Much Ado About Nothing? The Fate of the 2704 Proposed Regulations

By Klaralee R. Charlton

Five months ago, practitioners panicked when the IRS issued its proposed regulations to Internal Revenue Code Section 2704 (the “Regulations”). As drafted, the Regulations threatened to prohibit aggressive discounting of family owned businesses on which taxpayers and practitioners have come to rely to avoid hefty estate and gift tax liabilities. However, the pending change in administration poses the question: “Will these Regulations ever be finalized?”

Since introduction, the Regulations have been attacked from multiple angles. During the three month comment period, the IRS received 9,795 comments—the majority of which strongly object to their finalization, especially in current form. On September 15, 2016, Representative James Sensenbrenner, Jr., introduced legislation “[t]o nullify certain proposed regulations relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes.” A week later, Representative Warren Davidson introduced the Protect Family Farms and Businesses Act specifically aimed at “prevent[ing] proposed regulations relating to restrictions on liquidation of an interest with respect to estate, gift and generation-skipping transfer taxes from taking effect.” Senator Marco Rubio introduced an identical bill in the Senate on September 28, 2016. All three bills are currently in committee.

On December 1, 2016, the Treasury Department hosted a full day hearing on the Regulations, during which practitioners expressed concern about the anticipated hardships that would befall valuation experts and small family businesses if the Regulations are finalized. Testimony from the hearing included comments related to the administrative burden that would be created by the Regulations’ implementation and “forc[ing] business appraisers to make

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4 Comments can be found at https://www.regulations.gov/docketBrowser?rpp=50&so=DESC&sb=postedDate&po=0&det=PS&D=IRS-2016-0022.


hypothetical assumptions that are contrary to fact or unlikely to occur and again, are not consistent with the definition of FMV."8

At the end of the hearing, Catherine Hughes from the Treasury Department Office of Tax Policy assured practitioners that revisions would be made to the Regulations in response to the overwhelming concerns voiced about possible retroactive application and the valuation of interests as having a deemed put right.9 A revised set of Regulations has not yet been released.

With the change in administration only days away, opponents to the Regulations are cautiously optimistic that “the guidance (Regulations) is unlikely to survive under President-elect Donald Trump.”10 The President-elect has emphatically voiced his opposition to estate tax altogether. Since the Regulations are aimed at increasing taxpayers’ transfer tax liability, it is unlikely the President-elect will support any action in furtherance of finalizing the Regulations during his term.

The IRS proposed the Regulations to address perceived abusive transfers by taxpayers and to re-activate the effectiveness of IRC § 2704 which had become ineffective due to changes in state law.11 IRC § 2704 was enacted in 1990, partially, as a reaction to the Tax Court’s decision in Estate of Harrison v. Commissioner.12 In Harrison, the taxpayer transferred significant real estate holdings to an LLC owned by him and his sons. The taxpayer retained a 1% general partnership interest and a 77.8% limited partnership interest. Only the general partner had the right to liquidate the entity.

On the taxpayer’s estate tax return, the executor claimed a 45% lack of control discount on the limited partnership interest because, decoupled from the 1% general partnership interest, the limited partnership interest had no right to liquidate the entity. The Tax Court agreed with the taxpayer, costing the IRS roughly $18.5M in estate tax. In reaction to the Harrison decision, Congress enacted IRC § 2704 to prevent taxpayers from applying control restriction discounts in situations where the restriction has no real impact on the owner of the business interest.

Currently, IRC § 2704 has two primary purposes. The first, contained in subsection (a), creates a separate taxable asset when a lapse in voting or liquidation rights occurs and the individual originally holding such rights and/or his family control the entity before and after the lapse.13 The taxable value of this phantom asset is the value of the taxpayer’s interest before the lapse minus the value of the interest after the lapse—creating, in essence, a ban on applying a lack of control discount when a family controls the entity. For purposes of defining control, IRC §

11 See Background section of source cited supra note 2.
13 IRC § 2704(a).
2701(b)(2) sets the threshold at 50%. Family includes the transferor and his spouse, any ancestor or lineal descendant of the transferor or his spouse, siblings of the transferor and his spouse, and any spouse of these ancestors, descendants, or siblings.

Example 1 of the current regulations illustrates when a lapse subject to IRC § 2704(a) might occur. If taxpayer D owns 100% of Corp Y’s preferred stock with 60% of the voting rights which terminate at D’s death and D’s children own 100% of the common stock with 40% of the voting rights, a lapse subject to IRC § 2704(a) occurs at D’s death.14 Because the voting rights lapse at D’s death and D and D’s family control Corp Y before and after the lapse in voting rights, the difference between the value of D’s interest before and after the lapse will be added to D’s taxable estate for purposes of calculating estate tax.

An exception to IRC § 2704(a) applies if the actual liquidation rights are not restricted or eliminated but a transfer results in an owner losing his ability to liquidate the entity.15 This exception most often applies when a majority owner transfers enough of his interest that he becomes a minority owner. As illustrated in Example 4 of the current regulations, subsection (a) does not apply to the change in a taxpayer’s interest when his liquidation rights cease simply because he transfers enough of his interest to take him from a position in which he can liquidate the entity to one in which he does not have sufficient voting power to liquidate the entity.

As proposed, the Regulations target this exception by adding a three year look back period. If a taxpayer loses his ability to liquidate an entity due to the transfer of his interest and the taxpayer dies within three years of the transfer, subsection (a) applies to create the additional taxable asset for estate tax purposes.16

Practitioners have voiced concern over the three year look back period. Of particular concern is its potential retroactive application, the timing of the valuation and the interaction of Prop. Reg. § 25.2704-1(c)(1) with the remainder of IRC § 2704 if discounts are disallowed for other reasons. Practitioners were assured after the December 1, 2016 hearing that retroactive application would not be sought.17

The second purpose of IRC § 2704 contained in subsection (b), seeks to prevent family owned businesses from discounting interests when an entity’s liquidation restrictions are more restrictive than state law. Subsection (b) applies to prevent lack of control discounts when the following three factors are met:

1. A transfer of an interest in an entity to a family member in which the family controls the entity before and after the transfer AND
2. A restriction on the liquidation of the entity exists which is more restrictive than the default state law related to liquidation (“Applicable Restriction”) AND

16 See supra note 2.
17 Supra note 6 stating, “Hughes appeased opponents by stating that final rules would clarify that there is no deemed put right (as lawyers have read into the draft rules) and that the three-year lookback provision wouldn’t be retroactive.”
3. The restriction lapses after the transfer or the family has the ability to remove the restriction immediately after the transfer.

Since its passage in 1990, state laws across the country have been amended. Now, entities’ operating provisions relating to liquidation restrictions are rarely more restrictive than the default state law because states have adopted the most restrictive liquidation restrictions as part of their default entity statutes. Since an entity’s restriction on liquidation will rarely be more restrictive than the default state law, subsection (b) rarely applies.

The Regulations seek to address this issue by removing the state law comparison provision. If finalized, factor two above would read, “a restriction on the liquidation of the entity exists.” The result would be that no discount for an owner’s inability to liquidate the entire entity could be applied to an interest transferred between family members if, after the transfer, the restriction on that ability lapses or the family of the transferor can remove the restriction.18

Opponents to the Regulations cite the overwhelming breadth of the change. When originally enacted, entities could at least adopt the state’s level of liquidation restrictions and still take lack of control discounts on the transfer of an interest. Under the Regulations, entities are now precluded from taking any discount for a restriction on liquidation of the entity. There is no word on whether the IRS intends to revise this portion of the Regulations prior to finalization.

Because the courts interpret IRC § 2704(b) only to apply to restrictions on an owner’s ability to liquidate the entire entity, the Regulations broaden the scope of IRC § 2704 to apply to restrictions on an owner’s ability to liquidate his own interest.19 Proposed Reg. § 25.2704-3 creates a new definition known as “Disregarded Restrictions.” Like “Applicable Restrictions” defined in IRC § 2704(b), the Regulations prevent discounting for an owner’s inability to liquidate his own interest. Specifically, no discount may be taken for a limitation on the liquidation or redemption of an owner’s interest, payment of less than “Minimum Value” for an owner’s interest in the event of liquidation or redemption, deferral of payment for an entity interest for longer than 6 months, or provision of consideration for entity interest other than cash or property, if:

1. A transfer of an interest in an entity to a family member in which the family controls the entity before and after the transfer, AND
2. The restriction lapses after the transfer or the family has the ability to remove the restriction immediately after the transfer.

Specific to the Disregarded Restriction provisions is a limitation on considering third party owners when calculating whether the family may remove the restriction immediately after the transfer. When determining whether the family may remove the Disregarded Restriction,

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18 Exceptions still apply for commercially reasonable liquidation restrictions linked to 3rd party financing and restrictions imposed by federal and state law, except when those restrictions may be overridden by the governing document, or apply only to a narrow class of entities such as family controlled entities, or can be avoided by the adoption of alternate laws. Supra note 2, Prop. Treas. Reg. § 25.2704-2(b)(4).
19 Courts interpret IRC § 2704(b) to apply only to restrictions on the entire entity to liquidate and not to restrictions on individual interests to liquidate. See Kerr v. Comm’r, 113 T.C. 449 (1999), aff’d, 292 F.3rd 490 (5th Cir. 2002).
third party owners are to be disregarded unless: the third party has been an owner for three years prior to the transfer; and third party has at least a 10% ownership interest; and the total of all third party owners is at least 20% of all ownership interests; and all third party owners have a put right. These additional restrictions are intended to prevent the use of negligible owners to avoid the application of the Regulations.20

Two of the most criticized parts of Prop. Reg. § 25.2704-3 are the use of the new definition “Minimum Value” and the suggestion that interests be valued as though they have a deemed put right. First, many analysts argue that “Minimum Value” is significantly different from Fair Market Value and criticize the IRS for applying an entirely new definition of value in these valuation situations. Second, some practitioners believe that by disallowing discounts for restrictions on liquidating an owner’s interest the owner will now have to value his interest as though he has a deemed put right.

The IRS has not addressed practitioner criticism of the use of the Minimum Value definition; however, Catherine Hughes stated that the deemed put right interpretation is completely contrary to the IRS’ intent and that the Regulations will be clarified to ensure practitioners do not interpret the Regulations in this manner.21

The coming months will be decisive to the fate of the Regulations. Since it is highly improbable the Regulations will be finalized and go into effect, the real question may not be whether the Regulations will die, but how they will die. The Regulations are currently the target of both the President-elect’s campaign against estate tax and the legislation introduced in September, 2016. Even if neither of these formally thwart the finalization of the Regulations, it is unlikely we will see the Regulations finalized during the next four years.

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20 See analysis in Kerr relating to minority owners used to avoid the application of IRC § 2704.
21 Supra note 6.