**2704 Proposed Regulations**

**Annotated**

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***Comment:*** *No doubt practitioners across the country are studying the new Proposed 2704 Regulations and pondering the implications to wealth transfer planning. It appears that 2016 may be a redo of 2012 planning as clients still subject to the estate tax evaluate and likely implement transfer strategies before valuation discounts are reduced or eliminated by the finalization of these Regulations. For some of us, reviewing new Regulations means yellow highlighter and colored pens (for others it might mean bookmarking or comments on your PDF). Hopefully for both types of practitioners, having comments (even preliminary thoughts that have not been fully evaluated or formulated) embedded in the Regulations would be a practical tool to help practitioners review them.*

*It is vital to point out that these proposed Chapter 14 rules, as drafted, would apply regardless of the size of the estate so that even non-taxable estates must run the rigors of these provisions, although it might mean an increase in the “step up” in basis under Section 1014. But even the non-taxable estates might need to take proactive actions to address the valuation consequences of these Proposed Regulations to assure maximum basis step up.*

**This document is scheduled to be published in the Federal Register on 08/04/2016 and available online at** [**http://federalregister.gov/a/2016-18370 ,**](http://federalregister.gov/a/2016-18370) **and on FDsys.gov**

DEPARTMENT OF THE TREASURY Internal Revenue Service

26 CFR Part 25 [REG-163113-02] RIN 1545-BB71

Estate, Gift, and Generation-skipping Transfer Taxes; Restrictions on Liquidation of an

Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations concerning the valuation of interests in corporations and partnerships for estate, gift, and generation-skipping transfer (GST) tax purposes. Specifically, these proposed regulations concern the treatment of certain lapsing rights and restrictions on liquidation in determining the value of the transferred interests. These proposed regulations affect certain transferors of interests in corporations and partnerships and are necessary to prevent the undervaluation of such transferred interests.

**Comment**: The above is in fact the Treasury perspective that these transactions are undervalued. However, many non-controlling interests do in the real world suffer discounts as compared to a controlling interest. While no doubt there have been abusive situations, for many transactions, especially not controlling interests in active business endeavors and many real estate operations, discounts were in fact real. A 10% interests does not permit an unrelated owner to realize 10% of full enterprise value absent a rare provision in the operating documents granting such a right.

DATES: Written and electronic comments must be received by [**INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**]. Outlines of topics to be discussed at the public hearing scheduled for December 1, 2016, must be received by [**INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**].

***Comment****: This suggests that transactions prior to the effective date, which will certainly be after the December 1 hearing, may not be subject to the terms of the new regulations. If that is the case, then practitioners should consider mass mailings to clients to put them on notice of the need to plan, perhaps before year end. Some might view this as a “2012 Rush to Plan”-Redux but only for wealthier clients for whom discount planning may be valuable.*

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-163113-02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:LPD:PR (REG-163113-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the Federal Rulemaking portal at www.regulations.gov (IRS REG-163113-02). The public hearing will be held in the Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John D. MacEachen, (202) 317-6859; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Background**

***Comment****: The preamble to the Proposed Regulations provides an historical overview of IRC Sec. 2704.*

Section 2704 of the Internal Revenue Code provides special valuation rules for purposes of subtitle B (relating to estate, gift, and GST taxes) for valuing intra-family transfers of interests in corporations and partnerships subject to lapsing voting or liquidation rights and restrictions on liquidation. Lapses of voting or liquidation rights are treated as a transfer of the excess of the fair market value of all interests held by the transferor, determined as if the voting or liquidation rights were nonlapsing, over the fair market value of such interests after the lapse.

***Example****: Taxpayer owned 75% of the voting stock of Corporation A, and her children owned the remaining 25% of the stock. The bylaws of Corporation A provided that a shareholder's voting rights lapsed at death. Taxpayer’s Will provided that, upon her death, all of her Corporation A stock would pass to her children. The value of Taxpayer's stock with voting rights (i.e., before or ignoring the lapse at her death) is $750,000. However, the value of the same stock without the voting rights is $600,000. Without the restrictions of IRC Sec. 2704, the Corporation A stock in Taxpayer’s estate would have been valued at $600,000, or $150,000 less than it was when she was alive. The application of IRC Sec. 2704 would prevent this valuation reduction.*

***Comment****: Under IRC Sec. 2704(a), the lapse of a voting or liquidation right created after October 8, 1990, is treated as a transfer if the holder of the lapsing right and his or her family control the entity before and after the lapse. The amount of the transfer is the excess, if any, of the value of the holder's interests in the entity immediately before the lapse over the value of such interests after the lapse.*

*Under IRC Sec. 2704(b), if an interest in a corporation or partnership is transferred to, or for the benefit of, a member of the transferor's family, and the transferor and his or her family control the entity before the transfer, any "applicable restrictions" are disregarded in valuing the transferred interest. Note that the Proposed Regulations add a new concept referred to as “disregarded restrictions.” As explained below, the new 2704(b) Regulation provisions appear to override the 2704(a) restrictions because of their breadth.*

Certain restrictions on liquidation are disregarded in determining the fair market value of the transferred interest. The legislative history of section 2704 states that the provision is intended, in part, to prevent results similar to that in Estate of Harrison v. Commissioner, T.C. Memo. 1987-8. Informal S. Rep. on S. 3209, 136 Cong. Rec. S15629-4 (October 18, 1990); H.R. Conf. Rep. No. 101-964, 2374, 2842 (October 27, 1990).

In Harrison, the decedent and two of his children each held a general partner

interest in a partnership immediately before the decedent's death. The decedent also held all of the limited partner interests in the partnership. Because any general partner could liquidate the partnership during life, each general partner could cause all partners to obtain the full value of such partner’s partnership interests. A general partner's right to liquidate the partnership lapsed on the death of that partner. In determining the estate tax value of the decedent's limited partner interest, the court concluded that the right of the decedent to liquidate the partnership (and thus readily obtain the full value of the limited partner interest) could not be taken into account because that right lapsed at death. As a result, the Court determined the value for transfer tax purposes of the limited partner interest to be less than its value either in the hands of the decedent immediately before death or in the hands of his family (the other general partners) immediately after death.

***Comment****: Value is determined at time of death when the lapse is deemed to occur. This presents some potentially costly problems that should be evaluated for clients contemplating transfers before the effective date of the proposed regulations. As explained below, if a client is of advanced age or has known health issues this date of death calculation could cause inclusion at a value that is greater than the date of transfer value. Thus, practitioners might wish to recommend a real life analysis (determination of actual estimated life expectancy) to help clients evaluate this risk.*

Section 2704(a)(1) provides generally that, if there is a lapse of any voting or liquidation right in a corporation or a partnership and the individual holding such right immediately before the lapse and members of such individual’s family hold, both before and after the lapse, control of the entity, such lapse shall be treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate, whichever is applicable. The amount of the transfer is the fair market value of all interests held by the individual immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing) over the fair market value of such interests after the lapse.

***Comment****: Treasury Regulation §25.2704-1(a)(2)(iii) defines Member of the family as the meaning given it in §25.2702-2(a)(1), as follows: “With respect to any individual, member of the family means the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the foregoing.” As a result, some practitioners gave rights to third parties such as charities. This is discussed below. Step-children apparently are covered.*

Section 25.2704-1(a)(2)(v) of the current Gift Tax Regulations defines a liquidation right as the right or ability, including by reason of aggregate voting power, to compel the entity to acquire all or a portion of the holder’s equity interest in the entity, whether or not its exercise would result in the complete liquidation of the entity.

Section 25.2704-1(c)(1) provides a rule that a lapse of a liquidation right occurs

at the time a presently exercisable liquidation right is restricted or eliminated. However, under §25.2704-1(c)(1), a transfer of an interest that results in the lapse of a liquidation right generally is not subject to this rule if the rights with respect to the transferred interest are not restricted or eliminated. The effect of this exception is that the inter vivos transfer of a minority interest by the holder of an interest with the aggregate voting power to compel the entity to acquire the holder’s interest is not treated as a lapse even though the transfer results in the loss of the transferor’s presently exercisable liquidation

right.

The Treasury Department and the IRS, however, believe that this exception should not apply when the inter vivos transfer that results in the loss of the power to liquidate occurs on the decedent’s deathbed. Cf. Estate of Murphy v. Commissioner,

T.C. Memo. 1990-472 (rejecting “attempts to avoid taxation of the control value of stock holdings through bifurcation of the blocks”). Such transfers generally have minimal economic effects, but result in a transfer tax value that is less than the value of the interest either in the hands of the decedent prior to death or in the hands of the decedent’s family immediately after death. See Harrison, supra. The enactment of section 2704 was intended to prevent this result. See Informal S. Rep. on S. 3209, supra; H.R. Conf. Rep. No. 101-964, supra. See also section 2704(a)(3) (conferring on the Secretary broad regulatory authority to apply section 2704(a) to the lapse of rights similar to voting and liquidation rights).

***Example****: If a taxpayer owned a 51% interest in an entity and made a gift of a minority interest of a 2% interest, then the taxpayer would be left holding a minority interest of a 49% interest as of the date of death. Under the current rules, since the right to liquidate inherent in each block of interests (2% and 49%) remained intact – even though neither block could separately force liquidation - there would be no lapse of the liquidation right when the gift is made and both interests could be valued with a minority discount.*

*Under the Proposed Regulations, both the 2% and the 49% interests must be valued as if the respective owner has the right to liquidate the interest and receive full value within 6 months.*

***Comment****: If the amount of the transfer is the fair market value of all interests held by the individual immediately before the lapse (determined as if the voting and liquidation rights were non-lapsing) over the fair market value of such interests after the lapse, then, by attributing a mandatory liquidation or “put” right into the value of each block of interest, no discount is feasible. The 51% interest is valued (without a minority discount) as would a 2% or 49% interest.*

*If there is a mandatory deemed liquidation right, how can there be lapse? For valuation purposes a put right is deemed to exist. This is essentially a kind of liquidation right. But a put or liquidation right might actually differ from the “minimum value” construct mandated by the Proposed Regulations. So, if every interest transferred will have a minimum value under the deemed mandatory put right concept, the lapse rule would not seem to be relevant for transfers that occur after the Proposed Regulations become effective. Therefore, it would appear that this lapse rule should apply only to transfers made before the effective date of the Proposed Regulations, i.e. all of the transfers practitioners will endeavor to complete before the effective date of the Proposed Regulations.*

*Contrast the result above with a situation in which a taxpayer owns a 45% interest in an entity and the remaining 55% is owned by an unrelated party. If the 45% owner transfers ½ of her interests to her son, the restrictions of the Proposed Regulations may not apply to the valuation of her transferred interests. However, if she owns 45% but is in a general partner position the control test discussed below will be met and the Proposed Regulation’s restrictions will apply. This situation can be more complex in the context of an LLC. How will the role of a manager be treated? There is no certainty as to this issue. But the Regulations appear to provide that a partnership includes an LLC {“A partnership is any other business entity within the meaning of §301.7701-2(a) of this chapter regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.”] It would appear that a manager will be deemed to have the same kind of control of an LLC that a general partner has in a partnership—although, of course, the partnership/operating agreement may limit the GP’s or the Manager’s powers and authority. The scope of powers of the manager may vary based on default state law provisions and terms of the governing agreement. How will this be handled? Another consideration is that different appraisals may be necessary for the 55% family controlled portion and the 45% non-controlling portion (assuming it fails the control test described below). Thus, one of the valuation opportunities that might remain is to structure entities in order to fail the control test as enunciated in the Proposed Regulations. Other possible remaining valuation planning considerations are discussed elsewhere in this annotation and the accompanying article.*

The Treasury Department and the IRS have concluded that the regulatory exception created in §25.2704-1(c)(1) should apply only to transfers occurring more than three years before death, where the loss of control over liquidation is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of a donor’s subjective motive which is administratively burdensome for both taxpayers and the IRS. Cf. section 2035(a) (replacing the contemplation of death presumption of prior law with a bright-line, three- year test). Accordingly, the proposed regulations treat transfers occurring within three years of death that result in the lapse of a liquidation right as transfers occurring at death for purposes of section 2704(a).

***Comment****: This “bright line test” means that the transfer of a portion of an equity interest three years or more prior to death will not be treated for valuation purposes as a transfer/lapse of such rights. While this might appear to leave open a planning opportunity, the window is likely immaterial when the other restrictions in the Proposed Regulations are considered.*

*This also means that transfers occurring prior to implementation of the Proposed Regulations may be tainted by the death of the transferor after the effective date of the Proposed Regulations. By operation of this bright-line three year test, some part of a transfer that had been made previously and valued at a discount will be included in the decedent’s estate based on the non-lapse of that power. For example, Taxpayer owns 80% of a member managed LLC and the operating agreement permits members by majority vote to liquidate the LLC. Taxpayer gifted 30% of the LLC membership interests in 2015 taking minority discounts for lack of control and lack of marketability. The Taxpayer dies in 2017, less than then three years after the gift.*

*The “bright line test” under the Proposed Regulations would seem to require recapture of the discount attributable to the lifetime gift of the 30% minority interest in the decedent/transferor’s estate, to the extent that the discount equaled the value of the deemed put right. If correct, this would appear to apply the restrictions of the Proposed Regulations retroactively and to transfers occurring before these new rules were drafted. Practitioners should warn clients endeavoring to complete planning prior to the effective date of the Proposed Regulations of this possible trap.*

Section 2704(b)(1) provides generally that, if a transferor transfers an interest in

a corporation or partnership to (or for the benefit of) a member of the transferor’s family, and the transferor and members of the transferor’s family hold, immediately before the transfer, control of the entity, any “applicable restriction” is disregarded in valuing the transferred interest. Under section 2704(b)(2), an applicable restriction is defined as a restriction that effectively limits the ability of the entity to liquidate, but which, after the transfer, either in whole or in part, will lapse or may be removed by the transferor or the transferor’s family, either alone or collectively. Section 2704(b)(3)(B) excepts from the definition of an applicable restriction any restriction “imposed, or required to be imposed, by any Federal or State law.”

***Comment****: Treasury initially presumed that state law would provide a reasonable benchmark for restrictions and only limited restrictions that went beyond those required under applicable state law. Treasury clearly misperceived the power of tax planners to convince state legislatures to modify state law in order to undermine the intent of this provision. The Service has been displeased with this perceived loophole for quite some time. The Proposed Regulations, as explained below, take direct aim at this state law exception.*

Section 2704(b)(4) provides that the Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of any interest in a corporation or a partnership transferred to a member of the transferor’s family if the restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee.

Section 25.2704-2(b) provides, in part, that an applicable restriction “is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction.”

The Treasury Department and the IRS have determined that the current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws and by other subsequent developments. First, courts have concluded that, under the current regulations, section

2704(b) applies only to restrictions on the ability to liquidate an entire entity, and not to restrictions on the ability to liquidate a transferred interest in that entity. Kerr v. Commissioner, 113 T.C. 449, 473 (1999), aff’d , 292 F.3rd 490 (5th Cir. 2002). Thus, a restriction on the ability to liquidate an individual interest is not an applicable restriction under the current regulations.

***Comment****: The Proposed Regulations expressly address this distinction between the ability to liquidate the entire entity and the ability to liquid the transferred interest, and address restrictions on discounts based on liquidation rights of individual interests.*

Second, as noted above, the current regulations except from the definition of an applicable restriction a restriction on liquidation that is no more restrictive than that of the state law that would apply in the absence of the restriction. The Tax Court viewed this as a regulatory expansion of the statutory exception to the application of section 2704(b) contained in section 2704(b)(3)(B) that excepts “any restriction imposed, or required to be imposed, by any Federal or State law.” Kerr, 113 T.C. at 472. Since the promulgation of the current regulations, many state statutes governing limited partnerships have been revised to allow liquidation of the entity only on the unanimous vote of all owners (unless provided otherwise in the partnership agreement), and to eliminate the statutory default provision that had allowed a limited partner to liquidate his or her limited partner interest. Instead, statutes in these jurisdictions typically now provide that a limited partner may not withdraw from the partnership unless the partnership agreement provides otherwise. See, e.g., Tex. Bus. Orgs. Ann.

§ 153.110 (West 2016) (limited partner may withdraw as specified in the partnership agreement); Uniform Limited Partnership Act (2001) § 601(a), 6A U.L.A. 348, 448 (Supp. 2015) (limited partner has no right to withdraw before completion of the winding up of the partnership). Further, other state statutes have been revised to create elective restrictions on liquidation. See, e.g., Nev. Rev. Stat. § 87A.427 (2016) (limited partnership electing to be restricted limited partnership may not make any distributions for a 10-year period). Each of these statutes is designed to be at least as restrictive as the maximum restriction on liquidation that could be imposed in a partnership agreement. The result is that the provisions of a partnership agreement restricting liquidation generally fall within the regulatory exception for restrictions that are no more restrictive than those under state law, and thus do not constitute applicable restrictions under the current regulations.

Third, taxpayers have attempted to avoid the application of section 2704(b) through the transfer of a partnership interest to an assignee rather than to a partner. Again relying on the regulatory exception for restrictions that are no more restrictive than those under state law, and the fact that an assignee is allocated partnership income, gain, loss, etc., but does not have (and thus may not exercise) the rights or powers of a partner, taxpayers argue that an assignee's inability to cause the partnership to liquidate his or her partnership interest is no greater a restriction than that imposed upon assignees under state law. Kerr, 113 T.C. at 463-64; Estate of Jones v. Commissioner, 116 T.C. 121, 129-30 (2001). Taxpayers thus argue that the assignee

status of the transferred interest is not an applicable restriction.

***Comment****: For example, if a limited partner could only transfer the rights of an assignee and not the rights of a substituted partner without unanimous consent of all partners, the assignee would not have the rights of a substitute partner and, therefore, would be precluded from participating in voting and other partner rights. The value of such an assignee interest may be less than the value of a participating substitute partner’s interests and, if so, has been valued lower than the interest of a successor partner. The Proposed Regulations expressly address this distinction and eliminate discounts based on a mere assignment.*

Finally, taxpayers have avoided the application of section 2704(b) through the transfer of a nominal partnership interest to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a

restriction. Kerr, 292 F.3rd at 494.

As the Tax Court noted in Kerr, Congress granted the Secretary broad discretion

in section 2704(b)(4) to promulgate regulations identifying restrictions not covered by section 2704(b) that nevertheless should be disregarded for transfer tax valuation purposes. 113 T.C. at 474. The Treasury Department and the IRS have concluded that, as was recognized by Congress when enacting section 2704(b), there are additional restrictions that may affect adversely the transfer tax value of an interest but that do not reduce the value of the interest to the family-member transferee, and thus should be disregarded for transfer tax valuation purposes. H.R. Conf. Rep. No. 101-

964, supra, at 1138.

***Comment****: The rationale above is the basis upon which the Treasury believes it has authority to issue these new Proposed Regulations. While many commentators question this interpretation and the legitimacy of the breadth of the Proposed Regulations, practitioners should focus on implementing planning before the effective date of these Proposed Regulations, rather than rely on possible successful challenges to their validity.*

The Treasury Department and the IRS have determined that such

restrictions include: (a) a restriction on the ability to liquidate the transferred interest; and (b) any restrictions attendant upon the nature or extent of the property to be received in exchange for the liquidated interest, or the timing of the payment of that property.

Further, the Treasury Department and the IRS have concluded that the grant of an insubstantial interest in the entity to a nonfamily member should not preclude the application of section 2704(b) because, in reality, such nonfamily member interest generally does not constrain the family’s ability to remove a restriction on the liquidation of an individual interest. Cf. Kerr, 292 F.3rd at 494 (noting that a charity receiving a partnership interest would “convert its interests into cash as soon as possible, so long as it believed the transaction to be in its best interest and that it would receive fair market value for its interest”). The interest of such nonfamily members does not affect the family’s control of the entity, but rather, when combined with a requirement that all holders approve liquidation, is designed to reduce the transfer tax value of the family- held interests while not ultimately reducing the value of those interests to the family member transferees. The enactment of section 2704 was intended to prevent this result. See section 2704(b)(4) (conferring on the Secretary broad regulatory authority to apply section 2704(b) to other restrictions if the restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee). The Treasury Department and the IRS have concluded that the presence of a nonfamily-member interest should be recognized only where the interest is an economically substantial and longstanding one that is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of whether the interest of the nonfamily member effectively constrains the family’s ability to liquidate the entity. Accordingly, the proposed regulations disregard the interest held by a nonfamily member that has been held less than three years before the date of the transfer, that constitutes less than 10 percent of the value of all of the equity interests, that when combined with the interests of other nonfamily members constitutes less than 20 percent of the value of all of the equity interests, or that lacks a right to put the interest to the entity and receive a minimum value.

***Comment****: In some instances, practitioners had previously given modest interests to a charity (or a more distant relative) in order to avoid the restrictions on discounts if family alone could control liquidation. The Proposed Regulations create a bright line test that has a high threshold if interests of a third party are to be respected. By way of example, it is presumably irrelevant, for purposes of determining if the family controls the entity, that a key employee of a family business holds a 15% interest in the entity if the “20% third party test” is not satisfied in the aggregate. It would also seem that any percentage of third party interests will not be relevant if held less than three years prior to transfer.*

***Example****: Taxpayer is diagnosed with a terminal illness and negotiates a succession plan with a key employee, transferring a 25% equity interest in the business to her. In the following year, the Taxpayer transfers 45% of his interests in the business to a trust for the benefit of his children. Since the key employee did not hold her 25% equity interest for at least three years as of the date of transfer of the 45% interest to the trust, the third-party test is not satisfied – even though there was a pure non-tax motive for transferring interests to the key employee and despite the fact that the key employee’s interests hold real economic power.*

Finally, since the promulgation of §§301.7701-1 through 301.7701-3 of the Procedure and Administration Regulations (the check-the-box regulations), an entity’s classification for federal tax purposes may differ substantially from the entity’s structure or form under local law. In addition, many taxpayers now utilize a limited liability company (LLC) as the preferred entity to hold family assets or business interests. The Treasury Department and the IRS have concluded that the regulations under section 2704 should be updated to reflect these significant developments.

***Comment****: The impact of the Proposed Regulations on entity formation and structure could be significant and have a number of ramifications. The Proposed Regulations create an anomaly for counsel who should continue to craft restrictions that serve to reduce the economic value of an entity for business and asset protection purposes, despite knowing that those same restrictions will disregarded for transfer tax valuation purposes. However, caution must be exercised as it may be adverse to a transferee to pay transfer tax on something which he or she cannot obtain for the property interest and, in some cases such as, perhaps, where there is significant animosity with other owners of the entity, the inability to “capture” what would have been a greater value for the interest. In other words, although “artificially” imposed restrictions to reduce the value for creditor protection purposes, may not, in some situations, offset the real loss to the transferee.*

*For some taxpayers not subject to the estate tax because of the high exemption amounts, the changes contemplated by the Proposed Regulations resulting in the elimination of most discounts for transfer tax purposes is a positive development. After the effective date of the Proposed Regulations, such taxpayers can include in their governing instruments the most stringent restrictions advisable to achieve business and asset protection goals without worrying about the impact on transfer tax value and eventual basis step up on death. With this in mind, practitioners may need to revisit governing instruments drafted for clients not likely to have been subject to the federal estate tax and confirm that these instruments are drafted with business and asset protection considerations in mind. Any documents originally drafted to minimize or avoid discounts in order to maximize basis step up should likely be modified. While practitioners should evaluate opportunities for relaxing restrictions in instruments to garner a higher value for basis step up but they still should be cognizant of the competing objective of remaining restrictive to maintain asset protection. This will be a complex, fact sensitive, analysis for each client’s particular situation. Practitioners should be cautious on relying on standard documentation for these purposes.*

*Some commentators have advocated another perspective. They have suggested that the basis step-up on death is determined under IRC Sec. 1014 based on a “fair market value” standard that is independent and potentially different from the valuation standards under IRC Sec. 2704. Simply put, these commentators suggest that the IRC Sec. 1014 and 2704 valuation standards are different. Others strongly disagree with this idea.*

*In any event, the Proposed Regulations do not appear to have the same draconian impact on discounts associated with the underlying assets. For example, there might remain some planning opportunity to secure valuation discounts on real estate owned not in an entity but as tenants in common (“TIC”). The risk is that the IRS might successfully argue that these relationships should be treated as a partnership arrangement and, of course, the TIC approach does not provide limited liability from creditors as an entity structure might. Would having each member of the TIC own their interests through a single member disregarded LLC provide some measure of asset protection (albeit not charging order protection) while preserving a TIC arrangement that might preserve transfer tax valuation discounts? What might the proposed amendments to Treas. Reg.* §25.2701-2 that refer to “other arrangement” encompass? See the discussion of *Regulation §301.7701-2(a) below.*

**Explanation of Provisions**

The proposed regulations would amend §25.2701-2 to address what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership, or limited partnership. The proposed regulations would amend §25.2704-1 to address deathbed transfers that result in the lapse of a liquidation right and to clarify the treatment of a transfer that results in the creation of an assignee interest. The proposed regulations would amend §25.2704-2 to refine the definition of the term “applicable restriction” by eliminating the comparison to the liquidation limitations of state law. Further, the proposed regulations would add a new section, §25.2704-3, to address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interests held by persons who are not members of the family.

***Comment****: The above paragraph summarizes a number of the key changes effected by the Proposed Regulations: (1) The term “control” is redefined in a more restrictive manner; (2) there will no longer be a valuation distinction for a transfer of an assignee interest versus an interest of a substitute partner or member; (3) the exception for restrictions that do not exceed those permitted under state law will effectively be eliminated; (4) insignificant ownership by a non-family member will not change the discount result (the term “insignificant” being defined in a manner that could be quite significant).*

***Comment****: It is true that elimination of the state law exception for discount purposes could result in many practitioners who had routinely formed out-of-state entities in the past to revert now to creating home-state entities which are likely less costly to form and administer. This simplistic prognostication overlooks the asset protection benefits of entities that vary meaningfully from state to state. Securing a more protective legal entity structure is certainly not affected by the reduction or even loss of discounts contemplated by these Proposed Regulations. Clients will still benefit from creating trusts in jurisdictions that are more trust friendly than their home states (e.g., a client who lives in a state that does not permit self-settled trusts creating a self-settled trust in a jurisdiction that does). There might still be an advantage in such situations to create an entity, e.g., an investment LLC, in the trust-friendly jurisdiction in order to bolster the nexus to that jurisdiction and, perhaps, minimize the contacts with the client’s home state. For example, if a client has real property in the home state that would better be held by the client’s trust, then forming an LLC so that the trust does not own real property in the home state might be essential. Having that LLC formed in the same jurisdiction in which the trust was formed may be advantageous as compared to forming it in the client’s home state. Thus, the elimination of the state law exception should not necessarily result in practitioners using the home jurisdiction as the default state for client entities.*

Covered Entities

The proposed regulations would clarify, in §§25.2704-1 through 25.2704-3, that section 2704 applies to corporations, partnerships, LLC’s, and other entities and

arrangements that are business entities within the meaning of §301.7701-2(a), regardless of whether the entity or arrangement is domestic or foreign, regardless of how the entity or arrangement is classified for other federal tax purposes, and regardless of whether the entity or arrangement is disregarded as an entity separate from its owner for other federal tax purposes.

***Comment****: To elaborate on the above, consider: Regulation §301.7701-2(a) reads as follows: “(a) Business entities. For purposes of this section and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner...”*

Classification of the Entity

Section 2704 speaks in terms of corporations and partnerships. Under the proposed regulations, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8), an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation that is separate from its parent owner. For most purposes under the proposed regulations, a partnership would be any other business entity within the meaning of §301.7701-1(a), regardless of how the entity is classified for federal tax purposes.

However, these proposed regulations address two situations in which it is necessary to go beyond this division of entities into only the two categories of corporation and partnership. These situations (specifically, the test to determine control of an entity, and the test to determine whether a restriction is imposed under state law) require consideration of the differences among various types of business entities under the local law under which those entities are created and governed. As a result, for purposes of the test to determine control of an entity and to determine whether a restriction is imposed under state law, the proposed regulations would provide that in the case of any business entity or arrangement that is not a corporation, the form of the entity or arrangement would be determined under local law, regardless of how it is classified for other federal tax purposes, and regardless of whether it is disregarded as an entity separate from its owner for other federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity or arrangement is created or organized. Thus, in applying these two tests, there would be three types of entities: corporations, partnerships (including limited partnerships), and other business entities (which would include LLCs that are not S corporations) as determined under local law.

Control of the Entity

Section 2704(c)(1) incorporates the definition of control found in section

2701(b)(2). Control of a corporation, partnership, or limited partnership is defined in sections 2701(b)(2)(A) and (B). The proposed regulations would clarify, in §25.2701-2, that control of an LLC or of any other entity or arrangement that is not a corporation, partnership, or limited partnership would constitute the holding of at least 50 percent of either the capital or profits interests of the entity or arrangement, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. Cf. section 2701(b)(2)(B)(ii) (defining control of a limited partnership as including the holding of any interest as a general partner). Further, for purposes of determining control, under the attribution rules of existing §25.2701-6, an individual, the individual’s estate, and members of the individual’s family are treated as holding interests held indirectly through a corporation, partnership, trust, or other entity.

*Comment: Control of a partnership or LLC taxed as a partnership will be more broadly defined and based on a 50% interest, or the right to cause a partial liquidation of the entity. The Proposed Regulations apply this concept to any “arrangement” as well. Thus, control of a family limited partnership (FLP) will not require a general partnership (“GP”) interest.*

Lapses under Section 2704(a)

The proposed regulations would amend §25.2704-1(a) to confirm that a transfer that results in the restriction or elimination of any of the rights or powers associated with the transferred interest (an assignee interest) is treated as a lapse within the meaning of section 2704(a). This is the case regardless of whether the right or power is exercisable by the transferor after the transfer because the statute is concerned with the lapse of rights associated with the transferred interest. Whether the lapse is of a voting or liquidation right is determined under the general rules of section 25.2704-1.

The proposed regulations also would amend §25.2704-1(c)(1) to narrow the exception in the definition of a lapse of a liquidation right to transfers occurring three years or more before the transferor’s death that do not restrict or eliminate the rights associated with the ownership of the transferred interest. In addition, the proposed regulations would amend §25.2704-1(c)(2)(i)(B) to conform the existing provision for testing the family’s ability to liquidate an interest with the proposed elimination of the comparison with local law, to clarify that the manner in which liquidation may be achieved is irrelevant, and to conform with the proposed provision for disregarding certain nonfamily-member interests in testing the family’s ability to remove a restriction in proposed §25.2704-3 regarding disregarded restrictions.

Applicable Restrictions under Section 2704(b)

The proposed regulations would remove the exception in §25.2704-2(b) that limits the definition of applicable restriction to limitations that are more restrictive than the limitations that would apply in the absence of the restriction under the local law generally applicable to the entity. As noted above, this exception is not consistent with section 2704(b) to the extent that the transferor and family members have the power to

avoid any statutory rule. The proposed regulations also would revise §25.2704-2(b) to provide that an applicable restriction does include a restriction that is imposed under the terms of the governing documents, as well as a restriction that is imposed under a local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. In applying this particular exception to the definition of an applicable restriction, this proposed rule is intended to ensure that a restriction that is not imposed or required to be imposed by federal or state law is disregarded without regard to its source.

Further, with regard to the exception for restrictions “imposed, or required to be imposed, by any Federal or State law,” in section 2704(b)(3)(B), the proposed regulations would clarify that the terms “federal” and “state” refer only to the United States or any state (including the District of Columbia (see section 7701(a)(10)), but do not include any other jurisdiction.

A restriction is imposed or required to be imposed by law if the restriction cannot be removed or overridden and it is mandated by the applicable law, is required to be included in the governing documents, or otherwise is made mandatory. In addition, a restriction imposed by a state law, even if that restriction may not be removed or overridden directly or indirectly, nevertheless would constitute an applicable restriction in two situations. In each situation, although the statute itself is mandatory and cannot be overridden, another statute is available to be used for the entity’s governing law that does not require the mandatory restriction, thus in effect making the purportedly mandatory provision elective. The first situation is that in which the state law is limited in its application to certain narrow classes of entities, particularly those types of entities most likely to be subject to transfers described in section 2704, that is, family-controlled entities. The second situation is that in which, although the state law under which the entity was created imposed a mandatory restriction that could not be removed or overridden, either at the time the entity was organized or at some subsequent time, that state’s law also provided an optional provision or an alternative statute for the creation and governance of that same type of entity that did not mandate the restriction. Thus, an optional provision is one for the same category of entity that did not include the restriction or that allowed it to be removed or overridden, or that made the restriction optional, or permitted the restriction to be superseded, whether by the entity’s governing documents or otherwise. For purposes of determining whether a restriction is imposed on an entity under state law, there would be only three types of entities, specifically, the three categories of entities described in §25.2701-2(b)(5) of the proposed regulations: corporations; partnerships (including limited partnerships); and other business entities.

A similar proposed rule applies to the additional restrictions discussed later in this preamble.

***Comment****: Recognizing that practitioners have had considerable success lobbying state legislatures to modify state statutes to support transfer tax valuation discounts, the Proposed Regulations take a harsh view of state law restrictions. Treasury lamented in the preamble to the Proposed Regulations that several states and the Uniform Limited Partnership Act designed statutes “to be at least as restrictive as the maximum restriction on liquidation that could be imposed in a partnership agreement.” As a result, “provisions of a partnership agreement restricting liquidation generally fall within the regulatory exception for restrictions that are no more restrictive than those under state law, and* ***thus do not constitute applicable restrictions under the current regulations****.” (Emphasis added.)*

*In response, the Proposed Regulations make clear that the only state law restriction that can be considered is one that is mandatory for the entity – and only if there is no other option under state law to avoid that otherwise mandatory restriction, such as by forming the entity under an alternative state law. This appears intended to prevent a state from enacting a statute with mandatory restrictions from which an entity could choose in order to maximize transfer tax valuation discounts.*

*For example, if a state enacted a special Family LLC statute that imposed mandatory restrictions on transfer, but the same state retained its existing general LLC statute that did not have such restrictions, a taxpayer could not avail himself or herself of the new Family LLC statute’s mandatory restrictions since the taxpayer could choose to form its entity under the general LLC statute and avoid the mandatory restrictions. It is not at all clear what mandatory restrictions a state law could impose in order to assist taxpayers with taking transfer tax valuation discounts in light of this rule. And note that using the laws of a foreign (non-US) jurisdiction also will not provide any mandatory restriction benefit for valuation purposes.*

If an applicable restriction is disregarded, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction does not exist (that is, 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.

Disregarded Restrictions

A new class of restrictions is described in the proposed regulations that would be

disregarded, described as “disregarded restrictions.” This class of restrictions is

identified pursuant to the authority contained in section 2704(b)(4).

***Comment****: Under the Proposed regulations, there would be two types of restrictions to consider under IRC Sec. 2704: “Applicable Restrictions” and “Disregarded Restrictions,” the latter of which is a new concept added by the Proposed Regulations. “Applicable Restrictions” are disregarded. These existed under prior law Reg. Sec. 25.2702-2 and have been tightened in the Proposed Regulations. Disregarded Restrictions are being added by new Prop. Treas. Reg. Sec. 25.2704-3(b) to further enhance the restrictions and limitations on discounts.*

***Caution****: While practitioners will need, if the proposed regulations are adopted as final, to deal with both “Applicable Restrictions” and “Disregarded Restrictions,” one Disregarded Restriction alone appears to negate entirely any non-control or minority interest discount. Specifically, Treasury has proposed that any restriction on the right of an equity-interest holder to redeem his or her interest will be disregarded for transfer tax valuation purposes. This deleterious new Disregarded Restriction effectively imposes, for valuation purposes but not for “real world” purposes in a family controlled entity, a Deemed Liquidation Right or Deemed Put Right upon every equity interest transferred to a family member. As written in the Proposed Regulations this provision could supersede all other issues on the availability of a discount in any given situation. The scope of this deemed put right is of concern. Also, the unusual definitions and requirements it contains, as discussed below, can have a surprising and significantly adverse impact, e.g., the minimum value rule. Practitioners might consider in some instances including a buy-out arrangement to fund the deceased owner’s estate tax based on this fictional imputed minimum value.*

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.

***Comment****: IRC Sec. 2703(a)(1) deals with buy sell agreements and provides as follows: “any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property. (b) Exceptions — Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements: (1) It is a bona fide business arrangement; (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.”*

*It appears that the intent of the Proposed Regulations is to confirm that all restrictions possible apply to reduce discounts. In contrast to the Treasury comment above, bear in mind that 2704(b) could apply to a sale to a defective or grantor trust, not IRC Sec. 2703. Although not certain, an enforceable option (e.g., a right to buy pursuant to a buy-sell agreement) should not be disregarded under IRC Sec. 2704 if it is not disregarded under IRC Sec. 2703.*

Under §25.2704-3 of the proposed regulations, in the case of a family-controlled entity, any restriction described below on a shareholder’s, partner’s, member’s, or other owner’s right to liquidate his or her interest in the entity will be disregarded, [for valuation purposes,] if the restriction will lapse at any time after the transfer, or if the transferor, or the transferor and family members, without regard to certain interests held by nonfamily members, may remove or override the restriction.

***Comment****: It would appear that the above phrase “without regard to certain interests held by nonfamily members” means that the analysis cannot consider non-family members for purposes of recognizing restrictions unless additional tests are met. The tests under the Proposed Regulations for respecting restrictions or powers held by non-family members require that the individual own 10% interests, and that the non-family must in aggregate own 20% of the interests, and those interests had to have been held for 3 or more years prior to the transfer to be respected. From a practical perspective most family business enterprises will be precluded from giving equity to a third party or charity in order to bolster restrictions for discounts. Moreover, even if the taxpayer could establish that, by reason of family animosity or market reasons, that he or she could not realistically receive the full value that would be determined by disregarding Disregarded Restrictions, these restrictions nonetheless will be disregarded. As indicated, it seems that, if the breakup of the entity (by a transferee being able to demand to be bought out) would cause the entity to lose market share or otherwise suffer a reduction in its value, such a loss in value would not be considered for valuation purposes.*

Under the proposed regulations, such a disregarded restriction includes one that: (a) limits the ability of the holder of the interest to liquidate the interest; (b) limits the liquidation proceeds to an amount that is less than a minimum value; (c) defers the payment of the liquidation proceeds for more than six months; or (d) permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.

***Comment****: This is the deemed liquidation or redemption right that the Proposed Regulations effectively mandate be inferred, for valuation purposes. into every governing document. This effectively eliminates any minority discount.* ***This is perhaps one of the most critical points in the entirety of the Proposed Regulations.*** *Please note that the governing documents do not have to contain any mandatory “put” right but only that the valuation of interest in the entity will be determined as though there were one.*

“Minimum value” is the interest’s share of the net value of the entity on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, 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. For

example, and subject to the foregoing limitation on outstanding obligations, 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. The minimum value of the interest is the net value of the entity multiplied by the interest’s share of the entity. For this purpose, the interest’s share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity.

***Comment****: Not only do the Proposed Regulations mandate that a deemed put right be read into the governing instrument but a formula for determining that value is also mandated, creating complexity and difficulties in determining values that might exceed what otherwise would have been determined - even apart from valuation discounts.*

*If the value calculated under the formula set forth in the Proposed Regulations exceeds the “fair market value” as determined under the current gift and estate tax regulations definition, it appears that the new 2704 formula value must be used. Example: A manufacturing company is owned 85% by father and 15% by an unrelated supplier. Father falls ill and gifts his two sons, who have always been antagonistic towards each other, his interests and they take over the business. There overt discord has already impeded essential business decision making. As is common with many family businesses no succession planning had been addressed and there is no dispute resolution mechanism to address their disunity. Under current law each 42.5% interest would be discounted. The Proposed Regulations impute a mandatory put right to each interest based on the enterprise value unreduced for discounts and ignoring the realities of the circumstances. This This is a very important point practitioners must consider. Thus, even if the taxpayer could establish that, by reason of family animosity (or market reasons), that he or she could not realistically receive the full value that would be determined by disregarding Disregarded Restrictions, these restrictions nonetheless will be disregarded. As indicated, it seems that, if the breakup of the entity (by a transferee being able to demand to be bought out) would cause the entity to lose market share or otherwise suffer a reduction in its value, such a loss in value would not be considered for valuation purposes.*

*The value of assets must be determined under IRC Sec. 2031 or 2512. IRC Sec. 2031 provides: “In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange.” Many factors should be considered when valuing such stocks for estate and gift tax purposes. See, e.g. Rev. Rul. 59-60, 1959-1 CB 237.*

*On the other hand, the Proposed Regulations contemplate that only debts meeting the requirements of IRC Sec. 2053 as if those debts were claims against an estate may be considered when valuing an asset. Under §2053, a debt arising from a promise is a deductible debt if contracted in a bona fide manner for adequate and full consideration in money or money's worth. There are many fact specific cases addressing valid debts under IRC Sec. 2053 especially with respect to intra-family loans. The IRS could take the position that obligations of an entity that are not of the type permitted under IRC Section 2053 could be disregarded in the application of the Proposed Regulations. Many valuation consultants believe that this entire concept is overreaching and contrary to generally accepted valuation standards. It remains to be seen what success practitioners will have in getting Treasury to retreat from this new, complex and controversial approach. The more pressing and practical issue is that even if practitioners believe that there should be some (or hopefully a lot) of success in modifying Treasury’s position, can clients afford to take the risk of waiting and potentially miss out on what might be the last window of opportunity to use many types (perhaps most types) of valuation discounts to leverage wealth out of their estates.*

*It is common for complex family businesses to pay for a matter from the entity where cash flow is available and later the transfer may be reflected in a loan or exchange account or addressed in an adjusting entry. Example: Family Furniture Co., Inc. purchased a boat that the matriarch wanted for personal use. Following year end the corporation’s CPA reclassified the transaction as a personal loan from the corporation to the matriarch and booked it as such. If the IRS could prove that there would be no deduction and that the transaction might be a deemed dividend perhaps the transaction would be disregarded under general valuation principles even without regard to proposed regulations. But as reclassified the transaction might well be treated as a loan. This is common business practice for many industries and clients and while these loans might be respected by an appraisal as they represent real advances it is not clear that this type of transfer would pass muster under the IRC Sec. 2053 standard. This illustrates the excessive scope of the Proposed Regulations. Or maybe not… They do not merely endeavor to minimize or eliminate discounts but rather they appear to create new valuation standards. Example: In February 2017 Family Office Rental LLC has excess cash and paid for a roof replacement for a building owned by Family Residential Rental LLC. In June 2017 gifts were made to a child of 25% interests in Family Residential Rental LLC. Following year end, the family CPA reclassified the transaction of the roof repair as a loan from Family Office Rental LLC to Family to Family Residential Rental LLC (and the capital improvement was reflected on the latter entity’s books and records). Although the transaction, one entity with excess cash paying for/loaning a related family real estate entity funds for a needed repair is common in the industry, and the books and records reflect correctly the loan, that loan may not pass muster under IRC Sec. 2053 standards and could be disregarded in determining the value of the gift made in June under the Proposed 2704 Regulations. This is in spite of the fact that the generally accepted valuation standards might consider it a valid indebtedness that should reduce the value of Family Residential Rental LLC.*

*By way of example:*

*A Noninterest bearing promissory note was given when cash was loaned by the decedent to her children. The note was not payable until the earlier of the decedent's death or her attaining age 95. The court held the notes were not bona fide debts contracted for full and adequate consideration and therefore were not deductible claims against the estate. L. Flandreau Est, TC Memo. 1992-173).*

*If a debt of a family business is disregarded under the “minimum value” rule set forth in the Proposed Regulations, the actual value of a business interest, not just the discount, could be affected.*

A disregarded restriction includes limitations on the time and manner of payment of the liquidation proceeds. Such limitations include provisions permitting deferral of full payment beyond six months or permitting payment in any manner other than in cash or property. For this purpose, the term “property” does not include a note or other obligation issued directly or indirectly by the entity, other holders of an interest in the entity, or persons related to either.

***Comment****: The Proposed Regulations impose into the valuation calculus a six month liquidation time frame to realize the fair value, subject to the exception discussed below. Does that imply that the value for transfer tax purposes should be the value that could reasonably be realized in six months or, should the transfer tax value be that which can be garnered within a normal time frame for a sale of the particular asset – deemed accelerated to only six months? For example, in one case, over 20% market absorption discount was determined for certain real property based on a 4-year estimated sales period. Is that prolonged sales period still part of fair value or does the six month liquidation somehow imply a shorter liquidation period? Jane Z. Astleford v. Commissioner, T.C. Memo. 2008-128. Has the new Proposed Regulation minimum value divorced transfer tax valuation standards from the historic litmus test of willing buyer and willing seller? It would appear that valuation issues inherent in the underlying asset, such as that above in Astleford should continue to be permitted and that only the discounts applicable to the entity should be affected and that entity value should be assumed realized based on the fictional put right.*

An exception is made for the note of an entity engaged in an active trade or business to the extent that (a) the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), and (b) the note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value (when discounted to present value) equal to the liquidation proceeds.

***Comment****: There is a limited exception for the minimum value rule’s requirement of six month liquidation for cash for active trades or business that may for active businesses (as defined) permit a limited use of deferred payments beyond the six month fictional presumed put right. The above provision does not clarify what will constitute an active trade or business for this purpose. IRC Sec.* *6166(b)(9)(B) provides “The term ‘passive asset’ means any asset other than an asset used in carrying on a trade or business.” Will real estate held by an active developer (characterized as such for purposes of IRC Sec. 469) constitute an active trade or business or be deemed a passive endeavor? Revenue Ruling 2006-34 illustrates five hypothetical fact scenarios of real estate endeavors to evaluate them under the IRC Sec. 6166 active business standard. An active business could incorporate into a redemption or buy-sell provision the right to defer the payment of a purchase price using a note. However, the note must surmount a number of hurdles that effectively contradict common business practices, have nothing to do with discounts, and appear too indeterminate that even for an active business, no discount could be achieved. It is common in closely held business buy out arrangements to limit security or provide for none. Shareholders of closely held businesses are often loath to use their homes as collateral to secure the buyout of a deceased shareholder, even family members. Payouts under buy sell agreements often include a deferral of payments to address the reality that a going concern business could be disrupted by the death of a key person. Even this reality must be disregarded under the Proposed Regulations.*

*The Proposed Regulations require any such permitted note to use market interest rate instead of an IRC §1274 rate. As set forth in the Proposed Regulations, use of an IRC Section 1274 interest rate may not constitute an arm’s length rate. Once again, what has heretofore been traditional intra-family planning may not suffice under the Proposed Regulations.*

A fair market value determination assumes a cash sale. See Section 2 of Rev. Rul. 59-60, 1959-1 C.B. 237 (defining fair market value and stating that “[c]ourt decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing to trade…”). Thus, in the absence of immediate payment of the liquidation proceeds, the fair market value of any note falling within this exception must equal the fair market value of the liquidation proceeds on the date of liquidation or redemption.

Exceptions that apply to applicable restrictions under the current and these proposed regulations also apply to this new class of disregarded restrictions. One of the exceptions applicable to the definition of a disregarded restriction applies if (a) each holder of an interest in the entity has an enforceable “put” right to receive, on liquidation or redemption of the holder’s interest, cash and/or other property with a value that is at least equal to the minimum value previously described, (b) the full amount of such cash and other property must be paid within six months after the holder gives notice to the entity of the holder’s intent to liquidate any part or all of the holder’s interest and/or withdraw from the entity, and (c) such other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related either to the entity or to any holder of an interest in the entity. However, in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include a note or other obligation if such note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of the liquidation or redemption equal to the liquidation proceeds. A similar exception is made to the definition of an applicable restriction in proposed §25.2704-2(b)(4).

***Comment****: If the note must have a fair value equal to the liquidation proceeds, effectively preventing the fair value of the note from reducing the minimum value of the interests under the Proposed Regulations, what is the relevance of this note exception? This cannot relate to any provisions in a governing instrument.*

In determining whether the transferor and/or the transferor’s family has the ability to remove a restriction included in this new class of disregarded restrictions, any interest in the entity held by a person who is not a member of the transferor’s family is disregarded if, at the time of the transfer, the interest: (a) has been held by such person for less than three years; (b) constitutes less than 10 percent of the value of all of the equity interests in a corporation, or constitutes less than 10 percent of the capital and profits interests in a business entity described in §301.7701-2(a) other than a

corporation (for example, less than a 10-percent interest in the capital and profits of a partnership); (c) when combined with the interests of all other persons who are not members of the transferor’s family, constitutes less than 20 percent of the value of all of the equity interests in a corporation, or constitutes less than 20 percent of the capital and profits interests in a business entity other than a corporation (for example, less than a 20-percent interest in the capital and profits of a partnership); or (d) any such person, as the owner of an interest, does not have an enforceable right to receive in exchange for such interest, on no more than six months’ prior notice, the minimum value referred to in the definition of a disregarded restriction. If an interest is disregarded, the determination of whether the family has the ability to remove the restriction will be made assuming that the remaining interests are the sole interests in the entity.

***Comment****: This new Disregarded Restriction could eliminate the use of non-family members to support a restriction on liquidation or redemption that could reduce value.*

Finally, if a restriction is disregarded under proposed §25.2704-3, the fair market value of the interest in the entity is determined assuming that the disregarded restriction did not exist, either in the governing documents or applicable law. Fair market value is determined under generally accepted valuation principles, including any appropriate discounts or premiums, subject to the assumptions described in this paragraph.

***Comment****: Is the value determined under “generally accepted valuation principles” or do the new Proposed Regulations modify those principals with the minimum value rule above?*

Coordination with Marital and Charitable Deductions

Section 2704(b) applies to intra-family transfers for all purposes of subtitle B relating to estate, gift and GST taxes. Therefore, to the extent that an interest qualifies for the gift or estate tax marital deduction and must be valued by taking into account the special valuation assumptions of section 2704(b), the same value generally will apply in computing the marital deduction attributable to that interest.

***Comment****: A typical QTIP trust planning strategy was illustrated by the Tax Court decision in Estate of Mellinger. H’s stock passed into QTIP trust for the benefit of W. The QTIP owned about 28% of stock and W owned (in a revocable trust) about 28%. IRS argued that since §2044 treats the property as passing from W (the surviving spouse), both blocks of 28% equity interest should be aggregated to create a control premium for transfer tax valuation purposes. The Tax Court concluded that, despite the tax treatment under §2044 which required inclusion in W’s estate of both the QTIP trust interests and W’s interests, since the QTIP trust interests were not actually passing from W, the interests should not be aggregated. Instead, the Court concluded, the interests should be treated as separate blocks and permitted the Estate to take a minority discount on each block of equity interests. Estate of Mellinger v. Comr., 112 T.C. 26 (1999), acq. 1999-35 IRB 314, corrected Ann. 99-116, 1999-52 IRB 763.*

*The mandatory Deemed Put Right inferring a six month liquidation demand right into every block of equity interest under the Proposed Regulations appears to have entirely negated this QTIP trust planning opportunity.*

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 Chenoweth v. Commissioner, 88 T.C. 1577 (1987).

***Comment****: Where the estate tax does not apply, an estate may be able to cause aggregation by naming the spouse as trustee of a QTIP trust and create a valuation control premium, thereby permitting a greater basis step up. A practitioner should exercise caution when taking this approach. In Nowell Est. v. Comr., TC Memo 1999-15 the court did not aggregate interests even though the decedent and a grandchild were co-trustees. Perhaps, a more certain result would be to terminate the QTIP trust in favor of the surviving spouse so there would be no non-aggregation discount “suffered” as in Mellinger or Nowell.*

Section 2704(b) does not apply to transfers to nonfamily members and thus has no application in valuing an interest passing to charity or to a person other than a family member. If part of an entity interest includible in the gross estate passes to family members and part of that interest passes to nonfamily members, and if (taking into account the proposed rules regarding the treatment of certain interests held by nonfamily members) the part passing to the decedent’s family members is valued under section 2704(b), then the proposed regulations provide that the part passing to the family members is treated as a property interest separate from the part passing to nonfamily members. The fair market value of the part passing to the family members is determined taking into account the special valuation assumptions of section 2704(b), as well as any other relevant factors, such as those supporting a control premium. The fair market value of the part passing to the nonfamily member(s) is determined in a similar 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).

**Effective Dates**

The amendments to §25.2701-2 are proposed to be effective on and after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. The amendments to §25.2704-1 are proposed to apply to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register**. The amendments to §25.2704-2 are proposed to 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**. Section 25.2704-3 is proposed to apply to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the **Federal Register**.

***Comment****: The effective date of the Proposed Regulations is 30 days after the final regulations are published, providing a short window of opportunity to plan prior to that date. Such planning could potentially secure discounts limited only by current law, e.g. Applicable Restrictions, but not by the more restrictive Disregarded Restrictions and other provisions of the Proposed Regulations. While the validity of the Treasury’s authority to issue the Proposed Regulations has been questioned by some commentators, it would seem more prudent to act now.*

*The impending national elections may also lend to the urgency of accelerating planning. If the Democrats win the White House and sufficient down-ballot races to gain a majority in the Senate as some pundits have projected, any glimmer of transfer tax valuation discounts remaining after these Proposed Regulations are implemented may be darkened entirely. If the Treasury is not successful on points it feels important in the Proposed Regulations, the Democratic tax platform which focuses on increasing taxes on the wealthy could incorporate statutory changes that would give Treasury whatever it does not achieve in the Proposed Regulations.*

**Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. The proposed

regulations affect the transfer tax liability of individuals who transfer an interest in certain closely held entities and not the entities themselves. The proposed regulations do not affect the structure of such entities, but only the assumptions under which they are valued for federal transfer tax purposes. In addition, any economic impact on entities affected by section 2704, large or small, is derived from the operation of the statute, or its intended application, and not from the proposed regulations in this notice of

proposed rulemaking. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely (in the manner described in “ADDRESSES”) to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be available at [www.regulations.gov,](http://www.regulations.gov/) or upon request.

A public hearing on these proposed regulations has been scheduled for

December 1, 2016, beginning at 10 a.m. in the Auditorium, Internal Revenue Building,

1111 Constitution Avenue, NW, Washington, DC 20224. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

***Comment****: The Proposed Regulations cannot be made final until after the hearing and publication. This is the window of opportunity practitioners have to plan for wealthy clients. While it would appear some (perhaps many) components of the Proposed Regulations should be modified, the risk of waiting is that if they final version of the Regulations contain sufficient teeth, significant discount planning opportunities might be lost.*

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit comments by [**INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**], and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by [**INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**].

A period of 10 minutes will be allotted to each person for making comments. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal author of these proposed regulations is John D. MacEachen, Office of the Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the Treasury Department and the IRS participated in their development.

**List of Subjects in 26 CFR Part 25**

Gift taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 25 is proposed to be amended as follows: PART 25--GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 1. The authority citation for part 25 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805. \* \* \*

Section 25.2701-2 also issued under 26 U.S.C. 2701(e). Section 25.2704-1 also issued under 26 U.S.C. 2704(a).

Sections 25.2704-2 and 25.2704-3 also issued under 26 U.S.C. 2704(b).

\* \* \* \* \*

Par. 2. Section 25.2701-2 is amended as follows:

1. In paragraph (b)(5)(i), the first sentence is revised and five sentences are added before the last sentence.

2. Paragraph (b)(5)(iv) is added.

The revision and additions read as follows:

§25.2701-2 Special valuation rules for applicable retained interests.

\* \* \* \* \*

(b) \* \* \* (5) \* \* \*

(i) \* \* \* For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of §301.7701-2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor’s spouse. The form of the entity determines the applicable test for control. For purposes of determining the form of the entity, any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B) is a corporation.

separate from its parent corporation. In the case of any business entity that is not a corporation under these provisions, the form of the entity is determined under local law, regardless of how the entity is classified for federal tax purposes or whether it is disregarded as an entity separate from its owner for federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under whose laws the entity is created or organized. \* \* \*

\* \* \* \* \*

(iv) Other business entities. In the case of any entity or arrangement that is not a

corporation, partnership, or limited partnership, control means the holding of at least 50 percent of either the capital interests or the profits interests in the entity or arrangement. In addition, control means the holding of any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part.

\* \* \* \* \*

***Comment****: The broad language of this provision “or arrangement” is perhaps intended to reach other structures taxpayers might endeavor to use to avoid the restrictions in Chapter 14 as amended by the Proposed Regulations. Perhaps the phrase “or arrangement” could be construed to include a tenants in common structure and subject it to the same toxic Disregarded Restrictions if family members control 50%. Applying the control concept under the Proposed Regulations to a LLC could be fact sensitive. If a manager has the “ability to cause the liquidation of the entity or arrangement in whole or in part” that might pass the control test. What does “in part” mean? In a member managed LLC must the rights of each member be evaluated under the operating agreement to ascertain whether that member has “the ability to cause the liquidation of the entity or arrangement in whole or in part?” It would appear so. Thus, it might be possible in some instances to draft around the control requirement. Worrisome, however, is the risk of running afoul of this test and unintentionally vesting a member with sufficient power to violate the control test. What does state law provide in this regards?*

Par. 3. Section 25.2701-8 is amended as follows:

1. The existing text is designated as paragraph (a).

2. The first sentence of newly designated paragraph (a) is revised and paragraph (b) is added.

The revision and addition reads as follows:

§25.2701-8 Effective dates.

(a) Except as provided in paragraph (b) of this section, §§25.2701-1 through

25.2701-4 and §§25.2701-6 and 25.2701-7 are effective as of January 28, 1992. \* \* \*

(b) The first six sentences of §25.2701-2(b)(5)(i) and (iv) are effective on the date these regulations are published as final regulations in the **Federal Register**.

Par. 4. Section 25.2704-1 is amended as follows:

1. In paragraph (a)(1), the first two sentences are revised and four sentences are added before the third sentence.

2. In paragraph (a)(2)(i), a sentence is added at the end.

3. Paragraph (a)(2)(iii) is removed.

4. Paragraphs (a)(2)(iv) through (vi) are redesignated as paragraphs (a)(2)(iii)

through (v), respectively.

5. In newly designated paragraph (a)(2)(iii), a sentence is added before the third sentence.

6. Paragraph (a)(4) is revised.

7. Paragraph (a)(5) is added.

8. In paragraph (c)(1), the second sentence is revised and a sentence is added at the end.

9. Paragraph (c)(2)(i)(B) is revised.

10. In paragraph (f) Example 4, the third and fourth sentences are revised and a

sentence is added at the end.

11. In paragraph (f) Example 6, the third sentence is removed.

12. In paragraph (f) Example 7, the third and fourth sentences are revised and a

sentence is added at the end.

The revisions and additions read as follows:

§25.2704-1 Lapse of certain rights.

(a) \* \* \*

(1) \* \* \* For purposes of subtitle B (relating to estate, gift, and generation- skipping transfer taxes), the lapse of a voting or a liquidation right in a corporation or a partnership (an entity), whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse (the holder) to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is controlled by the holder and/or members of the holder’s family immediately before and after the lapse. For purposes of this section, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified

subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of §301.7701-2(a) of this chapter regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes. \* \* \*

(2) \* \* \*

(i) \* \* \* For purposes of determining whether the group consisting of the holder, the holder’s estate and members of the holder’s family control the entity, a member of the group is also treated as holding any interest held indirectly by such member through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6.

\* \* \* \* \*

(iii) \* \* \* In the case of a limited liability company, the right of a member to participate in company management is a voting right. \* \* \*

\* \* \* \* \*

(4) Source of right or lapse*.* A voting right or a liquidation right may be conferred

by or lapse by reason of local law, the governing documents, an agreement, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs voting or liquidation rights.

***Comment****: These rules may only apply to transfers prior to the effective date of the Proposed Regulations because once the Regulations become effective the minimum value and put right rule would operate to negate the value of any lapse. This will, however, remain a trap for clients consummating transfers before the effective date of the new Proposed Regulations and who die after the effective date of the Proposed Regulations and within three years of the initial transfer. Practitioners must warn clients consummating transfers prior to the effective date of the new Proposed Regulations that if they die after the effective date and within three years of the transfer that there will be an add back to their taxable estate based on the value of the lapse. Further, clients should be warned that if the Democrats win the White House, and the estate tax proposals contained in the Democratic platform are enacted, the exemption might revert to $3.5 million and the gift exemption to $1 million (not inflation adjusted) with a 45% tax rate, making a potential add back even more costly than anticipated. . As discussed above a lapse will be included in the transferor’s estate if the transferor dies within three years of the transfer. That provisions could have a much costlier trap that might be anticipated.*

*The value of the lapse added back to the taxable estate is based on the date of death value of the entity, which could be substantially more than the value as of the date of the original transfer.*

*Could the discount taken at the gift transfer date be greater than the value of the lapse?*

*Is it possible the value of the lapse is greater than the discount originally taken plus the value of the loss of basis step-up on the transferred asset? If so, the transaction could prove detrimental overall.*

***Example****: Taxpayer gives stock in an LLC worth $1M in 2016. The discount is 40% or $400,000 for a gift valued at $600,000. On death 3 years later the underlying stock is worth $2M.*

*It may be that the lapse value is calculated by determining the value of the interests transferred as if those values could have been liquidated at not less than minimum value (as defined by the Proposed Regulations) within 6 months and then subtracting the value determined as of the date of the transfer.*

*What is the value of the lapse deemed to have occurred on the date of death in 2018 on the interest that was transferred in 2016? If the value of the assets has doubled, could the inclusion be greater than the initial discount? If this inclusion occurs, what is included in the estate to garner a basis step up? Does the original transferee get the step up or is this an asset in the transferor’s estate? What is included in the estate to be stepped up? Is it only the lapse right or the actual interest that is included in the estate?*

(5) Assignee interests. A transfer that results in the restriction or elimination of

the transferee’s ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights. For example, the transfer of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest.

***Comment****: This provision eliminates the valuation discount that had been achievable by the transferring an assignee interest only and not a full partnership or member interest in the entity.*

(c) \* \* \*

(1) \* \* \* Except as otherwise provided, a transfer of an interest occurring more than three years before the transferor’s death that results in the lapse of a voting or liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated. \* \* \* The lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor’s death is treated as a lapse occurring on the transferor’s date of death, includible in the gross estate pursuant to section 2704(a).

***Comment****: The three year rule above is a new addition added by the Proposed Regulations. It is intended to prevent the pre-death transfer of a minority interest at a discount thereby reducing the transferor/decedent’s remaining interests to a non-controlling position that will also be discounted on death. With the introduction of what appears to be a mandatory six month deemed liquidation right, it is not clear what additional clout the three year rule adds to the Proposed Regulations attack on discounts. See example illustrating the possible application of this above.*

(2) \* \* \* \* (i) \* \* \* \*

(B) Ability to liquidate. Whether an interest can be liquidated immediately after

the lapse is determined under the local law generally applicable to the entity, as modified by the governing documents of the entity, but without regard to any restriction (in the governing documents, applicable local law, or otherwise) described in section

2704(b) and the regulations thereunder. The manner in which the interest may be liquidated is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, revising the governing documents, merging the entity with an entity whose governing documents permit liquidation of the interest, terminating the entity, or otherwise. For purposes of making this determination, an interest held by a person other than a member of the holder’s family (a nonfamily- member interest) may be disregarded. Whether a nonfamily-member interest is disregarded is determined under §25.2704-3(b)(4), applying that section as if, by its terms, it also applies to the question of whether the holder (or the holder’s estate) and members of the holder’s family may liquidate an interest immediately after the lapse.

\* \* \* \* \*

***Comment****: Restrictions under the governing instrument, local law (the so-called state law exception), or “otherwise” no longer apply to reduce the value of a family controlled entity.*

(f) \* \* \*

Example 4. \* \* \* More than three years before D’s death, D transfers one-half of D’s stock in equal shares to D’s three children (14 percent each). Section 2704(a) does not apply to the loss of D’s ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D’s death. However, had the transfers occurred within three years of D’s death, the transfers would have been treated as the lapse of D’s liquidation right occurring at D’s death.

***Comment****: The above example illustrates the three year rule that would apply to require a transfer occurring less than three years before death to cause inclusion of the lapse right in the transferor’s estate. The estate tax value will include the value of the interest owned at death (undiscounted due to the deemed liquidation right), plus presumably the value of the liquidation rights attributable to each interest transferred less than three years’ earlier.*

*Once the Proposed Regulations become effective, it appears that the concepts in the Example 4 would be irrelevant since IRC Sec. 2704(b) would require inclusion of a deemed put right in each 14% interest gifted for valuation purposes.*

\* \* \* \* \*

Example 7. \* \* \* More than three years before D’s death, D transfers 30 shares of common stock to D’s child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D’s death. \* \* \* However, had the transfer occurred within three years of D’s death, the transfer would have been treated as the lapse of D’s liquidation right with respect to the common stock occurring at D’s death.

***Comment****: It is not clear what Example 7 adds that Example 4 did not.*

Par. 5. Section 25.2704-2 is amended as follows:

1. Paragraphs (a) and (b) are revised.

2. Paragraphs (c) and (d) are designated as paragraphs (e) and (g), respectively.

3. New paragraphs (c), (d), and (f) are added.

4. The first sentence of newly designated paragraph (e) is revised.

5. The third sentences of newly designated paragraph (g) Example 1. and

Example 3. are removed.

6. The third sentence of newly designated paragraph (g) Example 5. is revised.

The revisions and additions read as follows:

§25.2704-2 Transfers subject to applicable restrictions.

(a) In general. For purposes of subtitle B (relating to estate, gift, and generation-

skipping transfer taxes), if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor’s family, and the transferor and/or members of the transferor’s family control the entity immediately before the transfer, any applicable restriction is disregarded in valuing the transferred interest. For purposes of this section, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of

§301.7701-2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

(b) Applicable restriction defined--(1) In general. The term applicable restriction

means a limitation on the ability to liquidate the entity, in whole or in part (as opposed to a particular holder’s interest in the entity), if, after the transfer, that limitation either lapses or may be removed by the transferor, the transferor’s estate, and/or any member of the transferor’s family, either alone or collectively. See §25.2704-3 for restrictions on the ability to liquidate a particular holder’s interest in the entity.

(2) Source of limitation. An applicable restriction includes a restriction that is

imposed under the terms of the governing documents (for example, the corporation’s by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(4)(ii) of this section.

***Comment****: This change includes provisions of local law within the definition of an applicable restriction subject only to a modest exception which appears unlikely to apply. Thus, forming an LLC under a Nevada statute that prohibits distributions for 10 years will be an applicable restriction (as redefined by the Proposed Regulations) and will not permit a discount.*

(3) Lapse or removal of limitation. A restriction is an applicable restriction only to

the extent that either the restriction by its terms will lapse at any time after the transfer, or the restriction may be removed after the transfer by any one or more members, either

alone or collectively, of the group consisting of the transferor, the transferor’s estate,

and members of the transferor’s family. For purposes of determining whether the ability to remove the restriction is held by any member(s) of this group, members are treated as holding the interests attributed to them under the rules contained in §25.2701-6, in addition to interests held directly. The manner in which the restriction may be removed is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

(4) Exceptions. A restriction described in this paragraph (b)(4) is not an

applicable restriction.

(i) Commercially reasonable restriction. An applicable restriction does not

include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity’s trade or business operations, whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term fiduciary

of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

***Comment****: A commercially reasonable restriction, for example, by a bank, co-venturer, tenant, etc. appears to be an exception to the list of applicable restrictions. However, if the Proposed Regulations mandate a six month put right, it is not clear what relevance this would have unless this commercially reasonable restriction would reduce the minimum value required to be imputed under the put right rule.*

(ii) Imposed by federal or state law. An applicable restriction does not include a

restriction imposed or required to be imposed by federal or state law. For this purpose,

federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. 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. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity’s governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in §25.2701-2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

***Comment****: The above exception has been very narrowly crafted to exclude most state law restrictions from being relevant to the determination of value. As such, forming an LLC under a favorably crafted Texas or Alaska statute that would have provided for a discount under current law will no longer provide any reduction in value once the Proposed Regulations are implemented.*

(iii) Certain rights under section 2703. An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction.

(iv) Put right of each holder. Any restriction that otherwise would constitute an

applicable restriction under this section will not be considered an applicable restriction if each holder of an interest in the entity has a put right as described in §25.2704-3(b)(6).

(c) Other definitions. For the definition of the term controlled entity, see

§25.2701-2(b)(5). For the definition of the term member of the family, see §25.2702-

2(a)(1).

***Comment****: Control is defined to include more than a 50% interest or any GP interest. The term “member of the family” is restrictive and transfer to most third parties will not likely break the family control unless they meet a 10%, 20% and 3 year test. In the context of most family businesses, it is unlikely that transfers to third parties could be used to break the family control given the new 10%, 20%, 3 year restriction. The magnitude of this new restriction is so great that few closely held businesses would be willing to give away or sell sufficient equity to have restrictions held by third parties respected. This differs from current law where a very modest position held by a third party was able to support the restrictions leading to discounts.*

(d) Attribution. An individual, the individual’s estate, and members of the

individual’s family are treated as also holding any interest held indirectly by such person

through a corporation, partnership, trust, or other entity under the rules contained in

§25.2701-6.

(e) \* \* \* If an applicable restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction (whether in the governing documents, applicable law, or both) does not exist. \* \* \*

***Comment****: The Proposed Regulations refer at a number of points to “generally applicable valuation principles” but appear not to follow those very principles, most notably by imposing a six month mandated put right and by defining “minimum value” by ignoring legally enforceable debt, which would otherwise apply to reduce value under “generally applicable valuation principles.”*

(f) Certain transfers at death to multiple persons. Solely for purposes of section

2704(b), if part of a decedent’s interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent’s family and part of that includible interest passes to one or more persons who are not members of the decedent’s family, and if the part passing to the members of the decedent’s family is to be valued pursuant to paragraph (e) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent’s family is also treated as a single, separate property

interest. See paragraph (g) Ex. 4 of §25.2704-3.

(g) \* \* \*

Example 5. \* \* \* The preferred stock carries a right to liquidate X that cannot be exercised until 1999. \* \* \*

\* \* \* \* \*

§25.2704-3 [Redesignated as §25.2704-4]

Par. 6. Section 25.2704-3 is redesignated as §25.2704-4. Par. 7. New §25.2704-3 is added to read as follows.

§25.2704-3 Transfers subject to disregarded restrictions.

(a) In general. For purposes of subtitle B (relating to estate, gift and generation-

skipping transfer taxes), and notwithstanding any provision of §25.2704-2, if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor’s family, and the transferor and/or

members of the transferor’s family control the entity immediately before the transfer, any restriction described in paragraph (b) of this section is disregarded, and the transferred interest is valued as provided in paragraph (f) of this section. For purposes of this section, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B).

For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of §301.7701-2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited

liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

***Comment****: This provision introduces, in addition to the tightening of the “Applicable Restrictions” above under prior law, a new category of restrictions referred to as “Disregarded Restrictions.”*

(b) Disregarded restrictions defined--(1) In general. The term disregarded

restriction means a restriction that is a limitation on the ability to redeem or liquidate an

interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor’s family (subject to paragraph (b)(4) of this section), either alone or collectively.

(i) The provision limits or permits the limitation of the ability of the holder of the interest to compel liquidation or redemption of the interest.

(ii) The provision limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a minimum value. The term minimum value means the

interest’s share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, 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. For example, and subject to the foregoing limitation on outstanding obligations, if the entity holds an operating business, the rules of §20.2031-2(f)(2) or §20.2031-3 of this chapter 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. The minimum value of the interest is the net value of the entity multiplied by the interest’s share of the entity. For this purpose, the interest’s share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity. If the property held by the entity directly or indirectly includes an interest in another entity, and if a transfer of an interest in that other entity

by the same transferor (had that transferor owned the interest directly) would be subject to section 2704(b), then the entity will be treated as owning a share of the property held by the other entity, determined and valued in accordance with the provisions of section 2704(b) and the regulations thereunder.

***Comment****: This is the minimum value rule for the mandatory put right discussed above. It appears that this rule could result in a greater value for the entity interest than the pro-rata portion of the underlying assets multiplied by the equity interest involved. This could occur because of the mandatory sale terms that may not comport with reality, or the elimination of debts that generally accepted valuation principles would consider. Has the pendulum swung too far?*

(iii) The provision defers or permits the deferral of the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder’s intent to have the holder’s interest liquidated or redeemed.

(iv) The provision authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property. Solely for this purpose, except as provided in the following sentence, a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related to either the entity or any holder of an interest in the entity, is deemed not to be property. In the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non- passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See §25.2512-8. For purposes of this

paragraph (b)(1)(iv), a related person is any person whose relationship to the entity or to any holder of an interest in the entity is described in section 267(b), provided that for this purpose the term fiduciary of a trust as used in section 267(b) does not include a

bank as defined in section 581 that is publicly held.

***Comment****: If a client operates an active trade or business and the primary asset is a real property that is appropriate characterized as passive, so that the 60% value rule above is violated, then the note exception would not apply. As discussed above, if the note has to be issued at fair value, with a fair interest rate (not the applicable 1274 rate) what benefit is this exception?*

(2) Source of limitation. A disregarded restriction includes a restriction that is

imposed under the terms of the governing documents (for example, the corporation’s by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, which governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(5)(iii) of this section.

(3) Lapse or removal of limitation. A restriction is a disregarded restriction only to

the extent that the restriction either will lapse by its terms at any time after the transfer or may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor’s estate, and members of the transferor’s family. For purposes of determining whether the ability to remove the restriction is held by any one or more members of this group, members are treated as holding interests attributed to them under the rules contained in §25.2701-6, in addition to interests held directly. See also paragraph (b)(4) of this section. The manner in which the restriction may be removed is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

(4) Certain interests held by nonfamily members disregarded--(i) In general. In

the case of a transfer to or for the benefit of a member of the transferor’s family, for purposes of determining whether the transferor (or the transferor’s estate) or any member of the transferor’s family, either alone or collectively, may remove a restriction within the meaning of this paragraph (b), an interest held by a person other than a member of the transferor’s family (a nonfamily-member interest) is disregarded unless all of the following are satisfied:

(A) The interest has been held by the nonfamily member for at least three years immediately before the transfer;

(B) On the date of the transfer, in the case of a corporation, the interest constitutes at least 10 percent of the value of all of the equity interests in the corporation, and, in the case of a business entity within the meaning of §301.7701-2(a) of this chapter other than a corporation, the interest constitutes at least a 10-percent interest in the business entity, for example, a 10-percent interest in the capital and profits of a partnership;

(C) On the date of the transfer, in the case of a corporation, the total of the equity interests in the corporation held by shareholders who are not members of the transferor’s family constitutes at least 20 percent of the value of all of the equity interests in the corporation, and, in the case of a business entity within the meaning of §301.7701-2(a) of this chapter other than a corporation, the total interests in the entity held by owners who are not members of the transferor’s family is at least 20 percent of all the interests in the entity, for example, a 20-percent interest in the capital and profits of a partnership; and

(D) Each nonfamily member, as owner, has a put right as described in paragraph

(b)(6) of this section.

**Comment**: The above describes the stringent limitation on consideration of third parties involved. Prior to the current regulations, a modest percentage could be given to a third party, such as a charity, that could uphold a restriction. The Proposed Regulations appear to require a three-fold test: 10%, 20% and 3 year be met for any consideration. But even if this is done, will this override the deemed put right?

(ii) Effect of disregarding a nonfamily-member interest. If a nonfamily-member

interest is disregarded under this section, the rules of this section are applied as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.

(iii) Attribution. In applying the 10-percent and 20-percent tests when the

property held by the corporation or other business entity is, in whole or in part, an interest in another entity, the attribution rules of paragraph (d) of this section apply both in determining the interest held by a nonfamily member, and in measuring the interests owned through other entities.

(5) Exceptions. A restriction described in this paragraph (b)(5) is not a

disregarded restriction.

(i) Applicable restriction. A disregarded restriction does not include an applicable

restriction on the liquidation of the entity as defined in and governed by §25.2704-2.

(ii) Commercially reasonable restriction. A disregarded restriction does not

include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity’s trade or business operations whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term fiduciary

of a trust as used in section 267(b) does not include a bank as defined in section 581

that is publicly held.

(iii) Requirement of federal or state law. A disregarded restriction does not

include a restriction imposed or required to be imposed by federal or state law. For this purpose, federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. 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. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is a disregarded restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity’s governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in §25.2701-2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

(iv) Certain rights described in section 2703. An option, right to use property, or

agreement that is subject to section 2703 is not a restriction for purposes of this paragraph (b).

(v) Right to put interest to entity. Any restriction that otherwise would constitute a

disregarded restriction under this section will not be considered a disregarded restriction if each holder of an interest in the entity has a put right as described in paragraph (b)(6) of this section.

(6) Put right. The term put right means a right, enforceable under applicable

local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder’s interest, within six months after the date the holder gives notice of the holder’s intent to withdraw, cash and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs liquidation or redemption rights with regard to interests in the entity. For purposes of this paragraph (b)(6), the term other property

does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or to any holder of an interest in the entity. However, in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), the term other property does include a note or other obligation if

such note or other obligation is adequately secured, requires periodic payments on a

non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See §25.2512-8.

The minimum value of the interest is the interest’s share of the net value of the entity, as

defined in paragraph (b)(1)(ii) of this section.

(c) Other definitions. For the definition of the term controlled entity, see

§25.2701-2(b)(5). For the definition of the term member of the family, see §25.2702-

2(a)(1).

(d) Attribution. An individual, the individual’s estate, and members of the

individual’s family, as well as any other person, also are treated as holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6.

(e) Certain transfers at death to multiple persons. Solely for purposes of section

2704(b), if part of a decedent’s interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent’s family and part of that includible interest passes to one or more persons who are nonfamily members of the decedent, and if the part passing to the members of the decedent’s family is to be valued pursuant to paragraph (f) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent’s family is also treated as a single, separate property

interest. See paragraph (g) Example 4 of this section.

(f) Effect of disregarding a restriction. 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. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized.

(g) Examples. The following examples illustrate the provisions of this section.

Example 1. (i) D and D’s children, A and B, are partners in Limited Partnership X that was created on July 1, 2016. D owns a 98 percent limited partner interest, and A and B each own a 1 percent general partner interest. The partnership agreement provides that the partnership will dissolve and liquidate on June 30, 2066, or by the earlier agreement of all the partners, but otherwise prohibits the withdrawal of a limited partner. Under applicable local law, a limited partner may withdraw from a limited partnership at the time, or on the occurrence of events, specified in the partnership agreement. Under the partnership agreement, the approval of all partners is required to amend the agreement. None of these provisions is mandated by local law. D transfers a 33 percent limited partner interest to A and a 33 percent limited partner interest to B.

***Comment****: The two children have GP interests. Parent owns a 98% LP interest. Note how the Example provides that no provision is “mandated” by local law, an obvious attempt to illustrate that restrictions imposed by local law will be disregarded unless mandatory. And it should be kept in mind that even state law mandated will be disregarded if the entity could have been formed under an alternative statute (or, perhaps, common law) of the state which does not mandate such provisions.*

(ii) By 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 and that may be removed by the transferor and members of the transferor’s family, acting collectively, by agreeing to amend the partnership agreement. Therefore, under section 2704(b) and paragraph (a) of this section, the restriction on a limited partner’s ability to liquidate that partner’s interest is disregarded in determining the value of each transferred interest.

Accordingly, the amount of each transfer is the fair market value of the 33 percent

limited partner interest determined under generally applicable 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. See paragraphs (b)(1)(i) and (f) of this section.

***Comment****: The Disregarded Restrictions would be disregarded for valuation purposes and there would be no valuation discount for this restriction. While it appears at first blush that the “lack of marketability discount” is still remaining, the Proposed Regulations, in particular the mandatory deemed redemption right for minimum value, appear to quash this possible discount.*

Example 2. The facts are the same as in Example 1, except that, both before and after the transfer, A’s partnership interests are held in an irrevocable trust of which A is the sole income beneficiary. The trustee is a publicly-held bank. A is treated as holding the interests held by the trust under the rules contained in §25.2701-6. The result is the same as in Example 1.

***Comment****: A child’s interests are held in an irrevocable trust. There is no difference in result as the trust’s interests are attributed to the child and the results are the same as in the prior example.*

Example 3. The facts are the same as in Example 1, except that, on D’s subsequent death, D’s remaining 32 percent limited partner interest passes outright to D’s surviving spouse, S, who is a U.S. citizen. In valuing the 32 percent interest for purposes of determining both the amount includible in the gross estate and the amount allowable as a marital deduction, the analysis and result are as described in Example 1.

***Comment****: The marital deduction and the amount included in the estate are the same, and there is no discount.*

Example 4. (i) The facts are the same as in Example 1, except that D made no gifts and, on D’s subsequent death pursuant to D’s will, a 53 percent limited partner interest passes to D’s surviving spouse who is a U.S. citizen, a 25 percent limited partner interest passes to C, an unrelated individual, and a 20 percent limited partner interest passes to E, a charity. The restriction on a limited partner’s ability to liquidate that partner’s interest is a disregarded restriction. In determining whether D’s estate and/or D’s family may remove the disregarded restriction after the transfer occurring on D’s death, the interests of C and E are disregarded because these interests were not held by C and E for at least three years prior to D’s death, nor do C and E have the right to withdraw on six months’ notice and receive their respective interest’s share of the minimum value of X. Thus, the 53 percent interest passing to D’s surviving spouse is subject to section 2704(b). D’s gross estate will be deemed to include two separate assets: a 53 percent limited partner interest subject to section 2704(b), and a 45

percent limited partner interest not subject to section 2704.

***Comment****: This example illustrates non-controlling interests passing to third parties in excess of the 10% and 20% tests but they have not been held for three years. This results in a higher marital deduction for which there is no discount. There is a discount on the value of the charitable interest so its value is different than that for the marital deduction. If the estate inclusion value and deduction are based on the same value there should be no difference. However, there might be if the estate elects IRC Sec. 6166 alternate valuation or other tax elections based on percentages of the value of the estate. So, if part of the estate consisting of a family business is bequeathed to a child and a part to a charity, the values could be different since the charitable bequest is eligible for discounting.*

*Could this affect the IRC Sec. 6166 requirement that the interests not be less than 35% of adjusted gross estate test?*

*Practically, this would require the estate to obtain two different valuations of the same asset, one with discounts and one without, adding substantial costs and complexity to the appraisal and estate administration.*

*What if all beneficiaries are residuary beneficiaries and the executor has to allocate assets? Will the determination of which asset to give to which person affect the tax, 6166 qualification, etc. based on whether the discounts apply and to which shares?*

(ii) The fair market value of the 53 percent interest is determined for both inclusion and deduction purposes under generally applicable 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. The 45 percent interest passing to nonfamily members is not subject to section 2704(b), and will be valued as a single interest for inclusion purposes under generally applicable valuation principles, taking into account all relevant factors affecting value including the rights determined under the governing documents and local law as well as the restriction on a limited partner’s ability to liquidate that partner’s interest. The 20 percent passing to charity will be valued in a similar manner for purposes of determining the allowable

charitable deduction. Assuming that, under the facts and circumstances, the 45 percent interest and the 20 percent interest are subject to the same discount factor, the charitable deduction will equal four-ninths of the value of the 45 percent interest.

***Comment****: As noted above “family” is defined “With respect to any individual, member of the family means the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the foregoing.” §25.2702-2(a)(1).*

*In the case where a clause in the Will defines heirs to include children born out-of-wedlock or non-adopted step-children but state law provides otherwise, it would seem that those heirs would not be considered family members under these rules.*

*Practitioners may need to amend governing documents in spite of the harsh 2704 Proposed Regulations to address the issue of discounts on transfers to heirs who do not qualify as family.*

Example 5. (i) D and D’s children, A and B, are partners in Limited Partnership Y. D owns a 98 percent limited partner interest, and A and B each own a 1 percent general partner interest. The partnership agreement provides that a limited partner may withdraw from the partnership at any time by giving six months’ notice to the general partner. On withdrawal, the partner is entitled to receive the fair market value of his or her partnership interest payable over a five-year period. Under the partnership agreement, the approval of all partners is required to amend the agreement. None of these provisions are mandated by local law. D transfers a 33 percent limited partner interest to A and a 33 percent limited partner interest to B. Under paragraph (b)(1)(iii) of this section, the provision requiring that a withdrawing partner give at least six months’ notice before withdrawing provides a reasonable waiting period and does not cause the restriction to be disregarded in valuing the transferred interests. However, the provision limiting the amount the partner may receive on withdrawal to the fair market value of the partnership interest, and permitting that amount to be paid over a five-year period, may limit the amount the partner may receive on withdrawal to less than the minimum value described in paragraph (b)(1)(ii) of this section and allows the delay of payment beyond the period described in paragraph (b)(1)(iii) of this section. 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 and that may be removed by the transferor and members of the transferor’s family, acting collectively, by agreeing to amend the partnership agreement.

***Comment****: This example illustrates the minimum value rule. Even if a five year payout is reasonable under the circumstances, there cannot be a net present value calculation but rather the payout shall be treated as if paid over six months.*

(ii) Under section 2704(b) and paragraph (a) of this section, the restriction on a limited partner’s ability to liquidate that partner’s interest is disregarded in determining the value of the transferred interests. Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest, determined under generally applicable 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. See paragraph (f) of this section.

***Comment****: This example suggests applying a “fair market value” analysis but the restrictions in the Proposed Regulation modify that in ways that might change what fair value is, not merely remove discounts. Disregarded Restrictions may disregard a five year payout that might be arm’s length and of economically sound substance and may apply for real world purposes.*

*It is not merely a different discount analysis but a different valuation analysis that may be required for different components of the same business. By way of example: If a portion of the estate is bequeathed to children, the Disregarded Restrictions must be factored into the analysis. If another portion of the business interest is bequeathed to non-family heirs, the Disregarded Restrictions and the various valuation assumptions required by the minimum value rules will not apply. So, for example, loans can only reduce the value of the business interests children inherit if they meet the litmus test of IRC Sec. 2053. For the portion of the business bequeathed to non-family heirs, the IRC Sec. 2053 analysis will not apply to the deductibility of debts on the valuation.*

*It is vital to point out that these Chapter 14 rules apply* ***regardless of the size of the estate*** *so that even non-taxable estates must run the rigors of these provisions. Further, what valuation rules will a state look to? If the state looks to federal law as of 2001, do those laws govern valuations for state estate tax purposes - so that yet another appraisal is necessary to comply with the federal laws that existed prior to these rules for state purposes (e.g., New Jersey)?*

Example 6. The facts are the same as in Example 5, except that D sells a 33 percent limited partner interest to A and a 33 percent limited partner interest to B for fair market value (but without taking into account the special valuation assumptions of section 2704(b)). Because section 2704(b) also is relevant in determining whether a gift has been made, D has made a gift to each child of the excess of the value of the

transfer to each child as determined in Example 5 over the consideration received by D

from that child.

***Comment****: This example illustrates how a sale to a defective grantor trust at fair market value using discounts will result in a gift equal to the differential between the sales price and the value determined under the Chapter 14 rules as amended by the Proposed Regulations. A formula valuation mechanism should reflect these considerations, although it should be noted that the IRS has non-acquiesced in the Wandry formula valuation case.*

*Consider the following scenario: A physician-client is concerned about asset protection and sells assets to a grantor trust to remove them from the reach of claimants. She maximizes discounts so that she can leverage more assets out of her estate and out of the reach of her creditors. The above example makes clear that there will be a gift component to this transaction.*

Example 7. The facts are the same as in Example 5, except, in a transaction unrelated to D’s prior transfers to A and B, D withdraws from the partnership and immediately receives the fair market value (but without taking into account the special valuation assumptions of section 2704(b)) of D’s remaining 32 percent limited partner interest. Because a gift to a partnership is deemed to be a gift to the other partners, D has made a gift to each child of one-half of the excess of the value of the 32 percent limited partner interest as determined in Example 5 over the consideration received by D from the partnership.

***Comment****: This example continues the line of reasoning from the prior example in which a sale triggered a deemed gift. Here, a withdrawal at a price that does not reflect the appropriate 2704 rules also can trigger an indirect gift to the partnership. If the partnership includes non-family members, then this calculation might have to be bifurcated and different valuation calculations made. It is not clear and clarification would be helpful.*

*Where a partner liquidates his interest for less than full undiscounted value (i.e., determined as required under the Proposed Regulations) and some partners are family members and others are not, is the gift the entire differential or just the differential multiplied by the interests of remaining partners that constitute “family”?*

*Will that imputed gift qualify for an annual gift exclusion under IRC §2503(b)? How is the gift valued for IRC Sec. 2503 purposes? The fact that restrictions are disregarded under IRC Sec. 2704 does not necessarily mean that they are disregarded for purposes of determining whether the deemed gift qualifies for the annual gift exclusion. In this case, the client might be whipsawed with a higher deemed gift under IRC Sec. 2704 and not qualify for an annual gift exclusion because of same restrictions are disregarded.*

Example 8. D and D’s children, A and B, organize Limited Liability Company X under the laws of State Y. D, A, and B each contribute cash to X. Under the operating agreement, X maintains a capital account for each member. The capital accounts are adjusted to reflect each member’s contributions to and distributions from X and each member’s share of profits and losses of X. On liquidation, capital account balances control distributions. Profits and losses are allocated on the basis of units issued to each member, which are not in proportion to capital. D holds 98 units, A and B each hold 1 unit. D is designated in the operating agreement as the manager of X with the ability to cause the liquidation of X. X is not a corporation. Under the laws of State Y, X is neither a partnership nor a limited partnership. D and D’s family have control of X because they hold at least 50 percent of the profits interests (or capital interests) of X. Further, D and D’s family have control of X because D holds an interest with the ability

to cause the liquidation of X.

***Comment****: This example illustrates the control rules in the Proposed Regulations.*

Example 9. The facts are the same as in Example 8, except that, under the operating agreement, all distributions are made to members based on the units held, which in turn is based on contributions to capital. Further, X elects to be treated as a corporation for federal tax purposes. Under §25.2701-2(b)(5), D and D’s family have control of X (which is not a corporation and, under local law, is not a partnership or limited partnership) because they hold at least 50 percent of the capital interests in X. Further, D and D’s family have control of X because D holds an interest with the ability to cause the liquidation of X.

***Comment****: This is another example that illustrates the control rules in the Proposed Regulations. Treatment as a corporation will have different distribution rights, etc. but the control rules under the Proposed Regulations will still apply.*

Example 10. D owns a 1 percent general partner interest and a 74 percent limited partner interest in Limited Partnership X, which in turn holds a 50 percent limited partner interest in Limited Partnership Y and a 50 percent limited partner interest in Limited Partnership Z. D owns the remaining interests in partnerships Y and Z. A, an unrelated individual, has owned a 25 percent limited partner interest in partnership X for more than 3 years. The governing documents of all three partnerships permit

liquidation of the entity on the agreement of the owners of 90 percent of the interests but, with the exception of A’s interest, prohibit the withdrawal of a limited partner. A may withdraw on 6-months’ notice and receive A’s interest’s share of the minimum value of partnership X as defined in paragraph (b)(1)(ii) of this section, which share

includes a share of the minimum value of partnership Y and of partnership Z. Under the governing documents of all three partnerships, the approval of all partners is required to amend the documents. D transfers a 40 percent limited partner interest in partnership Y to D’s children. For purposes of determining whether D and/or D’s family members

have the ability to remove a restriction after the transfer, A is treated as owning a 12.5 percent (.25 x.50) interest in partnership Y, thus more than a 10 percent interest, but less than a 20 percent interest, in partnership Y. Accordingly, under paragraph (b)(4)(i)(C) of this section, A’s interest is disregarded for purposes of determining whether D and D’s family hold the right to remove a restriction after the transfer

(resulting in D and D’s children being deemed to own 100 percent of Y for this purpose).

However, if D instead had transferred a 40 percent limited partner interest in partnership X to D’s children, A’s ownership of a 25 percent interest in partnership X would not have been disregarded, with the result that D and D’s family would not have had the ability to remove a restriction after the transfer.

***Comment****: This example illustrates the control rules in the Proposed Regulations applied to tiered entities.*

Example 11. (i) D owns 85 of the outstanding shares of X, a corporation, and A, an unrelated individual, owns the remaining 15 shares. Under X’s governing documents, the approval of the shareholders holding 75 percent of the outstanding stock is required to liquidate X. With the exception of nonfamily members, a shareholder may not withdraw from X. Nonfamily members may withdraw on six

months’ notice and receive their interest’s share of the minimum value of X as defined in paragraph (b)(1)(ii) of this section. D transfers 10 shares to C, a charity. Four years later, D dies. D bequeaths 10 shares to B, an unrelated individual, and the remaining

65 shares to trusts for the benefit of D’s family.

(ii) The prohibition on withdrawal is a restriction described in paragraph (b)(1)(i) of this section. In determining whether D’s estate and/or D’s family may remove the restriction after the transfer occurring on D’s death, the interest of B is disregarded because it was not held by B for at least three years prior to D’s death. The interests of A and C, however, are not disregarded, because each held an interest of at least 10 percent for at least three years prior to D’s death, the total of those interests represents at least 20 percent of X, and each had the right to withdraw on six months’ notice and receive their interest’s share of the minimum value of X. As a result, D and D’s family hold 65 of the deemed total of 90 shares in X, or 72 percent, which is less than the 75 percent needed to liquidate X. Thus, D and D’s family do not have the ability to remove the restriction after the transfer, and section 2704(b) does not apply in valuing D’s interest in X for federal estate tax purposes.

***Comment****: This example illustrates the control rules in the Proposed Regulations and a situation in which the restrictive rules of the Proposed Regulations do not apply. This illustrates the complexity of the detailed analysis that may have to be completed for an entity to determine which rules apply. This is essential in determining whether restrictions are ignored or not and what valuation rules apply.*

Par. 8. Newly designated §25.2704-4 is amended as follows:

1. The undesignated text is designated as paragraph (a).

2. In the first and second sentences of newly designated paragraph (a), the language “Section” is removed and the language “Except as provided in paragraph (b) of this section, §” is added in its place.

3. Paragraph (b) is added. The addition reads as follows:

§25.2704-4 Effective date.

\* \* \* \* \*

(b)(1) With respect to §25.2704-1, the first six sentences of paragraph (a)(1), the last sentence of paragraph (a)(2)(i), the third sentence of paragraph (a)(2)(iii), the first and last sentences of paragraph (a)(4), paragraph (a)(5), the second and last sentences

of paragraph (c)(1), paragraph (c)(2)(i)(B), and Examples 4, 6 and 7 of paragraph (f),

apply to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

(2) With respect to §25.2704-2, paragraphs (a), (b), (c), (d), and (f), the first sentence of paragraph (e), and Examples 1, 3 and 5 of paragraph (g) 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**.

(3) Section 25.2704-3 applies to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the **Federal Register**.

John Dalrymple

Deputy Commissioner for Services and Enforcement

[FR Doc. 2016-18370 Filed: 8/2/2016 11:15 am; Publication Date: 8/4/2016]

**LISI** Estate Planning Newsletter #2448 (August 22, 2016) at [http://www.leimbergservices.com](http://www.leimbergservices.com/)  Copyright © 2016 Martin M. Shenkman

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