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Featured Article

Valuation Discounts under Attack for Family Business Planning under the Proposed Section 2704 Regulations

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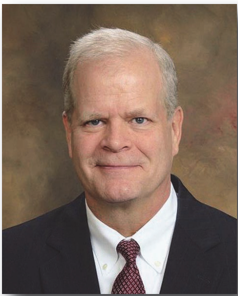

Brief Summary of the Proposed Regulations

The major components of the new Section 2704 proposed regulations[1] issued by the Internal Revenue Service in August can be briefly summarized as follows:

The First Set of New Rules

The Internal Revenue Service has chosen to impose a bright line "transfers within three years of death rule." If an owner transfers an interest in a closely-held entity within three years of his or her death, and the transfer results in a lapse of a right in the owner to liquidate the entity, the transferred interest or interests will effectively be included in the transferor's gross estate for federal estate tax purposes.

For example, if an owner owns 100% of a company, she effectively possesses the ability to liquidate the company and receive the full value of the company's underlying assets. This is a valuable right, under the Internal Revenue Code. If the owner transfers the stock of the company 25% to each of her three children, and retains 25%, her ability to liquidate the company has lapsed. The IRS could theoretically tax the value of this lapsed right, but by this proposed regulation has chosen to only tax the lapse if the transfer occurs within three years of the owner's death. See, however, the discussion at the end of the *IRS Exceeds its Authority* section of this article, below, which challenges the IRS' ability to have the lapse treated as occurring at the owner's date of death versus at the date of the actual lapse.

The Second Set of New Rules

Under the second set of new rules, if state law provides that a limited partner does not have a right to have the partnership purchase his or 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 is assumed that each family member possesses this liquidation right. These new rules will have the effect of increasing the value of the partnership interests for federal estate and gift tax purposes.

Further, even if the restriction is mandated by state law, and could not be removed, it still will not 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 does not mandate the restriction. These changes are no doubt intended to prevent states from passing creative laws to avoid the intent of this new set of rules.

The Third Set of New Rules

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 he or she did liquidate his or her interest. Thus, these "disregarded restrictions" on liquidation cover any restriction which: (1) limits the ability *of the holder of the interest* to liquidate the interest; (2) limits the liquidation proceeds to an amount that is 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

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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 did not exist, either in the governing documents or applicable law. Thus, it would appear that the proposed regulations have not done away with lack of marketability and minority interest discounts in their entirety. (More on this point, later.)

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," and therefore constitutes a "disregarded restriction," the proposed regulations disregard an interest held by a non-family member that has been held less than three years before the date of the transfer, that constitutes less than 10 percent of the value of all of the equity interests, that when combined with the interests of other non-family members constitutes less than 20 percent of the value of all the equity interests, or that lacks a right to put the interest to the entity and receive a minimum value.[2]

Similar to the changes to the applicable restriction rules described above, restrictions imposed under federal or state law will not constitute a "disregarded restriction" provided the law is one which 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 is not 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 described in section 2704.

Planning Under the Proposed Regulations

Transfers Before Proposed Regulations Become Final

The proposed regulations, while generally retroactive to restrictions created after October 8, 1990, apply only to lapses and transfers occurring on or after the date the proposed regulations are published as final regulations, the only exception being that the third set of new rules outlined above only applies to transfers occurring 30 or more days after the date the proposed regulations are published as final regulations. Thus, one obvious planning technique would be to transfer, either by gift or by sale, affected interests before the date the proposed regulations become final. Significantly, this "grandfathering provision" would appear to include even interests which are newly-created after the date of the proposed regulations.

The final section of this article will address another possible technique to avoid application of the final regulations to existing interests which does not involve giving up all control over the existing interests.

The Future of Discount Planning

Assuming the proposed regulations are eventually finalized and upheld in substantially their current form, at first blush it would appear that future estate and gift tax discount planning should return to its original form of creating marketability and minority interest discounts for transferred and retained interests. The reason for this conclusion is that the proposed regulations imply that minority and lack of marketability discounts will continue to be honored by the IRS, as long as the transfers are made more than three years prior to the decedent's death. The Conference Committee Report which accompanied the passage of Section 2704 in 1990 also makes it abundantly clear that "[t]hese rules do not affect minority discounts or other discounts available under present law."[3]

The open question, however, will be determining the level of these discounts in the future. Because family members could always agree, even as shareholders in a corporation, to liquidate the entity, would the general state law majority and super majority shareholder voting requirements for liquidation now constitute "applicable restrictions" or "disregarded restrictions," and therefore effectively reduce the level of the discount? The proposed regulations for both applicable restrictions and disregarded restrictions imply that this is the case: "The manner in which the restriction may be removed is irrelevant for [the purpose of determining whether the ability to remove the restriction is held by any one or more family members], whether by voting, taking other action authorized by the governing documents or applicable local law, *...terminating the entity*, or otherwise."[4]

It would thus appear that the only type of entity which will benefit significantly from a lack of marketability or minority interest discount in the future will be one which is engaged in an active operation, i.e., where the going concern value of the interest is significantly greater than its liquidation value. The entity's "liquidation value per unit" may be its future floor estate and gift tax value, or its "minimum value," employing the IRS' new term.

Note, however, the arguments which are advanced in the *IRS Exceeds its Authority* section, below, for the invalidity of two elements of the proposed regulations - the "three-year rule" and the "and/or addition." If the three-year rule is ultimately rejected as constituting an invalid exercise of

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the IRS' regulatory authority, lifetime gifts of minority interests in a closely-held entity, *at a time when only the transferor holds an interest in the entity*, should continue to fully qualify for lack of marketability and minority interest discounts, *even if made within three years of the donor's death.*

If the gifts are made more than three years before the transferor's death, but again at a time when only the transferor holds an interest in the entity, the discounts should continue regardless of the validity of the proposed regulations. The reason for this conclusion is that the proposed regulations do not attempt to tax the "resulting lapse" of the liquidation power inherent in the transferred interest if the transfer occurs more than three years before the transferor's death.

If, however, the transferor does not possess a unilateral right to liquidate the entity at the time he transfers interests in the same to his children, the proposed regulations would not allow an estate and gift tax discount to reflect this inability, because the family members as a group could remove this restriction after the transfer, for example by voting as a group to liquidate a closely-held corporation.

Use of an Incomplete Gift Trust

If one again assumes the proposed regulations will eventually be finalized and upheld in substantially their current form, all future lapsing rights and restrictions on liquidation will need to somehow fall within their cracks. Set forth below is just one planning idea which should not only avoid the proposed regulations, but Section 2704 completely.

The owner first establishes and funds an irrevocable trust in which he retains no interest other than the exclusive lifetime and testamentary power to determine all distributions of principal or income to other persons, including the owner's descendants. In an effort to avoid having the transferor considered the owner of any trust assets for Section 2704 purposes, the trust document is drafted to eliminate any ability to distribute trust income or principal to or for the benefit of the transferor. The trust serves the additional important business purpose of insulating the trust assets from creditor attack in most states.

According to the regulations, "[a] beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust, including the income therefrom or the proceeds from the disposition thereof, is not considered the holder of theequity interest." The grantor may not receive distributions from the type of "incomplete gift" trust described above. The regulations add that "[a]n individual holds as equity interest held by or for a trust if the individual is considered an owner of the trust (a "grantor trust") under subpart E, part 1, subchapter J of the Internal Revenue Code (relating to grantors and others treated as substantial owners)."[5] It is therefore also necessary to structure transfers to the irrevocable trust, and the trust instrument itself, so that it does constitute a grantor trust for federal income tax purposes.

The gift should also be incomplete for federal gift tax purposes, in accordance with the regulations: "A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard." One issue to bear in mind is that if the owner only has one child and no other descendants, it will be necessary to broaden the class of permissible beneficiaries and/or remaindermen (other than the owner or the owner's spouse, or their respective estates, creditors or creditors of their estates), in order to satisfy the requirements of this language from the regulations.

A principal requirement of Section 2704(a) is that "the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity." Similarly, a primary requirement of Section 2704(b) is that "the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity." As a consequence of the IRS' above-outlined trust attribution rules, if a corporate or partnership interest is owned inside the type of incomplete gift trust described above, for Section 2704 purposes no portion of the interest is owned by the grantor of the trust. The Section 2704(a) lapsing rules and the Section 2704(b) applicable and disregarded restriction rules therefore cannot apply when a transfer of the interests is deemed made by the grantor, either for gift tax purposes as a result of the lapse, exercise or release of the grantor's retained powers, or for estate tax purposes as a result of a completed transfer of an interest included in the grantor's gross.

The individual's spouse should not be a beneficiary of the trust under this formulation, because the application of a Code section could then render the grantor an owner of the trust under subchapter J. However, either the individual or the individual's spouse should be able to receive bona fide loans from the trust, since fair market value loans would not constitute a beneficial interest in the trust.[6] The drafter would only need to be careful not to violate any of the "defective loan" provisions of another Code section.

What does this all mean for Section 2704 purposes, and the proposed regulations? It means simply that if the corporation or partnership arrange-

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ment contemplated by Section 2704 and the proposed and final Section 2704 regulations is established by a trust in which the grantor owns no ability to receive distributions of either income or principal, Sections 2704(a) and (b) cannot apply to gifts or estate tax inclusion with respect to the grantor's interest in the trust. Thus, although there will still be a taxable gift by the grantor when he or she exercises or releases his or her retained rights, or estate tax inclusion when his or her retained rights lapse at death, the valuation of the gifts of the included interest should not be limited by the rules under Section 2704, because the interests are not considered owned by the grantor for purposes of determining the requisite Section 2704 concurrent control in the grantor and his or her family.

Of course, efforts should be made to avoid any potential step-transaction argument stemming from situations where, for example, the owner transfers her entity interest to the incomplete gift trust, and then follows the transfer up shortly thereafter by exercising her retained power to direct that trust assets be distributed for the trust beneficiaries' reasonable support and comfort, or the client transfers her interest to the incomplete trust in contemplation of death.[7] Subject to this potential step-transaction issue, the mere exercise or release of the owner's retained powers within three years of her death should not run afoul of the IRS' proposed rule treating a lapse of a voting or liquidation rights which results from a transfer which occurs within three years of the decedent's death as a lapse which occurs on the date of the transferor's death. The reason for this conclusion is that, immediately before the exercise or release of the owner's retained powers (i.e., the transfer which potentially resulted in the loss of voting or liquidation rights), the client and her family did not hold control of the entity.[8]

IRS Exceeds its Authority

A potential issue with the type of incomplete gift trust discussed in the previous section of this article arises because the IRS has attempted to add regulations which change the law so that no longer must the control of the entity immediately before the lapse or transfer be in the hands of the transferor and members of his family, as required by both Section 2704(a) and 2704(b), but instead control immediately before the transfer need only be in "the transferor *and/or* members of the transferor's family."[9] The Conference Committee Report which accompanied the passage of Section 2704 in 1990 was very specific in including the requirement that control of the corporation or partnership immediately before the lapse or transfer be in "the transferor *and* family members,"[10] and included this concurrent arrangement in all three of its examples illustrating the application of Section 2704(a) and 2704(b).

The IRS has clearly exceeded its regulatory authority by *changing* the Congressionally-imposed "and" to an IRS-imposed "and/or." Congress granted the IRS certain regulatory authority in Code Section 2704(b)(4):

> The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

Congress thus gave the IRS authority to disregard other restrictions, which the IRS clearly has done by proposing new section 25.2704-3, but Congress did not grant the IRS authority to make other unilateral changes to the Internal Revenue Code, which it clearly has also done by changing the key concurrent word "and" to the concurrent or disjunctive phrase "and/or."

Utilizing an Incomplete Gift Trust for Existing Arrangements

May a client transfer the client's retained entity interests to the type of incomplete gift trust described above, either before or after the proposed regulations become final, and thereby avoid Section 2704 in its entirety?

For example, assume an existing family partnership arrangement where A is the 99 percent limited partner and A's son, B, is the general partner. The limited partnership agreement relies on a state law provision which does not allow A the right to liquidate A's limited interest in the partnership absent the general partner's approval, in order to create an estate and gift tax discount. If A transfers the limited partner units to the type of incomplete gift trust described above, and dies after the proposed regulations become final, how will the limited units be valued for federal estate tax purposes?

Assuming one agrees with the analysis in the preceding section of this article, which demonstrates why the IRS has exceeded its authority in changing the "control immediately before the lapse or transfer requirement" of Code Sections 2704(a) and 2704(b) from one which is possessed concurrently by the individual "and" the individual's family to one which is possessed by the individual "and/or" the individual's family, there is no apparent reason why the limited interests would be valued under Section 2704. Due to the manner in which the incomplete gift trust is structured, there would be no shared control on the part of the previous interest owner and his or her family "immediately before" the lapse (Section 2704(a)) or transfer[11] (Section 2704(b)), and therefore neither Section 2704(a) nor

Section 2704(b) should apply.[12]

Another Example Where the IRS has Exceeded its Authority

Assume A owns 100% of a corporation and transfers 25% each to his three children, retaining the other 25%, taking a minority interest discount for each of the three separate gifts (the transfer resulting in the lapse of voting and liquidation rights). A dies two years later owning all of the nonvoting stock, with no evidence that the transfer two years earlier was in contemplation of A's death. In this situation, i.e., when only A controlled the corporation *immediately before the lapse of the voting and liquidation rights* (i.e., the date A transferred the voting stock to A's three children), and there is no evidence that the transfer two years earlier was in contemplation of A's death, does the IRS have authority to unilaterally impose a new three-year rule treating the resulting lapse of the voting and liquidation rights *as occurring at A's death*, for purposes of Section 2704(a)?

This question is relevant because immediately before the *actual* lapse date, *only A* was in control of the corporation, while at the time of A's death (i.e., the "deemed" lapse date, under the proposed regulations), both A and A's children controlled the corporation. The IRS' only regulatory authority under Code Section 2704(a)(3) is to "apply this subsection to *rights similar* to voting and liquidation rights." But the rights at issue here are not rights "similar to" voting and liquidation rights; they *are* voting and liquidation rights. Considering a resulting lapse of voting and liquidation rights as a transfer under Code Section 2704(a), under the IRS' general grant of authority to render reasonable interpretations of the Code, is not the issue, since such a construction of the Code is at least arguable; deeming the lapse to have occurred at death, however, is a problem, since this construction constitutes an impermissible change in the Code.

Therefore, if the IRS' proposed "three-year rule" is ultimately determined to constitute an invalid exercise of the IRS' regulatory power, lifetime gifts of minority interests by a transferor *who is the sole owner of the entity*, even if made within three years of the transferor's death, would not be subject to IRC Section 2704(a), because of the balance of the proposed regulations which do not tax other "resulting" lapses, and would not be subject to IRC Section 2704(b), because there is no applicable restriction on the transferor's ability to liquidate the entity or the transferor's interest therein, at the time of the gifts. If the gifts are made more than three years before the transferor's death, and again assuming the transferor is the sole owner of the entity at the time, none of Section 2704 would apply regardless of the validity of the proposed regulations.

No Time for a "Lapse" of Attention

As already mentioned, the proposed regulations confer a measure of grandfather protection from their grasp if rights lapse or interests subject to applicable or disregarded restrictions are transferred before final regulations are published in the Federal Register, with 30 additional "grace days" provided for disregarded restrictions. Advisors must therefore begin to immediately identify clients affected or potentially affected by the proposed rules, discuss the various alternatives with them, and take appropriate actions. Of course no one knows for certain when the proposed regulations will be finalized, but it would seem wise to set the end of 2016 or early 2017 as the target deadline for taking responsive action. ❒

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

[2]Prop.Reg. §25.2704-3(b)(4).

[3]Conference Committee Report at p. 157.

[4]Prop.Reg. §§25.2704-2(b)(3), 25.2704-3(b)(3) (emphasis supplied).

[5]Reg. §25.2701-6(a)(4)(ii)(C).

[6]Reg. §25.2701-6(a)(4)(ii)(B).

[7]Note the distinction between the latter situation and IRS' proposed rule for transfers within three years of the transferor's death that result in the lapse of a voting or liquidation right. In the latter situation, no transfer occurs during the decedent's lifetime.

[8]Reg. §25.2704-1(a)(1). ("This section applies only if the entity is controlled by the holder and members of the holder's family immediately before and after the lapse.")

[9]Prop.Reg. §25.2704-2(a).

[10]Conference Committee Report at p. 158. (emphasis supplied)

[11]Note that the relevant "transfer" under Code Section 2704(b)(1)(A) is the transfer of the interest "to (or for the benefit of) a member of the transferor's family." Thus, although it can technically be argued that the existing entity interest has been "transferred" to the incomplete gift trust, there is no transfer to a member of the transferor's family until the grantor's retained power of appointment is either exercised or released by the grantor, or until it lapses at the grantor's death.

[12]But see the important discussion regarding the need to avoid the step-transaction doctrine at the end of my article entitled "Strategies to Prepare for Implementation of 2704 Proposed Regulations"

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