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Proposed 2704 Regulations: "Commercially Reasonable Restriction Exclusion"

Trusts & Estates
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Could this provide a lower valuation for certain transactions?

The proposed Internal Revenue Code Section 2704 regulations (the regs) prevent taxpayers from considering a range of restrictions that could otherwise reduce the value of an interest in an entity for transfer tax purposes. These restrictions include those denominated "applicable restrictions" that had been in prior law. The regs make these applicable restrictions much tougher and add a new category of restrictions referred to as "disregarded restrictions." The regs throw taxpayers a bone, a rather small one, in terms of permitting at least one type of restriction on value to be respected. This leniency permits consideration of restrictions a lender or other financial partner may place on the entity or transaction. If the restriction applies, then the valuation of an interest in a family entity might qualify for a valuation discount, for example, for lack of control.

The Commercially Reasonable Restriction Exclusion

The regs read as follows:

> Commercially reasonable restriction. An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

For example, a commercially reasonable restriction imposed by a bank, co-venturer providing capital, etc. appears to be an exception to the comprehensive list of "applicable restrictions" and "disregarded restrictions" that can't be factored into a valuation analysis. It would appear that a commercially reasonable restriction could result in the reduction of the minimum value required to be imputed under the put right rule.

Four Examples

The examples below help to explain, understand and apply the exclusion.

Example 1: A real estate developer obtains financing from a local bank. The bank, as a condition of financing the project, insisted on the Matriarch of the project serving as manager of the limited liability company (LLC) owning the project and placed restrictions on the transfer of any equity interests during the term of the loan or the liquidation of the property LLC. Because other lenders have used these restrictions for many similar development deals, these restrictions would appear to be respected when the appraiser values the LLC borrowing funds for transfer tax purposes. It isn’t clear whether the requirement of the Matriarch serving as manager is a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity. Will the IRS consider these restrictions in the valuation? Because this is a real estate development, will the lending restriction actual fall within the ambit of this new rule? That may turn on whether the project arises to the level of a “trade or business operations.” Will the same determination noted above apply (that is, reference to IRC Section 6166(b)(9)(B) for the definition of a passive asset, which is “any asset other than an asset used in carrying on a trade or business”)?

Example 2: A real estate developer owns and operates an apartment complex and seeks to refinance the property with a local bank. The developer, who’s a substantial real estate entrepreneur with significant equity in the project, requests the bank to require, as a condition of refinancing the project, that the developer serve as manager of the LLC owning the project and place restrictions on the transfer of any equity interests during the term of the loan. The bank sees no issue in complying with the developer’s request because these terms add to its security. The lender also isn’t concerned about complying with the request, understanding that the developer has made the request to support valuation discounts. Because other lenders have used these restrictions, the bank isn’t concerned that the Internal Revenue Service could accuse it of being complicit in manufacturing discounts. The issue as to whether the size or net equity of this particular developer would negate the need for customer restrictions is one of fact that might vary by lender, and the quantum of capital to obviate the need for restrictions is a judgment call by any lender. So the question remains to be seen whether this is just another example of how the regs will force business owners to find other avenues to reflect the reality of valuations in their planning.

Example 3: A real estate developer leases 35 percent of a strip shopping center to a major chain as the anchor tenant. Securing that tenant will assure bank financing essential to the development proceeding and will be the magnet to attract local stores to rent the rest of the project. The anchor tenant as part of all of its leases with shopping center developers insisted on a list of restrictions on the operations of the entity owning the shopping center, including restrictions on transfer, liquidation and financing. These are all commercially reasonable, and the developer couldn’t sign the anchor tenant without agreeing to them. But because the tenant doesn’t fall within the ambit of “person providing capital to the entity,” the restriction won’t come under the exception provided by this provision.

Example 4: Assume the same facts as in the preceding example. However, the tenant loans $100,000 to the developer. Will that suffice to characterize the anchor tenant’s restrictions, now replicated in a loan document in addition to the lease, within the ambit of the exception? What if the developer increased the tenant allowance for tenant improvements by $100,000 in the negotiations? The net economic result might be the same, but would the discount be substantially different? So long as the tenant allowance is reasonable, how could the IRS, or any third party for that matter, discern what result from the negotiation process? The exception doesn’t appear to include a de minimus rule.

How many commercial transactions will be modified to address the onerous and unrealistic valuation provisions of the regs?

Need for Clarity

The regs are scheduled for a public hearing Dec. 1. Hopefully, the lack of clarity and unreasonable narrowness of the commercial borrowing exception will be addressed before the final regs are issued. In their present form, issues are legion.

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