in a manner that reflects the overall control of the entity by the family. See Revenue Ruling 81-253 for an example of the Service's thinking on this issue.[1]

The Service, however, has lost a number of cases on this subject, as courts concluded that noncontrolling ownership interests transferred among family members should be valued as noncontrolling ownership interests, often recognizing restrictions.

Congress subsequently enacted Section 2036(c) in 1987 to remedy perceived abuses in this and other types of intrafamily transactions, such as estate freezes. Because Section 2036(c) proved to be unworkable, it was repealed retroactively.

Congress then passed Chapter 14 of the Code in 1990. Final regulations for Chapter 14 were issued between 1992 and 1994.

Chapter 14 was supposed to prevent abuses by forcing taxpayers and their appraisers to make unfavorable assumptions to disregard retained rights and other restrictions. However, Congress noted that the changes to the law were not intended to prevent families from freely engaging in standard intrafamily transactions.[2]

The Service appeared to acquiesce to this better designed framework and the trend in judicial rulings (which have recognized that noncontrolling interest transfers among family members should be allowed greater discount adjustments to reflect their noncontrolling status) by issuing Revenue Ruling 93-12.[3]

Since that time, courts have continued to issue rulings that limit the scope of the Chapter 14 effect.[4]

In addition, some 47 states have changed their default laws in a manner that aided taxpayers to use allowable restrictions in state law to increase the discounts they could justify on gift and estate transfers among family members, even though the family as a whole continued to control the entity.

The Service has been pondering how to address this perceived increase in loopholes since at least 2003.[5]

The Obama administration has also been concerned enough about what they perceive as abuses to consider ways to reduce or eliminate discounts on family-controlled business interest transfers since at least 2010, via passage of new laws or via new regulations.[6]

Among the sections of Chapter 14 is Section 2704. Section 2704(b) gives the Service the authority to craft new regulations to disregard other restrictions that taxpayers and their advisers may invent that reduce value for tax purposes, but not ultimately reduce the value to the transferee.

On August 2, 2016, the Service issued proposed new regulations that they claim would deal with these issues. The proposed regulations include changes to Sections 2701, 2704(a), and 2704(b), which are all part of the special valuation rules under Chapter 14.

The following discussion outlines the proposed changes related to each section of the Code.

## Explanation of Changes to Section 2701

### Family-Controlled Entity

The proposed changes to this regulation amends the definition of a family-controlled entity to include any form of business entity, such as a corporation, partnership, limited liability company (LLC), or other business entity arrangement. This definition also includes a qualified subchapter S subsidiary.

From discussions with Catherine Hughes, a representative of the Service, our firm understands that this change is designed to include any existing or future organizational form that may be used by families to hold their wealth, foreign or domestic. This redesigned definition makes it unnecessary to update the definition in the future, because it is very inclusive for transfer tax purposes.

### Family Control

The proposed changes also update the definition of family control to include or clarify that control is defined as aggregate family ownership of 50 percent or more of capital or profits interests, or any equity interest (such as voting stock, a general partnership interest, or an LLC manager interest) with the ability to cause liquidation of the entity in whole or in part.

The form of the entity determines the test for control. The test also considers the local law under which the entity was created and governed.

### Family Member Definitions

The definitions of applicable family member and transferor's family remain unchanged from the original definitions in Sections 2701, 2704-1(a), and 2704-3(c).

It should be noted that, under these definitions, two unrelated families could be defined as having "control" if each family owned 50 percent of the business entity. Also, the definition excludes co-ownership by cousins.

The inclusion of relatives as applicable family members for measuring family control is always assessed from the standpoint of the transferor under these regulations.

## Explanation of Changes to Section 2704-2(a)

### Three-Year Rule

The proposed changes to this section include a new rule that would tax lapses of a voting or liquidation right if the transferor dies within three years of the transfer that causes the lapse. The lapse is treated as a lapse occurring on the transferor's date of death and is includable in the value of the gross estate.

For example, if a transferor with a controlling interest in an entity transferred enough interests to put himself/herself below the point where the transferor could exercise control voting or liquidation rights, then the resulting decrease in value is taxed if the transferor dies within three years of the transfer.

Presumably, this change was made to eliminate deathbed transfers that would remove control from the deceased's estate.

### Assignee Interests Included

For example, if a transfer of an interest triggers a reclassification of the interest into an assignee interest that loses the ability to vote, then the resulting decrease in value is taxed if the transferor dies within three years of the transfer. This change was most likely made to eliminate the automatic reduction in the value of limited partnership and other interests by operation of state law upon transfer or death.

## Explanation of Changes to Section 2704-2(b)

### More Restrictive Than under Local Law Exception Is Removed

The proposed regulations would remove the exception that limits the definition of an *applicable restriction* to one that is more restrictive than those under applicable under local law governing the entity. Applicable restrictions are lapsing or other defined restrictions to be ignored for valuation purposes.

A family-controlled business interest transferred to a member of the transferor's family is valued without regard to applicable restrictions limiting liquidation of the entity, so long as the restriction can be removed or avoided by any member or members of the transferor's family acting alone or collectively.

There are exceptions to what will be defined as an applicable restriction under the proposed changes to Section 2704-2. There are four remaining exceptions that will not be regarded as applicable restrictions to be ignored for valuation purposes.

#### Exception 1

A *commercially reasonable restriction* imposed by an unrelated third party. A restriction imposed by a bank lending agreement is a typical example.

#### Exception 2

A *restriction imposed by a mandatory law* that the controlling family cannot avoid by using its collective control to structure the entity under some other option under the entity's governing law that would allow the family to avoid the restriction.

#### Exception 3

Restrictions imposed by *buy-sell agreement terms valid under Section 2073*. Section 2703 addresses restrictions on the sale or use of interests in family-controlled entities, while the proposed regulations under Section 2074 address restrictions on the liquidation or redemption of such interests.

#### Exception 4

If all the family members have a *put right* with certain terms, redeemable at a *minimum value* (both of these terms are described further below).

## Explanation of Changes to Section 2704-3

### Disregarded Restrictions

A new regulation is added under proposed regulation Section 2704-3. This designates a new class of *disregarded restrictions* on liquidation or redemption rights.

A family-controlled business interest transferred to a member of the transferor's family is valued without regard to the disregarded restrictions limiting liquidation or redemption of the interest, so long as the restriction can be removed or avoided by any member or members of the transferor's family acting alone or collectively. This rule is similar in nature to the applicable restrictions rule discussed above.

Such disregarded restrictions include the following:

1. Limitations on the holder to compel liquidation or redemption
2. Limitations on the amount to be received to be less than minimum value
3. Deferrals of more than six months on receipt of liquidation or redemption proceeds
4. Payment of proceeds in other than cash or property (notes from the company or related parties are not considered property in this case, subject to further qualifications as noted below)

There are exceptions to what will be defined as a disregarded restriction under the proposed Section 2704-3. There are five exceptions that will not be considered as disregarded restrictions to be ignored for valuation purposes:

#### Exception 1

A *commercially reasonable restriction* imposed by an unrelated third party. A restriction imposed by a bank lending agreement is a typical example.

#### Exception 2

A *restriction imposed by a mandatory law* that the controlling family cannot avoid by using its collective control to structure the entity under some other option under the entity's governing law that would allow the family to avoid the restriction.

#### Exception 3

Restrictions imposed by *buy-sell agreement terms valid under Section 2073*. Section 2703 addresses restrictions on the sale or use of interests in family-controlled entities, while the proposed regulations under Section 2074 address restrictions on the liquidation or redemption of such interests.

#### Exception 4

If all the family members have a *put right* with certain terms, redeemable at *minimum value* (both of these terms are described further below).

#### Exception 5

If there are nonfamily noncontrolling interest holders above a certain size with a *put right* with certain terms, redeemable at a *minimum value* (as described further below).

## Impact of Nonfamily Holders Explained

Under the above-listed exception 5, nonfamily noncontrolling owners' voting and other rights to block liquidation, redemptions, or other control actions are disregarded restrictions unless they meet all of the following qualifications:

1. Any single nonfamily interest holder has at least 10 percent of total equity interests.
2. Total nonfamily interests equal at least 20 percent of total equity interests.
3. Such interests have been held by the nonfamily owners for at least three years.
4. All such nonfamily interests have a put right at minimum value (see below for details).

## Explanation and Definition of a Qualifying Put Right

In order to qualify as a put right that won't be ignored under Section 2704, the put right has to have all of the following terms:

1. It must apply to the entire interest held.
2. It must provide for payment of the put's proceeds within no more than six months.
3. The proceeds must be in the form of cash or property at minimum value.
4. If the entity is engaged in an active business and has at least 60 percent of its value in nonpassive assets, then a long-term note may be used as payment for the put, if the note is:

a. not funded by passive assets <u>and</u>

b. adequately secured <u>and</u>

c. repaid in periodic (nondeferrable) payments <u>and</u>

d. at a market rate of interest <u>and</u>

e. at a fair market value equal to the put proceeds of minimum value.

Note that the qualifications for the put right would appear to eliminate the use of long-term notes at the Applicable Federal Rate, which is available for many other family transactions.

## Explanation and Definition of Minimum Value

Minimum value is a new standard of value proposed by the Service. The existing standard of value for transfer tax purposes is fair market value.

It is noteworthy that in some cases, minimum value may be the same as fair market value. However, that similarity does not mean that the definitions of these values are the same. They are not.

1. *Minimum value* is defined as follows:

   a. The interest's pro rata share of the "net value" of the entity on the date of liquidation or redemption.

   b. Note that the terms "net value" and "minimum value" are not defined terms under standard nomenclature in the relevant technical community of private business valuation analysts. Nor are the terms typically used by real world buyers and sellers or by their advisers.

2. *Net value* is defined as follows:

   a. The fair market value of the entity's assets, determined under Section 2031 (for estate taxes) or Section 2512 (for gift taxes), depending on whether the matter concerns gift or estate taxes.

   b. This value standard can only be defined as an entity-level standard of value, given the definition less the "outstanding obligations" of the entity. Again, this is an entity-level standard of value.

3. *Outstanding obligations* are defined as obligations that would be allowable as deductions under Section 2053 as claims against an estate.

   We understand that Section 2053 claims are only those obligations that are actually payable and are ascertainable, as noted below:

   a. To be deductible, a claim against a decedent's estate must represent a personal obligation of the decedent existing at the time of the decedent's death.

      Except as otherwise provided in paragraphs (b) and (c) of this section, and to the extent permitted by Section 20.2053-1, the amounts that may be deducted as claims against a decedent's estate are limited to:

      i. the amounts of bona fide claims that are enforceable against the decedent's estate (and are not unenforceable when paid) and

      ii. claims that:

         (1). are actually paid by the estate in satisfaction of the claim or

         (2). meet the requirements of Section 20.2053-1(d)(4) for deducting certain ascertainable amounts.

   The Service does not explain how *personal obligations* fit into the context of *business entity* obligations.

Therefore, minimum value may be considered to be similar to—but not quite the same as—using an asset-based (net asset value) valuation approach, using a premise of value under an assumption of an orderly liquidation.

However, if the entity is an active business, one may assume that minimum value may represent the sale of the entire entity to a single buyer under a premise of value assumption of a sale as a going concern.

## Explanation of How These Values Are Applied

The proposed regulations also note, or imply, how these values are applied to various transactions and recipients.

The proposed regulations state that the higher values under the applicable/disregarded restriction valuation rules and put rights at minimum value also apply to the *marital deduction* and for the *stepped-up cost basis* value for a spouse for estate tax and income tax purposes.

The proposed regulations also imply that other family members inheriting or buying interests can also adopt these higher values (unless they fall under one of the exceptions) for stepped-up cost basis for gift/estate tax and income tax purposes.

The proposed regulations also establish that these higher values *do not apply* to transfers to nonfamily members, such as charities. In such cases, the ordinary fair market value standard applies.

## Implications for Valuation

### Worst Case: If Minimum Value Is the Only Applicable Value

Some legal commentators have concluded that the requirement that all restrictions resulting in a value less than minimum value for family transactions must be ignored for valuation purposes (unless they fall under one of the exceptions noted above). This interpretation results in a de facto deemed value at minimum value for all family transactions that fall under the proposed regulations of Section 2704.

If this is the case, then the only valuation issues would be at the entity level under the new minimum value standard.

### Pessimistic Case: If Fair Market Value of the Entity Is the Applicable Value

If the ability to liquidate the entity is a mandatory restriction imposed under local laws, then the fair market value of the entity, assigned on a pro rata basis to the subject interest, is the standard of value applicable under exception 2 noted above for any interests, even noncontrolling interests, transferred among family members.

If this is the case, then considerations of risk factors that would result in company obligations such as built-in gains tax exposures for C corporations and environmental or other regulatory exposures that exist for all entities (but which cannot be reduced to ascertainable amounts) can be considered as they always are under fair market value standards by hypothetical willing buyers and sellers.

Consideration of other factors, such as the amount of value that is assignable to the personal goodwill of a key family member-owner—and not as part of the entity's goodwill—will also become part of the assessment of minimum value. In most cases for active businesses, the entity-level fair market value of an interest will be less than its minimum value.

In many cases for holding company or investment management businesses, the entity-level fair market value of an interest will be equal to or less than its minimum value. But discounts for lack of control and for lack of marketability will be smaller, if they can be justified.

### Best Case: If Fair Market Value under Applicable/Disregarded Restriction Standards Is the Applicable Value

Some legal commentators have concluded that transfers among family members will still allow consideration of noncontrolling status for noncontrolling interest transfers (subject to the three-year rule).

If this is the case, then attorneys and appraisers will have to work together to arrive at a set of assumptions regarding the remaining terms and conditions that will be allowable for consideration regarding liquidation and redemption restrictions (and other factors applicable) in arriving at the fair market value for the transferred noncontrolling interest.

One would assume that some reduced set of lack of control and lack of marketability factors would apply once the other applicable/disregarded restrictions are "sanded off" of the entity's governing documents.

However, one would expect that discounts for lack of control and lack of marketability would still be applicable at the transferred interest (i.e., noncontrolling, non-publicly-marketable) level—just not as large as taxpayers have seen previously.

## Implications for Planning

### Better the Devil You Know Than the Devil You Don't Know

We are seeing some clients going ahead and finishing all feasible intrafamily transfers before the proposed regulations are finalized. The Service's comments indicate that the regulations will not be finalized until sometime later in 2017 (at the earliest).

We understand that the Service has received over 8,000 comments on the proposed regulations, and has indicated that they will be in no particular hurry to finalize the proposed regulations, given the real problems that commentators have already noted in the interpretation of the wording of the proposed regulations.

Members of Congress have also indicated that they believe that the Service has overreached its regulatory authority in this matter and, therefore, plan to stop, alter, or delay the changes to the regulations. So there should be adequate time to plan and execute transfers under the well-understood current valuation standards.

## When to Opt into Using Put Rights at Minimum Value

If minimum value is not the deemed value for all intrafamily transfers, then taxpayers should be able to opt into using this alternative as a *safe harbor*.

We can think of only two circumstances in which it makes sense to use qualifying put rights at minimum value:

1. If the entity is a pass-through entity and owns nothing but publicly traded securities and has no material obligations, then put rights at minimum value and the fair market value of the entity will be the same.

   Some clients who are averse to fighting with the Service over tax issues may opt into using qualifying put rights at minimum value for administrative convenience. Anyone actually triggering his or her put rights should expect to receive low basis assets as proceeds.

   The potential disruption to the entity's continuing investment activities due to the necessity to honor put rights would discourage many taxpayers.

2. In the same set of circumstances as above, if the client wishes to obtain a significant charitable gift deduction, and the charity prefers to be a long-term owner and not trigger its put rights at minimum value, then establishing a charity with a gift of a 20 percent or more interest with qualifying put rights would allow consideration of the charity's blocking right restrictions on other family members for transfer tax purposes.

## Beware of the Three-Year Rule

Although the Service has indicated that the three-year rule will only apply to transactions that occur after the proposed regulations are finalized, any interim planning should take into account the impact of the rule once it is adopted.

This may include commissioning valuations for planning purposes that assume the client dies within three years after making a transfer to assess the implied magnitude of the value of these phantom assets.

## When the Regulations Become Final

Assuming that the Service finalizes the regulations some time in 2017, then valuation issues will be clarified and, presumably, the Service will have closed the perceived loopholes to which it has long objected. In anticipation of this end stage, clients and their legal counsel should review all relevant entity-governing documents to make changes to reduce the impact of the proposed regulations.

As a note, the Service has claimed that the proposed regulations do not require either a regulatory impact assessment or a regulatory flexibility analysis.

This claim is completely preposterous, as every family-owned business entity of every type will have to review its governing documents to see if liquidation, redemption, or buy-sell rights and restrictions need to be amended in light of the proposed changes to the regulations. The federal government's own statistics show that there are millions of these entities.[7]

## Summary and Conclusion

The Service has proposed regulations regarding Internal Revenue Code Section 2704. The proposed regulations lack clarity in a number of essential areas affecting the valuation of family-owned entities.

Any reasonable analysis indicates that future valuations will have less scope to apply discounts for noncontrolling interests in family-controlled entities for transfer tax purposes for transfers among family members.

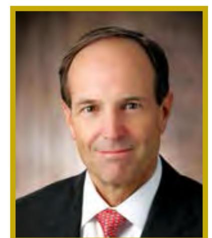
Taxpayers should consider moving forward with all feasible intrafamily transfers before the proposed regulations are finalized.

Clients and their legal counsel should review all relevant entity-governing documents to develop a plan to make changes to reduce the impact of the regulations once they are finalized.

We stand ready to help our clients with valuations and analysis of planning issues now and in the future to deal with the proposed regulations under Section 2704.

Notes:


1. Rev. Rul. 81-253, 1981-1 C.B. 187.
2. Revenue Reconciliation Act of 1990, Senate Finance Committee Report (Washington, DC: U.S. Government Printing Office, 1990), 61.
3. Rev. Rul. 93-12, 1993-1 C.B. 202.
4. See Kerr v. Commissioner, 113 T.C. 449 (1999).
5. IRS Priority Guidance Plan 2003–04.
6. Fiscal Year 2010 Revenue Proposals (Greenbook).
7. https://www.irs.gov/uac/tax-stats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