
Speculation About Upcoming Section 2704 Proposed Regulation

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1. OVERVIEW

Section 2704(b)(4) gives the Treasury broad authorization to issue regulations that would disregard certain “other restrictions” in determining the value of an interest in a corporation or partnership transferred to a family member if the restriction “does not ultimately reduce the value of such interest to the transferee.” IRS and Treasury officials hinted about eight years ago that they were close to issuing such a proposed regulation (reflecting a §2704 guidance project that was placed on the IRS/Treasury Priority Guidance Plan in 2003), but President Obama’s first budget proposal included a revenue proposal to revise §2704, and the §2704 regulation project was put on hold pending the possible passage of such legislation that might provide legislative support for the positions the new proposed regulation might take. Not a single bill was ever introduced addressing the legislative proposal, however, and the §2704 legislative proposal was omitted from the President’s budget proposal released in February 2012.

IRS and Treasury officials have indicated that the §2704 regulation project is proceeding. Cathy Hughes, a Treasury official, had some comments about the §2704 regulation project at the recent ABA Tax Section meeting. The proposed regulation may have a dramatic impact on the valuation of interests in closely-held corporations or partnerships that are transferred to family members—and the proposed regulation might conceivably be effective when the regulation is finalized retroactive to the date of the proposed regulation.

Observe that a regulation disallowing discounts in certain situations may actually be advantageous for the many decedents who do not owe estate tax but would benefit from a stepped-up basis at death to the undiscounted value of the assets (assuming the value determined under §2704 is recognized for purposes of §1014, see Reg. §1.1014-1(a)).

2. SECTION 2704 STATUTORY BACKGROUND

Section 2704 was enacted in 1990 as a part of Chapter 14. The goal in particular was to limit discounts for certain family partnership or LLC interests that are transferred to family members. Section 2704(b) is titled “Certain Restrictions on Liquidation Disregarded.” It provides that any “applicable restriction” is disregarded in valuing an interest in a corporation or partnership that is transferred to a family member if the transferor and family members control the entity. An “applicable restriction” is any restriction that (i) effectively limits the ability of the corporation or partnership to liquidate, and (ii) the restriction lapses (entirely or partially) after the transfer OR the transferor or family members can remove the restriction (entirely or partially), but an “applicable restriction” does not include “any restriction imposed, or required to be imposed, by any Federal or State law” (or commercially reasonable restrictions imposed by unrelated persons in a financing transaction).

Section 2704(b)(4) includes broad legislative authority for the IRS to issue regulations that would disregard “other restrictions”:

“The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor’s family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.”

The title to §2704(b) is “Certain Restrictions on Liquidation Disregarded.” The authorization of regulatory authority in §2704(b)(4) does not specifically limit the regulations to “other liquidation restrictions” but merely refers to “other restrictions.” Does this provide legislative authority for regulations limiting discounts for reasons other than merely disregarding liquidation restrictions despite the title of §2704(b)?

3. SIGNIFICANCE OF STATE LAW EXCEPTION

The exception for “any restriction imposed, or required to be imposed, by any Federal or State law” is very important. The “state law” exception is clearly integrated into the existing regulations.

“An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction.... Ability to remove the restriction is determined by reference to the State law that would apply but for a more restrictive rule in the governing instrument of the entity.... A restriction imposed or required to be imposed by Federal or State law is not an applicable restriction.” Treas. Reg. §25.2702-2(b).

“(c) Effect of disregarding an applicable restriction.—If an applicable restriction is disregarded under this section, the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the State law that would apply but for the restriction.” Treas. Reg. §25.2704-2(c).

The exception for restrictions imposed by State law has dramatically reduced the applicability of §2704 to partnership and LLC transfers. Many state legislatures have revised limited partnership and LLC laws after the passage of §2704 to provide various limitations on the rights of limited partners or LLC members to make transfers under default rules that apply unless the partnership or operating agreement specifically overrides those default rules.

4. UPCOMING REGULATION PROJECTS

Cathy Hughes provided insight as to the regulation projects impacting estate planners that we might expect to see in the near future. Projects that she mentioned include: (1) Final portability regulations (the temporary regulations expire June 15, 2015); (2) Guidance under the ABLE Act allowing states to create “Section 529-type” accounts for the disabled (which would also likely appear in June); (3) Final regulations regarding basis rules for interests in charitable remainder trusts; (4) Guidance regarding the §2801 tax on gifts by certain expatriates to U.S. citizens and residents (this has been a “high priority” for several years); and after that guidance is issued (5) Section 2704 proposed regulations. (The preceding information is based on a summary of the ABA Tax Section meeting by Diane Freda. Freda, *Guidance on Material Participation For Trusts, Estates May Emerge in Stages*, BNA Daily Tax Report (May 12, 2015).)

This summary suggests that the §2704 regulations will not be issued within the next several months but might conceivably be issued later this summer or this fall. Cathy Hughes said that various Treasury initiatives (she did not specifically include all of the projects listed above) are likely to be delivered before the ABA Tax Section fall meeting (which is September 17-19, 2015).

5. POSSIBLE SCOPE OF NEW §2704 PROPOSED REGULATION

Cathy Hughes said that the scope of what the new regulations might include are indicated by the §2704 legislative proposal (last included in the Fiscal Year 2013 Greenbook, “General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals” dated February 2012). (This suggests that the new proposed regulations may include many of the items that were being considered eight years ago. The Treasury presumably suggested the §2704 legislative project to the Obama administration to support the provisions that it wanted to include in its new regulations.)

The §2704 legislative proposal in the Greenbooks for the Obama administration, ending with the 2013 Fiscal Year Greenbook, includes five items. The new §2704 regulation may include some or all of these subjects.

- a. Additional “Disregarded Restrictions.” An additional category of restrictions (“disregarded restrictions,” which are in addition to the liquidation restrictions addressed in §2704) may be disregarded in determining the value of interests in “family-controlled entities” (observe, this is not limited just to partnerships and LLCs) that are transferred to family members. What are those additional restrictions? They are “to be specified in regulations.” Transferred interests would be valued by substituting for “disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder’s right to liquidate that holder’s interest that are more restrictive than a standard to be identified in regulations.”
- b. Assignee Interests. Restrictions on a transferee being able to become a full-fledged partner (or member of an LLC) would be a disregarded restriction.
- c. Third Party Involvement in Removing Restrictions. Section 2704(b)(2)(B)(ii) says that one of the general requirements of an “applicable restriction” is that the transferor or family members can remove the restriction. (The Greenbook proposal generally retains this family-removal requirement with respect to “disregarded restrictions.”) The Fifth Circuit in the *Kerr* case reasoned that §2704 did not apply to the partnership in that case because charities had small limited partnership interests, and all partners had to consent to removing restrictions; thus, the family acting alone could not remove the restrictions. *Kerr v. Commissioner*, 292 F.3d 490 (5th Cir. 2002). Under the legislative proposal, “certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family.”
- d. Safe Harbor. The statute would provide regulation authority that would include “the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met.”
- e. Marital and Charitable Deduction. The legislation would include provisions dealing with the interaction of the marital and charitable deductions for transfer tax purposes. Therefore, if an interest is valued higher than its actual fair market value for transfer tax purposes, the higher value might also be applied for marital deduction and charitable deduction purposes (a taxpayer-friendly provision).

To view the legislative proposal that was included in the President's budget proposals for fiscal years 2010-2013, click [here](#).

6. EFFECTIVE DATE

Treasury regulations are typically effective on the date final regulations are issued. At least several years typically lapse from the time proposed regulations are issued until the regulations are finalized. In very limited situations, proposed regulations provide they will be effective when finalized retroactive back to the date of the proposed regulations. For example, the proposed regulations regarding the income tax effects of private annuities issued in 2006 take that approach (and interestingly, those regulations still have not been finalized, nine years after the proposed regulations were issued, see REG-141901-05k proposing changes to Reg. §§1.72-6(e) & 1.100(j)). The initial “anti-Kohler” proposed regulations that were issued in 2008 also took that “retroactive effect” approach, but the revised proposed regulation issued in 2011 dropped that harsh effective date provision. See Prop. Treas. Reg. §20.2032-1(f). Cathy Hughes suggested at the ABA Tax Section meeting that the Treasury and IRS are still considering what should be the appropriate effective date of the proposed regulation.

7. LEGISLATIVE HISTORY

Some planners have expressed concern that the proposed regulation may limit the availability of minority and marketability discounts for transfers involving family-controlled entities. See Freda, *Guidance on Material Participation For Trusts, Estates May Emerge in Stages*, BNA Daily Tax Report (May 12, 2015) (summarizing comments of Richard Dees). The legislative history (the 1990 Conference Report) makes clear that Chapter 14 was not intended to “affect minority discounts or other discounts available under [former] law.” The Senate’s discussion of the former law and the impact of Chapter 14 is rather emphatic.

“The value of property transferred by gift or includable in the decedent’s gross estate generally is its fair market value at the time of the gift or death. Fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer. Accordingly, courts generally have refused to consider familiar relationships among co-owners in valuing property. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.

....

The bill does not affect minority discounts or other discounts available under present law.

....

... the bill does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally in all items of income, deduction, loss and gain in the same proportion (i.e., straight-up allocations).” (136 CONG. REC. § 15679, 15681 (October 18, 1990) (emphasis added)).

Perhaps the existence of this legislative history is the reason that the IRS beginning in 2009 sought legislative changes to §2704 before issuing its new proposed regulations.