PROPOSED §2704 REGULATIONS TAKE AIM AT CERTAIN DISCOUNTS

1. Introduction and Effective Dates

On August 2, 2016, Treasury issued long-awaited (and long-feared) proposed regulations under §2704. The most important thing to understand up front is that none of these new rules (Proposed Regulation §§25.2704-1 through 25.2704-3) will take effect until the regulations are finalized (indeed, the more controversial provisions have an effective date that is 30 days after the date the regulations are finalized). The hearing on the proposed regulations has been scheduled for December 1, 2016. Most likely, then, none of these rules will apply until sometime in 2017, if at all. That gives planners and clients some time to consider how the new rules might affect current and future arrangements regarding closely-held family entities.

A short primer on §2704 (cribbed largely from the new 4th edition of FEDERAL WEALTH TRANSFER TAXATION by Kevin M. Yamamoto and Samuel A. Donaldson) will provide some context for the new regulations. Section 2704 contains two sets of rules for measuring the value of transferred interests in a corporation or partnership among family members. The first set of rules, in §2704(a), considers the effect of lapsing rights. The second set of rules, in §2704(b), relates to whether certain restrictions on liquidation of the entity will be respected for valuation purposes.

2. Section 2704(a) Background

Under §2704(a)(1), some lapses in voting, liquidation, or similar rights in a "controlled" corporation or partnership are treated as transfers of those rights by the holder. If the lapse occurs while the holder of the right is alive, the transfer is a gift. If the lapse occurs upon the death of the holder of the right, the transfer is deemed to occur at death and thus is included in the decedent's gross estate. There are thus two elements to the application of §2704(a)(1). First, there must be a lapse of voting or liquidation right in a corporation or partnership. Second, the holder of the lapsed right and members of his or her family must control the entity both before and after the lapse. Under §2704(a)(2), the amount of the transfer (or the amount included in the gross estate, as the case may be) is the excess of the value of all interests in the entity held by the holder immediately before the lapse (determined as if the lapsed rights were non-lapsing) over the value of such interests immediately after the lapse.

An example might help. Suppose George was a partner in a limited partnership. At his death, George held both a general partner interest and a limited partner interest. The general partner interest carried with it the right to liquidate the partnership; the limited partner interest had no such power. Accordingly, the value of the limited partner interest was $59 million if it was held jointly with the general partner interest but only $33 million if it was held alone. A buy-sell agreement between George and his son, William Henry, required George's estate to sell the general partner interest to William Henry for $750,000. Absent §2704(a), the value of the limited partner interest included in George's estate would be $33 million, for the right to liquidate the partnership lapsed at death due to the obligation to sell the general partner interest to William Henry. This was the holding of *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8. But now §2704(a) applies, assuming George and members of his family (including William Henry) controlled the partnership before and after George's death. Accordingly, George is treated as having made a transfer of $26 million (the excess of the $59 million value of the limited partner interest assuming the liquidation right was non-lapsing over the $33 million value of the limited partner interest after the lapse) at death, and that extra $26 million is also included in George's gross estate.

The regulations already contain an exception to the application of §2704(a). Under this exception, the deemed gift or deemed gross estate inclusion does not occur where the liquidation rights with respect to a transferred interest are not restricted or terminated. Because of this exception, most inter-vivos transfers of a minority interest by a controlling partner or shareholder do not trigger the deemed gift rule of §2704(a).

3. Proposed Regulations Restrict Scope of Regulatory Exception to §2704(a)

The proposed regulations limit the regulatory exception to inter-vivos transfers made more than three years before death. Any transfers made within three years of death would trigger gross estate inclusion under §2704(a) upon the transferor's death. The following example from the proposed regulations illustrates how this new rule would work:

> D owns 84 percent of the single class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. More than three years before D's death, D transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

4. Section 2704(b) Background

Section 2704(b) relates to restrictions imposed on a power to liquidate a corporation or partnership. Under §2704(b)(1), if three requirements are met, any "applicable restrictions" are to be disregarded when valuing a transferred interest in the entity. These requirements are: (1) a transfer of an interest in a corporation or partnership (2) to or for the benefit of a member of the transferor's family (3) where the transferor and the members of the transferor's family control the entity immediately before the transfer.

An "applicable restriction" is any limitation on the entity's ability to liquidate that either lapses to any extent after the transfer or can be removed after the transfer by the transferor or any member of the transferor's family. For instance, assume Wendy and Peter, a married couple, own general partner and limited partner interests in a limited partnership. Under their partnership agreement, Wendy and Peter have agreed that the partnership can be liquidated only with the written consent of all partners, though this restriction on liquidation may be removed by a unanimous vote of the partners. Wendy transfers her limited partner interest to her son, Michael. All of the requirements of §2704(b)(1) are met, for Wendy has transferred to her son an interest in the partnership controlled by Wendy and her husband. Thus the value of the limited partner interest transferred to Michael must be determined without regard to the restriction that the partnership may be liquidated only with the consent of all partners, because this restriction can be removed upon the vote of Wendy, Peter, and Michael, all members of the same family.

The statute provides that certain restrictions on liquidation are not to be disregarded even where the elements of §2704(b)(1) are met. Commercially reasonable restrictions on liquidation arising from a financing transaction with an unrelated party, for example, are not subject to §2704. In addition, §2704(b)(3)(B) provides that restrictions on liquidation imposed by state or federal law do not trigger §2704(b). In effect, then, only those liquidation restrictions that are more stringent than those under applicable federal and state laws or those found in commercially reasonable financing transactions will be disregarded.

5. Proposed Regulations Eliminate Comparison to State Law

The current regulations restrict the scope of §2704(b) to limits "on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." The preamble to the proposed regulations observe that some states have, in response to this regulation, changed their statutes to allow liquidation only upon a unanimous vote of all owners and to eliminate existing laws that allowed limited partners the right to liquidate their interests in a partnership. That makes Treasury mad. In response, the proposed regulations remove the restriction in the current regulations that limits the definition of "applicable restrictions" to those that are more restrictive than under applicable state law. Indeed, the proposed regulations go on to state that an "applicable restriction" includes any restriction imposed under the entity's governing documents or under local law "regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise."

Lest you think that's contrary to §2704(b)(3)(B), the proposed regulations state that the statutory exception is limited to restrictions imposed or required to be imposed by federal or state law. The proposed regulations go on to explain:

> A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the [owners] or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is 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 transfers described in section 2704, is not a restriction that is imposed or required to be

imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise.

6. There's More – Proposed Regulations Create More Disregarded Restrictions

Section 2704(b)(4) authorizes regulations providing 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." In each of 2009, 2010, 2011, and 2012, President Obama's budget called for legislation that would have broadened the scope of §2704(b) to include as disregarded restrictions "limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations." That this idea never caught traction didn't stop Treasury in issuing the proposed regulations.

New Proposed Regulation §25.2704-3(b) lists four restrictions that will be disregarded in valuing an interest in a corporation or partnership transferred to or for the benefit of one of the transferor's family where the transferor and members of the transferor's family control the entity immediately before the transfer.

The first restriction to be disregarded is one that limits the ability of the holder of the interest to liquidate the interest. Thus, for example, when a parent transfers a limited partner interest to a child, the child's inability to liquidate the transferred interest is to be disregarded when valuing the interest.

The second restriction to be disregarded is one that limits the liquidation proceeds to an amount less than "minimum value," defined in the proposed regulations as the interest's share of the "net value" of the entity at the time of liquidation (net value, in turn, is generally defined as the net asset value of the entity). So any restriction that would pay the holder less than the liquidation value of the interest is to be disregarded under this rule.

The third restriction to be disregarded is one that defers the payment of liquidation proceeds for more than six months. The final restriction to be disregarded is one that permits payment of the liquidation proceeds in any form other than cash, property, or certain notes.

Combine the four disregarded restrictions and it appears that, for example, a limited partner interest subject to §2704(b) would be valued under the assumptions that the holder could cash it in at any time for its full liquidation value, with such amount to be paid in full in cash or other property within six months.

7. Preliminary Thoughts

For planners who worry that the proposed regulations spell the end of certain strategies related to family-owned entities, the message is clear: you have a few months remaining to implement those strategies before the regulations take effect. For those who insist the proposed regulations exceed the scope of the statute or, indeed, violate the statute, it might be best to remember the high degree of deference accorded to agency interpretation of statutes under the current common law. The burden of proof on those alleging legislative regulations to be invalid is, to put it mildly, high. While it may well come to pass that final regulations will be more diluted than the proposed regulations, planners should probably proceed under the assumption that the proposed regulations will take effect and listen for updates as the proposed regulations undergo the comment stage.