President Trump’s Executive Order Deals Blow to Proposed 2704 Regulations

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Since their publication on August 4, 2016, the proposed regulations on valuation discounts for family-owned businesses under Internal Revenue Code (*Code*) § 2704 (*Proposed Regulations*) have drawn the ire of the estate planning community. The Proposed Regulations made several significant changes aimed at restricting the use of minority discounts to transfer family-controlled business interests at a lower estate tax value. Many commentators believe that the Treasury exceeded its authority by issuing the Proposed Regulations and voiced concerns at a hearing on December 1, 2016.

<callout>For a detailed analysis of the Proposed Regulations, see our discussion of [Paper Title].
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The future of the Proposed Regulations was cast into further doubt by the election of Donald J. Trump as President of the United States and the Republican majority in both houses of Congress. Many commentators believed that estate tax repeal would occur early in 2017, rendering the Proposed Regulations irrelevant. Tax reform did not occur in the first half of 2017, and the federal estate tax remains alive and well. But outside of a few comments at trade conferences, the Treasury has been silent about the Proposed Regulations since the December 1, 2016, hearing.

The silence was broken recently by President Trump’s issuance of Executive Order 13789[1] and the corresponding implementation by the Internal Revenue Service (*IRS*) in IRS Notice 2017-38[2] (*Notice 2017-38*). Notice 2017-38 was issued in response the Executive Order’s requirement to identify and reduce regulatory tax burdens. By identifying Code § 2704 as “burdensome,” Notice 2017-38 dealt a critical—and perhaps fatal—blow to the Proposed Regulations. This article summarizes Notice 2017-38 and its effect on the Proposed Regulations.

Background of the Proposed Regulations

The Proposed Regulations made several significant changes, the most controversial of which is the creation of new disregarded restrictions that will be ignored for valuation purposes unless they are required by non-waivable provisions of state law (*Disregarded Restrictions*). Section 25.2704-3(b)(1) of the Proposed Regulations creates four categories of Disregarded Restrictions:

1. Provisions that limit or permit the limitation of the holder’s ability to compel liquidation or redemption of the interest.
2. Provisions that limit or permit the limitation of the amount the interest holder may receive on liquidation or redemption of the interest to an amount that is less than minimum value.
3. Provisions that defer or permit the deferral of the payment of the full liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder’s intent to have the holder’s interest liquidated or redeemed.

[1] Executive Order 13789, 82 Fed. Reg. 19317 (April 26, 2017).
[2] Notice 2017-38, 2017 WL 2899737.

4. Provisions that authorize or permit the payment of any portion of the full liquidation or redemption proceeds in any manner other than in cash or property.

Many commentators read these new categories of Disregarded Restrictions as treating all family-owned interests as though the owner could require the entity to redeem the interest for cash or equivalent property within a six-month period at a value equal to the interest's pro rata share of the entity's assets. By disregarding all non-mandatory restrictions to the contrary, the Proposed Regulations can be interpreted to create a deemed mandatory put right for all interests in family-controlled businesses. Although Catherine Hughes, Attorney-Advisor in the Treasury Department's Office of Tax Policy, has denied that this was the Treasury's intent [link to paper on hearing on proposed regulations], a plain reading of the Proposed Regulations could support a Tax Court determination of a deemed put right, despite Ms. Hughes's statements to the contrary.

The public hearing on the Proposed Regulations on December 1, 2016, lasted almost six hours. All but one of the 37 commentators requested that the Proposed Regulations be withdrawn and reconsidered. Although the Treasury noted the comments, neither the Treasury nor the IRS provided any indication of whether the regulations would be ultimately withdrawn.

Executive Order, Notice, and Appropriation Bill

On April 26, 2017, President Trump issued the Executive Order. It required the Treasury to "immediately review all significant tax regulations issued by the Department of the Treasury on or after January 1, 2016." The Treasury had 60 days from the date of the order to provide an interim report identifying all such regulations that:

1. Impose an undue financial burden on the Unites States Taxpayers;
2. Add undue complexity to the Federal tax laws; or
3. Exceed the statutory authority of the Internal Revenue Service.

After providing the interim report, Executive Order directs the Treasury to prepare and submit a final report by September 18, 2017. The final report must recommend "specific actions to mitigate the burden imposed by regulations identified in the interim report."

In response to the Executive Order, on July 8, 2017, the Treasury issued Notice 2017-38. Notice 2017-38 identified eight regulations that were deemed to have met the Executive Order's criteria, one of which was the Proposed Regulations. The Treasury explained why the Proposed Regulations was identified as burdensome:

> Section 2704(b) of the Internal Revenue Code provides that certain noncommercial restrictions on the ability to dispose of or liquidate family-controlled entities should be disregarded in determining the fair market value of an interest in that entity for estate and gift tax purposes. These proposed regulations would create an additional category of restrictions that also would be disregarded in assessing the fair market value of an interest. Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens. Commenters were also concerned that the proposed regulations would make valuations more difficult and that the proposed narrowing of existing regulatory exceptions was arbitrary and capricious.

The Treasury requested that all public comments be submitted by August 7, 2017. The public comments should address whether to rescind or modify the Proposed Regulations, "and in the latter case, how the regulations should be modified in order to reduce burdens and complexity."

Following Executive Order and Notice 2017-38, the House Committee on Appropriations noticed the adverse comments regarding the Proposed Regulations and entered the fray with an Appropriations Bill[3]. Section 115 of the Appropriations Bill provides:

> None of the funds made available by this Act may be used to finalize, implement, or enforce amendments to Treasury Regulations proposed in the Notice of Proposed Rulemaking in the Federal Register on August 4, 2016 (81 Fed. Reg. 51413) (relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes under section 2704 of the Internal Revenue Code of 1986), or any substantially similar amendments to such regulations.

If Section 115 of the Appropriations Bill remains intact, it would operate to shut down the application of the Proposed Regulations by failing to provide funds that would be necessary for enforcement.

Analysis and Takeaways

Much like the Proposed Regulations themselves, the Executive Order and related Notice 2017-38 can be viewed as attempts by the executive branch to influence tax policy absent clear statutory guidance. The Executive Order requires withdrawal or revision of those regulations identified as burdensome in Notice 2017-38. This requirement means that Treasury must decide whether to withdraw the Proposed Regulations or completely rewriting them. Any attempt to predict which alternative the Treasury will choose is speculative. We can expect some indication, though, by September 18, 2017, when the Treasury must submit its final report to the President.

Section 115 of the Appropriations Bill is also noteworthy. If enacted, it would increase the pressure on the Treasury to fix the Proposed Regulations. The Bill is part of a political process, so there is no way to know that Section 115 will remain intact. If it does, it will effectively shut down application of the Proposed Regulations as currently drafted. The Treasury should note the Appropriations Bill as it considers how it will proceed with the revision or revocation of the Proposed Regulations.

After the Proposed Regulations were issued, many commentators recommended immediate action to obtain any valuation discounts before the Proposed Regulations became effective. Given the successful attacks against the Proposed Regulations since that time, this type of reactive tax-driven planning is no longer prudent. Unless clients have a non-tax reason for gifting minority interests to family members or others, it is probably best to wait until we have further clarification before making any gifts in anticipation of the potential enactment of the Proposed Regulations.

Regardless of the exact change, we can expect the Treasury to either tone down or withdraw the Proposed Regulations. These related developments, coupled with remarks previously made by Ms. Hughes, seems to indicate that valuation discounts are not going away anytime soon.

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[3] https://appropriations.house.gov/uploadedfiles/bills-115hr-sc-ap-fy2018-fservices-financialservicesandgeneralgovernment.pdf