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Practice Update

Proposed Treasury Regulations Cause for Concern Among Family Controlled Businesses

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A profound effect on family controlled businesses may be in store when proposed Treasury Regulations under Section 2704 of the Internal Revenue Code come to pass. Under the new regulations, taxpayers would be precluded from obtaining discounts for lack of marketability or control on transfers of interest in family businesses and family controlled entities for estate, gift, and generation skipping tax (GST) planning.

Beginning in 2015, we heard rumors that there was a likelihood that the Internal Revenue Service (IRS) would be issuing new Treasury Regulations to Section 2704 of the Code which would significantly curtail the use of such discounting. As 2015 became 2016, however, the rumblings of such an issuance simmered.

Why should you be concerned now?

At the recent Spring Symposium in May 2016 of the American Bar Association's Real Property Probate and Trust Law Section, a Branch Chief in the Office of the Chief Counsel, IRS, stated that these Regulations were "...coming out very, very soon," and

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would be the IRS' "...first publication of spring." We are well into spring, but the Regulations have not come out. The speculation as to when the Regulations will be released is currently on any-day-now status.

While there are no guarantees, there still may be a short window open to plan, provided you act now. If you have been thinking about transfers of interests in your family controlled entity to members of your family, it is recommended that you take action immediately if you want to take advantage of discounting under Section 2704, before the new Regulations are published and take effect.

Current Dilemma

Since its inception, Section 2704(b)(4) always provided that:

The Secretary [meaning the Secretary of the Treasury] 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.

This subsection had the practical effect of leaving Section 2704 open to amendment in the form of a Treasury Regulation.

Current Law

Chapter 14 of the Code, Sections 2701 through 2704, [i]deals with special valuation rules. Section 2704 of the Code in particular deals with the treatment of certain lapsing rights and restrictions.

Under Section 2704(a), if there is a lapse of any voting or liquidation right in a corporation or partnership and the individual holding such right (immediately before the lapse) and members of such individual's family both before and after the lapse, control the entity, the lapse will be treated as a transfer by such individual by gift, or a transfer includible in the gross estate of the decedent. The amount includible in the gross estate of the decedent is determined as provided in Section 2704(a)(2) of the Code.

Section 2704(b)(1) of the Code describes that if there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and the transferor and members of the transferor's family hold control of the entity immediately before the transfer, any applicable restriction shall be disregarded in determining the value of said interest.

Under Section 2704(b) of the Code, any "applicable restriction" is disregarded if an interest is (A) transferred to a family member; and (B) the transferor of such interest or a member of his or her family controls the corporation or partnership immediately before the transfer. An applicable restriction is a restriction on liquidation that either lapses sometime after the transfer or can be removed by the transferor or a family member (either individually or together).

Under Section 2704(b)(3) of the Code, an applicable restriction is not any commercially reasonable restriction arising as part of any financing with a person who is not related to the transferor or transferee (or a member of the family of either), or any restriction imposed by Federal or State law.

Section 2704(c) of the Code defines the terms "control," and "member of the family" and provides that the rule of Section 2701(e)(3) of the code applies for purposes of determine the interests held by any individual.

While on its face Section 2704 appears light on word count, this particular area of the Code has been ripe for our clients to use as the statutory authority for some time now to undertake planning which transfers family business interests to younger generations, taking advantage of minority and marketability discounts for transfers involving family-controlled businesses.

Conclusion

The issuance of new Regulations for Section 2704 of the Code will endanger future planning for family business owners. If you were considering making a gift of a family business interest in order to mitigate potential estate tax in the future, better to act now before time runs out.

[i] Unless otherwise indicated, all section references to the "Code" shall refer to the Internal Revenue Code of 1986, as amended

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