

Proposed Regulations Under Section 2704

**Presented by
Mitchell M. Gans &
Jonathan G. Blattmachr**

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InterActive Legal

PEAK TRUST COMPANY
Elevated Trust & Wealth Management Solutions

Introduction

■ What We Will Cover:

- Background

- An Overview

- Details of the Proposed Regulations

- Planning Before and After Adoption

- Validity of the Regulations if Adopted

- Most Probable Changes to the Regulations

Overview of the Proposed Regulations and Their Effect

The proposed regs, if adopted in their current form as final, would eliminate virtually all minority or lack of control discounts for family controlled entities, whether active businesses or not, for gift, estate, or generation-skipping transfer tax purposes.

The regulations attempt to do so through a variety of proposed new rules.

These would clarify what entity interests they would apply to by modifying the concept of control, by aggregating certain transfers made within three years of death and those occurring at death, and by introducing new restrictions on entity interests that would be ignored for wealth transfer tax valuation purposes.

More on the Overview

More specifically, the proposed regulations would make two broad changes:

- One set of changes to the Section 2704(a) regulations with respect to the lapse of a liquidating right would put more teeth in the “Applicable Restriction” concept
- The second set of changes to the Section 2704(b) regulations would create a new concept called “Disregarded Restrictions” that would be ignored in valuing interests in family controlled entities

Legislative Background

Adoption in October 1990 of Chapter 14:

Section 2701: Designed to kill preferred “stock freezes” through junior and senior equity

Section 2702: Eliminate valuation benefits of Grantor Retained *Income* Trusts

Section 2703: Disregard Buy-Sell and similar agreements unless certain conditions are met

Section 2704: Tax loss of value from a lapse of a voting or liquidation right; disregard certain restrictions on liquidation that would reduce value; authorizes regulations to disregard other restrictions that reduce value but do not ultimately reduce the value to the transferee.

The Details: Background and More

Kerr, 113 TC 449 (1999): Facts: under agreement, could not liquidate before the year 2043 without consent of *all* partners, and charity (a non-family member) was a partner

IRS position: Disregard the restriction on liquidation as an Applicable Restriction

Tax Court held:

- restriction on liquidation was not more onerous than default rule under state law – which required consent of all partners as default rule;
- limiting partner's right to redeem her interest is not an Applicable Restriction; and
- an Applicable Restriction only exists where restriction is on liquidation of entire entity.

Fifth Circuit in *Kerr*: Affirms on Different Ground

Because charity owned an interest, family could not remove the restriction

“For a restriction to be considered removable by the family, the Code specifies that “[t]he transferor or any member of the transferor's family, either alone or collectively,” must have the right to remove the restriction. I.R.C. § 2704(b)(2)(B)(ii). The Code provides no exception allowing us to disregard non-family partners who have stipulated their probable consent to a removal of the restriction. The probable consent of [charity], a non-family partner, cannot fulfill the requirement that the family be able to remove the restrictions on its own.”

What the Proposed Regs. Seek to Do

Proposed Section 2704(b) Regulations seek to accomplish three objectives – to change the outcome in *Kerr*

(1) Eliminate default-rule concept:

- We will now only respect state law where it is mandatory
- What does this mean?
- If state law says liquidation requires consent of all partners and this cannot be modified by agreement
- As a practical matter, this will not occur

More on What the Proposed Regs. Seek to Do

(2) Use Section 2704(b)(4), authorizing regulations, to create the new concept of a Disregarded Restriction:

- Each owner is deemed to have a six-month put right
- Unless mandatory state law bars it – which will not happen
- This will eliminate discounts or suppress them

What! Even More??? Yes. Here Is How...

(3) Disregarded Restriction can't be avoided by giving nominal interests to non-family members (10%/20% rule)

- This is only true re: Prop Reg. 2704-3 given Fifth Circuit in *Kerr*
- Valuation based on each partner having a six-month put right: Based on the concept of minimum value

Example of Application of Proposed 2702(b) Reg.

Example: I own 100 shares of stock and gift one share

Deemed to carry a liquidation right – eliminating any discount

Because no state or Federal mandatory law exists to the contrary

Bottom Line: New 2704(b) regs will eliminate or largely suppress discounts in family context

In effect, the IRS is trying to use regs. under 2704(b)(4) to take back Rev. Rul. 93-12 and the string of defeats it had suffered in court on Family Attribution

Proposed Regs. under Section 2704(a): Background

Section 2704(a) provides that the lapse of a liquidation or voting right where family has control triggers gift tax or estate inclusion

It was designed to overrule *Harrison*, TC Memo 1987-8:

- Facts: GP died and under the partnership agreement, his right to cause liquidation ended at his death
- Tax Court: Partnership interest was valued by taking into account lapse of liquidation right
- Section 2704(a): Adds to gross estate the reduction in value attributable to the lapse

More on Section 2704(a)

Gift of Minority Interest?

Example: I have 52% and can liquidate. I make a gift of 3%, so I have only 49% and I can no longer liquidate.

Question: Has my liquidation right lapsed?

Answer under existing Regs. is No.

Proposed Reg. 25.2704-1 would make an exception if gift occurs within 3 years of death, in which case include value attributable to the lapse in gross estate

Contrast of Proposed Regulations under 25.2704-2 and 25.2704-3

- Proposed Regs. under 25.2704-2 and 25.2704-3:

Even if donor survives three years, 3 percent interest will be *deemed* to have put right or liquidation right

Proposed Reg. 25.2704-1 and Assignees: Confirms gift of partnership interest because a transfer to an Assignee is a Lapse

Differences in the Regs.

Differences between Prop. Reg. 25.2704-2 and Prop. Reg. 25.2704-3:

Prop. Reg. 25.2704-2 deals with *liquidation* right

Whereas Prop. Reg. 25.2704-3 deals with *put* right

Prop. Reg. 25.2704-2 *does not have* a nonfamily member provision

Whereas Prop. Reg. 25.2704-3 *does have* a nonfamily concept

Some Critical Definitions and Rules

- Only Apply to Family Controlled Entities: Modification of Meaning of Control
- State or Federal Laws (not foreign) but only if no alternate statute available
- Requirement that Disregarded Restrictions do not ultimately reduce the value in the hands of the recipient: implication: if it is to lapse or can be removed by the transferor and family members
- Tenancy in Common
- Marital Deduction and Charitable Deduction Property
- Buy Sell Agreements
- Good News for some taxpayers: Basis Matters

Effective Date of the Proposed Regs.

- Not before 30 days after the proposed regulations become final
- Hearing will be held December 1st
- Hence, not likely effective until next year
- Why it may be a long time before the proposed regulations become final

What Can/Should Be Done Now

Do not proceed on the assumption that the regulations will be declared invalid

Advise clients and advise advisers

Action taken before the effective date can use the current rules (e.g., gift and sales of “discounted” assets)

Examples:

- Gifts (always in trust)
- Installment sales to grantor trusts (Rev. Rul. 85-13)
- GRATs—probably longer term; discount in but no discount out?
- 100 Year GRAT?
- CLATs

What Can Be Done *After* the Regulations Become Final?

- We just don't know
- There is some likelihood that the final regs. will be less “harsh” than the proposed regulations would suggest
- Likely, excellent estate tax planning will continue to be available for assets that produce excellent financial returns

Would the Proposed Regulations, if Adopted as Final, be Valid?

Chevron, 467 U.S. 837 (1984):

If statute is ambiguous, IRS can resolve it if reasonable

Mayo, 562 U.S. at 55: Incorporates *Chevron* in the tax context

Brand X, 545 U.S. 967 (2005):

Agencies can overturn court decisions if statute is ambiguous

So overturning court decisions is OK (e.g., *Hubert*)

More on Validity of the Regulations

Interaction with legislative history:

Conference Report: “[t]hese rules do not affect minority discounts or other discounts available under present law.”

Chevron n.9 addresses issue

Home Concrete, 132 S. Ct. 1836 (2012): ‘examination of legislative history’ ... can lead to the conclusion "that Congress had decided the question definitively, leaving no room for the agency to reach a contrary result"

Thus, if the legislative history here is found to be sufficiently ambiguous ...

Summary and Conclusions

- The proposed regulations, if adopted as final, will represent the biggest change in estate tax planning in 25 years
- They would eliminate minority (lack of control) discounts for family controlled entities, whether passive or active, by reason of a deemed put right
- Indirectly, they likely will affect lack of marketability discounts as well
- Some uncertainty on tenancy in common
- Basis should increase as estate tax values increase (what about the three-year rule)?
- Tell clients and consider action soon

Year-End Planning and Discounting

2016 Year-End Estate Planning, Including Discounting
in Light of §2704 Proposed Regulations

**Presented by
Martin Shenkman &
Jonathan G. Blattmachr**

Coming in October 2016!