



Proposed §2704 Treasury Regulations Jeopardize Valuation Discounts for Transfers of Family-Owned Entities

By:

Karen P. D'Antuono, Esq.
kdantuono@rubinrudman.com
(617) 330-7074
Rubin and Rudman LLP

Robert A. Vigoda, Esq.
rvigoda@rubinrudman.com
(617) 330-7103
Rubin and Rudman LLP

On August 4, 2016, the Department of Treasury and the IRS published long-anticipated proposed regulations that, if finalized, will eliminate or significantly curtail most minority interest and lack of control discounts, making intra-family transfers of family-controlled entities more expensive for estate, gift and generation-skipping transfer tax purposes.

If you are contemplating a transfer in a family-controlled entity, you should consider making such transfer in the near future, before the sweeping proposed regulations go into effect, potentially by the end of the year. Please contact an attorney in the Trusts and Estates practice listed on the last page to discuss the proposed regulations and possible next steps.

Current Law

Section 2704 of the Internal Revenue Code, enacted in 1990, applies special valuation rules to intra-family transfers of interests in closely-held corporations and partnerships. The rules attempt to limit valuation discounts, such as discounts for minority interests and lack of control. Despite the existence of section 2704 and the Treasury regulations promulgated thereunder, practitioners and individuals have been successful in applying discounts and reducing the value of the transfers for transfer tax purposes.

- **Lapsing Voting or Liquidation Rights**

Under current law, the lapse of a voting or liquidation right in a family-owned corporation or partnership is treated as a transfer for gift or estate tax purposes. However, a transfer that results in a lapse of a voting or liquidation right is not subject to this rule if the rights with respect to the transferred interest are not restricted or eliminated.

- **Applicable Restrictions**

Section 2704(b) provides that if an interest in a corporation or partnership is transferred to a family member, any "Applicable Restriction" will be disregarded in valuing the interest for gift, estate and generation-skipping transfer tax purposes if the transferor and members of his or her family control the entity before the transfer. An "Applicable Restriction" is defined as a

restriction that limits the ability to liquidate the entity but which, after the transfer, will lapse or may be removed by the transferor or the transferor's family.

- **Avoiding 2704(a) and 2704(b)**

It is not difficult to avoid the application of the lapsing voting or liquidation and Application Restriction rules to intra-family transfers under current law.

- Lapsing voting and liquidation rights: Assume, for example, that a taxpayer who owns 51% of the stock of a closely-held corporation gifts 2% of the stock to the taxpayer's child. Acting alone, neither the taxpayer nor the child can liquidate the entity because neither has a controlling interest. Despite this, in general, the taxpayer will be able to apply a lack of control discount to the gift since the gifted stock still has voting rights, albeit insufficient to liquidate the corporation.
- Applicable Restrictions: Excepted from the definition is a restriction on liquidation that is no more restrictive than that of the default rule under applicable state law. Assume, for example, that a partnership agreement requires a unanimous partner vote to liquidate the entity. So long as applicable state law also requires unanimity in the absence of a partnership agreement, the restriction in question is not an Applicable Restriction and may be considered in valuing the transfer for transfer tax purposes.

Highlights of Proposed Treasury Regulations

The far-reaching proposed section 2704 regulations attempt to close these perceived loopholes and go even further in an effort to eliminate or curtail valuation discounts.

- **Lapse of Voting or Liquidation Rights**

The proposed regulations add a provision addressing "death bed" transfers of interests in family-owned entities designed to take advantage of minority interest discounts. Under this proposed provision, the lapse of a voting or liquidation right as a result of an intra-family transfer made within three years of a transferor's death is treated as a lapse occurring on the transferor's date of death, includable in the gross estate as a phantom asset. This treatment likely will capture the value of any minority or lack of control discount taken at the time of the gift in the transferor's gross estate.

- **Applicable Restrictions**

The proposed regulations remove the current exception that limits the definition of Applicable Restriction to limitations that are more restrictive than the applicable default state law and only allow very narrow exceptions to the definition. As a result, many restrictions will be disregarded for valuation purposes, thereby curtailing the application of minority interest and lack of control discounts.

- **Disregarded Restrictions**

The Treasury Department and IRS, through the proposed regulations, add a new class of restrictions to be disregarded for gift, estate and generation-skipping transfer tax purposes. Aptly named "disregarded restrictions," such a restriction is defined generally as a restriction that limits the ability of an interest-holder to redeem or liquidate an interest in a family-controlled corporation, partnership, limited liability company or other closely-held entity. As with Applicable Restrictions (which apply at the entity level), the section only is applicable to restrictions that lapse or end after the transfer or that, in general, can be removed by the transferor or any member of the transferor's family.

A disregarded restriction is a provision that (1) limits (or permits the limitation of) an interest-holder's ability to compel liquidation or redemption of such interest or the amount an interest-holder may receive from such liquidation or redemption, (2) defers (or permits the deferral of) the payment of the full amount of the liquidation or redemption proceeds for more than six months after the interest-holder gives the entity notice of such liquidation or redemption, or (3) authorizes or permits the payment of any portion of the proceeds in any manner other than in cash or property. Except for certain family-controlled entities engaged in an active trade or business, a promissory note issued by the entity, other entity interest holders or a person related to either is not considered property.

- **Interests Held by Non-Family Members**

One strategy for avoiding the Applicable Restriction rules under current law is to transfer nominal interests in a family-controlled corporation or limited partnership to non-family members such as employees or charities. If such non-family member interest holders must consent to removing a restriction on liquidity, § 2704(b) is not applicable because family members acting alone do not control liquidation.

The proposed regulations change this result in the Disregarded Restriction context. The proposed regulations disregard the interest held by a non-family member unless the interest meets certain stringent criteria that show the interest is economically substantial and longstanding.

- **Covered Entities**

Current regulations refer to corporations and partnerships. The proposed regulations clarify that the special valuation rules apply to all business entities, whether they be corporations, partnerships, limited liability companies or other arrangements that the IRS considers to be business entities.

Section 2704 and the regulations thereunder apply only to entities that the transferor and his or her family members control. They apply regardless of whether or not the family-controlled entity operates an active trade or business. The proposed regulations define control as the holding of at least 50 percent of the equity in an entity. For a limited partnership, having an interest in the general partner is control.

Effective Dates of Proposed Regulations

In general, the proposed regulations apply after the regulations are finalized and published in Federal Register. The new Disregarded Restrictions rules will be effective 30 days after publication in the Federal Register. A hearing on the proposed regulations is scheduled for December 1, 2016.

This alert is authored by Karen P. D'Antuono and Robert A. Vigoda. Both attorneys are located in Rubin and Rudman LLP's office at 50 Rowes Wharf, Boston MA 02110. This alert is intended to provide general information about an area of law. It is not legal advice and does not create an attorney-client relationship. You should consult with legal counsel for advice specific to your circumstances.

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Trusts and Estates Attorneys

Glenn B. Asch	gasch@rubinrudman.com	617.330.7106
Matthew A. Berlin	mberlin@rubinrudman.com	617.330.7177
Karen P. D'Antuono	kdantuono@rubinrudman.com	617.330.7074
Susan B. Grandis	sgrandis@rubinrudman.com	617.330.7160
Nicholas S. Gray	ngray@rubinrudman.com	617.330.7168
Roland Gray, III	rgray3@rubinrudman.com	617.330.7169
Susan Moniz Harrington	sharrington@rubinrudman.com	617.330.7172
Dana F. Lewis	dlewis@rubinrudman.com	617.330.7184
Jennifer N. Lucas	jucas@rubinrudman.com	617.330.7226
Pamela B. Marsh	pmarsh@rubinrudman.com	617.330.7222
Ronald N. Stetler	rstetler@rubinrudman.com	617.330.7015
Robert A. Vigoda	rvigoda@rubinrudman.com	617.330.7103
Donna M. White	dwhite@rubinrudman.com	617.330.7141