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Proposed Section 2704 Regulations

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On August 2, 2016, the Treasury Department released proposed regulations amending and expanding upon the current regulations to Internal Revenue Code Section 2704. The proposed regulations, if adopted, would limit or eliminate certain discounts currently recognized under the law that are used when valuing certain transfers of an interest in a family-owned or closely held business. The stated aim of the proposed regulations is to prevent specific perceived abuses of valuation discounts. However, the scope of the proposed regulations as drafted may potentially have a much broader impact on legitimate valuations. Nevertheless, there is likely to remain the potential for some valuation discounts, such as for lack of control and lack of marketability, that reflect genuine economic realities.

Background

Appraisers have long recognized that interests in family-owned entities that are subject to certain restrictions are valued at a discount over liquidation value. Such discounts have been applied and upheld in valuing interests in family-owned entities as well as nonfamily private entities. The proposed regulations, if adopted, make some of those discounts largely unavailable to family-owned entities.

In 1990, Congress enacted Section 2704 to limit the scope of available valuation discounts for transfer tax purposes in valuing interests in family-owned entities. Section 2704(a) provides that a lapse of voting or restriction rights upon a transfer of an interest in a family-owned entity will be treated as an additional transfer of the lapsed right. However, there is a broad exception to this rule in the existing regulations; a valuation discount is still available when the voting or restriction rights are still in existence after the transfer, even if the right is no longer exercisable solely by the transferor.

Section 2704(b) provides that certain restrictions shall be disregarded for valuation purposes. Such restrictions that will be disregarded include the ability to liquidate an entity but only to the extent the liquidation right exceeds the rights available under State law and if the liquidation right will automatically lapse or can be removed by the transferor or the transferor's family after the transfer.

Thus, Section 2704 as enacted placed boundaries on the use of valuation discounts, but it did not eliminate them. The proposed regulations further curtail the availability of certain valuation discounts.

Timeline to Adoption

The proposed regulations will be subject to public comment for 90 days, and a public hearing will be held on December 1, 2016. After the hearing, the proposed regulations may be further revised or may be published as final. We anticipate significant commentary to be submitted, which is likely to postpone publishing of the final regulations. The effective date for adoption will be 30 days after the regulations are published as final.

The Proposed Regulations

The proposed regulations would affect the taxation of transfers by limiting certain valuation discounts judicially recognized under existing law in several ways, including the following:

1. Where a person transfers an interest in a family-owned business in a manner that creates a lapse of the transferor's voting and liquidation rights, if the transferor subsequently dies within three years of that transfer (i.e., a "deathbed transfer"), the proposed regulations provide that there is an additional deemed transfer at the transferor's death that is potentially subject to transfer tax (but would not be eligible for the marital deduction or charitable deduction);

2. The proposed regulations would expand on the existing "applicable restrictions" that may not be included in the valuation of an interest in a family-owned business by creating a new category of "disregarded restrictions." The disregarded restrictions include the following:

    a. No valuation discount is available due to the fact that the transferee is an assignee of an economic interest, as opposed to a full voting member in the family-owned business;

    b. Certain transfers of interests in family-owned entities would be valued as if the holder had a "put right" to sell the interest to the entity within six months for cash (and certain forms of obligations) for a pro rata share of the entity's net value;

    c. A valuation discount will be available where a nonfamily member owner can block the removal of applicable restrictions only if the nonfamily member has held the interest for more than three years, owns a substantial interest in the entity, and has the right to be redeemed or bought out for cash or property upon six months' notice; and

    d. No valuation discount is available where the discount is based on default liquidation restrictions provided for, but not *mandated*, under Federal or State law.

3. The proposed regulations also define entities covered by the rules broadly, including LLCs, whether or not they are "disregarded" entities under federal tax rules.

However, the proposed regulations may not eliminate certain discounts for lack of control and lack of marketability, leaving open the potential for such kinds of valuation discounts which reflect substantive economic realities.

Conclusion

At this time, the full impact of the Section 2704 proposed regulations is unknown, but if the proposed regulations are published as final without further revisions, they would substantially limit discounts available to certain family-owned and other closely held businesses for transfer tax purposes. We will continue to monitor the situation closely. In the meantime, we recommend that any client who is interested in moving forward with a transfer of an interest in a family-owned or other closely held business consider acting promptly, as the proposed regulations will only apply to transfers on or after the date that the final regulations are published in the Federal Register. Please contact us if you would like to discuss the proposed regulations further.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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