

The End of Valuation Discounts is Coming

Proposed Regulations to Section 2704

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The days of reducing gift and estate tax through valuation discounts for closely-held family businesses appear to be coming to an end. After months of anticipation, the U.S. Treasury has released proposed regulations that will significantly restrict the ability of family-owned entities to reduce the fair market value of their assets for gift and estate tax purposes.

The silver lining is that there is a window of planning between now and when the final regulations are introduced.

Background

Many family businesses are created using business entities, such as partnerships and limited liability companies (LLCs). The transfer of interests in these entities among family members is subject to gift and estate tax based on the fair market value of the interest transferred. A common estate and gift tax reduction strategy uses various methods to create valuation discounts in order to reduce the fair market value for transfer tax purposes. Those discounts occur when an interest holder is restricted on their ability to vote or transfer their interests.

For years the IRS has fought – often unsuccessfully – to disregard valuation discounts. In 1990, IRC §2704 was enacted to establish special valuation rules for intra-family transfers of interests in two broad areas: 1) Section 2704(a) causes a taxable event to occur when liquidation or voting rights lapse; and 2) Section 2704(b) provides that in valuing property for estate and gift tax purposes, certain restrictions on liquidation are disregarded in determining the fair market value of the transferred interest.

Since the enactment of §2704, practitioners have successfully employed nuanced strategies that effectively allow the continued use of valuation discounts. The new Proposed Regulations under §2704 seek to eliminate those strategies, effectively eliminating minority (lack of control) discounts for closely-held family entities.

Proposed Regulations:

The Proposed Regulations seek to enact restrictions that disregard valuation discounts the following key ways:¹

- Close the exception allowed under Treas. Reg. §25.2704-1(c)(1), when transfers during life result in the loss of the power to liquidate occurring on the decedent's deathbed. Essentially, unwinding transfers that occur within 3 years of death. Under the Proposed Regs, transfers occurring within 3 years of death that result in the lapse of a liquidation right will be treated as transfers occurring at death. Thus, the exception under Regs. Sec. 25.2704-1(c)(1) would apply only to transfers occurring more three years before death.

The Treasury indicates that a “loss of control over liquidation” that is at least 3 years prior to death “is likely to have a more substantive effect.”

Additionally, the Treasury and IRS believe that the current Regulations under §2704 have been made ineffective by changes in state laws and court decisions. Additionally, various estate planning techniques avoid the application of § 2704(b), under which certain liquidation restrictions are disregarded. As such, the Proposed Regulations make the following additional changes:

- Proposed Regulation §25.2704-2(b) restricts the definition of the term “applicable restriction” under §2704(b) by eliminating the comparison to the liquidation limitations of state law, as well as not including restrictions that are imposed by the terms of the governing instrument.

Currently, there is an exception limiting applicable restrictions to limitations that are more restrictive than the limitations that would apply in the absence of the restriction under local law generally applicable to the entity. The Treasury notes that these changes are necessary because many states have created laws that are more restrictive pursuant to state law, and therefore allow for the unintended expansion of the exception.

- Proposed Regulations §25.2701-2 clarifies that control of an LLC or of any other entity or arrangement that is not a corporation, partnership, or limited partnership would constitute the holding of at least 50 percent of either the capital or profits interests of the entity or arrangement, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. Cf. §2701(b)(2)(B)(ii).ⁱⁱ
- Proposed Regulations §25.2704-3 adds a section that addresses a new term referred to as “disregarded restrictions.”ⁱⁱⁱ Under the Proposed Regulations, any restriction on an owner’s right to liquidate his or her interest in the entity will be disregarded if the restriction will lapse at any time after the transfer, or if the transferor or the transferor and family members, regardless of interests held by non-family members, may remove or override the restriction.

A disregarded restriction includes limitations on the time and manner of payment of the liquidation proceeds. Such limitations include a provision permitting deferral of full payment beyond six months or permitting payment in any manner other than in cash or property.

If a restriction is disregarded under these Proposed Regulations, the fair market value of the interest in the entity is determined assuming that the disregarded restriction did not exist, either in the governing documents or applicable law.

TIME IS OF THE ESSENCE

It is important to understand that these proposed regulations have not yet been finalized. There is a public hearing scheduled on December 1, 2016 to review public feedback on the Proposed

Regulations. The Treasury may revise the Proposed Regulations before they are finalized. Additionally, most of the provisions under the Proposed Regulations won't become effective until 30 days after they are finalized. If the Treasury moves quickly to finalize the regulations after the hearing, it is possible that the final regulations could become effective as early as January 1, 2017.

The Proposed Regulations are the death knell for most valuation discount-based planning strategies. Practitioners should take action immediately if they have clients that hold interests in closely-held family entities, and wish to take advantage of valuation discount transfers. Although the three-year claw back can't be avoided, taking advantage of discounts associated with state law and governing documents are viable planning options before the final regulations are issued.

ⁱ See, Proposed Regulations to §2704.

ⁱⁱ Control of a limited partnership is defined as including the holding of any interest as a general partner.

ⁱⁱⁱ A disregarded restriction includes one that: (1) limits the ability of the interest-holder to liquidate the interest; (2) limits the liquidation proceeds to an amount that is less than the minimum value, which is defined in Proposed Reg. §25.2704-3(b)(ii); (3) defers the payment of the liquidation proceeds for more than six months; or (4) permits the payment of the liquidation proceeds in any manner other than cash or property, other than certain notes.