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TALKING POINTS OF NEW PROPOSED §2704 REGULATIONS

Denver Estate Planning Council Meeting – November 17, 2016

Presented by: Carol Lewis, CPA, ABV

AGENDA

- // Introduction
- // Background
- // Proposed regulations
- // Talking points
- // Planning opportunities



CAROL LEWIS, CPA/ABV



- Firm wide leader of BKD's business valuation services practice
- 30 plus years of experience in valuation, accounting, tax & litigation support
- Performed business valuation services for more 20 years, including valuations for the purpose of financial reporting, estate and gift tax, employee stock ownership plans, divorce, shareholder disputes and mergers and acquisitions
- Served as an expert witness and has provided testimony regarding business valuation and damages
- Accredited in Business Valuation (ABV) by the American Institute of CPAs.



KEY TERMS & CONCEPTS

// Unified transfer tax system

- Estate tax: transfers by reason of death
- Gift tax: transfers during life
- Generation-skipping transfer tax: transfers to skip persons

// Value transferred = fair market value of property passing from transferor

KEY TERMS & CONCEPTS

// *Fair market value* (Rev. Rul. 59-60)

- Price at which subject equity ownership interest would change hands between a willing buyer & a willing seller when the former is under no compulsion to buy & the latter is under no compulsion to sell & both parties have reasonable knowledge of relevant facts





POLLING QUESTION 1

Which of the following factors are provided by Rev. Rul. 59-60 as requiring careful analysis in determining fair market value?

- // Type of business & its history since inception
- // Economic outlook of general economy
- // Book value & financial condition of a business
- // All of the above
- // Not sure

KEY TERMS & CONCEPTS

// Valuation discounts

- Adjustments to FMV in entity interest for
 - Lack of control/minority interest
 - Lack of marketability
 - Selling large blocks of stock
 - Fractional ownership interests
 - Impact of losing key person



KEY TERMS & CONCEPTS

// *Family limited partnership*

- Enable families to hold & manage wealth
- Must have legitimate & significant nontax purpose
- Often result in valuation discounts
- Senior generation establishes FLP with general & limited partner interests
- Transfer LP units to trusts for descendants
 - Transfers discounted to reflect applicable valuation discounts





BACKGROUND

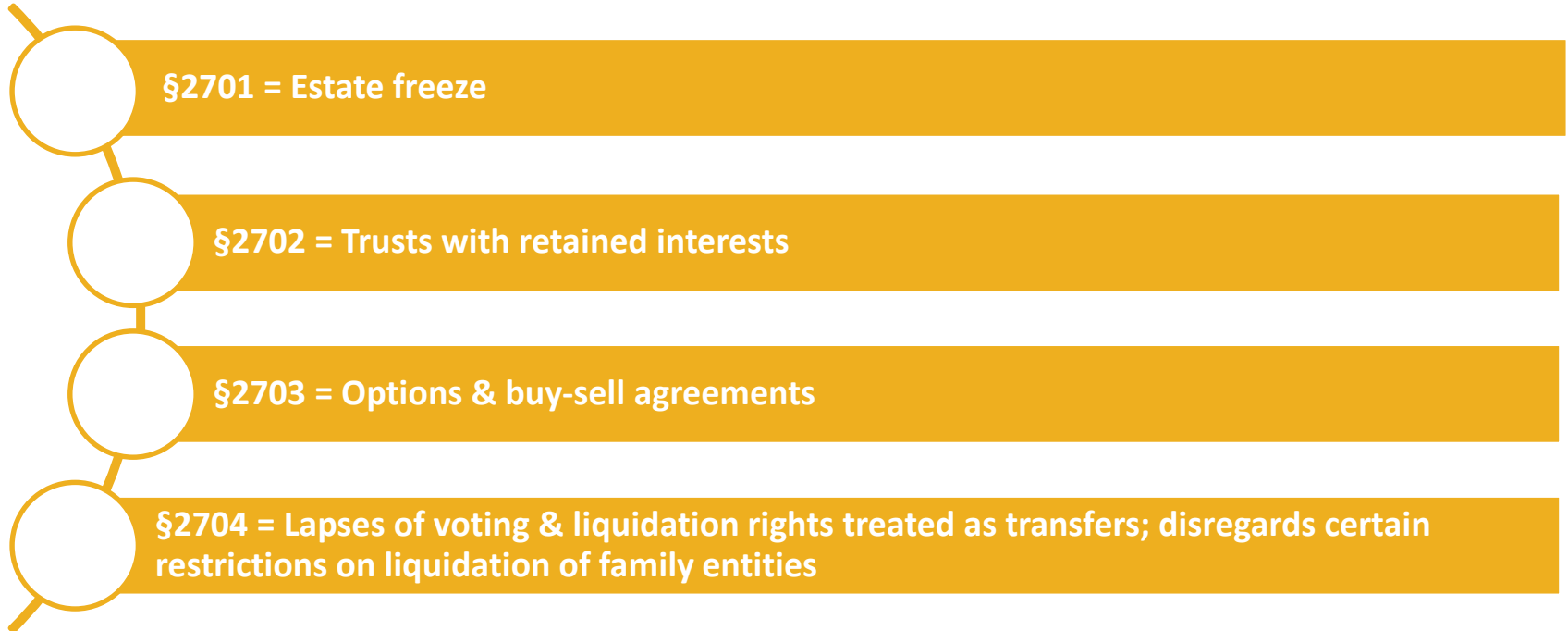
// Chapter 14 – §§2701-2704

- Enacted to curtail perceived abuse of techniques to discount transfers for transfer tax purposes
- Disregards FMV concepts for certain transfer tax purposes





CHAPTER 14 OVERVIEW



WHAT IS §2704?

// §2704

- Lapsing rights & restrictions can be used to lower value of interest in entity
- Addresses perceived abusive structures in family-owned entities
- Statutory framework
 - (a) Treatment of lapsed voting/liquidation rights
 - (b) Certain restrictions on liquidation disregarded



KEY TERMS & CONCEPTS

// §2704(a) = Lapses

- Lapse of any voting/liquidation right deemed as transfer for transfer tax purposes if individual holding such right immediately before lapse & members of such individual's family hold control of entity both before & after lapse
- Value of deemed transfer = value of transferee's units before lapse less value of units after
- See *Estate of Harrison v. Commissioner* (T.C. Memo 1987-8)



KEY TERMS & CONCEPTS

// *Voting right*

- Right to vote with respect to any matter of entity. Right of general partner to participate in partnership management is a voting right



KEY TERMS & CONCEPTS

// *Liquidation right*

- Right or ability, including by reason of aggregate voting power, to compel entity to acquire all/portion of holder's equity interest whether or not exercise would result in complete liquidation of entity





KEY TERMS & CONCEPTS

// *Family member*

- Individual's spouse
- Ancestors
- Lineal descendants
- Siblings
- Spouse of any such ancestor, lineal descendant or sibling

§2704(c)(2)



POLLING QUESTION 2

Is transferor's niece or nephew considered family member for purposes of §2704?

- // Yes
- // No
- // Not sure

KEY TERMS & CONCEPTS

// *Control*

- For corporations, holding at least 50% of total voting power or total FMV of equity interests in corporation
- For partnerships, holding at least 50% of either capital interest or profits interest in partnership





KEY TERMS & CONCEPTS

// §2704(b) = *Liquidation rights*

- Any *applicable restriction* is disregarded in determining value of transfer of interest in corporation/partnership to or for benefit of member of transferor's family if transferor & members of transferor's family hold control of the entity immediately before transfer



KEY TERMS & CONCEPTS

// §2704(b) = *Liquidation rights*

- Value determined for transfer tax purposes to be computed without consideration of certain applicable restrictions
- If restrictions are disregarded, transferred interest valued as if transferor's rights were determined under state law default provisions

Reg. §25.2704-2(c)

KEY TERMS & CONCEPTS

// §2704(b) = *Liquidation rights*

- Value determined using subtraction method
- See *Estate of Kerr v. Commissioner* 113 T.C. 449 (1999)



KEY TERMS & CONCEPTS

// *Transfer of interest*

- Contribution to capital of new/existing entity
- Capital structure transaction
- Termination of indirect holding in entity if interest is held in grantor trust or includable in gross estate of indirect holder before termination

Reg. §25.2701-1(b)(2))



KEY TERMS & CONCEPTS

// *Applicable restriction*

- Any restriction that

- Effectively limits ability of corporation/partnership to liquidate
- Restriction lapses (entirely or partially) after transfer OR transferor or family members can remove restriction (entirely or partially)

§2704(b)(2)

KEY TERMS & CONCEPTS

// *Applicable restriction*

- Except does **not** include

- Any restriction imposed, or required to be imposed, by any federal or state law
- Commercially reasonable restrictions imposed by unrelated persons in a financing transaction

§2704(b)(2)

REASON FOR REGS

Current regulations substantially ineffective

- Many states modified their law to become more “taxpayer friendly”
- Subsequent developments

Proposal to modify statute appeared in Treasury’s Green Book from 2010–2013

REASON FOR REGS

Proposed statutory changes dropped in favor of Treasury issuing regulations

Statute grants broad authority for Treasury to issue regulations

- 2704(a)(3): similar rights
- 2704(b)(4): other restrictions



POLLING QUESTION 3

New proposed regulations under §2704 have potential to impact all taxpayers holding interest in family-controlled entities

- // True
- // False
- // Not sure

NEW PROPOSED REGULATIONS

Proposed regulations apply to all entities under state law regardless of classification for federal tax purposes

Clarify control of entity = 50%

Confirm assignee interest is treated as a lapse within meaning of §2704(a)



NEW PROPOSED REGULATIONS

Extend §2704(a) to deathbed transfers – new three-year rule

Refine definition of *applicable restriction* by eliminating comparison to liquidation limitations of state law



NEW PROPOSED REGULATIONS

Provide bright-line test to disregard interest held by nonfamily member if any of the following apply

Held less than three years before date of transfer

Constitutes < 10% of value of all interests

Constitutes < 20% of value of all interests when combined with interests of other nonfamily members

Lacks right to put interest in entity & receive *minimum value*



NEW PROPOSED REGULATIONS

// *Minimum value (Prop. Reg. §25.2704-3(b)(1))*

- Interest's share of net value of entity on date of liquidation/redemption
- FMV determined under §2031 & §2512 – property held by entity reduced by outstanding obligations allowable as deductions under §2053



NEW PROPOSED REGULATIONS

Adds new
disregarded
restrictions

Limit ability of holder to liquidate interest

Limit liquidation proceeds to an amount less than
minimum value

Defers payment of liquidation proceeds for more
than six months

Permits payment of liquidation proceeds in any
manner other than cash/property (not in form of
notes except in certain situations)



NEW PROPOSED REGULATIONS

// New *disregarded restrictions* effectively value transfer of interests in family-controlled entities as if holder has a put right to sell interest to entity within six months for a value at least equal to a *minimum value*





NEW PROPOSED REGULATIONS

Exceptions to safe harbor put right for commercially reasonable restrictions

- Every owner has enforceable put right to sell interest to entity or other owners
- Payment must be made within six months of exercise of put right
- Payment not in form of a note except for certain types



NEW PROPOSED REGULATIONS

§2704(b) generally applies in computing marital deduction

§2704(b) does not apply to transfers to charity or nonfamily members

NEW PROPOSED REGULATIONS

Effective dates

- Generally effective on & after date regulations are finalized
- New *disregarded restrictions* effective 30 or more days after date regulations are finalized (Prop. Reg. §25.2704-3)

Comments due November 2, 2016

Public hearing December 1, 2016



POLLING QUESTION 4

What is the soonest the proposed regulations could be finalized?

// August 2, 2016

// November 2, 2016

// December 1, 2016

// January 2, 2017

// Not sure



TALKING POINTS

- // Far-reaching & broad
- // Intended to largely eliminate use of valuation discounts on interests in family-owned entities





TALKING POINTS

- // Reduce ability to apply valuation discounts to intrafamily transfers of interests in entities
- // Apply to active trade/business entities



TALKING POINTS

// Create uncertainty

- Validity of proposed regulations
- Application of new three-year rule
- Valuation impact

// Act now before effective date





TALKING POINTS

// Action plan depends on estate tax exposure

- *Facing estate tax*: discuss & potentially execute plans to transfer interests in family-owned entities before effective date of proposed regs
- ***Not facing estate tax***: consider modifications to ownership structure as undiscounted values in family-owned entities may provide income tax benefit



POLLING QUESTION 5

What percentage of people in the United States would have no federal estate tax if they died today?

- // 75%
- // 88.8%
- // 99.8%
- // 100%
- // Not sure

PLANNING POINTS IF REGS ARE FINALIZED

Grantor Retained Annuity Trusts (GRATs)

Promissory notes

Reverse freeze

- §2701 affects estate freeze transactions
- Senior generation keeps common interest & gives away preferred



PLANNING POINTS IF REGS ARE FINALIZED

Nonfamily members

- Ex-spouse
- Unmarried couple

Undivided interests in real estate



CONCLUDING THOUGHTS



QUESTIONS?



FOR MORE INFORMATION // For a complete list of our offices and subsidiaries, visit **bkd.com** or contact:

Carol Lewis, Partner // clewis@bkd.com // 303.861.4545

