Section 2704 Regulations to be Withdrawn

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On August 2, 2016, the Treasury Department issued proposed regulations under Internal Revenue Code Section 2704. The proposed regulations, through a web of dense rules and definitions, would have narrowed longstanding exceptions and dramatically expanded the class of restrictions that are disregarded under Section 2704. In addition, the proposed regulations would have required an entity interest to be valued as if disregarded restrictions did not exist, either in the entity?s governing documents or under state law. No exceptions would have been allowed for interests in active or operating businesses.

In Executive Order 13789, President Trump directed the Secretary of the Treasury to identify significant tax regulations issued on or after January 1, 2016, that (i) impose an undue financial burden on U.S. taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the Internal Revenue Service (IRS).

In an interim Report to the President, dated June 22, 2017, Treasury identified eight such regulations, including the proposed regulations under Section 2704. Executive Order 13789 further directed the Secretary to submit to the President a report recommending ?specific actions to mitigate the burden imposed by regulations identified in the interim report.? Please click here for an earlier discussion of this review of the **proposed regulations**.

On October 4, 2017, the Treasury Department issued a second report recommending that the proposed regulations under Internal Revenue Code Section 2704 be withdrawn entirely. The report noted that the proposed regulations were intended to counteract changes in state statutes and developments in case law that have eroded Section 2704?s applicability and have facilitated the use of family-controlled entities to generate artificial valuation discounts, such as for lack of control and marketability. Commenters warned, however, that the valuation requirements of the proposed regulations were unclear and that their effect on traditional valuation discounts was uncertain. In addition, commenters argued that it was not feasible to value an entity interest as if no restrictions on withdrawal or liquidation existed in either the entity?s governing documents or state law. Commenters also argued that the proposed regulations could have produced unrealistic valuations. For example, the lack of a market for interests in family-owned operating businesses is a reality that, commenters argued, should continue to be taken into account when determining fair market value.

After reviewing these comments, Treasury and the IRS concluded that the proposed regulations? approach to the problem of artificial valuation discounts was unworkable. The report noted that taxpayers, their advisors, the IRS, and the courts would not, as a practical matter, be able to determine the value of an entity interest based on the fanciful assumption of a world where no legal authority exists. Given that uncertainty, it was unclear whether the valuation rules of the proposed regulations would have even succeeded in curtailing artificial valuation discounts. The report noted that the burden of compliance with the proposed regulations would have been excessive, given the uncertainty of any policy gains. Finally, the proposed regulations could have affected valuation discounts even where discount factors, such as lack of control or lack of a market, were not created artificially as a value-depressing device.

Based on those concerns, Treasury and the IRS recommended that the proposed regulations be withdrawn in their entirety. Treasury and the IRS plan to publish a withdrawal of the proposed regulations shortly in the Federal Register.

The withdrawal of the Section 2704 regulations should allow practitioners to breathe a temporary sigh of relief. It is unclear whether Treasury will ?go back to the drawing board? or will wait to see what might happen legislatively with respect to the repeal of the estate tax.

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