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## Proposed Regulations Under Internal Revenue Code Section 2704: Changes May Be Coming to Transfers of Closely Held Business Interests

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On August 2, 2016, the Treasury Department issued proposed regulations under the authority provided in Section 2704(b) of the Internal Revenue Code (the “Code”). These proposed regulations were much anticipated by the estate planning community for the assumed consequences they likely would have on the transfer of interests in closely held family businesses. While the proposed regulations could become final as early as the beginning of 2017, they are sufficiently controversial enough that it may be years before they become final. Nonetheless, regardless of the eventual timing, it is important to know that changes are likely coming to commonly used estate planning techniques.

### History

Section 2704 of the Code provides certain rules for valuing intra-family transactions of closely held business interests. Under the current Section 2704, “lapses of voting or liquidation rights are treated as a transfer of the excess of the fair market value of all interests held by the transferor, determined as if the voting or liquidation rights were non-lapsing, over the fair market value of such interests after the lapse.” The major limitations on the effectiveness of Section 2704 of the Code are the exceptions to the general rule. For example, if an individual nearing death relinquished liquidation control of a closely held family business on his death bed, and if the transferred shares had the same rights as prior to the transfer, the rule stated above would not apply. Effectively, the individual would receive a discount in his estate on the shares he retained (since he no longer had liquidation control) simply because he transferred a certain amount of shares immediately prior to his death, and the transfer would not be defined as a lapse of a right under Section 2704 of the Code because the transferred shares had retained all of the same rights as before the transfer.

There are many other exceptions in the regulations that allow a well-planned transaction to circumvent application of Section 2704. Appraisers were able to value the interests transferred (or, conversely, the interest retained) at a discount to the going-concern value of the business. For decades the IRS has sought to curtail the use of minority discounts when valuing interests in closely held family businesses. The IRS largely lost the valuation battles, both in the courts and legislatively. Left with unfavorable case law and a Congress unwilling to act upon the IRS’s advice to curtail the use of minority discounts in the areas of gift tax, estate tax and generation-skipping transfer tax, the IRS has taken matters into its own hands using an administrative solution to curtail the use of these discounts via these proposed regulations.

### **Three-Year Lookback Period**

The proposed regulations would curtail the use of the “death-bed” transfer as described above by adding a three-year lookback period. Under the new proposed rule, transfers within three years of death will be disregarded in determining the value of the interest held by a decedent’s estate. Accordingly, only de-controlling transfers made more than three years prior to a decedent’s death will be allowed to be considered in determining the value of the decedent’s interest. This new rule effectively limits the “death-bed” transfer scenario and creates a bright-line test.

\* *Louis A. Laski, an associate in the Trusts and Estates practice and candidate for admission to the Illinois bar, contributed to this advisory.*

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### ***Applicable Restrictions***

Section 2704 also uses the term “applicable restriction” to define certain aspects of interests in a closely held family business that will be disregarded for purposes of determining the value of such interest for transfer tax purposes. An “applicable restriction” is defined by Section 2704(b)(2) of the Code as a restriction that effectively limits the ability to liquidate the entity. However, the rule previously only applied if that restriction was more restrictive than the limitations that would apply under state law. States revised the applicable statutory restrictions so that state law would provide a default rule concerning liquidation, but allow other liquidation rights to be established in the entity’s operational agreements. To remedy the issue, the IRS now determines that an applicable restriction only exists if the restriction is mandatory under state law, effectively eliminating the exception to “applicable restriction” for reliance on state law.

### ***Disregarded Restrictions***

With the proposed regulations, the IRS has created a whole new classification of restrictions on interests in closely held businesses that will not be considered when valuing that interest. Case law interpreting Section 2704 of the Code has held that the application of Section 2704 is permissible only when dealing with the liquidation rights of the entity as a whole, as opposed to the liquidation rights that may be present with regard to individual interests in the entity. The proposed new class of “disregarded restrictions” deals with individual interests in the entity. In essence, the regulations constructively create a “put right” for all interests in an entity which, prior to a transfer, was controlled by the family, and after the transfer restrictions on liquidation or transfer could be removed by family members or lapse by their inaction. This has the practical effect of completely eliminating many discounts because the owner of a minority interest would have a “deemed” right to liquidate the interest at any time. Additionally, the IRS would disregard certain other restrictions on the manner and form of the payout on the exercise of a put right. This new group of “disregarded restrictions” severely limits many of the techniques currently used for obtaining a minority discount upon the transfer of minority interests in closely held family businesses.

### **Conclusion**

There are many nuances in the proposed regulations that are not discussed in this advisory. The takeaway is that while the exact timing of any regulatory changes remains uncertain, there is still time to take advantage of existing estate planning techniques with closely held businesses. If you have any questions about the proposed regulations or existing law under Section 2704 of the Code, you are encouraged to contact your advisor. Public hearings on the proposed regulations are set for December 1, 2016.

If you would like more details, please do not hesitate to contact your Katten attorney or the following members of Katten's **Trusts and Estates** practice:

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