



Restricting Valuation Discounts

Practical Implications of the
Proposed Regulations to
IRC §2704

IRC §2704 – Special Valuation Rules

- Special Rules for valuing intra-family transfers of interest in corporations and partnerships
 - Pertains to Transfers involving:
 - **Lapsing voting or liquidation rights**
 - **Restrictions on liquidations**
- Relates to valuation of such interest for Estate and Gift Tax purposes

IRC §2704 – Special Valuation Rules

- Lapses of Voting or Liquidation Right
 - Treated as a transfer of
 - The excess of FMV of all interests held by Transferor (determined as if the rights were non-lapsing)
 - Over
 - The FMV of such interest after the lapse

IRC §2704 – Special Valuation Rules

- Restrictions on liquidation
 - Certain restrictions on liquidation are disregarded in determining the FFMV of such interest after the lapse.
 - Intended to prevent results similar to that in Estate of Harrison v. Commissioner, T.C. Memo. 1987-8.

Affected Regulations

○ Amendments

➤ **Treas. Reg. §25-2701-2 –**

- ❖ What constitutes control of an entity that is not a corporation, partnership or limited partnership

➤ **Treas. Reg. §25.2704-1**

- ❖ Deathbed transfers that result in the lapse of a liquidation right
- ❖ Clarify the treatment of a transfer that results in the creation of an assignee interest

➤ **Treas. Reg. §25.2704-2**

- ❖ Refine the definition of the term “Applicable Restriction”

➤ **Treas. Reg. §25.2704-3**

- ❖ Address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interest of nonfamily members

○ Clarifications

➤ **Treas. Reg. §25.2704-1 through 25.2704-3**

- ❖ Expands definition of “Covered Entities”

IRS Reasoning for Proposed Regulations

- Current regulations have been rendered **substantially ineffective** by:
 - Changes in state law; and
 - Other Subsequent Developments

IRS Reasoning for Proposed Regulations

➤ “Other Developments”

1. Courts held that 2704(b) applies only to restrictions on the ability to liquidate an entire entity, and not to restrictions on the ability to liquidate a transferred interest in that entity.
 - ❖ As a result – restrictions on the ability to liquidate an individual interest is not an applicable restriction under the current regulations

IRS Reasoning for Proposed Regulations

➤ “Other Developments” (Con’t)

2. Current regulations except from the definition of an “applicable restriction” a restriction that is *no more restrictive than that of the state law* that would apply in the absence of the restriction.

- ❖ At the time that 2704 was enacted, the state law applicable to partnerships granted owners certain rights to liquidate the entity;
- ❖ Many state laws have been amended to allow liquidation only upon unanimous vote of the owners;
- ❖ Many state laws have been amended to eliminate the statutory provision that allowed a partner to liquidate his or her interest;
- ❖ States statutes create elective restrictions on liquidation

IRS Reasoning for Proposed Regulations

➤ **“Other Developments”** (Con’t)

3. Taxpayers have attempted to avoid the application of § 2704(b) through the transfer of a partnership interest to an assignee rather than to a partner; or
4. Transfers of nominal interest to a nonfamily member, such as a charity or an employee

See, Kerr v. Cmm’r, 113 T.C 449 (1999), *aff’d* 292 F.3rd 490 (5th Cir. 2002).

Authority to Promulgate Regulations

- Congressional Grant – Broad Discretion
 - IRS and Treas. Dept. have concluded that there are *additional restrictions* that may adversely affect the transfer tax value of an interest but that do not reduce the value of the interest to the transferee, and thus should be disregarded.

[Proposed]

Disregarded Restrictions

1. A restriction on the ability to liquidate the transferred interest;
2. Any restriction attendant upon the nature or extent of the property to be received in exchange for the liquidated interest or the timing of the payment of that property;
3. The grant of an “Insubstantial Interest” in the entity to a nonfamily member

Disregarded Restrictions [Proposed]

(Con't)

- Bright-Line Test for “Insubstantial Interest” by Third Party
 - ❖ Held by non family member for less than 3 years and
 - ❖ Constitutes less than 10% of the value of all of the equity interests and
 - ❖ When combined with the interests of other nonfamily members constitutes less than 20% of the value of all of the equity interests or that lacks a right to put the interest to the entity and receive a minimum value

[Proposed]

Covered Entities

- Section 2704 applies to
 - Corporations
 - Partnerships
 - LLCs
 - Other business entities within the meaning of § 301.7701-2(a)

[Proposed]

Control of Entity

- Control is clarified to mean
 - A holding of at least 50% of either
 - ❖ Capital Interest or
 - ❖ Profits Interest; or
 - The Holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement.

[Proposed]

Control of Entity

- *Attribution Rules*

- For purposes of determining control, an individual, the individual's estate, and members of the individual's family are treated as holding interest held indirectly through an entity.

- ❖ Treas Reg § 25.2701-6

[Proposed]

Lapses under § 2704(a)

- Any discount based on the transferee's status as a mere assignee and not a full owner and participant in the entity is eliminated
- The lapse of voting and liquidation rights for transfers made within three years of death of interests in a family-controlled entity is treated as an additional transfer
 - Thereby eliminating or substantially limiting the lack of control and minority discounts for these transfers

[Proposed] Applicable Restrictions under § 2704(b)

- Revise § 25-2704-2(b)'s definition of “Applicable Restrictions”
 - Removing reference to “more restrictive” than state law;
 - Provide that a default state law restriction that may be superseded by the governing documents is not a restriction imposed or required to be imposed by Federal or state law
 - ❖ Regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise

[Proposed]

Disregarding Certain Restrictions on Redemption or Liquidation

- **Restriction on Right to Liquidate**

- Disregarded Restriction Includes ones that:
 - ❖ Limit the owner's ability to liquidate the interest;
 - ❖ Limit the proceeds from a liquidation to an amount that is less than FMV;
 - ❖ Minimum Value - interest's pro rata share of the NFMV of the assets
 - ❖ Defers the payment of the liquidation proceeds for more than 6 months;
or
 - ❖ Permits the payment of the liquidation proceeds in any manner other than in cash or other property
 - ❖ Not for a promissory note, except in the case of certain "market interest rate" notes issued by an active trade or business.
- Fair market value is deemed to be the value as of the date of the liquidation or redemption

[Proposed]

Disregarding Certain Restrictions on Redemption or Liquidation

- Threshold Element - after the transfer:
 - Will the restriction lapse?
 - Can the transferor or any member or any member of the transferor's family remove the restriction?

[Proposed]

Effective Dates

- Voting and Liquidation Rights
 - Applicable to rights and restrictions created after October 8, 1990, but only to transfers occurring after the date the regulations are published as final regulations
- Disregarding Certain Restrictions on Redemption or Liquidation
 - 30 days after the date the final regulations are published as final



Questions?

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