

Tax, Trusts & Estates Law

IRS Issues Proposed Regulations Under Code §2704 Impacting Gift and Estate Taxes

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The IRS has at last issued long-anticipated proposed regulations under Code §2704. We perceive the proposed regulations as an attempt by the IRS to curtail the use of discounts – such as minority interest and lack of marketability discounts – in valuing transfers of interests in family-controlled entities for gift and estate tax purposes.

“Family limited partnerships” – that is, family investment entities usually structured as LLCs or limited partnerships – have been a popular estate planning technique for years. Generally speaking, a client can transfer non-voting, non-marketable interests in these types of entities to children or a trust, and claim a valuation discount due to the restrictions that apply to the interest transferred.

Code §2704 provides that certain “applicable restrictions” on ownership interests in family entities, ie, entities where the transferor and family members control the entity, should be disregarded for valuation purposes. The statute also permits the IRS to issue regulations providing for other restrictions (as determined by the IRS) to be disregarded in determining the value of a transfer to a family member, if a restriction has the effect of reducing the value of the transferred interest but does not ultimately reduce the value of such interest to the transferee.

The proposed regulations make two overarching changes. First, changes under Code §2704(a) create new rules relating to a lapse of a liquidating right. These changes are less

relevant, at least in our practice, as we generally do not structure entities to include liquidation or other rights that lapse.

Second, changes under Code §2704(b) create a new concept of “Disregarded Restrictions.” Under the proposed regulations, a restriction that will lapse at any time after the transfer, or a restriction that may be removed or overridden by the transferor (or the transferor and family members acting together) will be disregarded for gift and estate tax valuation purposes. This is the case even if the restriction on the interest is pursuant to state law rather than a governing business agreement. There are certain exceptions – for example, an owner’s right to liquidate or “put” his or her interest to the entity and receive cash within six months is not considered a “disregarded restriction.”

The effect of this rule appears to be that it would eliminate minority interest discounts, because the holder of any interest would be deemed to be able to liquidate his or her interest in the entity without restrictions. The effect of the proposed regulations on lack of marketability discounts is unclear, although it seems the IRS similarly could argue for a small or zero lack of marketability discount on the theory that the holder of the interest is deemed to be able to liquidate the interest.

Thus, if the proposed regulations are adopted in their current form, they likely will increase the value for gift and estate tax purposes of transfers of interests in family-controlled entities.

The proposed regulations are controversial. Commentators already have questioned whether the Treasury has exceeded its statutory authority in issuing the proposed regulations. The proposed regulations are (at least in this author’s opinion) complicated and ambiguous, and perhaps unfair. For example, if a client creates an LLC to purchase and manage a commercial property, and the client transfers an interest in the LLC to his or her child, and the interest is subject to typical restrictions on sale of the interest or the ability of a member to liquidate (largely because the asset owned by the LLC is illiquid and perhaps leveraged), then it seems that the true value of the interest transferred to the child would be reduced due to these restrictions (think about what a willing buyer would really pay the child for the LLC interest); however, under the proposed regulations, the value of the LLC interest transferred would be artificially inflated for gift tax purposes.

The proposed regulations are not effective until they are finalized. Treasury has requested written comments by November 2, 2016 and a public hearing on the regulations is scheduled for December 1, 2016.

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