

## Proposed Regulations to Section 2704 Prompts New Considerations

In a move that has attracted the attention of a group of Republican senators, several Republican congressmen and the editorial page of the Wall Street Journal, the Treasury Department has released proposed regulations concerning interests in family-controlled entities.

The regulations are to Section 2704 of the Internal Revenue Code. To understand the proposed regulations, it is first necessary to discuss the valuation of interests in entities such as corporations, partnerships and limited liability companies.

At this time, it is not clear whether Donald Trump's election will effect the adoption of the proposed regulations.

### Background

The basic principle for valuing an interest in a corporation, partnership or limited liability company, for purposes of the federal estate and gift tax, is what a third party would pay for the interest. With interests that are publicly traded, for example, a share in Apple, there is an established market on which buyers and sellers, operating at arm's length, decide what Apple is worth on any given day. Most business interests owned by a family, however, are not publicly traded, and the value must be established by a recent sale (less likely) or an appraisal (much more likely).

Business valuers recognize that an interest in an entity that does not represent control of the entity should be valued at a discount. For example, assume that the "lock, stock and barrel" value of a company is \$1 million. A 10% interest in the business would not be valued at \$100,000; rather, the value of the interest would be discounted for the fact that the interest does not have any realistic control over the direction of the company or the payment of distributions from the company, whether in the form of dividends, or partnership or LLC distributions. Thus, a business valuator will reduce the pro rata value to reflect the minority status of the interest. Depending on the circumstances, the discount may be 10% to 30% of the pro rata value.

Section 2704 of the Internal Revenue Code was enacted in 1990 to deal with the perceived abuses that entities would be structured to take advantage of the discounts and, after the relevant time--the owner's death or the transfer of the interest--the provisions creating the discount would be eliminated by the remaining family members. Section 2704 states that if there is a restriction on the ability to liquidate or redeem an interest, and that restriction can be lifted following a transfer, the restriction is ignored for valuation purposes.

### The Proposed Regulations

The proposed regulations to Section 2704 are comprehensive: there are provisions for liquidating or redeeming an interest, touching on the method of valuing an interest and the form of payment. This LEGALcurrents® will focus on one provision: namely, the portion of the proposed regulations dealing with transfers of minority interests.

### Valuation of Transfers of Minority Interests

The Internal Revenue Service has long been unhappy with minority interest discounts. As can be readily seen, the ability to transfer interests at a discount means that there is less wealth subject to estate or gift taxation.

The Service's response is not a direct assault on such discounts. Rather, the proposed regulations provide that if an individual makes a transfer of an interest that is subject to a minority interest discount and the individual dies within three years of the transfer, the value of the discount is includable in his or her estate for estate tax purposes. Quite simply, the regulations provide for the creation of a "phantom asset:" literally, there is no asset that can be owned, much less transferred.



This portion of the proposed regulations is quite controversial. It is questionable whether the creation of the phantom asset is a proper exercise of the Service's regulatory authority for what is, after all, a valuation provision.

### The Choice

Nonetheless, the proposed regulations prompt a choice. The regulations will be effective thirty days after they are published as final in the Federal Register. Public hearings on the regulations are scheduled for December 1, 2016. Even if the Service does not heed the criticisms of the regulations that are sure to be made at the hearing, the earliest that the regulations would be effective is January 1, 2017. Effectively, there is a window for making transfers of interests subject to minority interest discounts without worrying about the possible effect of the Section 2704 regulations.

Quite obviously, there are many considerations involved in deciding whether to transfer an interest in a business including possible loss of control, possible loss of any dividends or distributions, and the need to have an interest appraised for gift tax purposes. Thus, we are not suggesting that all owners of closely held businesses take advantage of the window of opportunity. Rather, we believe that the owner of a family business or family entity should consider the advisability of taking advantage of the window.

If you have any questions about this LEGALcurrents®, please do not hesitate to contact any member of our firm's Trusts & Estates practice group at (585) 232-6500. ■



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