Closing an Existing Tax Loophole

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New regulations have been proposed under IRC Section 2704, which are intended to close an existing tax loophole that taxpayers have long used to understate the fair market value of their assets for estate and gift purposes.

The purpose of the proposed regulations is to prevent the undervaluation of interests in corporations and partnerships when gift, estate and generation-skipping transfer taxes are involved. The proposed rules are known as the "valuation discount rules" or "disregarded restrictions" and are thought to be a new tool in the government's stance against business valuation discounts taken on interests in family owned companies and partnerships for gift and estate tax purposes.

The most significant and efficient estate and gift tax planning strategies include freezing or stabilizing the value of what's owned by the most senior generation of a family, all the while deflecting growth to younger generations, or changing the nature of what a taxpayer owns in a manner so as to reduce its value for tax purposes.

Internal Revenue Code Section 2704 was enacted to prevent the reduction of taxes through the use of "freezes" and other arrangements designed to reduce the value of the transferor's taxable estate or gifts and discount the value of the taxable transfer to the beneficiaries of the transferor without reducing the economic benefit to the beneficiaries. A common way to change the nature of what's owned and, therefore, reduce its value has been to transfer interests into a private, family controlled entity, such as a partnership, often called a "family limited partnership" or to a family limited liability company.

The following is a summary of the changes that are being considered under the proposed regulations:

- 2704(b) states that "applicable restrictions," typically those restrictions listed in the entity's operating or partnership agreement, and which would normally justify discounts, are to be ignored

- Several judicial decisions and State statutes, which came about after the enactment of 2704(b), effectively re-characterized these types of restrictions so that they fall outside the definition of an "applicable restriction"

- Treasury is proposing to put into place a new set of “disregarded restrictions” that would apply when valuing an interest in a “family controlled entity” in connection with an intra-family transfer, if, after the transfer the restriction will lapse or may be removed by the transferor and/or the transferor’s family

- The regulations are said to replace the disregarded restrictions with certain assumptions to be specified

- Disregarded restrictions would include (1) limitations on the owner’s right to liquidate the interest (withdrawal rights), if such restrictions are more onerous than a standard set by the regulations and (2) any limitations on transferees being admitted as full owners of the entity.

- Safe harbors may allow family entities to draft documents in such a way as to avoid the application of Section 2704

- Proposed regulations have no impact on transactions until the proposed regulations are adopted as temporary or final regulation. The proposed regulations would apply to transfers of property subject to restrictions if such transfer occurs 30 days or more after the regulations are published as final regulation.

It is not known how these proposed changes will eventually play out, but close attention to these changes would be advisable for wealth transfers in the near term.