

Code Section 2704 Regulations – Update and Considerations in 2017

As many will recall at this point, last summer, the Department of Treasury (“Treasury”) issued proposed regulations under Chapter 14 – Code Sections 2701-2704 – that would significantly increase valuations for purposes of federal estate and gift tax. Needless to say, the proposed regulations have caused significant debate in the estate planning community.

Proposed Regulations

Treasury offered three central justifications for the proposed regulations. In the preamble to the proposed regulations, Treasury explained that the regulations were intended to reinvigorate the legislative intent of Chapter 13, which, in the view of Treasury, has been maligned by case law and various state law changes. The preamble to the proposed regulations also cites case law, that in some cases is more than 25 years old (i.e. cases decided before Chapter 14 was enacted by Congress), as evidence of the original legislative intent, which is not reflected in regulations enacted in the 1990s. Finally, in informal comments, Treasury suggested that the valuation regulations are justified by the current estate tax exemption levels of \$5 million (indexed for inflation – for 2017 \$5,490,000).

Treasury requested comments by November 2, 2016 and scheduled a hearing for December 1, 2016.

Current Law

In general, Estate & Gift tax valuation rules apply a willing buyer/willing seller test. That is, what price would a willing buyer and a willing seller of an interest agree to, each under no compulsion to buy or sell and both having full knowledge of all facts and circumstances (the “Willing Buyer Test”). Under present law (and regulations), additional valuation rules are applied in certain circumstances to transfers and transaction between family members. The additional valuation rules are defined under Chapter 14 of the Internal Revenue Code (the “Code”) – i.e. Code Section 2701-2704.

Based on more than 50 years of law, the Willing Buyer Test applied to a business interest (i.e. shares of non-publicly traded stock and non-publicly traded partnership or LLC interests) has universally included two valuation discounts: (1) marketability and (2) minority. Marketability discounts reduce the purchase price because the purchaser has no readily accessible means (market) to sell the interest. Minority discount reflects the fact that the purchaser of a minority interest would have no ability to direct the operations of the business, including distributions and liquidation.

Example: X Corporation has 100 shares of stock issued and net assets worth \$1,000, or \$10 per share. A intends to purchase 1 share of X. A may demand a 20% discount for lack of marketability reducing the value to \$8 ($\$10 \times .8$). A may also demand a 20% minority discount reducing the value to \$6.4 ($\$8 \times .8$). While the percentages have been

debated heavily, estate & gift tax rules have accepted both discounts in the Willing Buyer Test valuation for estate and gift purposes.

The Chapter 14 restrictions, first introduced in 1990, require further analysis for transfer between family members. In general, transfers that conform to state entity (partnership, LLC and corporation) laws avoid Chapter 14 restrictions and allow the Willing Buyer Test. Entity restrictions that attempt to go well beyond state law and significantly increase valuation discounts tend to run afoul of Chapter 14.

Proposed Regulations

The new regulations were proposed on August 4, 2016. The Department of Treasury requested comments on the proposed regulations by November 2, 2016, and a public hearing was held December 1, 2016. Each of the three steps are required under the Administrative Procedures Act.

The new regulations - proposed under Chapter 14, Code Section 2704 - are limited to transfers between certain family members. The new regulations may eliminate some or all marketability and valuation discount. More specifically, the new regulations presume that a business interest includes a "Put Right" for the fractional interest value of entity assets that must be paid no more than six months after exercise.

Example: Assuming same facts as above, under the "Put Right" there would be no marketability discount because the interest could be immediately liquidated. There is also no minority discount under the "Put Right." As a result, the value of 1 share would be \$10.

The new regulations also propose to apply family attribution rules for purposes of assessing voting control.

Comments to Proposed Regulations

Comments to the proposed regulations ranged from requests for clarification of various provisions to arguments that the proposed regulations were in no way supported by the legislative history and should be withdrawn.

Several commentators pointed out that the proposed regulations have already caused and would continue to cause disruption of the orderly transfer of business interests, resulting from departure from 25 years of consistent regulations and from rejection of 25 years of case law. The commentators argued that Chapter 14 was intended to resolve the disruption and uncertainty, not magnify the difficulties.

December Hearing

Treasury faced a far different situation than anticipated at the December 1st hearing. The Presidential election was significant as both the incoming Trump Administration and Congress

proposed repeal or significant change to the federal estate and gift tax. Some even speculated that the hearing would be postponed, but the hearing went forward.

Another factor Treasury was not expecting was a federal district court ruling against the Department of Labor. The Department of Labor had issued proposed regulations related to overtime compensation eligibility and definitions, using a similar “reinvigoration” theory. The federal district court concluded that, absent action by Congress, the Department of Labor attempt to rewrite long-standing law to reflect an updated approach could not survive judicial scrutiny. The Court permanently enjoined the Department of Labor proposed regulations.

Against that backdrop, Treasury conducted the hearing and listened to comments from several commentators. One significant comment from Treasury was an acknowledgment that the interpretation of the “Put Right” as eliminating all valuation discounts was not intended. Treasury indicated that the next version of the regulations (whether further proposed or final) would reflect changes to the put right concept.

Other than the Put Right, there was little indication as to other changes being considered. Treasury also acknowledged that, while final regulations could theoretically be issued in January, 2017, no final regulations were expected before the new administration is in place.

What is Next

The Treasury comments are an indication that the regulation project will continue, despite the potential repeal or replacement of the gift and estate tax. There was some hope that the regulation project would be withdrawn.

As recommended in the fall, for those otherwise considering estate planning alternatives should proceed, as the proposed regulations are applicable to transfers after the regulations are issued as final regulations. For those that are not actively considering estate planning alternatives, continued monitoring of developments should be sufficient.

2016 Gift Reporting – Adequate Disclosure

Beginning in a few weeks, tax advisors will begin preparing gift tax returns reporting calendar year 2016 gifts. In order to get statute of limitation protection for the 2016 gift reporting, the gift tax returns must meet the adequate disclosure rules. See Treas. Reg. Section 301.6501(c)-1(e) – 2701 & 2702 transfers; Section 301.6501(c)-1(f)(2) – gifts; and Section 301.6501(c)-1(f)(4) - nongifts.

The adequate disclosure rules require a statement regarding any position that is contrary to an existing regulations, temporary regulations or proposed regulations. See Treas. Reg. Section 301.6501(c)-1(f)(2)(v) and Section 301.6501(c)-1(f)(4)(i). Application of this rule to the proposed 2704 regulations is particularly difficult because there is no clear understanding of how the proposed regulations impact (or do not impact) valuation discounts. Even the Department of Treasury has acknowledged that the intended impact on valuation discounts was not clearly

articulated in the proposed regulations and would require revision. As a result, there is no way of knowing whether a valuation is contrary to the proposed regulations.

There is also no clear explanation of the disclosure that is required for proposed regulations. The preamble to the proposed regulations states that the regulations would only apply to transfers after the regulations are issued as final regulations, which leaves the question -- How exactly is such a position relative to a proposed regulations that does not yet apply disclosed?

While an argument could be made that no disclosure related to the proposed regulations is required under the adequate disclosure requirements, a more cautious approach would be some type of reference to the proposed regulations along with a statement that such regulations do not apply to the transfer.

Regardless of approach, tax advisors should consider the proposed regulations under the adequate disclosure requirements before filing gift tax returns for 2016.