

The Family Owned Business- IRC 2704

Take-Away: Family owned and controlled business can pose tax traps for senior family members due to *deemed gifts* on the lapse of a retained power or interest, or when partnership or operating agreements contains provisions that are *more restrictive* than what state law requires.

Background: Chapter 14 of the Tax Code deals with special valuation rules for transfers of interests in family-owned businesses. The rules are intended to prevent families from undervaluing business interests. Recently we covered IRC 2701, 2702 and 2703. This summary looks at IRC 2704 and its two subsections, (a) and (b) which relate to eliminating valuation discounts with respect to family entities, and by implication they create the risk of causing the value of a transferred interest to be included in the transferor's (for convenience, 'Dad's) gross estate under IRC 2036.

Proposed IRC 2705: In the past year or so there was a proposal floating around Congress that would have added a new IRC 2705 (to replace IRC 2704(b)) that would have expressly eliminated *all* valuation discounts with respect to family owned entities, but that proposed legislative change never got any traction and, to my knowledge, the proposal is not part of the new tax legislation Congress is currently considering.

IRC 2704(a)-Lapse of a Right: This Tax Code section can be either a *deemed gift* in a gift tax context, or an increase in the decedent's gross estate in the estate tax context. Both are related to the **lapse or disappearance of either liquidation rights or voting rights** in a family owned and controlled business.

Lapse: A *lapse* is defined as a "*restriction or elimination of either a voting right or a liquidation right.*" IRC 2704(a) addresses the disappearance of that right.

Example: Dad dies with a large, limited partnership interest in a family partnership, and he also owns a general partnership interest. Dad's general partnership interest allows the general partner to compel dissolution of the partnership; if that liquidation right was exercised, the general partner would be able to take back his assets held in the

partnership. When Dad dies, under the partnership agreement, the general partnership (and its liquidation right) basically lapses on his death. Dad's estate would then argue that the value of Dad's gross estate should be only the limited partnership interest, *without the general partnership* because at the time of Dad's death, the general partnership interest lapsed or disappeared; the general partnership interest simply disappeared on Dad's death. IRC 2704(a) was put into the Tax Code to prevent this sudden 'disappearance' of a right to control that has value.

Estate Tax: The effect of IRC 2704(a) is to say, for estate tax purposes, if an interest in the entity lapses or is restricted or is eliminated, either a voting right or a liquidation right, and that happens at death, the IRS will increase the value of that disappearing interest in the decedent's estate to what it would have been before the lapse.

Gift Tax: In the gift tax context, the amount of the *deemed gift* is going to be determined by looking at the value of the interest the day before the lapse and then looking at the value of the interest after the lapse, and the difference between the two values is the amount of the *deemed gift* by the family member.

IRC 2704(b)- Disregarded Restriction: Much like IRC 2703 (previously covered) , IRC 2704(b) is a 'disregarding provision' which disregards some restrictions on the ability to liquidate a family-controlled entity if those restrictions are *more restrictive* than those rights would otherwise be provided for under state law- so a comparison is involved.

Example: Dad is a member of a family partnership. State law provides that 75% of the members of the partnership can vote to liquidate the partnership. Dad's family partnership agreement provides that 85% of the members of the partnership can vote to liquidate the partnership. Dad owns 80% of the partnership interest. Dad dies. Dad's estate wants to claim valuation discounts because Dad's 80% interest could not force a liquidation of the partnership because only an 85% interest could force the partnership liquidation. IRC 2704(b) provides that while Dad's estate claims that he did not have the right to liquidate the partnership because he *only* owned 80% interest, thus triggering a lack of control valuation discount for Dad's interest in the partnership, state law provides that only a 75% interest is required to liquidate the partnership. Consequently, the provision in the partnership agreement, i.e., 85% of the membership interest is needed to compel a

liquidation, will be ignored, or disregarded, because it is more restrictive than what rights would otherwise be given under state law.

IRC 2036: These Chapter 14 lapsing right and disregarded interest provisions, in turn, can implicate IRC 2036. This Tax Code provision is often called one of the *string provisions* where a retained right can cause estate inclusion when the transferor (with the retained right) dies, causing the full value of the entity in the lifetime transferor's gross estate at death. IRC 2036(a)(1) is the retained enjoyment string, while IRC 2036(a)(2) is the retained control string. Either of these provisions (enjoyment or control) can cause the value of the assets that Dad contributed to the family partnership to come back into Dad's gross estate. This might result, for example, if Dad is advised that he has a Chapter 14 problem, and then takes steps, prior to his death, to release or eliminate the Chapter 14 problem. If this release of the 'tainted' right occurs within 3 years of Dad's death, then the valued interest will still be included in Dad's gross estate. [IRC 2035(a).]

Therefore, if Dad dies owning some or all of the general partnership interest in a family limited partnership, or he holds the managerial interest in an LLC, there is a risk that the value of the assets that Dad transferred to the partnership could come into his gross estate under IRC 2036(a)(2) because Dad, either alone or in conjunction with other general partners, had the right to control the disposition of the partnership assets, and any lifetime effort by Dad to release, relinquish, or eliminate his retained 'tainted' right in the partnership within 3 years of his death will not end the exposure to IRC 2036 estate inclusion..

Expanded Scope: The IRS and the Tax Court have recently taken a much broader view of the implications of the 'in conjunction with' provision IRC 2036(a)(2). The recent *Powell* and *Fields v. Commissioner*, *Tax Court Memo 2024-90* decisions are examples of this more expansive view of when IRC 2026(a)(2) can apply to cause gross estate inclusion.

Example: Dad is a limited partnership in a family partnership. As limited partner, Dad can cast a vote, yes or no, towards the liquidation of the partnership. This continued right held by him, either alone or 'in conjunction with' other partners to control the disposition of the partnership assets, has been held by the Tax Court to control the ultimate disposition of the partnership. If the partners collectively vote to liquidate the partnership, then Dad will get

his assets back from the partnership. Thus, under the more expansive view of IRC 2036(a)(2) Dad will be deemed to be in control of the partnership 'in conjunction with others', which then triggers the risk that the assets that Dad transferred to the partnership will be included in Dad's gross estate at his death.

Practical Implications: A couple of final thoughts-

Need to Stress Test: The risk posed by IRC 2704, coupled with IRC 2036, leads to the need to evaluate the relative strength, or lack of strength, of family limited partnerships and the senior family member's interests in the partnership (or LLC.) The ability to act in connection with other general partners to liquidate the partnership and ultimately control the disposition of its assets, now needs to be evaluated, and any partnership agreement or LLC operating agreement needs to periodically be 'stress tested' so determine if Dad's rights, either alone or in conjunction with others, will expose the entity's assets to estate inclusion..

Decontrolling Measures: If Dad has too much control, either as a general partner, or as the LLC manager, an analysis should turn to implementing what are sometimes called '*decontrolling measures*' to rid Dad of any 'tainted' control interest in the entity, hopefully three years before Dad dies, to avoid IRC 2036. This entails looking at how to get rid of the interest held by Dad so that Dad does not own or hold that interest at his death, which is problematic. Thus, when looking at ways to avoid IRC 2036(a)(2) exposure, IRC 2704(a) stands in the way with its *deemed gift* rule due to the disappearance or the lapse of either a voting right or the lapse of a liquidation right that Dad held. In other words, if planning to avoid IRC 2036(a)(2), you just cannot just take the troublesome right away from Dad without some *deemed gift* consequences. Just making the right disappear will trigger the gift tax consequences of a *deemed gift* on the lapse of one of the rights Dad held in the initial 'bundle' or rights under IRC 2704(a).

Conclusion: In summary, Chapter 14 and its harsh valuation rules are often overlooked, or not fully understood. It is important to periodically 'stress test' family businesses to see if there are troublesome liquidation or voting rights, and if so, understand the need to be careful when thinking about ways to 'decontrol' and rid Dad of his control interest and not

just simply eliminate it, since that could end up with a more immediate gift tax problem opposed to solving the estate tax problem that could be delayed 20+ years.

In some ways it might make more sense for Dad to simply transfer his interest to a younger generation family member, because the transfer of an interest, rather than a restriction or elimination, will not be a lapse that results in a *deemed gift*.

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