



FRIEDMAN
BRANNEN_{LLP}

3579 Valley Centre Drive, #125 / San Diego, CA 92130
(858) 794-2800 Phone / (858) 794-2899 Fax

CERTIFIED PUBLIC ACCOUNTANTS

ProVisors

San Diego Estate and Succession Planning Affinity Group

Proposed Regulations under Code Secs. 2701 and 2704 Lapsing Rights and Restrictions in Determining Value of Transferred Interests

NPRM REG-163113-02, August 2, 2016

August 23, 2016

Ronald A Friedman, CPA

- I.** Topics Covered
 - A. Brief history and overview of Chapter 14. Historical perspective.
 - B. Summary of pertinent provisions of Proposed Regulations
 - C. Impact on professional advisors, planning and compliance strategies.
 - D. Gaze into crystal ball.
- II.** Mid-1970s inflationary period
 - A. Freezing techniques
 - 1. Corporate and partnership recapitalizations
 - 2. Grantor Retained Interest Trusts (GRIT)
 - 3. Buy-Sell Agreements
 - 4. Lapsing rights
 - 5. Restrictions on liquidation
 - B. Congressional Reaction §2036 (c)
 - 1. 1987 with three-year loophole
 - 2. 1988 TAMRA – eliminate three-year loophole,
 - 3. 1990 – Repeal of §2036 (c), Chapter 14
- III.** Chapter 14 - IRC §§ 2701, 2702, 2703 and 2704
 - A. An ongoing attempt to curb abuse and provide guidelines
- IV.** IRC § 2704 –Lapsing rights and restrictions.
 - A. § 2704(a) General rule allows certain restrictions to reduce value of transferred interests. Lack of control, lack of marketability, etc.
 - B. § 2704(b) – Exceptions to general rule. Limits reduction in value by disregarding certain “applicable restrictions”.
 - 1. "applicable restriction" means any restriction which effectively limits the ability of the corporation or partnership to liquidate, and with respect to which either of the following applies:
 - a. The restriction lapses, in whole or in part, after the transfer
 - b. The transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.
 - C. § 2704(b)(3) – Exceptions to the exceptions

1. The term "applicable restriction" shall not include—
 - a. any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or
 - b. any restriction imposed, or required to be imposed, by any Federal or State law.
 - i. Reg. § 25.2704-2(b) provides, in part, that 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.
- V. Treasury Department responds with Proposed Regulations citing authority under 2704(b)(4)
 - A. *IRC § 2704(b)(4) 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.*
- VI. The proposed regulations treat transfers occurring within three years of death that result in the lapse of a liquidation right as transfers occurring at death for purposes of section 2704(a).¹
- VII. Disregarded Restrictions – Reg. §25.2704-3

¹ The Treasury Department and the IRS, believe that the exception under Reg. § 2704(b)(3) should not apply when the inter vivos transfer that results in the loss of the power to liquidate occurs on the decedent's deathbed. And have concluded that the regulatory exception created in §25.2704-1(c)(1) should apply only to transfers occurring more than three years before death, where the loss of control over liquidation is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of a donor's subjective motive which is administratively burdensome for both taxpayers and the IRS.

- A. Any restriction described below on owner's right to liquidate his or her interest in the entity will be disregarded if
 - 1. the restriction will lapse at any time after the transfer, or
 - 2. if the transferor, or the transferor and family members, without regard to certain interests held by nonfamily members, may remove or override the restriction.
- B. Under the proposed regulations, such a disregarded restriction includes one that: (a) limits the ability of the holder of the interest to liquidate the interest; (b) limits the liquidation proceeds to an amount that is less than a minimum value; (c) defers the payment of the liquidation proceeds for more than six months; or (d) permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.

VIII. Coordination with Marital and Charitable Deductions

- A. Section 2704(b) applies to intra-family transfers for all purposes of subtitle B relating to estate, gift and GST taxes. Therefore, to the extent that an interest qualifies for the gift or estate tax marital deduction and must be valued by taking into account the special valuation assumptions of section 2704(b), the same value generally will apply in computing the marital deduction attributable to that interest.
- B. Section 2704(b) does not apply to transfers to nonfamily members and thus has no application in valuing an interest passing to charity or to a person other than a family member.
- C. The proposed regulations would amend §25.2704-2 to refine the definition of the term “applicable restriction” by eliminating the comparison to the liquidation limitations of state law.

- IX.** The proposed regulations would clarify, in §§25.2704-1 through 25.2704-3, that section 2704 applies to corporations, partnerships, LLC's, and other entities and arrangements that are business entities within the meaning of §301.7701-2(a), regardless of whether the entity or arrangement is domestic or foreign, regardless of how the entity or arrangement is classified for other

federal tax purposes, and regardless of whether the entity or arrangement is disregarded as an entity separate from its owner for other federal tax purposes.

X. Effective Dates

A. The amendments to §25.2701-2 are proposed to be effective on and after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

XI. What does the future hold?

A. Does the Treasury Department have the authority to issue the regulations as proposed?²

XII. Comments and Public Hearing

A. Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely (in the manner described in “ADDRESSES”) to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be available at www.regulations.gov, or upon request.

B. A public hearing on these proposed regulations has been scheduled for December 1, 2016, beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC 20224.

² NPRM Special Analysis: Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. The proposed regulations affect the transfer tax liability of individuals who transfer an interest in certain closely held entities and not the entities themselves. The proposed regulations do not affect the structure of such entities, but only the assumptions under which they are valued for federal transfer tax purposes. In addition, any economic impact on entities affected by section 2704, large or small, is derived from the operation of the statute, or its intended application, and not from the proposed regulations in this notice of proposed rulemaking. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

The Sad Tale of Baron Bob and Billy

Once upon a time in a lovely village lived a very wealthy Baron called Baron Bob. Baron Bob lived in a castle filled with lots of Valuable Stuff. The Baron had a son, Billy, who lived in a not quite so lovely village. The two villages were separated by a wide river.

Baron Bob really loved Billy. So one day he decided to give Billy a bunch of his Valuable Stuff. So he put a bunch of his Valuable Stuff into a big box, put the big box on his carriage and set off to the Billy's village.

The only way to get over the river was by way of a toll bridge controlled by an evil troll.

At the toll booth the evil troll yelled to Baron Bob. "Stop you must pay the toll". "How much", asked Baron Bob. "That depends on what you have in the big box, what it is worth and what you plan to do with it" said the troll.

Baron Bob answered, "I am going to give the big box to my son Billy. It is filled with a bunch of Valuable Stuff worth \$10,000,000".

The troll said, "The toll for taking stuff worth \$10,000,000 over the bridge is \$4,000,000" "No way", shouted a very sad and very mad Baron Bob who turned right around and went back to his castle. Back at the castle Baron Bob had a great idea. Here is what he did.

He manufactured a locked steel cage into which he put his big box of Valuable Stuff. It took two keys to unlock this cage. Baron Bob and Billy made an agreement whereby Baron Bob would give to Billy the locked steel cage but only one of the keys. Therefore Billy could not unlock the cage unless Baron Bob agreed to come back to Billy's house with the other key.

Baron Bob put the locked steel cage on his carriage and once more set off to the Billy's village. At the toll booth, the troll shouted to Baron Bob, "Stop you must pay the toll. Tell me what you are taking over the bridge".

Baron Bob said I am taking this locked steel cage to my son Billy. Inside the locked steel cage is a big box of Valuable Stuff. But it takes two keys to open the locked steel cage and I am only giving one key to Billy. I am keeping the other one.

Baron Bob asserted that because Billy's access to the big box of Valuable Stuff is severely restricted on account of the two key agreement the value of the locked steel cage was only \$5,000,000 thus the toll should be \$2,000,000.

"Ha", said the troll, "you must be joking this is a fake restriction and doesn't really reduce the value at all. The toll is still \$4,000,000".

Now in the village disputes of this sort were decided by the toll authority. The toll authority's decision was as follows: The troll is wrong in asserting the restriction is fake and does not reduce value at all. However, this restriction does not reduce value by as much as Baron Bob claims. Therefore we hold that the restriction reduces the value from \$10,000,000 to \$7,500,000 and the toll is \$3,000,000.

In this fairytale everyone does not live happily ever after. And arguments about how much it should cost to move Valuable Stuff over the bridge have continued until today.

Just the Beginning