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IRS Issues Proposed Regulations for Section 2704

by Ray Slaton

IRS Proposes Regulations to Limit Discounts for Transferring Interests in Family-Owned Businesses

The Current Scheme

On August 4, 2016, the IRS and the Treasury Department published proposed regulations under Internal Revenue Code § 2704 that, when effective, will eliminate most valuation discounts in family controlled entities. Section 2704 was originally enacted to close loopholes in the estate and gift tax laws. Specifically, § 2704 covers two areas: (1) lapses of voting and liquidation rights in family controlled entities and (2) restrictions that prevent liquidation of family controlled entities. The practices the IRS sought to restrict were the transfer of restricted ownership interests to reduce the value of estates, as well as, reducing the value of the interest presently transferred. Section 2704 allowed the IRS to ignore or disregard restrictions placed on transferred or sold interests in certain situations, thereby increasing the value of retained interests and transferred interests. However, methods were developed to circumvent the reach of § 2704.

The Proposed Regulations

The following are the major provisions contained in the proposed regulations:

Entities now subject to § 2704

- Entities subject to § 2704 valuation rules and an additional definition for "control"
- Transfer of an interest to an "assignee" is now subject to § 2704
- Application of the "Deathbed transfer" to all transfers that occur within 3 years or less of the transferor's death
- Expanding what is an "applicable restriction"
- Creation of a new category ("Disregarded Restrictions") that apply to restrictions designed to restrict the ability to force an *interest* to liquidate

The additional language in the proposed regulations really applies to LLCs. Corporations, partnerships and limited partnerships are explicitly addressed under the current regulations. The IRS stated updating the "entities covered" section throughout the § 2704 regulations was to specifically include LLCs. Furthermore, control "of an LLC or of any other entity or arrangement that is not a corporation, partnership, or limited partnership would constitute the holding of at least 50 percent of *either* the capital or profits interests of the entity or arrangement, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement." The current attribution rules in place will still be used to determine control of an entity. For instance, an individual holding a 35% equity interest in an LLC, with family members owning an additional 20% equity interest, means that individual will be deemed to control 55%. The 35% combined with the family's 20% exceeds the 50% threshold.

"Assignee" transfers and § 2704

Proposed Regulation § 25.2704-1(a)(5) specifically subjects transfers of interests to "assignees" as a lapse of an interest. The proposed regulation provides some context for this new addition: "For example, the transfer of a partnership interest to an assignee, who neither has nor may exercise the voting or liquidation rights of a partner, is a lapse of the voting and liquidation rights associated with the transferred interest."

Applying the "Deathbed Transfer" rules

Under current regulation § 25.2704-1(c), a transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are

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not restricted or eliminated. However, the proposed regulations will apply the "deathbed transfer" rules and cause any transfer within three years of death to be considered a lapse. The following examples from the proposed regulations illustrate this point:

Example 4. More than three years before D's death, D transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

Example 7. More than three years before D's death, D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D's death. However, had the transfer occurred within three years of D's death, the transfer would have been treated as the lapse of D's liquidation right with respect to the common stock occurring at D's death.

As the above Examples show, if transfers like the ones above are made, and the Transferor dies within three years of the transfer, then the proposed regulations consider that a lapse, even though the current scheme would not consider this a lapse. This change is widely considered as the most impactful change to the current scheme.

Expansion of Applicable Restrictions

An applicable restriction is any restriction which limits the ability of an entity to liquidate and the restriction either (1) lapses after the transfer, in whole or in part, or (2) the family can remove the restriction in whole or in part. The IRS disregards applicable restrictions when valuing transferred interests in a family controlled entity.

Currently, the Code and regulations state that any restriction imposed, or required to be imposed, by Federal or State law is not an applicable restriction, and thus, not disregarded in valuing transferred interests. Proposed Regulation § 25.2704-2(b)(4)(ii), while parroting the current exception, further qualifies a restriction imposed or required to be imposed by Federal or State law and carves out exceptions to the exception. First, "filler" provisions that only takes effect if the governing documents (operating agreement, by-laws, etc.) do not have a contrary provision or may overridden are not imposed restrictions. Second, a law that is limited in application to a narrow class of entities (such as Family Limited Partnerships) subject to transfers described in 2704 also are not imposed restrictions. Finally, if a Federal or State law that imposes a restriction, while also simultaneously providing an option that does not include any imposed restriction, that law is not considered an imposed restriction.

A New Category: Disregarded Restrictions

The IRS created an entirely new section, Proposed Regulation § 25.2704-3, to introduce a new category, "Disregarded Restrictions." A disregarded restriction is almost identically defined as an applicable restriction, except the disregarded restrictions

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are limitations on the ability to liquidate an *interest* in an entity, not the entity itself. The following are examples of what the IRS considers disregarded restrictions:

- The provision limits or permits limitation of the ability of the interest holder to compel liquidation or redemption of the interest.
- The provision limits the amount that may be received by the holder to an amount that is less than a minimum value (the interest's share of the net value determined on the date of liquidation or redemption)
- The provision defers or permits deferral of payment of the full liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder's intent to have the holder's interest redeemed or liquidated
- The provision authorizes or permits the payment of any portion of the proceeds in any manner other than cash or property (A note or obligation issued directly or indirectly by the entity, interest holders of the entity or by a person related to the entity or related to an interest holder, is not deemed property)

The same lapse, family removal and family control rules that apply with applicable restrictions also apply to disregarded restrictions. However, there is a test to determine whether or not a disregarded restriction may be removed by the transferor and/or members of the transferor's family. Under Proposed Regulation § 25.2704-3(b)(4)(i), interests held by nonfamily members potentially may not be disregarded when determining if the family can remove a disregarded restriction. The catch is that in order for an interest held by a nonfamily member, or members, to not be disregarded, families must give away more control of their entities. For example, under Proposed Regulation § 25.2704-3(b)(4)(i), interests held by nonfamily members will not be disregarded if all of the following are met –

- The interest has been held by the nonfamily member for at least three years immediately before the *current* transfer;
- On the date of the transfer, the interest constitutes at least 10% of:
  - The value of all equity interests, if a corporation; or
  - The value of all capital or profits interests for non-corporate entities;
- On the date of transfer, the total of the interests held by nonfamily members must equal at least 20% of:
  - The value of all equity interests, if a corporation; or
  - The value of all capital or profits interests for non-corporate entities;
- Each nonfamily member has a put right (an enforceable right to receive an amount of cash or property, worth at least a minimum value, within six months of giving notice of intent)

The effect of disregarding a restriction can be illustrated as follows: A holds 80% of Partnership Y. A's son, B, holds a 10% interest in Partnership Y. M, who is not a member of A's family, holds a 10% interest that he received two years ago. A transfers a 10% interest to his daughter, C, with a restriction that limits C's ability to liquidate her interest. According to the Partnership Agreement, a 95% vote is required to remove any restrictions on liquidating interests. M's interest will be disregarded because he has not held his interest for at least three years immediately before the transfer. Thus, A and his family will considered to hold 100% of Partnership Y and be able to remove the restriction on C's interest, making the restriction disregarded for valuation purposes.

Additionally, the same excep-

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FEDERAL JUDGE BLOCKS NEW OVERTIME RULES

By Guy W. Murphy, Jr., and Ray Slaton

PRELIMINARY INJUNCTION ISSUED

On November 22, 2016, a U.S. District Judge in the Eastern District of Texas issued a nationwide injunction which has prevented the implementation of new overtime rules promulgated by the Department of Labor ("DOL") that were to have gone into effect on December 1, 2016. President Obama had previously directed the Secretary of Labor to "modernize and streamline" the existing overtime regulations for executive, administrative and professional employees. The current regulatory scheme under the Fair Labor Standards Act ("FLSA") contains three criteria an employee must fall within in order for his employer to be exempt from paying the employee overtime:

- An employee must be paid on a salary basis;
- An employee must be paid a minimum salary level established by regulations, which is currently $455 per week ($23,660 annually); <u>*AND*</u>
- An employee must perform executive, administrative or professional duties.

The DOL's proposed new regulations would have altered the second criterion above by almost doubling the minimum salary (for exempt status) to $921 per week ($47,892 per year). This would have had the practical effect of converting every exempt employee (under the current rules) making less than $47,892 per year to non-exempt status and thus eligible for overtime pay for hours worked exceeding forty in a pay period.

A group of 21 States, including Arkansas, filed suit against the DOL to both temporarily and permanently block the implementation of the new regulations.

In the process for determining whether a temporary injunction would be issued, the court discussed the likelihood the plaintiffs would eventually win the case on the merits. The Court concluded they most likely would and issued the preliminary injunction to preserve the status quo until a final decision is made.

The Court agreed with the States that DOL has exceeded its authority in increasing the salary requirement and perhaps in having a minimum salary requirement at all.

The Court seemed to be of the opinion that the DOL may have exceeded its authority when it issued regulations that added the salary basis to the overtime rules, "… nothing in the EAP exemption indicates Congress intended the Department to define and delimit with respect to a minimum salary level." This seems to open the possibility that the salary elements to the overtime regulations may have numbered days.

However, the matter is ongoing and the DOL is almost certain to appeal this decision to the Fifth Circuit.

New Basis Consistency Requirements

by James Weeks, Law Clerk

Regulations affecting the basis of property acquired from a decedent were proposed by the IRS on March 4, 2016, and these regulations aim to ensure consistency between a recipient's basis in that property and the property's value as finally determined for Federal estate tax purposes.

When property is passed by a decedent to a recipient, tax rules allow for what is commonly known as stepped-up basis (or stepped-down for downward adjustments) for tax purposes; essentially, what this amounts to is a transfer of not only the property but also the decedent's basis to the recipient of the gift; but the stepped-up basis is not necessarily the amount the decedent paid for the property. Stepped-up basis is determined by the fair market value of the property at the date of the decedent's death. Under Internal Revenue Code (IRC) § 1014(f), there must be consistency between the basis of that acquired property and its value for Federal estate tax purposes.

Under IRC § 6035, an executor is required to report to both the IRS and the beneficiary the value of property included on a required Federal estate tax return.

Under IRC § 6662(b)(8), imposes a new accuracy-related penalty for underpayments that are attributable to "any inconsistent estate basis." IRC § 6662(k) provides that an "inconsistent basis" arises "if the basis of property claimed on a return exceeds the basis as determined under [§] 1014(f)." There are also penalties for not properly furnishing the § 6035 reports.

In the Federal Register, Vol. 81, No. 43, the IRS, summarizing the comments and providing explanation of the new provisions, states that "newly enacted [IRC §] 1014 (f)(1) provides that the basis of certain property acquired from a decedent cannot exceed that property's final value as determined for Federal estate tax purposes. If no final value has been determined when the taxpayer's basis in the property becomes relevant for Federal tax purposes, for example, to calculate depreciation or amortization, or to calculate gain or loss on the sale, exchange or disposition of the property, the taxpayer uses the value reported on the statement required by [IRC §] 6035(a) (the fair market value reported on the Federal estate tax return) to determine the taxpayer's basis for Federal tax purposes."

An executor is required to report to the IRS and the beneficiary the value of the property included on a required Federal estate tax return.

In examining some of the salient provisions of the new regulations, we find that the value limitation applies to the property "whenever the taxpayer reports a taxable event [such as depreciation or amortization] with respect to the property to the [IRS] and continues to apply until the property is sold, exchanged, or otherwise disposed of in one or more transactions that result in the recognition of gain or loss for Federal income tax purposes."

In response to concerns expressed by some commentators that "[§] 1014(f) and [§] 6662(k) appear to prohibit otherwise permissible adjustments to the basis of property as a result of post-death events," the IRS explains that the proposed regulations require only that the initial basis of inherited property cannot exceed the final value of the property for Federal estate tax purposes. And that means that post-death adjustments like depreciation will not "cause the taxpayer's basis in the property on the date of a taxable event with respect to the property to be treated as exceeding the final value of the property."

Additionally, § 1014(f)(2) restricts the value limitation to "property the inclusion of which in the decedent's estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate." The regulations clarify how this rule operates when

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New Basis Requirements (continued)

no estate tax is imposed (e.g., due to allowable credits). Thus "property that qualifies for an estate tax charitable or marital deduction under §§ 2055, 2056, or 2056A, respectively, does not generate a tax liability" and is consequently not subject to the consistency requirement.

The final value of property as defined by the proposed regulations is the value as finally determined for purposes of the tax imposed by chapter 11, which is determined in part by the value reported on an estate tax return upon expiration of the period of limitations for adjustment or assessment.

The proposed regulations also include rules for any property that is discovered after the filing of the return (after-discovered property) or otherwise omitted from the return (omitted property). The expiration of the period of limitation on assessment, under the new regulations, affects the treatment and the regulations also provide for situations in which no return was filed.

Some commentators had concerns that § 6035 filing requirements might extend to situations of a return filed solely to make a portability election under § 2010(c)(5), or a generation-skipping transfer tax election or exemption, but those concerns are unfounded because the filing requirements do not apply in such situations due to a lack of a return in those situations under § 6018.

Under the proposed regulations, there are four § 6035 reporting requirement exceptions: (1) cash (with some exceptions); (2) income in respect of a decedent; (3) tangible property for which an appraisal is not required under Treas. Reg. § 20.2031-6(b); and (4) "[p]roperty sold, exchanged, or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized."

Other issues addressed by the proposed regulations include beneficiary issues (such as those who cannot be found), due date issues, supplemental information and statements, subsequent transfers, surviving joint tenants, and other issues.

Section 2704

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tions for applicable restrictions also apply to disregarded restrictions, except that a disregarded restriction does not include an applicable restriction on the entity's ability to liquidate.

What Can You Do?

There are several important things to keep in mind. First, the proposed regulations are not in effect. A public hearing was held on December 1, 2016. The regulations will become finalized some time after the public hearing. Now, the exact date will not be known until they are published in the Federal Register. It could be days, weeks or months after the hearing on December 1. However, this much is clear, the new regulations are coming and the time to utilize the current transfer rules is closing fast.

Second, if you own a family-owned entity in any form (outright, majority interest, minority interest, general partner, limited partner) and you have children, you may want to consider transferring interests for Christmas. Maybe it's something you've never considered, but with the advent of these new regulations, obtaining discounts to lower gift and estate taxes are about to become extremely difficult. We advise you to contact us at Hyden, Miron & Foster to consider your options and how you may utilize what time is left.

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