BESSEMER TRUST

Section 2704 Proposed Regulations

November, 2016

Section 2704 Proposed Regulation's Impose Far-Reaching Limitations on Valuation Discounts for Transfers of Interests in Family-Controlled Entities

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October 27, 2016

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Synopsis

The IRS has issued long-awaited proposed regulations under §2704 that may dramatically reduce the ability to apply valuation discounts to intra-family transfers of interest in entities (such as corporations, partnerships, or LLCs). In large part, these regulations may significantly restrict (or eliminate) lack of control discounts in valuing interests in entities and may impact marketability discounts as well.

Very importantly, the proposed regulations are not effective until they are finalized (or for some provisions, until 30 days after they are finalized). A new "three-year rule" might apply, however, to transfers made before the effective date if the transferor dies after the effective date but within three years of making the initial transfer.

Major provisions of the proposed regulations include:

- *Covered Entities*. Covered entities are defined broadly (for example, including LLCs regardless of whether they are disregarded as separate entities for federal tax purposes), and control rules are described for various types of entities.
- *Assignees*. Transfers to assignees may result in lapsed liquidation or voting rights under §2704(a) and will be subject to the "disregarded restrictions" rules.
- *Deaths Within Three Years*. Transfers that result in the transferor losing a liquidation right may be subject to a three year rule, requiring inclusion of the liquidation value in the transferor's gross estate at death, if the transferor dies within three years of the transfer. The phantom value included in the gross estate (generally speaking, the value attributable to being a minority interest or being less than the percentage ownership required to force the liquidation of the entity) would not qualify for the marital or charitable deduction. The three-year rule may be the most important part of these proposed regulations – creating a risk that the minority discount for lifetime transfers may be added into the donor's gross estate if the donor dies within three years.
- *State Law Default Restrictions Not Considered*. Default restrictions under state law (such as withdrawal restrictions that can be overridden by the family) can no longer be considered in valuing transferred interests that are subject to §2704(b).
- *Disregarded Restrictions.* A potentially far-reaching part of the proposed regulations is the creation of a new category of "disregarded restrictions." Some commentators have viewed these provisions as effectively valuing transfers of interests in family-controlled entities as if the holder of the interest has a put right to sell the interest to the entity within six months for a value at least equal to a pro rata part of the net value of the entity in return for cash or property (but not notes except in certain situations). The more likely view, expressed by other commentators, is that the disregarded restrictions category is much narrower, simply disregarding *explicit "restrictions"* limiting an owner's redemption of its interest in the entity to an amount that is less than a pro rata part of the net value of the entity or for which payment can be made in other than "cash or property."
- *Unrelated Parties Generally Not Recognized for Removal of Disregarded Restrictions By Family Test.* In determining whether the family can remove "disregarded restrictions," the

interests of unrelated parties are not considered unless unusually stringent conditions are satisfied (which usually will not be the case).

- *Commercially Reasonably Restrictions for Active Business Entities*. In light of the very broad scope of the application of the new provisions, a "commercially reasonable restriction" exception for entities with trade or business operations may become important.
- *Valuation Uncertainties*. Numerous uncertainties exist regarding the manner of determining the values of transferred interests that are subject to the new rules.
- *Marital and Charitable Deduction*. Values will generally be applied consistently for both estate inclusion and for deduction purposes (for the marital deduction and charitable deduction).

The proposed regulations have spawned a firestorm of responses. A Wall Street Journal editorials referred to the proposed regulations as "A Stealth Death Tax Increase." Wall St. J. (Sept. 5, 2016). Various bills have been introduced in the House and Senate in an attempt to negate the proposed regulations. A group of 41 Senators have sent a letter to the Secretary of the Treasury expressing serious concerns about the proposed regulations and requesting that they be withdrawn. Various commentators have expressed concern that the regulations will have a substantial adverse impact on family businesses. *E.g.*., Keith Shiller, *A Call to Congress for Action: Potentially Harmful Impact of 2704 Proposed Regulations on Succession of Family Businesses and Farms and Why It Must Be Stopped!,* LEIMBERG ESTATE PL. NEWSLETTER #2455 (September 26, 2016).

Brief Background

Section 2704 was enacted in 1990 as a part of Chapter 14. The goal in particular was to limit discounts for certain family partnership or LLC interests that are transferred to family members.

Section 2704(a), titled "Treatment of Lapsed Voting or Liquidation Rights," treats certain lapses of voting or liquidation rights as deemed transfers if the family controls the entity both before and after the lapse. (In *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8, the decedent owned all of the limited partnership interests and a small general partner interest in a limited partnership. As a general partner, the decedent could liquidate the partnership, but a general partner's right to liquidate the partnership lapsed at the partner's death. The court held that the estate tax value of the decedent's partnership interests did not include the value attributable to the right to compel liquidation of the partnership.)

Section 2704(b), titled "Certain Restrictions on Liquidation Disregarded," provides that any "applicable restriction" is disregarded in valuing an interest in a corporation or partnership that is transferred to a family member if the transferor and family members control the entity. An "applicable restriction" is any restriction that (i) effectively limits the ability of the corporation or partnership to liquidate, and (ii) the restriction lapses (entirely or partially) after the transfer OR the transferor or family members can remove the restriction (entirely or partially), but an "applicable restriction" does not include "any restriction imposed, or required to be imposed, by any Federal or State law" (or commercially reasonable restrictions imposed by unrelated persons in a financing transaction). Regulations interpreted the "imposed, or required to be imposed, by Federal or State law" exception to mean that default restrictions on the ability of an owner to withdraw from an entity could be considered, even though the family could have overridden those restrictions in the governing documents. Many states have a default rule limiting the ability of a limited partner or member of an LLC to withdraw, and the IRS has stated that the default rule in the regulations has made §2704(b) rather toothless.

Section 2704(b)(4) gives the IRS the authority to provide in regulations that other restrictions may similarly be disregarded in valuing transfers of interests in the entity if the restriction merely reduces the value for transfer tax purposes but does not ultimately reduce the value of the interest for the transferee.

Beginning with the 2003-2004 Treasury/IRS priority guidance plan, the plans have had a project for guidance/regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.

The IRS on August 2, 2016 released long-awaited proposed regulations under §2704 (published in the Federal Register on August 4, 2016). These proposed regulations generally implement the provisions of a proposal (included in the Administration's budget proposals submitted in 2009-2012) to amend §2704 legislatively. (The administration removed the proposal in the Fiscal Year 2014 budget proposal after no bills were ever introduced to enact the proposal).

Effective Date

The proposed regulations are NOT effective immediately. They only apply to transfers made after final regulations are promulgated, and the most pervasive provisions of the proposed regulations (regarding the new category of "disregarded restrictions") only apply to transfers made at least 30 days after the regulations become final. Prop. Reg. §§25.2701-8, 25.2704-4(b)(1)-(2).

The new rules might also apply to transfers made before that date if the transferor dies after the effective date but within three years of the date of the transfer. The new three-year rule, discussed below, provides that a lapse of a liquidation right under §2704(a) is treated as a lapse "*occurring*" on the date of the transferor's death in certain situations if the transferor dies within three years of making the transfer. The new regulations "apply to transfers of property subject to restrictions created after October 8, 1990, *occurring* on or after the date these regulations are published as final regulations in the Federal Register" (emphasis added). Does this effective date language apply to (i) the actual lapse that occurs at the time of the gift or (ii) the deemed lapse "occurring" at death? If the former, gifts made before the regulations become final would not be subject to the new three-year rule. If the latter, gifts made before the regulations are finalized (and presumably even before the proposed regulations were issued) may result in significant amounts being included the gross estate of the transferor if the transferor dies after the regulations are finalized and within three years of the gift. Interestingly, the same word "occurring" is used both in the three-rule and in the effective date provision. There are indications that the regulations will be clarified to apply only to transfers made after the regulations are finalized (if the transferor dies within the three years after the transfer).

A hearing about the proposed regulations is scheduled for December 1, 2016. Most proposed regulations (even non-controversial ones) are not finalized for two years or more. These proposed regulations will be quite controversial, and the IRS will, no doubt, receive many comments for consideration, which presumably will mean that the final regulations will not be issued any time soon after the December 1 hearing. (Under the Administrative Procedures Act, the IRS is required to consider and respond meaningfully to significant comments regarding proposed "legislative regulations." *See Altera Corporation and Subsidiaries v. Commissioner,* 145 T.C. 91 (2015) (on appeal to 9th Cir.) ("Although Treasury's failure to respond to an isolated comment or two would probably not be fatal to the final rule, Treasury's failure to meaningfully respond to numerous relevant and significant comments certainly is. [citation omitted] Meaningful judicial review and fair treatment of affected persons require "an exchange of views, information, and criticism between interested persons and the agency." [citation omitted] Treasury's failure to adequately respond to commentators frustrates our review of the final rule and was prejudicial to affected entities.")) If the IRS makes this a high priority project, the regulations conceivably could be finalized sometime in 2017, but finalizing the regulations will likely take longer than that. In any event, planners will have an additional 30 days after the regulations are finalized before the disregarded restrictions provisions become effective.

Major Provisions of Proposed Regulations

1. **Entities Subject to §2704; Controlled Entity; "Family."** The types of entities subject to §2704 are described very broadly to include any "entity or arrangement that is a business entity within the meaning of §301.7701-2(a)" that is controlled by the family, and a definition of control is provided. In particular, LLCs are included (regardless of whether they are disregarded for federal tax purposes), as well as corporations and partnerships. Prop. Reg. §§25.2701-2(b)(5)(i), (iv); 25.2704-2(a), (c)-(d); 25.2704-3(a). The definition of "control," as cross referenced in §2701 is clarified regarding LLCs or other entities other than corporations, partnerships, or limited partnerships to mean 50% of either capital or profits interests or the ability to cause the liquidation of the entity.

   Existing regulations provide that for corporations, control means at least 50% (by vote or value) of the stock, and for partnerships, control means at least 50% of the capital or profits interests or the holding of any interest as a general partner in a limited partnership. Reg. §25.2701-2(b)(5). How the general partner rule applies to someone who owns an interest – particularly a minority interest – in an entity that serves as general partner of a limited partnership is not clear. Section 2701(e)(3) expressly applies for purposes of the "holding any interest as a general partner" and "an individual shall be treated as holding any interest to the extent such interest is held indirectly by such individual through a corporation," suggesting that holding an interest in an entity serving as general partner would be treated as control for purposes of §2704 as well as §2701.

   Section 2704 (and the regulations thereunder, including the proposed regulations) apply only to transfers of interests in *entities* and not assets outside of entities (including undivided interests in real estate or art). However, if the undivided interests held by various owners are deemed to be a "business entity," the new rules could apply to transfers of those undivided interests.

   The description who qualifies as family members is not changed by the proposed regulations, but because that issue is so important in the application of §2704, the rules are summarized below.

   Family for Purposes of Determining Controlled Entity. Section 2704(a) and 2704(b) applies if the transferor and "members of the family" control the entity at particular times. Section 2704(c)(2) defines "member of the family" to include (i) the individual's spouse, (ii) any ancestor or lineal descendant of the individual or the individual's spouse, (iii) any brother or sister of the individual, and the spouse of any individual described in (ii) or (iii). But the story gets more complicated.

- For purposes of determining if an entity is a controlled entity (which is important for both §2704(a) and 2704(b)), §2704(c)(1) says "control" has the same meaning given to such term in §2701(b)(2).
- The proposed regulations (and the current regulations), refer to Reg. §25.2701-2(b)(5) (which is also revised in the proposed regulations). Prop. Reg. §§25.2704-2(c) & 25.2704-3(c) (definition of "controlled entity"); Reg. §25.2704-2(a) (definition of "control").
- Reg. §25.2701-2(b)(5)(i) refers to control by "the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse." (Section 2701 interestingly has two definitions of "applicable family members" (§§2701(e)(2) & 2701(b)(2)(C)), and the latter definition includes any lineal descendant of any parent of the transferor or the transferor's spouse.)
- The cross reference to "Reg. §25.2701-2(b)(5)" may really be intended to refer just to the 50% control tests for corporations, partnerships, and "other business entities," and not to the somewhat offhand reference in sub-paragraph (i) to the persons who have control for purposes of the §2701 provisions, in light of the fact that §2704 refers to control by the transferor or "a member of the family" and the very specific definition of "member of the family" in §2704(c)(2). For example, the current regulation seems to draw a distinction between the control definition and the member of the family definition. Reg. §25.2704-2(a) ("For the definition fo control, see §25.2701-2(b)(5). For the definition of member of the family, see §25.2702-2(a)(1).")

Where does this amalgamation of Code and regulatory references leave us? ***If*** the reference to the "persons" who hold control in Reg. §25.2701-2(b)(5)(i) applies for purposes of determining who is a "member of the transferor's family" in §2704 (despite the specific somewhat different definition of "member of the family" in §2704(c)(2)), some differences will apply:

> Therefore, for purposes of control, all ancestors and spouses of ancestors of the transferor and transferor's spouse as well as nieces and nephews are included, but aunts, uncles, **and spouses** of any generation **the same** or below the transferor or transferor's spouse (which would include spouses of children of each or both of them) are not included. Melissa Willms, *Practical Inter Vivos and Testamentary Estate Planning: Helping Our Clients in a High Exemption World*, 51st ANNUAL SOUTHERN FEDERAL TAX INST. T-59 n.61 (September 2016).

In particular, nieces and nephews are included in the Reg. §25.2701-2(b)(5)(i) definition for control purposes, but aunts, uncles and cousins as well as spouses of persons in the same or lower generation than the transferor are not included.

Member of the Family. Section 2704(b) applies only for certain transfers to "members of the transferor's family." For that purpose, the references in Reg. §25.2701-2(b)(5)(i) to family members who are included in determining who has control under §2701 clearly do not apply, so the definition of "member of the family" in §2704(c)(2) applies. This definition is generally narrower than the definition for purposes of who is considered for control purposes (*e.g.*, nieces and nephews and their descendants are not included), and but in other ways is more expansive (*e.g.*, spouses of described persons who are in the same or lower generation than the transferor are included).

See Item 3 of "Planning Implications" below for a discussion of the significance of these definitions in representing descendants of entities founded by ancestors (in particular, Gen III or more remote owners are likely not subject to §2704. Even under the broader scope of the Reg. §25.2701-2(b)(5)(i) test (if it applies), many "Generation III" entity owners will not be treated as having "control" and will not be subject to §2704.

2. **Section 2704(a) Lapses (Assignee and Three-Year Rules)**. The rules regarding lapses under §2704(a) (which treats lapses of voting or liquidation rights as deemed transfers) are revised in three ways. First, the regulations describe broadly (i) the types of entities subject to §2704(a) and (ii) the family's ability to liquidate an interest and the manner in which liquidation may be achieved for purposes of the exception in Reg. §25.2704-1(c)(2)(i) (which excepts from §2704(a) situations in which the family cannot compel liquidation after the transfer). Prop. Reg. §25.2704-1(a)(1), (a)(2)(i), (a)(2)(ii), (a)(4).

   Second, a transfer to an "assignee" is subject to §2704(a) (even if the transferor can continue to exercise the voting or management rights associated with the interest transferred to the assignee). Prop. Reg. §25.2704-1(a)(5). Assignees would also be subject to the new "disregarded restrictions" rules of §2704(b) (because they do not have "put" rights), but the new "disregarded restrictions" regulations do not specifically refer to assignees. The regulations do not address whether an exception would exist if the transferee is very quickly (perhaps even by pre-arrangement) accepted as a substitute partner by the remaining partners. (Various comments to the IRS have requested such an exception.)

   Third, and most important, a new three-year rule will apply to certain transfers made within three years of death. Prop. Reg. §25.2704-1(c)(1), (c)(2)(i)(B), (f)Exs. 4 & 7. The existing regulations include an important exception, providing that a transfer that results in a loss of a voting right or liquidation right for the transferor will not constitute a lapsed right subject to §2704(a) if the "rights with respect to the transferred interest are not restricted or eliminated." Reg. §25.2704-1(c)(1). For example, if an individual owns 84% of the stock of a family controlled company that requires 70% vote to liquidate, and if the individual gives 14% to each of three children (leaving the individual with 42%), §2704(a) will not apply, even though the individual has lost the right to force the liquidation of the company, because the voting rights with respect to the corporation are not restricted or eliminated. Reg. §25.2704-1(f)Ex. 4. This allows the very common practice of donors giving or selling minority interests leaving the transferor with a minority interest, in effect converting a controlling interest into various minority interests for transfer tax purposes (as recognized in Rev. Rul. 93-12). The IRS views that as an abusive transaction when done on an individual's deathbed (citing *Estate of Murphy v. Commissioner*, T.C. Memo. 1990-472). Under the proposed regulation, the special exception will not apply under a three-year rule. The three-year rule treats any transfer within three years of death, which transfer results in the transferor losing a liquidation or voting right, as a deemed transfer of the lapsed voting or liquidation power even though rights associated with the ownership of the transferred interest are not restricted (for example, children who receive gifts of stock continue to have the right to vote the stock). Accordingly, any transfers of interests in family-controlled entities made within three years of death that result in a loss of the ability to force the liquidation of the entity [such as a transfer of a minority interest that leaves the transferor with an interest below the level required to be able to force liquidation of the entity] will result in a deemed transfer of the value of the lapsed voting or liquidation right at the transferor's death if the donor dies after the regulations are finalized. (This "phantom asset" value would be included in the transferor's gross estate and would not qualify for a marital or charitable deduction.)

Determining If Individual Holds Liquidation Right. Section 2704(a) and the new three-year rule only applies if an individual holds a sufficient interest to give the person the right to force the liquidation of the entity and transfers enough of the interest so the person can no longer force the liquidation of the entity (and if the family controlled the entity before and after the transfer). For this purpose, consider the *actual* rights the holder has under the governing documents and state law. For example, if the individual holds 90% of the stock but the documents require unanimous consent of shareholders to liquidate, the individual does not hold a liquidation right and §2704(a) does not apply. The fact that the family imposed a more rigorous requirement than state law would otherwise have provided (often 50% or two thirds) is irrelevant. Section 2704(b) and its provisions ignoring "applicable restrictions" (restricting the right to liquidate the entity) do not apply for purposes of determining if the individual initially holds a liquidation right for purposes of section 2704(a). (The proposed regulations make clear that §2704(b) applies for purposes of determining the ability to liquidate but only with respect to the special exception that applies under Reg. §25.2704-1(c)(2)(i) if the family cannot force liquidation after the transfer.)

Determining Amount of Lapsed Value Included in Gross Estate. How this three-year rule works mechanically under the regulations is unclear. Perhaps the intent is to include the lapsed liquidation value with respect to the transferor's remaining assets and the transferred assets in the gross estate. Howard Zaritsky (Rapidan, Virginia) offers this example as a logical interpretation of the three-year rule (although he adds "what the IRS will ultimately say is anyone's guess"):

> If I own 100% of the stock of ACME and give my three hypothetical children 20% blocks each, Section 2704(a) does not currently apply, because the right to liquidate has not lapsed; it has just been divided among the four shareholders. Under the proposed regs, however, if I die within three years, the right to liquidate is now deemed to have lapsed at my death, and my gross estate should include the difference between 100% of the stock (no discount) and 40% of the stock (discounted). In effect, the estate tax base eliminates the discount on the 40% I retained, and recaptures the discounts on the 60% I transferred.

A calculation uncertainty exist as well in determining the amount of the deemed transfer. Even though a deemed lapse of a liquidation right may occur at the transferor's death if the transferor dies within three years, the *amount* of the deemed transfer is calculated (under existing regulations) by comparing the value of all interests in the entity owned by the holder before the lapse (as if the lapsed right were nonlapsing) with the value of those interests immediately after the lapse "(determined as if all such interests were held by one individual)." Treas. Reg. §25.2704-1(d).

In determining the amount of the value of the deemed lapsed liquidation value, are values on the date of the gift or on the date of death used? The proposed regulation is unclear. Also, are applicable restrictions and disregarded restrictions ignored in determining the value of the interests immediately after the lapse (since §2704(b) applies "for purposes of subtitle B (relating to estate, Gift and generation-skipping transfer taxes), *see* Prop. Reg. §§25.2702(a) (first sentence) & 25,2704-3(a) (first sentence, *and* §2704(b)(1)) when transferred interests are being valued and §2704(a) is in subtitle B).

Double Counting With Transfers That Are Disregarded Restrictions? Such transfers will often also be subject to §2704(b) under the new "disregarded restrictions" provisions of the proposed regulations; how these two sections will apply in coordination with each other to avoid taxing the same "liquidation value" multiple times is not addressed in the proposed regulations. Howard Zaritsky offers a logical explanation of how the interaction should work, based on the example quoted above:

> If, however, Section 2704(b) denied me the discounts on the interests I gave my children, because of the deemed right to liquidate the entity or the interests, then there should be no additional amount included in my gross estate under Section 2704(a), because there would be no difference between the value of the 60% and the 40% interests (with their put rights), and the value of the 100% I had before the transfer.

No provisions in the proposed regulations, however, state that the deemed lapse under §2704(a) if the transferor dies within three years would not apply if the liquidation value was effectively already taxed because of the new "disregarded restrictions" rules. Assuming the regulations are clarified to avoid taxing the same liquidation value at the time of the transfer and at the time of death, the three-year rule may become relatively unimportant in light of the wide application of the new disregarded restrictions rules. On the other hand, if the disregarded restriction rules are interpreted not to value interests as if a deemed put right exists, the new three-year rule under §2704(a) may be the most important change under the proposed regulations.

3. **Restrictions "Imposed or Required to Be Imposed" - Change From Default to Mandatory Rule**. Restrictions (including both "applicable restrictions" on the ability to force liquidation of the entity (in whole or in part) and "disregarded restrictions" on the ability to force the liquidation of the transferor's interest in the entity [described below]) that are disregarded under §2704(b) in valuing an interest in an entity include restrictions imposed under the governing documents *and* default restrictions imposed under local law that can be superseded by the governing documents (i.e., any default state law restrictions that are not mandatory). Even mandatory restrictions are disregarded if they apply only to family-controlled entities or if state law provides an optional or alternative statute for the creation of "that same type of entity" that do not include the mandated restriction. Prop. Reg. §§25.2704-2(b)(2), (b)(4)(ii), (e) (regarding applicable restrictions); 25-2704-3(b)(2), (b)(5)(iii) (regarding disregarded restrictions). The proposed regulations clarify that the "Federal or State law" referenced to in the exception does not include the laws of foreign jurisdictions. Prop. Reg. §§25.2704-2(b)(4)(ii) & 25.2704-3(b)(5)(iii).

   These provisions are important because state laws generally provide that limited partners in a partnership that last for a fixed term have no right to withdraw before the end of that fixed term. Many states have revised their statutes to allow the liquidation of the entity only on the unanimous vote of all owners (unless the governing documents provide otherwise) and to restrict partners from withdrawing from the entity unless the partnership agreement provides otherwise. The typical default rule in LLC statutes similarly is that members do not have the right to withdraw unless allowed in the operating agreement. The 2001 version of the Revised Uniform Limited Partnership Act and the Uniform Limited Liability Company Act address the power of a limited partner or member to "disassociate" but do not give the owner a "put right" to receive fair value upon disassociating; instead the owner merely becomes a "transferee" (similar to the concept of an "assignee"). Limited partnerships and LLCs are often structured in accordance with these state law default rules, so the ownership interests are valued taking into account that the limited partner or member has no withdrawal rights, which typically leads to discounts. Under the proposed regulations, because the state law restriction on withdrawal is not a mandatory requirement, restrictions in documents that are no more restrictive than those state law provisions will no longer be given effect in valuing the transferred interest.

4. **Disregarded Restrictions—General Description**. Section 2704(b) refers to "applicable restrictions," which term has been construed to refer to a limitation on the ability to force the liquidation *of the entity*, in whole or in part. (*Kerr v. Commissioner*, 113 T.C. 449. 473 (1999), *aff'd on other grounds*, 292 F.3d 490 (5th Cir. 2002)). A new category of "disregarded restrictions" applies to restrictions on the ability to force the liquidation or redemption of an *interest in the entity*. The "disregarded restrictions" rules may be interpreted to provide effectively that entity transfers will be valued as if the transferred interest had a deemed put right to sell the interest to the entity at any time on six months' notice if the family (determined under detailed rules summarized in paragraph 6 below) had the ability to cause a put right to exist. Under that interpretation, these provisions will significantly reduce (or eliminate) lack of control discounts for transfers of interests in family-controlled entities.

   a. **Definition of Disregarded Restrictions**. The legislative proposal to amend §2704 referred to "limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations." Based on that proposal, many had expected a list of the *kinds* of restrictions that would not be given effect in valuing entity transfers (for example, the imposition in governing documents of a 70% vote to liquidate the entity). Instead, the regulation describes "disregarded restrictions" by reference to their *effect* on the ability of the holder to compel the redemption of his or her interest (i.e., anything that has the effect of limiting the holder's ability to liquidate the interest at a described value, at a described time, and for a described type of consideration).

   > That linguistic tactic may be bold, or it may be unfortunate, but in any event it was not something the estate planning community seemed prepared for. It has proven so far to be a provocative choice. Ron Aucutt, *Proposed 2704 Regulations Are Significant, But Not a Disaster*, LEIMBERG ESTATE PL. NEWSLETTER #2456 (September 28, 2016).

   A disregarded restriction is one that does one or more of the following things:

   (a) the provision limits the ability of the holder of the interest to compel liquidation or redemption of the interest [observe that this could be interpreted VERY broadly, to include any transfers without a put right if the family could have forced inclusion of a put right unless state law *mandates* that the holder could not possibly have the ability liquidate his or her interest];

   (b) the provision limits liquidation proceeds to less than a "minimum value" (defined as a pro rata share of the "net value of the entity" – defined as the net value of property held by the entity less outstanding obligations of the entity that were incurred for consideration in money or money's worth (referencing §2053);

   (c) the provision defers payment of the liquidation proceeds for more than six months; **OR**

   (d) the provision permits payment of the liquidation proceeds other than in cash or other property (in particular, for a note from the entity or family members unless the note is (i) consideration for payment with respect to an entity that is in an active trade or business, (ii) attributable to active trade or business assets, (iii) that is adequately secured, (iv) with periodic payments, (v) at "market interest rates," (which presumably would not be the AFR) and (vi) that has a fair market value (when discounted to present value) equal to the liquidation proceeds). Prop. Reg. §25.2704-3(b)(1).

A one sentence summary is as follows:

> A "disregarded restriction" is defined as a provision of the governing documents or applicable law that limits the ability of the holder to compel liquidation or redemption of an interest on no more than six months' notice for cash or property equal at least to what the proposed regulations call "minimum value." Ron Aucutt, *Proposed 2704 Regulations Are Significant, But Not a Disaster*, LEIMBERG ESTATE PL. NEWSLETTER #2456 (September 28, 2016).

A transfer of an interest that is subject to a disregarded restriction will be valued under generally accepted valuation principles "as if the disregarded restriction does not exist in the governing documents, local law, or otherwise." Prop. Reg. §25.2704-3(f).

b. **"Silent Limitations"; Deemed Put Right?** The regulations do not include specific examples of corporations or limited partnerships or LLCs that are merely ***silent*** on the ability of a shareholder, limited partner, or member to withdraw and have the interest redeemed by the entity. Will interests in such entities will be treated the same as entities with explicitly stated limitations on the ability of the holder to liquidate the interest? For example, what is the difference between a corporation that explicitly states in governing documents that shareholders have no right to be paid for their stock on six months' notice and corporations without such explicit restrictions but that have no requirement under state corporate law principles to redeem shareholders' stock on six months' notice?

A similar issue is what analysis applies if a liquidation restriction in an agreement is a "disregarded restriction" and the transfer is valued as if the restriction "does not exist in the governing documents, local law, or otherwise."

Example 1 in the proposed regulations illustrates this issue. Under the example, D owns a 98% limited partner interest and his two children own the 2% general partner interests. The partnership agreement prohibits withdrawal of a limited partner for 50 years. Under local law, a limited partner may withdraw as specified in the partnership agreement, and the approval of all partners is needed to amend the agreement (but neither of these provisions is mandatory). D transfers 33% limited partner interests to each of D's two children. The example states that

> [b]y prohibiting the withdrawal of a limited partner, the *partnership agreement* imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law…. Therefore, … *the restriction* … is disregarded in determining the value of each transferred interest. Accordingly, the amount of each transfer is the fair market value … determined under generally accepted valuation principles taking into account all relevant factors affecting value including the rights determined under the governing documents *and local law* and assuming that the disregarded restriction does not exist in the governing documents, *local law*, or otherwise. Prop. Reg. §25.2704-3(g) Ex.1 (emphasis added).

How far does the reference to "local law, or otherwise" extend? Does "the restriction" that is disregarded refer only to the express prohibition on withdrawal under the agreement or to all limitations under local law on the ability to liquidate the interest (i.e., "silent limitations")? The last sentence quoted above says to value the interest taking into account rights under the governing documents and local law, but assuming the disregarded restriction "does not exist in the governing documents, local law or otherwise." By assuming the "disregarded restriction" (i.e., the limitation on the ability to compel liquidation or redemption of the interest) does not exist in local law, does that require an assumption that local law does afford a right to compel liquidation (particularly in light of the change to recognize only mandatory restrictions in the "imposed or required to be imposed by Federal of State law" exception because nothing in local law prohibits an entity from being able to redeem owners' interests in entities)? The example is obviously **quite unclear** about the result; is the interest valued (i) as if there is no *prohibition* on withdrawal but as if there is no *right* to withdraw and be paid the minimum value (in which event lack of control discounts and lack of marketability discounts would still be appropriate, but not as high as if a prohibition on withdrawal existed), or (ii) as if local law affirmatively grants a right to compel redemption at the minimum value (in which event lack of control and marketability discounts would be substantially lower if not eliminated)?

The regulations contain no example in which the agreement has no express prohibition on withdrawal or right of withdrawal, and local law merely provides that a limited partner may withdraw as provided in the agreement, and therefore the governing document and local law are silent regarding the right to withdraw. Is that silence treated as a limitation of the "ability … to compel liquidation or redemption of the interest"?

The preamble to the regulations similarly do not clarify whether the absence of a redemption right under state law is a limitation on the ability to compel liquidation of redemption that is a disregarded restriction. The section of the preamble to the proposed regulations regarding "applicable restrictions" states that the value is determined "as if the governing documents and the local law are silent on the question … and thus, there is deemed to be no such restriction on liquidation of the entity." The section of the preamble to the proposed regulations regarding "disregarded restrictions" states that the value is determined under "generally accepted valuation principles*, including any appropriate discounts or premiums*" (emphasis added) as if the restriction does not exist.

The regulations provide that the source of limitations on the ability to liquidate an interest can include restrictions in governing documents "and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise." Prop. Reg. §25.2704-3(b)(2); *see also* Prop. Reg. §25.2704-2(b)(2) (identical provision with respect to applicable restrictions). Similarly, the regulations address the statutory exception for restrictions "imposed, or required to be imposed by Federal or State law":

> A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. Prop. Reg. §25.2704-3(b)(5)(iii).

If local law does not give the owner a right to be redeemed, that could be interpreted as a "limitation on the ability of the holder of the interest to compel liquidation or redemption of the interest" even though the governing documents could grant such a right.

If the regulations are interpreted to include silent limitations, is a different result reached for a statute that provides for withdrawal as provided in the agreement (which is typical for partnerships or LLCs) than for a statute that is totally silent regarding an owner's right to be redeemed (which is typical for corporations). If a difference exists, states may revise their partnership and LLC statutes to delete any reference to a right of withdrawal so that state law is totally silent on the issue.

***Reasons Supporting Deemed Put Right Assumption*.** Various reasons support an interpretation of the regulation to apply to silent limitations on the ability of an owner to liquidate his or her interest in the entity, and to value the interest as if it has a deemed put right.

- The Uniform Limited Partnership Act in 1990 (when §2704 as enacted) generally gave limited partners the right to withdraw and receive "fair value" (except for fixed term partnerships). The regulations stated that restrictions that were no more restrictive than local law would be respected. As long as local law gave limited partners a withdrawal right, restrictions on that right would be disregarded under §2704. The preamble to the proposed regulations states that the amendment of state laws to remove the right of withdrawal (and state that a limited partner has the right to withdraw only as provided in the governing documents) is one of the reasons that "the current regulations have been rendered substantially ineffective." This suggests an intent that any restriction on a partner's right to compel redemption of his interest would be ignored.
- The disregarded restrictions provision may have very little impact on valuation if they are not interpreted to value transferred interests as if a six-month put right at minimum value exists (see Paragraph 8 below). Did the IRS go to all this trouble and effort to enact new concepts and provisions under §2704 that have very little practical impact?
- The proposed regulations provided that interests will be valued as if disregarded restrictions do not exist "under local law, or otherwise." Is the lack of a put right under local law a restriction on the "ability … to compel … redemption" of the interest? What do the extremely broad words "or otherwise" refer to?
- The revised interpretation of the "imposed or required to be imposed by … State law" exception to refer only to mandatory restrictions suggests that any limitations on the right to be redeemed that are not mandatory (such an absolute prohibition on an entity from redeeming owner's interests for specified periods of time) would not be given effect. Accordingly, if the family could agree to grant a put right (because local law does not prohibit such an agreement), the interest would be valued as if there were a put right.
- The provisions of the legislative proposal to amend §2704 were generally implemented in the proposed regulations. The legislative proposal about the additional category of disregarded restrictions provided that transferred interests would be valued by substituting for "disregarded restrictions certain assumptions to be specified in regulations." Interpreting the regulations to

provide an assumption of a deemed put right would seem to be consistent with the IRS's intent as expressed in that legislative proposal.

- The proposed regulations contain various exceptions, one of which is if all of the holders of the entity have a put right on six months' notice at the minimum value. This might suggest that the safe harbor provision is an illustration of how to satisfy the disregarded restrictions provision for any particular holder.
- Commentators have interpreted the proposed regulations to have a deemed put right assumption, based on the new interpretation of the "imposed or required to be imposed by … State law" exception. *See A Stealth Death Tax Increase,* Wall Street J. (Editorial, September 6, 2016); Mitchell Gans & Jonathan Blattmachr, *Recently Proposed Section 2704 Regulations*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2441 (August 5, 2016) ("What would be the outcome in Example 1 if the partnership agreement had been silent on the put-right issue? Assuming no mandatory provision in state or federal law precluding the partnership from granting a put right, and it is difficult to imagine such a provision under state or federal law, the failure to include a put right would presumably be disregarded.") [Interestingly, basing the "deemed put right" on the revised interpretation of the "imposed or required to be imposed by … State law" exception means that a deemed dissolution right would also exist. The definition in the regulations of an applicable restriction is also very broadly stated as "a limitation on the ability to liquidate the entity" and the revised interpretation of the "imposed or required to be imposed" exception applies to applicable restrictions as well as disregarded restrictions.]

Reasons Rejecting Deemed Put Right Assumption. The more likely result is that the proposed regulations do not value interests in entities as if they had a deemed put right. Ron Aucutt (Tysons Corner, Virginia) is firmly convinced that the proposed regulations do not value all entity interests as if they held a deemed put right and responds to the arguments listed above in favor of such an interpretation of the proposed regulations.

- The UPLA history may have suggested a "wish," but in the absence of legislation, the IRS backed off and only "disregards" "restrictions."

- The proposed regulations may have less impact than expected; the IRS tried but failed to get legislative authority to do more.

- The Greenbook proposals reflect that while the IRS sought legislation that would substitute certain assumptions for disregarded restrictions, they did not get that authority and did not do that in the proposed regulations.

- The all-holders-put safe harbor has nothing to do with the interpretation of a "disregarded restriction" as such.

After announcing the project to provide additional regulations under §2704 in 2003, the Obama administration's first budget proposal included a proposal to amend §2704 that, among other things, would create an additional category of restrictions ("disregarded restrictions") that would be ignored, and "the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations." Based on this history, Ron Aucutt speculates that the IRS may have wanted to restrict discounts dramatically, but came to the conclusion that it did not have the legislative authority to do so:

> Now section 2704(b)(4) says nothing about substituting affirmative assumptions for the "other restrictions" that may be disregarded.
>
> …
>
> In fact, a true "minimum value" for transfer tax purposes or a corresponding "deemed put right" may very well have been the kind of substituted valuation assumption for which, along with certain safe harbors, the Greenbooks had unsuccessfully sought legislative cover. But without such legislation, it should be clear that Treasury couldn't, and the proposed regulations don't provide an assumption like a "deemed put right" which would exceed the limited authority granted by section 2704(b)(4). Ron Aucutt, *Proposed 2704 Regulations Are Significant, But Not a Disaster*, LEIMBERG ESTATE PL. NEWSLETTER #2456 (September 28, 2016).

Mickey Davis (Houston, Texas) has analogized that the provision acts as an "eraser, not a pencil." Disregarded restrictions are merely "erased," and the proposed regulations do not "write in" additional rights or assumptions to determine the value of transferred interests.

Factors suggesting that no such "deemed put right" assumption is intended in the proposed regulations include the following.

- The "clincher" in Ron Aucutt's opinion is that the statutory authority in §2704(b)(4) for the regulations providing for this special category of restrictions beyond the "applicable restrictions" described in the statute merely states that "other restrictions shall be *disregarded*" and says nothing about assuming other rights to exist.
- The preamble to the proposed regulations regarding "disregarded restrictions" states that the value is determined under "generally accepted valuation principles*, including any appropriate discounts or premiums.*"
- The definition of what constitutes a disregarded restriction in Reg. §25.2704-3(b)(1)(i)-(iv) lists restrictions described in any of those sub-paragraphs, each of which begins with: "The provision …." A reference to a "provision" suggests something more explicit than the mere absence of legal principles giving an owner an absolute right of redemption, which absence could therefore be construed as "a limitation" of the right to compel redemption.
- Nothing in the proposed regulations explicitly states that "silent" limitations under state law on the ability of a holder to force redemption of his or her interest (i.e., the absence of an affirmative right to be redeemed at the owner's election) is a disregarded restriction. Nothing in the regulations refers to valuing an interest as if a deemed put right exists. To the contrary, the preamble to the proposed regulation states that ["f]air market value is determined under generally accepted valuation principles, *including any appropriate discounts or premiums*, subject to assumptions described in this paragraph." Valuing transfer interests as if an assumed deemed put right exists is a huge valuation change, and if the IRS had intended that bold change, it would have included a specific example clearly illustrating this requirement.

- The discussion in the proposed regulations about the source of limitations includes any restriction in "governing documents … and a *restriction imposed* under local law [unless mandatory]." Prop. Reg. §25.2704-3 (Emphasis added.) Reference to a "restriction imposed" by local law seems to connote something more explicit than just the absence of a redemption right.
- Example 1 (quoted above) states the "the restriction" is disregarded, and that appears to refer to the express provision in the partnership agreement prohibiting withdrawal. In explaining the effect of disregarding *that* explicit restriction, the example does not clearly state that the absence of a right of redemption under state law is also a restriction that must be disregarded.
- "[M]erely ignoring an explicit prohibition is not the same as bestowing a unilateral right; the holder still needs to negotiate a deal." Ron Aucutt, *Proposed 2704 Regulations Are Significant, But Not a Disaster*, LEIMBERG ESTATE PL. NEWSLETTER #2456 (September 28, 2016).
- The fundamental starting point of valuation for transfer tax purposes is first to determine what rights exist under state law and then to value those rights. *See Aldrich v. United States,* 346 F.2d 37 (5th Cir. 1965) ("It is now well established that state law is determinative of the rights and interests in property subject to federal estate taxation. In *Morgan v. Commissioner*, … the Supreme Court said … : 'State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.' … The courts must determine the substance of the state property law provisions and apply the estate tax provisions to the property interests so determined.")
- Perhaps most important, government officials have indicated informally in public presentations that the disregarded restrictions provisions in the proposed regulations merely disregard express restrictions on a holder's ability to compel the entity to redeem a holder's interest, and do not value interests as if there is a deemed put right.
- If only express restrictions are disregarded, examples would include a provision in a partnership agreement prohibiting the withdrawal of limited partners for a specified period of time (the Example 1 scenario) or an agreement giving the entity a call right at less than minimum value (for example, a call right at fair market value).

5. **Disregarded Restrictions—Minimum Value**. Provisions in the preamble and the proposed regulations suggest that the "minimum value" rules do not restrict the "net value of the entity" to the mere liquidation value of the entity's assets. The minimum value rule cross-references other regulations to make clear that the net value of the entity for operating businesses is not limited to the liquidation value of the hard assets of the entity, but also considers factors including the entity's earning capacity, economic outlook of the industry, the company's position in the industry and its management. (See Paragraph 8 below.) Presumably, the net value of the entity's assets would take into consideration appropriate undivided interest discounts of any undivided interests held by the entity and perhaps lack of marketability adjustments as well (although marketability

discounts are traditionally considered at the level of determining the value of an owner's interest in the entity because that is the only asset typically being valued). Considering the company's earning capacity rather than its asset value will not always lead to a higher "minimum value." The net value of the business may be less than the liquidation value of its assets for ongoing businesses that have no intention of liquidating. *See Giustina v. Commissioner*, T.C. Memo. 2016-114 (basing value on ongoing entity value of forestry operation under cash flow method even though the timber asset value of the entity was much larger).

The definition of "minimum worth" states that "the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate." The reference to §2053 creates uncertainty. Limitations apply on the deductibility under §2053 for contingent or uncertain obligations or guarantees. Does the proposed regulation's reference to "(if paid)" mean that the value of such contingent obligations can be considered despite the limitations under §2053 for deducting such claims until actually paid?

One appraiser (Curtis R. Kimball, national director for wealth management valuations at Willamette Management Associates) points out (his personal opinion) how important this §2053 issue will be in valuations:

> Only certain obligations allowable under §2053 are counted. In valuing a business that sells goods and services, business analysts routinely incorporate estimates of the impact of risks and other unbooked obligations and exposures. Are these to be ignored? For C corps, are built-in gains to be ignored?

If the proposed regulations are interpreted not to value interests as if a deemed put right exists, the minimum value concept may have little relevance. If an express restriction on being able to redeem one's interest in an entity does not exist (either in the governing documents or in express state law provisions), the "minimum value" of the interest will be irrelevant if the regulations do not value the interest as if it has a deemed put right at the minimum value.

6. **Disregarded Restrictions—Ability of Family to Remove Restriction**. One of the requirements for treating a liquidation restriction as an applicable restriction (that is disregarded in valuing the interest) is that the restriction later lapses or the family can remove the restriction. The Fifth Circuit in the *Kerr* case reasoned that §2704 did not apply to the partnership in that case because charities had small limited partnership interests, and all partners had to consent to removing restrictions; thus, the family acting alone could not remove the restrictions. *Kerr v. Commissioner*, 292 F.3d 490, 494 (5th Cir. 2002). The preamble cites *Kerr* in reasoning that taxpayers have avoided §2704(b) by transferring a nominal partnership interest to a nonfamily member, such as a charity or employee, "to ensure that the family alone does not have the power to remove a restriction." The preamble says that non-family members will be recognized only if "the interest is an economically substantial and longstanding one that is likely to have more substantive effect."

   In determining if the transferor's family can remove a restriction (or stated otherwise, has the ability to impose a right to sell the interest to the entity), any interest held by a non-family member will disregarded if *any* of the following situations exist:

(a) the interest has been held for less than three years;

(b) the interest is less than 10% of the value of all equity interests (or capital and profits interests in an entity other than a corporation);

(c) all non-family members hold less than 20% of all equity interests (or capital and profits interests in an entity other than a corporation); OR

(d) the non-family member does not have a put right to receive the "minimum value" on no more than six months' notice. Prop. Reg. §25.2704-3(b)(3)-(4).

In reality, non-family owners would almost never satisfy all of those conditions; almost no business arrangement gives a put right to owners as described in sub-paragraph (d) above. As a practical matter, involving an unrelated third party in the entity merely to avoid the "disregarded restrictions" rule is unworkable. (Interestingly, the same limitation regarding whether unrelated persons are considered in determining whether restrictions can be removed does not apply to "applicable restrictions.")

7. **Exceptions: Safe Harbor Put Right; Commercially Reasonable Restriction**. A liquidation restriction will not be an "applicable restriction" or "disregarded restriction" if the following conditions apply:

(a) *every* owner has an enforceable "put right" to sell the interest to the entity or other owners [presumably, the reference to sales to owners refers to a constructive redemption transaction made directly with the other owners, because "disregarded restrictions" are limitations on the ability to "liquidate or redeem," not restrictions on selling to other owners] for cash and/or other property at least equal to the "minimum value";

(b) the payment must be made within six months of exercise of the put right; AND

(c) payment is not in the form of a note except for certain types of notes as described in sub-paragraph 4(d) above. Prop. Reg. §25.2704-2(b)(4)(iv) regarding applicable restrictions); §25.2704-3(b)(v), (b)(6) (regarding disregarded restrictions).

This safe harbor will likely have very limited practical usage. Entities are very unlikely to give all owners a six-month put right at "minimum value."

A commercially reasonable restriction imposed by unrelated persons (referencing relationships described in §267(b)) providing capital to the entity for its trade or business operations (whether in the form of debt or equity) are not applicable restrictions or disregarded restrictions. Prop. Reg. §§25.2704-2(b)(4)(i) (applicable restrictions); 25.2704-3(b)(5)(ii) (disregarded restrictions). (A similar exception exists for applicable restrictions under the existing regulations. Reg. §25.2704-2(b).) This may be a very important exception for companies with active business activities. Banks often require various covenants including restrictions on redeeming owners' interests as a condition of making loans to businesses. If the exception applies, restrictions under such covenants could be considered in valuing the owners' interests for transfer tax purposes. Otherwise, some unrelated owners may not be able to avoid the disregarded restriction provisions. (For example, in a 50-50 entity, each owner would be deemed to have control [for purposes of being a family-controlled entity and for purposes of satisfying the "ability to remove the restriction" requirement because regulations use "at least 50%" as the test for control.) The commercially reasonable exception is now described in terms of restrictions required in connection with the provision of capital for trade or business operations. Commercially reasonable restrictions may apply in other contexts as well (for example, restrictions on franchisees), and perhaps the final regulations will broaden the exception beyond just the provision of capital to an entity.

8. **Determining Value If §2704(b) Applies**. If an applicable restriction is disregarded, "the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the State law that would apply but for the restriction." Reg. §25.2704-2(c) (which will become §25.2704-2(e) after the proposed regulations are finalized). The wording is somewhat different for valuing interests subject to disregarded restrictions:

> If a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise. … Prop. Reg. §25.2704-3(f).

The section of the preamble to the proposed regulations regarding "applicable restrictions" states that the value is determined "as if the governing documents and the local law are silent on the question … and thus, there is deemed to be no such restriction on liquidation of the entity." The section of the preamble to the proposed regulations regarding "disregarded restrictions" states that the value is determined under "generally accepted valuation principles*, including any appropriate discounts or premiums*" (emphasis added) as if the restriction does not exist.

None of the examples address how discounts or premiums would apply or discuss the valuation of interests in an active trade or business entity vs. an entity that merely holds passive investment assets. The preamble's discussion of the "minimum value" rule states that "if the entity holds an operating business, the rules of §20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer. (Those regulations refer to various factors including the earning capacity of the business.)

One appraiser concurs that determining the "minimum value" involves considerations beyond just the liquidation value of the entity's assets:

> Many attorneys will assume that minimum value is just net asset value under a premise of orderly liquidation, but it is not. The fair market value of "property" owned by the company has to be valued. Does this include unidentifiable intangible assets implied by a capitalization of earnings or unallowable personal goodwill or self-created intangibles? … The IRS definitions and standard of minimum value for new §2704 appears to me to bear an uneasy and unclear relationship with the regulations under Regulation §§20.2031-2, 20.2031-3, 25.2512-2 & 25.2512-3 that the IRS refers to. Curtis R. Kimball, Willamette Management Associates (his personal opinion).

a. **Valuation If Regulations Assume Holder Has Six-Month Put Right at Minimum Value**. Particularly for disregarded restrictions, these provisions create considerable uncertainty as to what assumptions the appraiser would make in valuing the business "under generally accepted valuation principles." If the proposed regulations are interpreted to value interests as if the holder of the transferred interest has a six-month put right, to be paid in cash or property, should the appraiser assume that all owners have six-month put rights when valuing the business? Even if the value should be determined assuming that only the transferred interest has a six-month put right for cash or property, would the company have to keep cash and assets on hand to fund the liquidation when requested, thus reducing available capital and increasing borrowing requirements? (For valuing a large percentage interest in an entity, assuming that the entity must keep cash or property on hand to be able to fund a redemption on six months' notice could significantly depress the value of the entity.)

One planner frames the issue this way – "What is a company worth in which all of the shareholders can (in theory) take their share at any time? How could there be comparables? No such third party operating businesses exist." Other planners have asked whether a "lack of continuity discount" would be applied.

One expert appraiser has raised various questions about how the value would be determined under "generally accepted valuation principles" in this hypothetical situation, and the impracticality of valuing the company under these assumptions:

> Let us assume a significant minority of the company shareholders prefers cash while the majority is content to hold shares. If suddenly one-third of the family wants to be cashed out what will happen? Most companies, will not have enough spare cash to honor but a small fraction of this demand. Accordingly, they would have to borrow either from a bank or provide the sellers with a note at a market interest rate.
>
> …
>
> Meanwhile, the company's existing bank lender will be none too happy about the redemptions and increased subordinated debt. In fact, such redemptions may well be prohibited by the company's existing loan agreements. If such is the case, is this an acceptable restriction under the Proposed Regs?
>
> Assuming they can borrow for this purpose at all, it would push the company into a higher risk category since these borrowings will diminish the company's ability to borrow for working capital or capital expenditure needs. The greater risk means the company's cost of equity must also rise. These two negative developments will drive up the company's cost of capital and drive down its value.
>
> …
>
> Of course, this is a fictional scenario since no operating company, family-owned or otherwise, has ever enacted such a nonsensical policy. So, in reality, if the Proposed Regs are finalized as produced, valuation for tax purposes will have no connection to the reality of values in the marketplace. Taxpayers will be taxed on a theoretical value that is impossible even in the theoretical world.
>
> …
>
> A company which gave its employees a put right as the regs suggest would probably have to book this contingent liability similar to an unfunded pension liability. It would devastate the company's balance sheet.
>
> William H. Frazier (Stout Risius Ross, Inc.), *Musings on the Theoretical Redemption Rights in Proposed Regulation 163113-02* (Aug. 8, 2016).

Two Step Process. Valuation issues are involved in two separate steps for disregarded restrictions: (i) in valuing the "minimum value" (which is a pro rata portion of the net value of the entity) price for the assumed six-month put option, Prop. Reg. §25.2704-3(b)(1)(ii), and (ii) in valuing the holder's interest in the entity under generally accepted valuation principles (even with the assumed six-month put option at minimum value), Prop. Reg. §25.2704-3(f).

Lack of Control Discounts. The major impact will be to restrict (or perhaps eliminate in some cases) a lack of control adjustment if the owner is deemed to have a six-month put right at the "minimum value." Even with that limitation, some appraisers have suggested that a lack of control discount would still be available for lack of control over day-to-day operations (about 10%) and for the six months delay in receiving the liquidation payout (about 5%).

Lack of Marketability Discounts and Other Discounts. Even though the holder is deemed to have the ability to liquidate its interest, lack of marketability discounts still would seem appropriate, in both of the two steps, to the extent that marketability delays would exist in selling the entity's assets (Step 1-minimum value determination) or in selling the transferor's interest in the entity (Step 2). *See, e.g., Estate of Jameson v. Commissione*r, T.C. Memo. 1999-43 (marketability discount allowed for valuing 98% interest in corporation, based on the nature and marketability of the corporation's assets; low marketability discount allowed because the major assets [timberland] "would sell within a few weeks after being placed on the market"), *rev'd on other grounds*, 267 F.3d 366 (5th Cir. 2001). In determining the value of the transferred interest in the second step, the marketability discount may be lower (based on the assumption that the transferor has a six month put right at the minimum value—thus having a deemed built-in purchaser). The size of the marketability discount in the Step 2 process may depend on the size of the interest being valued (for example, a 100% block may be entitled to a 10% lack of marketability discount, but a 10% block may be entitled to a 30% lack of marketability discount). Marketability concerns may impact the appropriate capitalization factor used in an EBITDA approach of determining the net value of the entity.

Another potential discount is a "lack of continuity" discount that would apply if the company is actually re-structured to comply with the safe harbor rule, which would give all owners a six month put right. Even if all owners do not have put rights, the valuation of the net value of the entity would seemingly take into consideration the amount of capital that would have to be set aside to satisfy the transferor's deemed six-month put right.

One appraisal firm takes the position that discounts adjustments can be appropriate even for 100% controlling interests:

> In appraising the control value of the company, will the IRS oppose the use of discount adjustments (often relatively minor) for lack of (100%) control and lack of marketability for the entire entity? Our firm believes that market evidence indicates that arm's length buyers and sellers take these risks into account in negotiating a price for the business interests, and therefore should be considered, even if the interest is a 100% controlling interest. Not every appraisal firm does. Curtis R. Kimball (Willamette Management Associates).

b. **Valuation if Regulations Do NOT Assume Holder Has Six-Month Put Right**. Many of the valuation uncertainties will disappear if the proposed regulations are interpreted not to assume that each holder has a six-month put right. The minimum value concept will not be important in the valuation. Any explicit restrictions on redemption rights (either in the governing documents or in local law) would be disregarded, but otherwise the interest would be valued under general valuation principles. The holder could attempt to negotiate with the entity to purchase its interest, but would have no assurance that a deal could be struck. If it is not a controlling interest, lack of control discounts would be appropriate. Similarly, lack of marketability discounts may be appropriate; the interest would be valued as if no prohibition on redemption rights existed, but not as if a ready purchaser for the interest on six months' notice were guaranteed.

Ron Aucutt has summarized the effect that the proposed regulations will have on valuing entity interest transfers:

> If the proposed regulations become final, then, in appraising such an interest in an entity for transfer tax purposes, an appraiser will be expected, as always, to take into account all relevant factors, including (1) the risk that the holder of the interest may be unable to negotiate a favorable buyout, (2) the risk a hypothetical willing buyer would incur in dealing with an unrelated family, and (3) the lack of ability to control or influence the entity as a going concern. And in the case of a family-owned operating business, the appraiser should be expected to take into account any relevant additional factors, including (4) illiquidity or other obstacles to the business's redemption of the interest, (5) the possible lesser relevance of a redemption or asset-based approach to valuation of an operating business, and (6) the simple fact of life that the managers or majority owners of the business may not consider a partial liquidation to be in the best interests of the business or the other owners. We could therefore expect discounts of the kind we have heretofore observed to continue to be applied by appraisers to reflect those and other relevant factors.
>
> If, however, the creators or owners of the entity tried to "put a thumb on the scale" to artificially enhance those discounts by provisions in the governing documents explicitly prohibiting a favorable buy-out even if those systemic barriers can be overcome by negotiation, the appraiser will be obliged to ignore those provisions. That's all. That will reduce discounts at the margin in many cases, especially in the more aggressive cases of the most artificial and ephemeral restrictions, but least of all in the case of operating businesses (which thus are shown not to be the prime targets of the proposed regulations). Ron Aucutt, *Proposed 2704 Regulations Are Significant, But Not a Disaster*, LEIMBERG ESTATE PL. NEWSLETTER #2456 (September 28, 2016).

9. **Buy Sell Agreements**. Buy sell agreements that impose restrictions on transfers of interests in the entity that comply with the safe harbor rules under §2703 apparently still are to be respected (even if those transfer restrictions are "applicable restrictions" or "disregarded restrictions"). Prop. Reg. §§25.2704-2(b)(4)(iii); 25.2704-3(b)(5)(4) (an option, right to use property, or agreement "that is subject to" §2703 is not an applicable restriction or disregarded restriction). Query whether an agreement that meets the §2703 safe harbor is "subject to" §2703? The preamble to the proposed regulations gives this explanation: "Note that, although it may appear that sections 2703 and 2704(b) overlap, they do not. While section 2703 and the corresponding regulations currently address restrictions on the sale or use of individual interests in family-controlled entities, the proposed regulations would address restrictions on the liquidation or redemption of such interests."

   In fact, significant overlap between §§2703 and 2704 seems to exist, but the issue has arisen infrequently despite a provision in the existing regulations that an "agreement that is subject to section 2703 is not an applicable restriction." Reg. §25.2704-2(b) (last sentence). The disregarded restrictions will be much more pervasive than applicable restrictions are under the existing regulations, so the §2703-2704 interaction will arise more frequently. For example, what if an agreement specifically provides that an owner will have no right to withdraw from the entity at the owner's election, and the agreement meets the safe harbor test of §2703(b) (after all, most commercial entities do not give put rights to owners to withdraw at any time – the point of making contributions to the investment or operating entity is to make long-term commitments for long-term growth opportunities)? Will that restriction avoid treatment as an applicable restriction or disregarded restriction? (To meet the §2703(b) safe harbor test, the taxpayer will have to demonstrate not only that the restriction was comparable to similar arrangements entered into by persons in an arms' length transaction, but also that the restriction is a bona fide business arrangement and is not a device to transfer property to members of the family for less than full consideration.)

Governing documents of entities or other agreements almost invariably place *transfer restrictions* on the ownership interests. A frequent restriction is to give the other owners or the entity a right of first refusal before a transfer may be made. This provision is not a limitation on the holder's ability to compel the entity to redeem his or her interest in the entity, and should not be treated as a disregarded restriction.

10. **Marital and Charitable Deductions.** The preamble explains that if property must be valued taking into account the special valuation assumptions of §2704(b), "that same value generally will apply in computing the marital deduction attributable to that interest. The value of the estate tax marital deduction may be further affected, however, by other factors justifying a different value, such as the application of a control premium. See, e.g., Estate of Chenowith v. Commissioner, 88 T.C. 1577 (1987)."

What does the reference to *Chenowith* mean? In *Chenowith*, a bequest of 51% of the stock of a family company to the surviving widow was entitled to a premium "control element" to increase the marital deduction. However, this principle may also work in reverse and value a minority interest that actually passes to a surviving spouse with a minority discount even though the decedent had owned a controlling interest. *E.g., Estate of Disanto v. Commissioner*, T.C. Memo. 1999-421.

Under the proposed regulations, if the decedent's interest is divided between the surviving spouse and a credit shelter trust, and if the interest left to the spouse is a minority interest, does the reference to *Chenowith* mean that the minority interest passing to the spouse will be valued as a minority interest? If so, if the decedent's interest in the entity passes to multiple beneficiaries, including the spouse, the marital deduction amount may not equal the inclusion value.

The substantive proposed regulations are rather vague in reaching the general result that the inclusion value would be the same as the marital deduction value (provisions address transfers passing to multiple persons). Prop. Reg. §§25.2704-2(f), 25.2704-3(e). An example in the disregarded restrictions proposed regulations, in which a decedent leaves a 53 percent limited partnership interest to the surviving spouse, states that "[t]he fair market value of the 53 percent interest is determined for both inclusion and deduction purposes … assuming that the disregarded restriction does not exist …." Prop. Reg. §2502704-3(g) Ex. 4(ii). *See also* Prop. Reg. §§25.2704-2(f), 25.2704-3(e).

Interests passing to charity will not be subject to §2704 because it only applies to transfers to family members. The same value generally will apply for inclusion and deduction purposes, although the deduction value may differ if interests pass to multiple nonfamily members. The preamble explains:

> Thus, if the sole nonfamily member receiving an interest is a charity, the interest generally will have the same value for both estate tax inclusion and deduction purposes. If the interest passing to nonfamily members, however, is divided between charities and other nonfamily members, additional considerations (not prescribed by section 2704) may apply, resulting in a different value for charitable deduction purposes. See, e.g., Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).

A practical implication of leaving business interests to charity is that the excess business holdings limitation applies to private foundations and certain supporting organizations. A possible alternative might be a transfer to a §501(c)(4) organization (to which contributions are not tax deductible, but the entity is a tax-exempt entity as to non-business income and the excess business holdings rule does not apply to the organization).

Planning Implications

1. **Firestorm Over Proposed Regulations; Legislative Proposals and Recommendations Reacting to the Proposed Regulations**. As an illustration of the firestorm that the proposed regulations have generated, a bill has been introduced to nullify the proposed regulations. H.R. 6042, introduced by Rep. Sensenbrenner (R- Wisconsin) on September 15, 2016 provides that the §2704 proposed regulations "and any substantially similar regulations hereafter promulgated, shall have no force or effect." He has indicated that the regulations would make it "difficult for family-owned businesses to keep their doors open." Versprille, *Practitioners Have Mixed Reaction to Valuation Discount Bill*, BNA DAILY TAX REPORT, 181 DTR G-5 (September 19, 2016). House Ways and Means Committee Chairman Brady reportedly has expressed "strong concerns" about the regulations. *Id*. While the bill likely will go nowhere, supporters suggest that the bill could assist in bringing attention to broad-based negative reaction to the proposed regulations and assist in getting them withdrawn or revised.

   Rep. Davidson (R-Ohio) introduced H.R. 6100 (which has 42 co-sponsors) to block funding for IRS work on the proposed regulations. A similar bill has been introduced in the Senate (S. 3436, Protect Family Farms and Businesses Act), sponsored by Senators Rubio (R-Fla.), Moran (R-Kan.), and Flake (R-Ariz.). Those bills provide that the §2704 proposed regulations "shall have no force or effect. No Federal funds may be used to finalize, implement, administer, or enforce such proposed regulations or any substantially similar regulations."

   A group of 41 Senate Republicans has sent a letter to Treasury Secretary Lew expressing "serious concerns" requesting that the Treasury Department withdraw the regulations, commenting that the proposal would significantly increase the estate tax burden on family businesses, possibly by 30% or more. This letter (signed by over **40%** of the Senators!) states: We ask that the proposed regulations not be finalized in their current form as they directly contradict long-standing legal precedent, create new uncertainty for taxpayers, and put family-owned businesses at a disadvantage relative to other types of businesses…We thus request that Treasury withdraw the proposed regulations and ask that any regulations that Treasury may issue in the future more directly target perceived abuses in the valuation of transferred interests in family businesses." Lorenzo, *Senate GOP Urges Treasury to Abandon Estate Tax Rules*, BNA DAILY TAX REPORT, 189 DTR G-5 (September 29, 20-16); Letter reproduced in BNA DAILY TAX REPORT, (September 30, 2016).

   The National Association of Manufacturers sent a letter to Secretary Lew signed by more than 3,800 companies that similarly cautioned against finalizing what it termed a sweeping rule that would reduce jobs, investment, and economic growth. *Id.*

   The IRS has received more than 6,800 comments regarding the proposed regulations (available at **www.regulations.gov**)! (Many of them are from small business owners criticizing the application of the proposed regulations to active ongoing business entities.)

Statements from the Treasury and the Obama administration to the effect that the proposed regulations "close a tax loophole" that certain taxpayers have used to undervalue assets for estate and gift tax purposes and "that allows some wealthy families to avoid paying their fair share in estate taxes" have fueled a belief that the proposed regulations significantly reduce lack of control and marketability valuation adjustments, producing the firestorm of reactions to the proposed regulations.

A statement from the Treasury Department Assistant Secretary for Tax Policy Mark Mazur when the proposed regulations were released (https://www.treasury.gov/connect/blog/Pages/Treasury-Issues-Proposed-Regulations-to-Close-Estate-and-Gift-Tax-Loophole.aspx) (August 2, 2016) discusses at length how the proposed regulations close a tax loophole of "aggressive tax planning tactics to artificially lower the taxable value of their transferred assets":

> Today, the U.S. Department of the Treasury announced a new regulatory proposal to **close a tax loophole that certain taxpayers have long used to understate the fair market value** of their assets for estate and gift tax purposes.
>
> Estate and gift taxes, or transfer taxes, are taxes on the transfer of assets from one person to another either by gift during his or her lifetime or by inheritance at death. Only transfers by an individual or their estate in excess of $5.45 million are subject to tax. For married couples, no tax is collected on the first $10.9 million transferred. These generous exemption amounts mean that fewer than 10,000 of the largest estates are subject to any transfer tax at all in a year.
>
> It is common for wealthy taxpayers and their advisers to use certain **aggressive tax planning tactics to artificially lower the taxable value** of their transferred assets. By taking advantage of these tactics, certain taxpayers or their estates owning closely held businesses or other entities can end up paying less than they should in estate or gift taxes. Treasury's action will **significantly reduce** the ability of these taxpayers and their estates to use such techniques solely for the purpose of lowering their estate and gift taxes. These proposed regulations are subject to a 90-day public comment period. The regulations themselves will not go into effect until the comments are carefully considered and in 30 days after the regulations are finalized. (Emphasis added)

The White House released a longer statement that same day (https://www.whitehouse.gov/blog/2016/08/03/closing-estate-tax-loophole-wealthiest-few-what-you-need-know) (Aug. 2, 2016) beginning as follows:

> The Obama administration has made considerable progress over the past eight years to make our tax code fairer. This week, the Treasury Department is building on that progress through proposed new rules **closing a loophole that allows some wealthy families to avoid paying their fair share in estate taxes**. Treasury's action will help working families around the country because, when the wealthiest households are able to use **sophisticated techniques to exploit loopholes** and reduce the taxes that they own, more of the tax burden ultimately falls on middle-class taxpayers. (Emphasis added)

2. **Effective Date Issues.** Perhaps the most important aspect of the proposed regulations from a planning perspective is that they are not currently effective, but generally only apply after the regulations are finalized. The process of finalizing regulations (even of non-controversial regulations) typically is a multi-year process, but if the IRS treats this project as a high priority, the regulations could conceivably be finalized by the second quarter of 2017. (The original Chapter 14 regulations were finalized within 15 months of the date of enactment of the statute!) A new administration will be in place beginning January 20, 2017 (whether it is a Democratic or Republican administration). Various persons who have to sign off on final regulations will almost certainly be new appointees, which could slow the process. Planners have no certainty about how long the process will take (a hearing on the regulations is scheduled for December 1, 2016), but planners have time to

address how the new rules will apply to prior transactions and implement new transactions before the new rules become effective. Even after the regulation is finalized, the important disregarded restrictions rules will not be effective for another thirty days (but the IRS's new position ignoring the default restrictions under state law would be applicable with respect to the applicable restriction provisions).

The exception to the effective date good news is that transfers before the effective date (even before the proposed regulations were issued) *may* be subject to the three-year rule (requiring lost liquidation value to be added back into the transferor's gross estate if the transferor dies after the regulations are finalized and within three years of the transfer. Transactions completed prior to when the regulations are finalized are inherently subject to the possible application three-year rule, and clients should understand the possibility of additional value being included in the gross estate that would not qualify for a marital or charitable deduction if the client were to die within three years of making the transfer. Planners should consider whether tax apportionment clauses should be adjusted to reflect that risk. Fortunately, there are indications that the effective date provision in the final regulations will be clarified to apply only to transfers made after the regulations are finalized if the transferor subsequently dies within three years of the transfer.

3. ***Implications for "Gen III" Owners of Entities Formed by Grandparents.*** Because of the manner in which "family" is defined (as summarized in Item 5.c above) for purposes of determining if the family controls the entity (which is a requirement for the application of either §2704(a) or §2704(b)), interests held by aunts, uncles, cousins, or more remote collateral relatives will not be considered, but interests held by nieces or nephews (or their descendants) apparently are included.

   For example, assume Grandparent (G I) founded the company and left it equally to three children A, B, and C (G II), who have died and left their interests to their children (G III). The client is a child of A and a grandchild of the founder. The definition of "family" in §2704(c) includes brother or sisters, but not descendants of brothers or sisters (so even nieces and nephews would not be included under that definition). Therefore, the client may be deemed to own all 1/3 of the interest originally held by A. Interests held by aunts, uncles, cousins, or more remote collateral relatives, however, would not be included. Even the broader definition of family as incorporated by the regulation's cross reference to §25.2701-2(b)(5) does not include aunts or uncles or their descendants (e.g., cousins); it refers to descendants of the transferor's parent, but not of the transferor's grandparent. Therefore G III owners will be deemed to own stock held by their siblings, but that would only aggregate to 1/3 ownership of the entity–which is less than 50% so the entity would not be a "controlled entity" as to any particular family member, and therefore §2704 will not apply.

4. **Valuation Impact.**

   a. ***If Value As If Hold Deemed Put Right.*** As discussed in Paragraph 8 of the "Major Provisions of Proposed Regulations" section above, major uncertainties exist as to the approach that will be used in valuing interests in entities that are transferred that are subject to the new rules if they are deemed to value interests as if the holder has a six month put right at minimum value. Most obviously, lack of control discounts will be impacted significantly, because the transferor will be deemed to hold a six-month put right to receive a pro rata share of the "net value of the entity." Even so, reduced lack of control discounts may be appropriate for the lack of control over day-to-day operations and for the six-month delay in receiving the liquidation value.

Valuation issues are involved in two separate steps for disregarded restrictions: (i) in determining the "minimum value" exercise price of the deemed put right, and (ii) in valuing the holder's interest in the entity under generally accepted valuation principles (even with the assumed six-month put option at minimum value), Prop. Reg. §25.2704-3(f).

The new regulation may significantly impact lack of control discounts, but marketability discounts still should be appropriate for consideration at each of the two valuation steps (although the marketability discount may be less in valuing the interest under the second step in light of the fact the holder will have an assured market for the interest if the entity has sufficient cash or other property to fund the redemption)**.**

Completing transfers before the regulation is finalized may allow being able to take advantage of discounts that will not be available later. Indeed, the balance of 2016 may be a busy year for planners structuring gifts, sales, and other transfer planning transactions.

Appraisal expenses may be increased in light of the additional valuation steps that are required under the proposed regulations. Furthermore, one appraisal (with the two-step approach) will be needed for family interests, and a separate appraisal may be needed for non-family interests that are not subject to §2704:

> There will be many cases that will now require two valuations: one for intra-family ownership transactions and one for others not covered by new §2704. Heretofore most closely-held entities had a single buy-sell value that would apply to all minority interest parties, regardless of affiliation or attribution. Curtis R. Kimball (Willamette Management Associates) (his personal opinion).

b. ***If Do Not Value As If Held Deemed Put Right.*** If the proposed regulations are interpreted not to assume the holder has a six-month put right, they may have little impact on valuations other than to ignore any express prohibition on withdrawal rights. For example, many states provide that limited partners or members of LLCs can withdraw as provided in the governing documents, and the governing documents often do not provide any prohibitions on the ability of the entity to redeem an owner's interest. In that case, no restriction exists to be disregarded under §2704 (if that is how the proposed regulations are interpreted).

5. ***Gifts or Sales Before Effective Date; Adequate Disclosure Requirements.*** To the extent that the §2704 proposed regulations disallow discounts that would otherwise be available, sales or gifts before the effective date may take advantage of the added valuation discounts. As expressed throughout this summary, the amount of any such additional discounts will likely be negligible in most situations. However, for clients who have been seriously considering making transfers in any event, making the transfers before the regulations are finalized may be advisable.

For gifts or sales that are made after the regulations were proposed (released on August 2 and published on August 4, 2016), return preparers making disclosures of the transactions may consider disclosing that the valuation does not consider the impact of the proposed §2704 regulations, in light of the fact that the regulations do not apply to transfers made before the regulations are finalized. Reg. §301.6501(c)-1(f)(2)(v) (adequate disclosure must include "[a] statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer"). In addition, the planner may wish to add that whether the valuation is inconsistent with the proposed regulations cannot be determined based on the ambiguity in the regulations, and that the valuation is likely consistent with the proposed regulations, assuming that the regulations are interpreted to describe as "disregarded restrictions" only express prohibitions or restrictions on the ability of the entity to redeem the owner's interest in the entity.

A potential disadvantage of making current transfers to trusts is that the flexibility to make adjustments at a later time (via sales, substitution powers, etc.) may be limited under after the regulations are finalized. If any difference between the §2704 value and fair market value exists, transactions with trusts may be difficult because fiduciaries will be unwilling to pay more than fair market value if the trust is buying something that would have an augmented value under §2704.

6. ***Arbitraged Transactions.*** Transactions may occur in which the value is not artificially inflated at one step but interests would be artificially inflated in value under §2704 at a later time. For example, existing trusts or entities that have been funded with discounted assets may later sell assets to the donor after the regulations become effective. The values of those assets may be determined under §2704 (at artificially inflated values) in order to avoid deemed indirect gifts by the trust beneficiaries or entity owners. Even assuming the step transaction doctrine does not apply, query whether the IRS may make a "duty of consistency" argument in these types of situations? (The trustee would have no fiduciary concern with being paid a higher amount under these artificial valuation rules than the interest is actually worth.)

   Similarly, in kind payments after the effective date of the regulations (using the artificially high §2704 values) of annuity amounts after the effective date for GRATs that were funded before the effective date with discounted assets may result in a similar value-shift. Whether §2704 applies in valuing those transfers is not totally clear.

   On the other hand, sales of interests in entities to grantor trusts may be more difficult after these regulations become effective. The trustee will have fiduciary concerns with paying a price that is artificially higher than the actual value of the transferred interest. Perhaps trust agreements in the future will authorize trustees to purchase assets from family members based on values as determined for gift tax purposes even if those values exceed the actual market value of the purchased interests. (The amount of the discount is a much smaller factor than the estate freezing and income tax "burn" aspect of sales to grantor trusts in the overall long-term transfer planning result.)

   When family members make contributions to existing entities in return for an additional interest in the entity, will an artificially high value of the additional interest in the entity as determined under §2704 be used to determine the amount of the contribution to the entity (if §2704 produces a higher value)? How would that be resolved with respect to non-family owners?

7. ***Current Transfers to Relinquish Liquidation Rights; Unwinding Partnerships.*** If an owner holds sufficient interest in an entity to force the liquidation of the entity, consider making a transfer of a sufficient interest before the regulations are finalized so that the owner no longer holds sufficient interest to force the entity's liquidation. (For example, if

state law provides that a corporation will be liquidated on the vote of two-thirds of the shareholders and the owner holds 80% of the stock, consider transferring at least 14% of the stock so that the owner will hold less than two-thirds of the vote.) As long as no voting rights for that 14% are eliminated, §2704(a) will not apply and the three-year rule will not apply under the current regulations.

Alternatively, the owners might amend the governing documents before the regulations are finalized to provide that a unanimous vote of owners would be required to force the liquidation of the entity. Section 2704(a) should not apply to that amendment because no rights associated with any ownership interests are eliminated as a result of the amendment (i.e., no voting rights are eliminated). Any owners holding less than all of the ownership interests could then make future transfers without risk that the new three-year rule of §2704(a) would apply.

Avoiding the three-year rule may be an additional impetus for an owner to get rid of the general partner interest in a limited partnership (in addition to avoiding the potential §2036(a)(2) risk). Getting rid of the general part interest before the regulation is finalized would avoid the three year risk that would apply if the holder gets rid of the general partner interest after the regulation is finalized.

For new entities being created, will there be a trend toward requiring unanimous consent of owners to liquidate to avoid the three-year rule for future transfers?

Should partnerships be unwound, with the partners receiving undivided interests in partnership assets? Making gifts of interests in entities may no longer get the benefit of a minority discount under the three-year rule if the donor dies within three years. As an alternative, the partnership could be dissolved into fractional undivided interests among the partners to pick up an undivided interest discount. (But is that really necessary? Under the three-year rule calculation of the lapsed liquidation value that is added back into the estate, in determining the value of holder's liquidation value of the interest, would the liquidation value be determined by examining the value of assets that would be distributed to the holder on liquidation (if the assets are such that undivided interests would be distributed among the owners)?)

8. **Undivided Interests.** Section 2704 addresses transfers of interests in entities, not assets outside of entities (including undivided interests in real estate or art). However, if the undivided interests held by various owners are deemed to be a "business entity," the new rules could apply to transfers of those undivided interests. Rev. Proc. 2002-22 discusses the types of items that can be in a co-tenancy agreement without creating a partnership. Under Rev. Proc. 2002-22, "mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes." *See also* Reg. § 301.7701-1(a)(2) (describing joint undertakings that are characterized as entities for tax purposes; generally, carrying on a trade, business, financial operations, or other venture and dividing the profits therefrom); UNIF. PARTNERSHIP ACT §202(c). In addition, a restriction on partition will be ignored under Sec. 2703 (*see Elkins v. Commissioner*, 757 F.3d 453 (5th Cir. 2014), *aff'g in part, rev'g in part* 140 T.C. 86 (2013).

9. **Corporations**. The rules will apply to interests in corporations, as well as partnerships and LLCs. A transfer of a minority interest in a corporation may be subject to the disregarded restrictions rule, which may disallow much of the lack of control discount that

ordinarily would be permitted under the existing regulation (if the regulations are interpreted to assume the existence of a deemed put right for valuation purposes).

As discussed in Item 6 of the "Major Provisions of Proposed Regulations" section above, most "unrelated" owners will not satisfy the unrelated owner test to determine if the family can remove "disregarded restrictions" (in particular, most owners will not have a six-month put right equal to the owner's pro rata share of the net value of the entity). Giving all owners six-month put rights would dramatically impact the economics of many business arrangements, leaving the business at constant risk of having its capital withdrawn through redemptions.

10. **Commercially Reasonable Restriction Exception.** Because of the incredibly broad application of §2704 under the proposed regulations to all family-controlled entities, the commercially reasonable restriction exception for entities with active businesses may become very important. If the business has legitimate needs for bank borrowing, and if the bank legitimately imposes covenants that include restrictions on redemptions of the owners' interests, §2704 may not apply and lack of control discounts still may be available.

11. **Active Trade or Business**. Planners have speculated about whether the new regulations would focus on entities holding passive investment assets rather than active trade or business entities. The regulations apply similarly to both, however. The only concessions for trade or business entities are (i) the ability of the entity or owners to use a note to pay the redemption proceeds on exercise of the six-month put right, and (ii) the availability of the "commercially reasonable restrictions" exception that applies only to trade or business operations. See Paragraphs 4 and 7 of the Major Provisions of Proposed Regulations section above.

12. **Tax Apportionment Clauses; "Net-Net Gifts**." Tax apportionment clauses should be reviewed for clients owning interests in family-controlled entities. Apportioning estate taxes to the recipients of assets in the gross estate rather than merely apportioning all taxes to the residue will be more important under the new regulations. Interests in entities may be valued at increased (some would say artificially high) values and apportioning all taxes to the residue may carry even more risk of unfairness than in the past. If the three-year rule applies and an additional value is added to the gross estate producing estate tax, can that estate tax somehow be allocated to the recipient of the lifetime gift that produced the three-year problem? Making gifts under a "net-net" gift arrangement (with the donee being responsible for gift tax AND any additional estate taxes that might later be attributable to the gift, *see Steinberg v. Commissioner*, 145 T.C. 184 (2015)) would be a way to make the donee responsible for any added estate tax burden under the three-year rule (if that is what the donor wants). Alternatively, the gift may be made with the donee specifically just agreeing to pay any added estate tax attributable to the three-year rule of Prop. Reg. §2704-1(c)(1).

13. **GRATs and Defined Value Transactions**. Using GRATs (with the built-in defined value clause allowed by the GRAT regulations) and using defined value transfers will be even more advantageous in the future in light of the increased inherent valuation risks under the proposed regulations. If a transfer is made under a defined value clause based on the finally determined gift tax value, apparently the transaction would have to be reported on a gift tax return in order eventually to know the finally determined gift tax value.

14. **Section 303 and 6166**. Meeting the requirements that interests in an entity constitute as specified percentage of the gross estate may become easier under the proposed regulations. The augmented value of the entity, under the new valuation principles, will constitute a greater percentage of the gross estate.

15. **Validity of Regulations.** The regulatory authority for additional regulations under §2704 (in §2704(b)(4)) is very broad. Even so, some planners question whether some of the provisions in the proposed regulations extend so far beyond the origin, legislative history, and purpose of Chapter 14 as to be an invalid regulation, even under the relaxed standard for testing the validity of regulations under the Supreme Court's announcements in the *Chevron* [467 U.S. 837 (1984)], *Mayo Foundation* [562 U.S. 44 (2011)], and *Home Concrete* [132 S. Ct. 1836 (2012)] cases.

    The legislative history of Chapter 14 (the 1990 Conference Report) has rather explicit statements that it was not intended to "affect minority discounts or other discounts available under [former] law."

    > The value of property transferred by gift or includable in the decedent's gross estate generally is its fair market value at the time of the gift or death. Fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer. Accordingly, courts generally have refused to consider familiar relationships among co-owners in valuing property. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.
    >
    > . . . .
    >
    > *The bill does not affect minority discounts or other discounts available under present law.*
    >
    > . . . .
    >
    > *. . . the bill does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally* in all items of income, deduction, loss and gain in the same proportion (*i.e.*, straight-up allocations)." (136 Cong. Rec. § 15679, 15681 (October 18, 1990) (emphasis added)).

    Perhaps the existence of this legislative history is the reason that the IRS beginning in 2009 sought legislative changes to §2704 before issuing its new proposed regulations.

    Richard Dees (Chicago, Illinois) wrote a 29-page letter to the Assistant Secretary of Tax Policy in the Treasury Department and to the Commissioner of the Internal Revenue Service on August 31, 2015, in which he maintains that if the regulation implements the provisions in the statutory proposal, the regulation "would be invalid as contrary to the origin, purpose and scope of the current statute." The letter provides a detailed summary of the statutory provisions in §2704, the legislative history behind §2704, and case law interpreting §2704 to support his position. Some of his reasoning is that the origin and intent of §2704 was "only to disregard liquidation provisions and other provisions of the organizational documents that lowered the value of interests in a family business for transfer tax purposes below what would occur under state law if those provisions were not in the documents." He argues that §2704(b) only empowers the IRS to *disregard* certain restrictions in family entity organizational documents, but not to replace those disregarded provisions with IRS-invented alternatives "that would make the valuation of minority interests in a family business the same as if family attribution applied;" instead the balance of the provisions in the documents that are not disregarded and provisions supplied by the operation of state law would be considered in valuing the transferred interest.

The potential invalidity of certain provisions in the regulations has no practical impact on planning. Many planners believe the validity of the regulations will be upheld. Even those planners who question the validity of the regulations would be unwilling to advise clients to make transfers assuming that the regulations do not apply.

16. **Comparison to Legislative Proposal**. The proposed regulations implement all of the legislative proposals included in Greenbooks for the Obama Administration, beginning with the 2010 Fiscal Year ending with the 2013 Fiscal Year Greenbook. The Obama Administration proposal included five major items, all of which are addressed in the proposed regulations.

(i) *Additional "Disregarded Restrictions*. "The IRS would be authorized to provide by regulations an additional category of restrictions ("disregarded restrictions," which are in addition to the liquidation restrictions addressed in §2704) that would be disregarded in determining the value of interests in "family-controlled entities" that are transferred to family members. Transferred interests would be valued by substituting for "disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations."

(ii) *Assignee Interests*. Restrictions on a transferee being able to become a full-fledged partner (or member of an LLC) would be a disregarded restriction.

(iii) *Third Party Involvement in Removing Restrictions*. Section 2704(b)(2)(B)(ii) says that one of the general requirements of an "applicable restriction" is that the transferor or family members can remove the restriction. (The Greenbook proposal generally retained this family-removal requirement with respect to "disregarded restrictions.") Under the legislative proposal, in response to the Fifth Circuit's holding in *Kerr,* "certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family."

(iv) *Safe Harbor*. The statute would provide regulation authority that would include "the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met."

(v) *Marital and Charitable Deduction*. The legislation would include provisions dealing with the interaction of the marital and charitable deductions for transfer tax purposes. Therefore, if an interest is valued higher than its actual fair market value for transfer tax purposes, the higher value might also be applied for marital deduction and charitable deduction purposes (a taxpayer-friendly provision).

17. **Implications for Basis Adjustment Purposes Under §1014.** The timing of the IRS's emphasis regarding §2704 is curious. In an environment in which very few decedents pay transfer taxes, presumably many taxpayers might benefit from not being required to discount interests in family entities, to permit larger basis adjustments under §1014 following an owner's death.

    Some planners have granted put rights to clients who own interests in entities but do not have estate tax concerns in order to minimize discounts for basis adjustment purposes. That approach raises the inherent risk that some family members may actually exercise the put right; under the proposed regulations, discounts may be avoided even without granting actual put rights that can be exercised.

    A caveat: Section 2704 applies only "for purposes of this subtitle" [i.e. Subtitle B-Estate and Gift Taxes], and the basis consistency provisions in §1014(f) state that the fair market value (for purposes of the basis adjustment under §1014(a)) "shall not exceed" the finally determined estate tax value. The IRS might argue that the fair market value that applies for basis purposes is not augmented as a result of ignoring certain liquidation restrictions under §2704. However, Reg. §1.1014-3 provides that the value of property "as appraised for the purpose of the Federal estate tax … shall be deemed to be its fair market value," suggesting that the estate tax value would apply. From a sense of fairness, the basis adjustment under §1014 should be based on the estate tax value, particularly in light of the fact that the basis adjustment value cannot be less than the estate tax value.