Report No. 1358

New York State Bar Association

Tax Section

Trusts and Estates Section

Joint Report on Proposed Regulations under Section 2704 of the Code

November 21, 2016

Contents

New York State Bar Association

Tax Section

Trusts and Estates Section

Joint Report on Proposed Regulations under Section 2704 of the Code

This report (the "**Report**")[1] provides comments on proposed regulations published August 4, 2016 (the "**Proposed Regulations**")[2] relating to the special gift, estate, and generation-skipping transfer ("**GST**") tax valuation rules of Section 2704 of the Internal Revenue Code of 1986, as amended (the "**Code**").[3]

The Proposed Regulations respond to taxpayers' use of entity-level valuation discounts in order to depress artificially the value of property for gift and estate tax purposes. We commend the Service for exercising its regulatory authority to enact reform in this important area. Nevertheless, as discussed in detail in Part III of this Report, the Proposed Regulations leave unresolved the critical question of how an interest in an entity is valued when, as provided in the Proposed Regulations, a restriction on liquidation or withdrawal is disregarded. This Report also describes alternatives that the Service may wish to consider in order to achieve the Service's policy objectives.

This Report is divided into five parts. Part I summarizes the Report's principal recommendations. Part II provides history and background relevant to the Proposed Regulations. Part III addresses the effect that disregarding a restriction under the Proposed Regulations has on valuation of an entity interest, and concludes by recommending approaches that the Service may wish to consider. Part IV recommends other changes to the Proposed Regulations, including relating to the classification of entities, the definition of family control, the lapse of liquidation or voting rights, and the definitions of "applicable restriction" and "disregarded restriction." Final-

[1] The principal author of this Report is Austin W. Bramwell. Mitchell L. Gans, Alan S. Halperin, Kevin Matz, and Joseph Septimus made substantial contributions. Helpful comments were provided by K. Eli Akhavan, David Choi, Jessica Goldsmith, Amy E. Heller, David J. McCabe, Jillian E. Merns, Stuart L. Rosow, Michael Schler, Jeffrey N. Schwartz, and Lois Tilton. This Report reflects solely the views of the Tax and Trust and Estate Sections of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.

[2] 81 Fed. Reg. 51413 (Aug. 4, 2016).

[3] All references in this Report to "Sections," except as otherwise indicated, are to sections of the Code.

ly, Part V recommends rules on the interaction between the special valuation rules of Section 2704 and the determination of basis of property acquired or passing from a decedent under Section 1014(a).

Our understanding of the Proposed Regulations' intent is informed in part by public comments of Service officials since the Proposed Regulations were issued.[4] In addition, we have spoken at length with the Proposed Regulations' principal authors. We are grateful for the Service's time and the effort that they have devoted to helping us understand the Proposed Regulations. Our comments are designed to aid the Service as far as possible in achieving its intentions, as we understand them.

I. SUMMARY OF PRINCIPAL RECOMMENDATIONS

Our recommendations include the following:

1. The Service should clarify what effect disregarding a restriction under the Proposed Regulations has on the valuation of an interest in an entity.

2. The Service should not adopt a valuation rule that would require the appraiser of a transferred interest to assume a state of legal uncertainty as to whether the holder has liquidation or withdrawal rights.

3. Where a restriction is disregarded, the Service should consider the following approaches: (a) providing clear substitute assumptions that an appraiser must apply when valuing an entity interest; (b) providing that a gift occurs on formation of the entity; or (c) providing that the entity interest is not valued under the traditional willing-buyer-willing-seller test.

4. The Service should provide that, in determining control of a limited partnership, a non-controlling interest in an entity that holds the general partnership interests is not equivalent to holding an interest as a general partner.

5. The Service should clarify that the new Section 2704(a) rules apply to lapses of voting or liquidation rights as a result of transfers of entity interests occurring after the final regulations are published, regardless of whether the interests were created on or before October 8, 1990.

[4] *See, e.g.*, Matthew R. Madara, *Proposed Estate Tax Regs Have Been Misconstrued, Official Says*, 2016 Tax Notes Today 1918 (Oct. 3, 2016); Colleen Murphy, *'A Lot of Misunderstanding' Surrounds New Estate Tax Rules*, 191 Daily Tax Report G1 (Sept. 30, 2016); Matthew R. Madara, *Misinformation Cited in Estate Tax Valuation Rules Controversy*, 2016 Tax Notes Today 223-5 (Nov. 17, 2016).

6. The Service should clarify that, in determining an entity's net value, only the expected value of the entity's obligations, rather than the face amount of any claims that may be asserted against the entity, may be taken into account.

7. The Service should consider further the effect of Section 2704(b) on the valuation of entity interests transferred by trusts.

8. The Service should clarify that the determination of fair market value for purposes of determining basis under Sections 1014 and 1015 is consistent with the determination of fair market value for gift and estate tax purposes.

II. HISTORY AND BACKGROUND

A. Summary of the Statute

Section 2704, which was enacted as part of the Omnibus Budget Reconciliation Act of 1990 ("**OBRA**"),[5] contains two distinct rules. The first rule, found in Section 2704(a), treats certain lapses of liquidation or voting rights as if they were transfers of property for gift and estate tax purposes. More specifically, Section 2704(a)(1) provides that if a lapse of a liquidation or voting right in a corporation or partnership occurs, and the individual possessing the right and members of that individual's family hold control of the entity both before and after the lapse, then the lapse shall be treated as a transfer by gift or as a transfer includible in the individual's gross estate at death, whichever is applicable. The amount of the transfer is equal to the difference between the fair market value of the individual's interests immediately before and after the lapse.[6]

The second rule, found in Section 2704(b), disregards certain restrictions when valuing interests in corporations and partnerships. Restrictions may be disregarded in two situations. First, restrictions known as "applicable restrictions" are disregarded under Section 2704(b)(1). That Section provides that if an individual transfers an interest in a partnership or corporation to or for the benefit of a member of the transferor's family, and the individual and members of the individual's family hold control of the entity immediately before the lapse, then any "applicable restriction" is disregarded in valuing the interest. An "applicable restriction" is defined in Section 2704(b)(2) as a restriction which effectively limits the ability of the entity to liquidate, provided that, after the transfer, the restriction will either lapse or can be removed by the transferor or the transferor's family, alone or collectively. Section 2704(b)(3) creates an exception in the case of restrictions that are "imposed, or required to be imposed" by any federal or state law. Regula-

[5] Pub. L. 101-508 § 11602(a), 104 Stat. 1388, 1388–491 to 1388–500 (1990).

[6] I.R.C. § 2704(a)(2).

tions currently interpret this exception to mean that a limitation on the ability to liquidate an entity is not an applicable restriction if it is no more restrictive than the limitations that would apply under state law.[7]

Other restrictions, though not defined in the statute, may also be disregarded under the authority granted the Treasury in Section 2704(b)(4). That Section provides that the Treasury may by regulation provide that restrictions, other than applicable restrictions, are disregarded in valuing an interest in a corporation or 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. The Proposed Regulations, as discussed further in this Report, exercise this authority by defining a new class of restrictions, designated "disregarded restrictions."[8] Like applicable restrictions, disregarded restrictions are, under the Proposed Regulations, disregarded for gift, estate, and GST tax valuation purposes.

B. Purposes of the Statute

The legislative history of Section 2704, as the Tax Court observed in *Estate of Kerr v. Commissioner*,[9] contains "no meaningful explanation of the detailed language or concepts that were made part of section 2704 as finally enacted." That said, the history[10] does indicate that Section 2704 targets results such as those achieved in *Estate of Harrison v. Commissioner*.[11] In *Harrison*, the decedent at the time of his death was one of three general partners and the sole limited partner of a limited partnership. As a general partner, the decedent had the right, during his lifetime, to compel the partnership to liquidate. Under the partnership agreement, however, the right lapsed at the decedent's death. Consequently, the Tax Court held that the right to liquidate the partnership would not be taken into account in valuing the interests included in the decedent's gross estate. Section 2704—specifically, Section 2704(a)—overturns this result by causing the difference between the value of a decedent's interests before and after lapse to be included in the amount subject to gift or estate tax.

Legislative history describing the purpose of Section 2704(b) is scant. Without distinguishing between Section 2704(a) and Section 2704(b), the history states that "[t]hese rules do

7 Treas. Reg. § 25.2704-2(b).

8 Prop. Reg. § 25.2704-3.

9 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002).

10 H. Conf. Rep. No. 101-964, at 1137 (1990) , 1991-2 C.B. 560, 606.

11 T.C. Memo 1987-8.

not affect minority discounts or other discounts available under present law."[12] The history also includes the following example, apparently intended to illustrate the application of Section 2704(b):

> Mother and Son are partners in a two-person partnership. The partnership agreement provides that the partnership cannot be terminated. Mother dies and leaves her partnership interest to Daughter. As the sole partners, Daughter and Son acting together could remove the restriction on partnership termination. [T]he value of Mother's partnership interest in her estate is determined without regard to the restriction. Such value would be adjusted to reflect any appropriate fragmentation discount.[13]

Finally, the legislative history acknowledges that the Treasury may disregard additional restrictions under Section 2704(b)(4).[14]

C. Minority Interest Discounts[15]

Prior to issuing the Proposed Regulations, the Service, as discussed in Part II.D below, had attempted to invoke Section 2704(b) to curtail taxpayers' use of minority interest discounts. Those discounts arise under the venerable willing-buyer-willing-seller test, which generally determines the value of property transferred for gift and estate tax purposes.[16] Under the test, the value of property is the price at which it would exchange hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and each being reasonably informed of relevant facts.[17] Where an interest in an entity is illiquid and not freely tradable, the price that a willing buyer would pay, and that a willing seller would demand, is determined based on factors such as the entity's net worth, its earning power, and its dividend-paying capacity.[18]

[12] H. Conf. Rep. No. 101-964, at 1137 (1990), 1991-2 C.B. 560, 606.

[13] H. Conf. Rep. No. 101-964, at 1137 (1990), 1991-2 C.B. 560, 606.

[14] *Id.*

[15] This Report uses the term "minority interest discount" as an umbrella term for the types of discounts, primarily for lack of control and lack of marketability, that are associated with non-controlling interests in privately held entities.

[16] Treas. Reg. §§ 20.2031-1(b), 25.2512-1; Rev. Rul. 59-60; United States v. Cartwright 411 U.S. 546, 551 (1973) (noting that "[t]he willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves.").

[17] Treas. Reg. §§ 20.2031-1(b); 25.2512-1; Rev. Rul. 59-60.

[18] Treas. Reg. § 20.2031-2(f).

Relevant factors also include the degree of control represented by the interest, as well as the presence or absence of a market in which the interest can be sold and converted to cash.[19] Appraisers generally agree that buyers pay (and sellers demand) less for an interest that does not confer control over management decisions.[20] Likewise, buyers pay less for an interest for which there does not exist an active market.[21] The cases, in consequence, are legion where the value of a minority or non-controlling interest in a privately held entity has been discounted for gift and estate tax purposes.[22]

Not surprisingly, taxpayers have exploited these minority interest discounts in order to depress the value of property for gift and estate tax purposes. In a typical fact pattern, a donor, before making any gift, first contributes assets, such as cash or publicly traded stock, to a limited partnership or another entity. In exchange for the contribution, the donor takes back an equity interest.[23] The donor then assigns a non-controlling interest in the entity to or for the benefit of family members.

The entity's governing documents, meanwhile, prohibit or limit the interest holder's ability to participate in management decisions, to compel the entity to liquidate, or to withdraw from the entity and receive back a share of the entity's capital. As a result of these restrictions, the value of the interest transferred is discounted in order to reflect minority interest discounts. In short, by using an entity shell, taxpayers under current law can cause the value of their property

[19] *See, e.g.*, Lappo v. Comm'r, T.C. Memo 2003-258 (allowing a 15% lack-of-control discount and 24% lack-of-marketability discount for limited partnership interests in an limited partnership which held municipal bonds and two pieces of commercial real estate).

[20] *See, e.g.*, Estate of Heck v. Comm'r, T.C. Memo 2002-34 (applying a 10% discount for lack of control over corporate dividend policy).

[21] *See* Lappo v. Comm'r, T.C. Memo 2003-258.

[22] *See, e.g.*, Lappo v. Comm'r, T.C. Memo 2003-258 (allowing a 15% lack-of-control discount and 24% lack-of-marketability discount); Pierre v. Comm'r, T.C. Memo 2010-106 (allowing for a 30% lack of marketability discount); Est. of Thompson v. Comm'r, T.C. Memo 2004-174 (allowing for a 15% lack-of-control discount and 30% lack-of-marketability discount).

[23] Often, the donor will be the sole initial owner of the entity, so that no gift results from the capital contribution. Even if others contribute capital to the entity, the courts have held that no gift occurs so long as each owner receives an interest that is proportionate to his or her share of capital contributions. Est. of Strangi v. Comm'r, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002); Est. of Jones v. Comm'r, 116 T.C. 121 (2001); Church v. United States, 268 F.3d 1063 (5th Cir. 2001), *aff'g per curiam* 2000 WL 206374 (W.D. Tex. 2000); *see also* Shepherd v. Comm'r, 115 T.C. 376, 389 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002) ("Obviously, not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of his contribution, thus entitling him to recoup the same amount upon liquidation of the partnership."). Thus, it is relatively easy, under current law, to avoid a gift on formation of an entity.

to be diminished for gift and estate tax purposes. Several cases have approved this type of planning and have allowed valuation discounts, even when the entity was funded with cash or marketable assets and gifts of entity interests occurred shortly thereafter.[24]

D. Case Law Limiting the Scope of Section 2704(b)

The Service has sought to curb the use of artificial minority interest discounts in part[25] by arguing that restrictions on an interest holder's ability to liquidate or withdraw should be disregarded under Section 2704(b). In *Estate of Kerr*,[26] for example, a case discussed in the preamble of the Proposed Regulations, the taxpayers, acting on the advice of an estate tax planning attorney, formed two Texas limited partnerships, which they funded with life insurance policies, stocks, bonds, and real estate. Shortly after creation of the partnerships, the taxpayers assigned all of the general partnership interests to their children. They then transferred a small number of limited partnership units to a charity. Finally, the taxpayers made gifts of much larger numbers of limited partnership units to their children and trusts for their benefit, which the taxpayers reported on gift tax returns at values that reflected discounts for lack of marketability and control.

The Service, in seeking to assess a gift tax efficiency, argued that provisions of the partnership agreements that prevented the partnerships from dissolving without the consent of all partners should be disregarded under Section 2704(b). The Tax Court, however, declined to disregard the restriction and held that, because the provisions were not more restrictive than the liquidation provisions that would apply under Texas's limited partnership act, they were excepted from the definition of applicable restriction.[27] In addition, the Tax Court rejected the Service's fallback argument that the restriction on liquidation was more restrictive than Texas law because Texas' limited partnership act, but not the partnership agreements, permitted limited partners to withdraw upon six months' notice to the general partner. On the contrary, the Tax Court held, a

[24] *See*, *e.g.*, Holman v. Comm'r, 130 T.C. 170 (2008), *aff'd* 601 F.3d 763 (8th Cir. 2010); Linton v. United States, 630 F.3d 1211 (9th Cir. 2011), *aff'g in part and rev'g in part* 638 F. Supp. 2d 1277 (W.D. Wash. 2009).

[25] The Service has advanced other arguments to deny discounts, with limited success. The Service's strategy for attacking abuse of valuation discounts is set forth in FSA 200049003 (Sept. 1, 2000). *See also* TAM 9842003 (Oct. 16, 1998); FSA 199950014 (Sept. 15, 1999). Of the arguments developed therein, the Service has perhaps had the most, albeit still limited success advancing the theory that assets of an entity may be included in a decedent's gross estate at death under Section 2036.

[26] 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002).

[27] Interestingly, the Tax Court commented that Treas. Reg. § 25.2704-2(b) represents a regulatory "expansion" of the Section 2704(b)(3)(B) exception for a restriction that is "imposed, or required to be imposed" by any federal or state law.

restriction on withdrawal is not a limitation on the ability to liquidate the entity and, therefore, does not come within the scope of Section 2704(b).

The Service appealed to the Fifth Circuit, which also held for the taxpayers, but on different grounds. The Fifth Circuit declined to decide whether the restrictions on liquidation or withdrawal in the partnership agreements could in principle constitute applicable restrictions. Instead, the court held that the restrictions could not qualify as applicable restrictions because the consent of the charity, which held small numbers of limited partnership units, was required before the family could remove the restrictions. Thus, even though the charity would have likely agreed to remove the restriction, the court held that the requirements of an applicable restriction were not satisfied, and that the restrictions of the partnership agreements would not be disregarded in valuing the limited partnership interests.

E. The Proposed Regulations' Response to *Kerr*

As acknowledged in the preamble, the Proposed Regulations are aimed at both the Tax Court's and the Fifth Circuit's holdings in *Kerr*.

First, the Proposed Regulations significantly narrow the Section 2704(b)(3) exception for any restriction "imposed, or required to be imposed" by any federal or state law. Under the current regulations, a provision limiting the ability of an entity to liquidate will not be disregarded as an applicable restriction if it is no more restrictive than the default limitations that would apply under state law.[28] Consequently, in *Kerr*, the Tax Court found that the partnership agreements' restrictions on liquidating the limited partnerships were no more restrictive than the default provisions of Texas's limited partnership act, and therefore held that they were not applicable restrictions.

The Proposed Regulations would change this result, first, by providing that an "applicable restriction" includes a restriction imposed under state law.[29] The definition of "disregarded restrictions" similarly provides that the source of the restriction is irrelevant.[30] Second, the Proposed Regulations, taking their cue from a comment in the Tax Court's opinion in *Kerr* that the current regulations expand the Section 2704(b)(3)(B) statutory exception,[31] limit the exception to provisions that apply regardless of any contrary provision of the entity's governing documents.[32]

[28] Treas. Reg. § 25.2704-2(b).

[29] Prop. Reg. § 25.2704-2(b)(2).

[30] Prop. Reg. § 25.2704-3(b)(2).

[31] 113 T.C. at 472.

[32] Prop. Reg. § 25.2704-2(b)(4)(ii).

A similar rule, once again, is found in the definition of "disregarded restriction."[33] Only mandatory statutory provisions, in short, would qualify for the Section 2704(b)(3)(B) exception under the Proposed Regulations. Mere default rules, by contrast, would not act as a safe harbor under the Proposed Regulations.

Second, the Proposed Regulations define a new category of restrictions, known as "disregarded restrictions," that are disregarded for valuation purposes. In general, disregarded restrictions are restrictions that limit the ability of an interest holder to redeem or liquidate the interest.[34] The Tax Court in *Kerr* held that limitations on an interest holder's ability to withdraw from an entity did not constitute limitations on the ability of the entity itself to liquidate and, therefore, could not be disregarded as applicable restrictions. Exercising the authority granted under Section 2704(b)(4), the Service has provided in the Proposed Regulations that restrictions on withdrawal will be disregarded as "disregarded restrictions" unless they meet certain requirements, including liberal rights to compel the entity to redeem the interest.

Finally, the Proposed Regulations, in defining the term "disregarded restriction" (but not the term "applicable restriction") provide that non-family member interests will be ignored for purposes of determining whether a restriction on withdrawal can be removed by the transferor or members of the transferor's family, unless non-family member interests meet stringent requirements.[35] The Fifth Circuit in *Kerr* had held that restrictions were not applicable restrictions because a charity with a *de minimis* interest could veto any attempt by family members to remove the restriction. Technically, the Proposed Regulations do not disturb that holding, because non-family member interests are not disregarded under the Proposed Regulations' revised definition of "applicable restriction." In the definition of "disregarded restriction," however, the Service would ignore the rights of non-family members unless the stringent conditions are satisfied.

F. Effect of Failure to Satisfy Put Right Safe Harbor

The Proposed Regulations' targeting of *Kerr* strongly suggests that, if a restriction is disregarded under the Proposed Regulations, then discounts for lack of control and marketability would be eliminated or at least significantly reduced. Support for that inference can be found in the Proposed Regulations' creation of a safe harbor for certain put rights. Specifically, classification of a restriction as an applicable or disregarded restriction can, under the Proposed Regulations, be avoided if the interest holder has the unilateral right to withdraw from the entity, within six months of notice, in exchange for an amount of cash or other property (or, in limited

[33] Prop. Reg. § 25.2704-3(b)(5)(iii).

[34] Prop. Reg. § 25.2704-3.

[35] Prop. Reg. § 25.2704-3(b)(4).

cases, a note) equal to the holder's share of "minimum value" (as defined in the Proposed Regulations).[36] A put right of that kind would normally eliminate, or nearly eliminate, discounts for lack of control or marketability.[37] Thus, if the interest holder does not possess a put right meeting the requirements of the Proposed Regulations, then, it might seem, the interest must be valued as if such a put right existed. Otherwise, taxpayers would have no reason to take advantage of the put right safe harbor, as more favorable results could be achieved outside of it.

Nevertheless, since the Proposed Regulations were issued, Service officials have publicly disavowed any intent to deem interest holders to have put rights.[38] Indeed, Service officials deny that the Proposed Regulations would eliminate (as opposed to merely reduce) discounts for lack of marketability or lack of control.[39] The Proposed Regulations, in other words, despite crafting rules apparently designed to overturn the holdings of *Kerr*, and despite creating a safe harbor for interests having liberal put or withdrawal rights, nevertheless leave taxpayers free, as under *Kerr*, to exploit minority interest discounts, at least according to the public comments of the Service since the Proposed Regulations were published.

Exactly how the Proposed Regulations do affect the valuation of entity interests is not obvious. The preamble states that if an applicable restriction is disregarded, then "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." Similarly, if a disregarded restriction is disregarded, then, according to the preamble, "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 governing law." Part III discusses in detail the

[36] Prop. Reg. §§ 25.2704-2(b)(4)(iv), 25.2704-3(b)(5)(v). For the definition of put right, see Prop. Reg. § 25.2704-3(b)(6).

[37] *Cf.* Est. of Jones v. Commissioner, 116 T.C. 121 (2001) ("We do not believe that a seller of [an interest that could force liquidation] would part with that interest for substantially less than the proportionate share of the NAV.")

[38] Matthew R. Madara, *Misinformation Cited in Estate Tax Valuation Rules Controversy*, 2016 Tax Notes Today 223-5 (Nov. 17, 2016) (quoting an official as stating that a deemed put right "isn't there"). LISI Estate Planning Newsletter #2467 (Oct. 31, 2016) reports that, on October 28, 2016, at the recent Notre Dame Tax and Estate Planning Institute, a Service official "stated that the six month put right provision in the Proposed Regulations does not mean that interests would be valued as if they were subject to a six month put right," and "expressed surprise that commentators were concluding that normal state law restrictions on liquidation of an entity would not yield the same discounts as now apply.").

[39] Matthew R. Madara, *Proposed Estate Tax Regs Have Been Misconstrued, Official Says*, 2016 Tax Notes Today 1918 (Oct. 3, 2016); Colleen Murphy, *'A Lot of Misunderstanding' Surrounds New Estate Tax Rules*, 191 Daily Tax Report G1 (Sept. 30, 2016).

valuation assumptions required under the Proposed Regulations where a restriction is disregarded.

G. Other Changes of the Proposed Regulations

In addition to changes aimed at the holdings in *Kerr*, the Proposed Regulations introduce a number of related reforms. These include:

1. Clarification of entities covered by Section 2704

As noted in the preamble to the Proposed Regulations, Section 2704 speaks of corporations and partnerships but does not address other business entities, such as limited liability companies. To fill this gap, and to confirm that Section 2704 applies to entities that are not corporations or partnerships under state law, the Proposed Regulations clarify that an entity will be classified, for purposes of Section 2704(a) and Section 2704(b), as either a partnership or a corporation.[40] A corporation is any entity, other than an association, that is classified as a corporation under Treasury Regulations § 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). A partnership is any other business entity, as defined in Treasury Regulations § 301.7701-2(a), regardless of its tax classification. Thus, a partnership includes a limited liability company that is not an S corporation and Section 2704 would apply to a limited liability company, even if disregarded.[41]

[40] Prop. Reg. §§ 25.2704-1(a), 2(a) and -3(a). More specifically, any business entity within the meaning of Treas. Reg. § 301.7701-1(a) will be treated as a partnership regardless of the entity's classification for other federal tax purposes, unless it is described in Treas. Reg. § 301.7701-2(b)(1) , (3), (4), (5), (6), (7), or (8), an S corporation within the meaning of Section 1361(a)(1), or a qualified subchapter S subsidiary within the meaning of Section 1361(b)(3)(B).

[41] Section 2704 will normally only apply where an entity has two or more owners. A disregarded entity, by contrast, may only have a single owner. Treas. Reg. § 301.7701-3(b)(ii). The paradox of a "disregarded entity" having two or more owners arises where one owner is an individual and the other owner or owners are grantor trusts with respect to that individual. *See* PLR 200102037 (Oct. 12, 2000) (treating a limited liability company owned by a grantor and a grantor trust as a disregarded entity); FSA 200035006 (Sept. 1, 2000) (concluding that a partnership did not exist for tax purposes where the only partners were taxpayer and a grantor trust treated as owned by taxpayer). The Service may wish to consider amending the check-the-box regulations under Section 7701 in order to clarify that a "disregarded entity" is not disregarded for gift, estate and GST tax purposes. *Cf*. Pierre v. Comm'r, 133 T.C. 2 (2009).

2. Clarification of entity control

Section 2701(b)(2), which is incorporated into Section 2704 by Section 2704(c), contains the definition of "control" for purposes of Section 2704. That definition provides three different tests for control, depending on whether the entity is corporation, partnership, or limited partnership, but does not provide a test for other business entities, such as limited liability companies. To fill this gap, the Proposed Regulations add a test of control for business entities or arrangements other than corporations, partnerships, or limited partnerships: control in the case of such entities or arrangements means the holding of at least fifty percent of either the capital interests or the profits interests in the entity or arrangement.

The Proposed Regulations also provide that the form of the entity determines the applicable control test. An entity has a corporate form if it is a corporation under Treasury Regulations § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8), an S corporation within the meaning of Section 1361(a)(1), or a qualified subchapter S subsidiary within the meaning of Section 1361(b)(3)(B). For any other entity, the form is determined under local law, regardless of tax classification. Thus, control of a limited liability company (if not an S corporation), regardless of its check-the-box election, is determined under the new control test that applies to business entities other than corporations, partnerships, or limited partnerships.

3. Limitation of Section 2704(a) exception where rights with respect to transferred interest are not restricted or eliminated

Under current law, Section 2704(a) does not apply to a transfer of an entity interest, even if the transfer causes the transferor's liquidation rights to lapse, provided that the transfer does not restrict or eliminate the rights associated with the transferred interest.[42] Existing regulations illustrate this rule as follows:

> D owns 84 percent of the single outstanding class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. D gives one-half of D's stock in equal shares to D's three children, (14 percent to 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 corporation are not restricted or eliminated by reason of the transfer.[43]

[42] Treas. Reg. § 25.2704-1(c)(1). However, if the transferor retains an interest that is subordinate to the transferred interest, the transfer is a lapse of a liquidation right if it results in the elimination of the transferor's right or ability to compel the entity to acquire that subordinate interest.

[43] *See* Treas. Reg. § 25.2704-1(f), Ex. 4.

The Proposed Regulations limit this rule to transfers that occur more than three years before the transferor's death. Consequently, under the Proposed Regulations, Section 2704(a) would apply to transfers that occur within three years of the transferor's death, even though the liquidation rights with respect to the transferred units have not been eliminated.[44] The Proposed Regulations also modify the example above by adding that "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."[45] A similar qualification is added to another example involving a transfer of shares that results in a lapse of a liquidation right.

4. Application of Section 2704(a) to transfers of assignee interests

Some taxpayers, such as those in *Kerr*,[46] have attempted to apply entity-level valuation discounts on the theory that the transferee was not admitted as a partner or member of the entity and, therefore, had only the rights of an assignee, but not the rights of a partner or member. The Proposed Regulations foreclose this strategy by providing that a Section 2704(a) lapse occurs where an interest in an entity is transferred to an assignee who may not exercise the voting or liquidation rights associated with the interest.[47]

5. Elimination of special purpose entity loophole

As noted in the preamble, in response to Section 2704(b), at least one state has enacted legislation that permits the creation of entities that, under the enabling statute, are not permitted to liquidate except in certain events, such as the lapse of ten years. These special purpose entities purport to allow taxpayers to claim that the restrictions on liquidation are "imposed, or required to be imposed" by state law within the meaning of Section 2704(b)(3)(B) and, therefore, are not disregarded under Section 2704(b). The Proposed Regulations eliminate this possible loophole, both in the revised definition of "applicable restriction" and the new definition of "disregarded restriction," by providing that a restriction does not satisfy the Section 2704(b)(3)(B) exception if state law permits the creation of an alternative entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded.

[44] Prop. Reg. § 25.2704-1(c)(1).

[45] *Id.* at (f), Example 4.

[46] 113 T.C. 449 (1999), *aff'd* 292 F.3d 490 (5th Cir. 2002). The Tax Court in *Kerr* found that the transferees had been admitted as partners and, therefore, did not acquire assignee interests.

[47] Prop. Reg. § 25.2704-1(a)(4).

6. Marital and charitable deductions

Section 2704(b) applies for all estate, gift, and GST tax purposes, including the estate and gift tax marital and charitable deductions. Consequently, as noted in the preamble, to the extent that a transfer qualifies for a charitable or marital deduction, the value that determines the amount of the transfer also determines the amount of the marital or charitable deduction. The Proposed Regulations implement this principle, in the case of transfers to charity, by providing that if an interest passes in part to family members and in part non-family members, such as a charity, then each part is treated as separate property interest.

III. IMPACT OF PROPOSED REGULATIONS ON VALUATION

A. Rules of Proposed Regulations Governing the Effect of Disregarding Restrictions for Valuation Purposes

The Proposed Regulations define the terms "applicable restriction" and "disregarded restriction" in detail but contain only brief statements of the effect that disregarding a restriction has on valuation. In the case of an applicable restriction, section 25.2704-2(e) of the Proposed Regulations provides:

> 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*.
>
> (emphasis added)

Similarly, in the case of a disregarded restriction, section 25.2704-3(f) of the Proposed Regulations provides:

> "[i]f a restriction [*i.e.*, a disregarded 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*.
>
> (emphasis added)

In other words, under the foregoing provisions, the effect of disregarding a restriction is to treat it as if it does not exist. An appraiser must instead assume that the applicable or disregarded restriction cannot be found in any source, whether in the governing instruments, an agreement between the owners, or state law. Exactly how the appraiser should go about valuing an interest under this assumption—referred to in this Report as the "nonexistence assumption"—is not spelled out in the Proposed Regulations. As discussed below, there are several possibilities.

B. Comparison of Nonexistence Assumption with Restrictions Disregarded under Section 2703

At first, it might seem that the nonexistence assumption simply incorporates valuation concepts that have existed for decades. In many cases, under Section 2703,[48] property interests have been valued without regard to certain rights or restrictions.[49] Even before that section was enacted, courts disregarded options to purchase property if they were not created for bona fide business reasons or were substitutes for a testamentary disposition.[50] The long history of disregarding restrictions in gift and estate tax cases may be relevant to the determination of value where an applicable or disregarded restriction is deemed not to exist. Indeed, we understand that the nonexistence assumption is intended to have effects similar to those of disregarding restrictions under Section 2703.

On closer inspection, however, it seems that the nonexistence assumption departs significantly from past cases where restrictions have been disregarded. An example of the latter is *Estate of Elkins v. Commissioner*.[51] There, the decedent and his children, who each owned fractional interests in the same collection of artworks, effectively agreed to waive their respective rights to bring an action for partition and sale of the works. The court disregarded the waiver of the owners' partition rights under Section 2703(a), and proceeded to value the decedent's fractional interests as if a right to partition existed after all.[52] Put another way, the court valued the decedent's fractional interests as if the default rules of state law, which granted each co-owner a right to sue for partition, applied.

[48] Section 2703 generally disregards, for gift, estate and GST tax valuation purposes, options and other rights to purchase property for less than fair market value, as well as restrictions on the right to sell or use property.

[49] *See, e.g.*, Est. of Elkins v. Comm'r, 140 T.C. 86 (2013), *rev'd on other grounds*, 767 F.3d 443 (5th Cir. 2014); Holman v. Comm'r, 130 T.C. 170 (2008), *aff'd* 601 F.3d 763 (8th Cir. 2010); Fisher v. United States, 106 A.F.T.R.2d 2010-6144 (S.D. Ind. 2010); Est. of Blount v. Comm'r, T.C. Memo. 2004-116, *rev'd on other grounds*, 428 F.3d 1338 (11th Cir. 2005).

[50] *See, e.g.*, Dorn v. United States, 828 F.2d 177 (3rd Cir. 1987); Est. of Lauder v. Comm'r, TC Memo. 1990-530; St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982); Bommer Revocable Trust v. Comm'r, T.C. Memo. 1997-380; Est. of True v. Comm'r, T.C. Memo 2001-167, aff'd 390 F.3d 1210 (10th Cir. 2004); Est. of Godley v. Comm'r, T.C. Memo 2000-242, *aff'd on other grounds*, 286 F.3d 210 (4th Cir. 2002*); see also* Treas. Reg. § 20.2031-2(h).

[51] 140 T.C. 86 (2013), *rev'd on other grounds*, 767 F.3d 443 (5th Cir. 2014).

[52] As it turned out, however, under the court's valuation analysis, which was rejected on appeal by the Fifth Circuit, 767 F.3d 443 (5th Cir. 2014), the decedent's partition right had little effect on value.

Restrictions under the Proposed Regulations, by contrast, may be disregarded regardless of whether they are found in state law or any other source. As section 25.2704-3(f) of the Proposed Regulations states, fair market value is determined "as if the disregarded restriction does not exist in the governing documents, local law, or otherwise." Consequently, state law default rules cannot, as in *Elkins* and other cases applying Section 2703, be used to determine value, unless the state law default rules themselves meet the stringent requirements of the Proposed Regulations. If those requirements are not met, then, under the nonexistence assumption, state law default rules must be assumed not to exist. Thus, unlike Section 2703, the Proposed Regulations forbid appraisers from assuming that state law default rules apply. Exactly what appraisers *are* required to assume, in lieu of a default state law rule, is discussed below.

C. Nonexistence Assumption Implies a Uniform Federal Standard

The Proposed Regulations are designed to produce the same results regardless of whether restrictions are found in the governing documents, state law, or otherwise. That goal, which we support, is illustrated by the following two scenarios:

> *Scenario A*: *D* holds all of the general and limited partnership interests of Limited Partnership *X*. *D* makes a gift of limited partnership interests to his child, *A.* Under the terms of the partnership agreement, a limited partner may not withdraw without the consent of the general partner.
>
> *Scenario B*: *D* holds all of the general and limited partnership interests of Limited Partnership *X*. *D* makes a gift of limited partnership interests to his child, *A.* Neither the partnership agreement nor any other governing documents contain any provision pertaining to the partners' rights to withdraw. However, under the default terms supplied by the state statute under which Limited Partnership *X* was formed (which terms could have been overridden in the limited partnership agreement), a limited partner may not withdraw without the consent of the general partner.

In both scenarios, limited partners are prevented from freely withdrawing their shares of capital. The only difference is that, in Scenario A, the restriction on withdrawal is found in a governing instrument, whereas in Scenario B it is found in state law default rules. Nevertheless, a limited partner's inability to withdraw will be classified as a disregarded restriction in both scenarios. Consequently, despite the difference in the source of the restriction, the value of *D*'s gift would, under the Proposed Regulations, be the same.

Yet the Proposed Regulations leave it unclear how, exactly, that uniform valuation result is achieved. As discussed, unlike in the case of a restriction that is disregarded under Section 2703, in the case of a restriction that is disregarded under the Proposed Regulations, state law

default rules must be ignored. The Proposed Regulations imply, therefore, that taxpayers and appraisers must adopt valuation assumptions independent of state law. Presumably, those assumptions, if not found in state law, are to be found in federal law. In other words, once restrictions are disregarded, an appraiser would be required to apply a federal valuation standard.

The nonexistence assumption is apparently meant to act as that federal valuation standard. Yet neither section 25.2704-2(e) nor section 25.2704-3(f) of the Proposed Regulations, which set forth the nonexistence assumption, explains what it means, for valuation purposes, for a restriction not to exist, even under state law. In particular, neither section states explicitly what facts an appraiser should assume in lieu of restrictions that are deemed not to exist. The Proposed Regulations instead leave the reader to infer what assumptions should be applied. Below, we identify three possible inferences from the nonexistence assumption. At a minimum, the final regulations should explain what facts, exactly, an appraiser should assume in place of a provision that is deemed not to exist, and provide examples illustrating how those facts should be taken into account.

D. Three Possible Federal Valuation Standards under the Nonexistence Assumption

We can see three possible ways of understanding how an interest in an entity should be valued under the nonexistence assumption. The first, as discussed below, is that the interest holder is deemed to have a right to compel the entity to liquidate or to redeem the interest from the holder. The second is that the nonexistence assumption has no effect on valuation. A final possibility is that an appraiser must assume a state of legal uncertainty as to whether interest holders may liquidate or withdraw.

We understand that the third possibility—an assumption of legal uncertainty—is closest to the intent of the Proposed Regulations. Nevertheless, for the sake of comparison, we describe each possibility in further detail below.

1. Deemed liquidation and put rights

The first possible inference from the nonexistence assumption is that the holder of a transferred interest is deemed, in the case of an applicable restriction, to have the right to compel the entity to liquidate, or, in the case of a disregarded restriction, to have the right to compel the entity to redeem the interest. In this view, the stipulation that a restriction is treated "as if [it] does not exist" is an indirect way of stating that an affirmative right to liquidate or withdraw does exist. Put another way, the *nonexistence* of a *restriction* on liquidation or withdrawal implies the *existence* of liquidation or withdrawal *right*. In Scenario A and Scenario B, for example, the holder of the limited partnership interest transferred by *D* to *A* would be deemed to have the right to receive, within six months of notice, an amount of cash from Limited Partnership *X* equal to the minimum value of the interest (as defined in the Proposed Regulations).

Deeming a put or liquidation right to exist would normally increase the value of an interest for gift and estate tax purposes. After all, if an interest holder can readily exit from an entity in exchange for cash or other property, a willing buyer of the interest would be less sensitive to the usual downsides of owning an illiquid, noncontrolling interest. For example, the lack of a market for the interest would not be a worry because the holder, even without any other interested buyer, could always sell the interest back to the entity. Similarly, lack of control would not be a worry because the interest holder, if unhappy with management, could exit and have complete control to redeploy cash elsewhere. For these reasons, courts have not allowed significant discounts where interest holders have liquidation rights.[53]

That said, we understand that the Service emphatically did not intend interest holders to be deemed to have deemed put rights.[54] Indeed, we understand that the Service does not believe that the Treasury even has the authority to deem the holder of an interest to have a put right. Consequently, where a restriction is disregarded, it appears that the final regulations will not treat holders of entity interests as having deemed liquidation or put rights.

2. No change in valuation assumptions

A second possible interpretation of the nonexistence assumption is that it has little or no actual impact on valuation. In this view, if a professional appraiser is asked to apply the nonexistence assumption, he or she would still value the interest based on the real-world characteristics of the interest, including that the interest holder may not be able to liquidate or withdraw. In other words, an applicable or disregarded restriction would be deemed not to exist only in a very narrow, technical sense. When actually valuing the interest, all of the practical consequences of the restriction would still be taken into account.

In Scenario A and Scenario B, for example, an appraiser would value the limited partnership interest by taking into account that a limited partner could not readily convert his or her interest into cash. Consequently, especially if there is no market for the limited partnership interest, the appraiser would, as under present law, likely conclude that discounts must be applied to reflect the interest's lack of marketability. In other words, under this reading of the Proposed

[53] *Cf.* Est. of Jones v. Commissioner, 116 T.C. 121 (2001) ("We do not believe that a seller of [an interest that could force liquidation] would part with that interest for substantially less than the proportionate share of the NAV.")

[54] Matthew R. Madara, *Proposed Estate Tax Regs Have Been Misconstrued, Official Says*, 2016 Tax Notes Today 1918 (Oct. 3, 2016); Colleen Murphy, *'A Lot of Misunderstanding' Surrounds New Estate Tax Rules*, 191 Daily Tax Report G1 (Sept. 30, 2016); LISI Estate Planning Newsletter #2467 (Oct. 31, 2016); Matthew R. Madara, *Misinformation Cited in Estate Tax Valuation Rules Controversy*, 2016 Tax Notes Today 223-5 (Nov. 17, 2016).

Regulations, as counterintuitive as it may sound, restrictions, though deemed not to exist, would still effectively be taken into account in the valuation process.

The notion that a provision is deemed not exist, yet still have the same impact on valuation as if it did exist, is hard to fathom. Certainly, it would be strange to impose complex and elaborate regulations that effectively failed to change current law. At a minimum, such regulations would create needless confusion and impose costs on taxpayers and their advisors as they try to understand them, if only to reach the conclusion that they regulation have no effect. We therefore disagree with other reports on the Proposed Regulations to the extent they recommend that the final regulations should have no effect on valuation.[55]

Fortunately, we understand that the Proposed Regulations are indeed intended to have some effect on value, even if the effect is merely to reduce but not eliminate valuation discounts. The only question is how.

3. Assumption of uncertainty

A final way of understanding the nonexistence assumption, and the way that we understand is closest to Service's intent, is that an appraiser must assume a complete absence of legal authority on the scope of the interest holder's liquidation and withdrawal rights. In Scenario A and Scenario B, for example, an appraiser and, ultimately, the courts would assume not only that the partners have not reached any agreement as to whether and on what terms partners may withdraw, but that there are literally no statutes, judicial decisions or other authorities that would shed light on the partners' withdrawal rights. The Proposed Regulations, in short, would assume the existence of a legal vacuum.

We urge the Service not to adopt this approach in the final regulations, whether expressly or by implication. Our objections are described below.

E. The Assumption of a Legal Vacuum

As discussed, the nonexistence assumption is intended to create a federal valuation standard independent of state law. The federal standard, however, is *not* that the interest holder is deemed to have the right to compel the entity to liquidate or to redeem the interest. Rather, an

[55] *See, e.g.*, The American College of Trusts and Estates Counsel (ACTEC) Comments on Proposed Regulations Under Section 2704 at 1 ("ACTEC seeks clarification that the price that a third party, unrelated purchaser would be willing to pay for an interest continues to be the appropriate measure of fair market value for federal transfer tax purposes and that specific features such as illiquidity, fiduciary duty to other owners, and other causes of inability or reluctance to liquidate an interest will continue to be treated as legitimate factors that a third party purchaser would take into account in determining the price he or she is willing to pay.").

appraiser must assume a state of legal uncertainty as to the holder's rights to liquidate or withdraw.

For the reasons described below, we believe that the final regulations should either reject this approach or at least provide detailed examples illustrating how it should work. We have six principal objections.

1. Impossibility of a legal vacuum

The first problem with assuming a state of legal uncertainty is that it would leave taxpayers, appraisers, the Internal Revenue Service, and, ultimately, the courts without a frame of reference. In reality, where an entity's governing documents are silent, state statutes provide default rules that determine whether interest holders have the right to withdraw or to compel an entity to liquidate.[56] If a statute does not furnish a default rule, that does not mean that no rules or precedents would apply. On the contrary, interest holders have ultimate recourse to the courts, which, in the absence of a statute, would apply background principles, common law, and other authorities in order to resolve any dispute. Eventually, even if the statutes remained silent, the courts would generate a body of case law to fill in the gap.

Even where state law rights are uncertain, the courts, in valuing an interest in property, do not assume the existence of a legal vacuum. On the contrary, they attempt to estimate value based on how the uncertainty is likely to be resolved. In *Dickerson v. Commissioner*,[57] for example, a waitress who held a winning lottery ticket made a gift of her winnings to family members. In valuing the gift, the court allowed a 65% discount in order to reflect a possible lawsuit by the waitress's coworkers for a share of the winnings. (The discounts were granted even though the taxpayer ultimately defeated her co-workers' claims in Alabama Supreme Court.) To determine the discount, the *Dickerson* court relied on testimony from experts in Alabama law as to the validity of the co-workers' potential claims. The court did not, in other words, assume a complete legal vacuum, even though legal issues critical to the value of the property were unresolved. Rather, the court valued the property based on the probable outcomes under state law as it existed at the time of the gift.

In short, the law, like nature, abhors a vacuum. Disputes over unresolved issues arise against a background of statutes, case law, secondary literature, fundamental legal principles, and other authorities. A hypothetical world with literally no legal authority, and, therefore, no way of determining the rights of parties, does not and probably cannot exist, at least not in an advanced legal system.

[56] *See, e.g.*, section 601 of the Uniform Limited Partnership Act.

[57] T.C. Memo 2012-60.

Yet the nonexistence assumption, if read the way that we understand it is to be read, would require taxpayers and the courts to value entity interests assuming just such a hypothetical world. As such a world is all but impossible even to imagine, it is difficult (if not itself impossible) to value property as if such a world existed. The assumption of a legal vacuum would leave courts without any frame of reference to apply.

2. Lack of rules on how to value property without reference to state law rights

A second, related objection is that courts and appraisers have no experience valuing property as if no law existed and, therefore, have no rules or principles to apply. A fundamental premise of estate and gift tax law is that, as the Tax Court put it in *Pierre v. Commissioner*,[58] "[s]tate law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights."[59] In valuation, even where rights and restrictions have been disregarded, state law default rules, as in *Estate of Elkins*, have been applied in their place. By contrast, to our knowledge, courts have never valued a property interest as if state law simply did not exist.

Consequently, if the nonexistence assumption is adopted, courts will be left with no precedents or rules to apply. That lack of precedent is not surprising, because, as discussed, a world without law is difficult even to imagine. In some sense, the very thing to be valued—that is, the bundle of property rights represented by the entity interest—would be left undefined. Without further guidance, courts would be left to fill in the gaps.[60]

3. Doubts as to validity of regulations unresolved

We understand that the Service does not believe that the Treasury has the authority, under Section 2704(b)(4) or otherwise, to deem an interest holder to have a put right. As some have explained it, Treasury may have an "eraser"—*i.e.*, the authority under Section 2704(b)(4) to *disregard* restrictions not otherwise described in the statute—but that does not mean it has a "pencil"—*i.e.*, the authority to *deem* interest holders to possess certain rights. Consequently, the

[58] 133 T.C. 2 (2009).

[59] *See also* Morgan v. Comm'r, 309 U.S. 78, 80–81 (1940) ("State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed."); *Knight v. Comm'r*, 115 T.C. 506, 513 (2000) ("State law determines the nature of property rights, and Federal law determines the appropriate tax treatment of those rights.").

[60] Does the assumption of a legal vacuum, for example, mean that the parties would have literally no recourse to a court in order to resolve a dispute over liquidation or withdrawal rights? In that case, perhaps, the parties may need to settle their dispute through extra-legal means (as in a Hollywood Western, perhaps). Or perhaps it means that there is a precisely equal 50% probability of either side prevailing in court.

Proposed Regulations make no mention of any rights that an interest holder is deemed to possess in place of a restriction. In lieu of deeming rights to exist, the Proposed Regulations instead take Treasury's "eraser" and purport to erase not only the provisions of the governing instrument but also the provisions of state law and, indeed, the very possibility of there being any state law.

This Report takes no position on whether the Service has taken an unduly conservative (or liberal) view of the Treasury's authority. We do, however, wish to suggest that the supposed dichotomy between the authority to disregard and the authority to create—so neatly brought to life by the metaphor of the eraser and the pencil—is a false one. Where a provision is disregarded, some assumption must be substituted in its place.[61] As we have seen, for example, where a restriction is disregarded under Section 2703(a), the property is valued as if the default rules of state law applied, as in *Elkins*. Similarly, under current law, where an applicable restriction is disregarded, the transferred interest is valued not only as if the restriction does not exist but also "as if the rights for the transferor are determined under the State law that would apply but for the restriction."[62]

If state law itself is disregarded, then, as discussed previously, some federal standard must be substituted in its place. The Proposed Regulations are artfully drafted to avoid the appearance that they create a substitute rule to replace provisions that are disregarded. But the nonexistence assumption, even as intended, *does* create a substitute rule, namely, complete legal uncertainty as to the rights of interest holders to compel liquidation or to withdraw. The Service may or may not decide to adopt that substitute assumption, but it is a substitute assumption nevertheless. It is as much penciled into being by the Proposed Regulations as the deemed put rights that Service wishes to disavow.

To elaborate further, if literally no law exists on whether an interest holder has the right to withdraw, then it follows that an interest holder must have at least some nonzero chance of ultimately being allowed to withdraw. (The chance may be precisely fifty percent: after all, if there is, hypothetically, no law on point, then perhaps it follows that any outcome is equally likely and there is exactly a fifty percent chance of success and exactly a fifty percent chance of defeat.) A right with less than a one hundred percent probability of being vindicated is not the same thing as an undisputed right, but it is still a right. If, as the Service believes, the Treasury cannot deem interest holders to have put rights that are undisputed, then, by the same token, the Treasury cannot deem interest holders to have put rights of uncertain validity. In both cases, the regulations would be deeming a right to exist, which is the very outcome that we understand that the Proposed Regulations were attempting to avoid.

[61] The metaphor even fails on its own terms: where a mark is erased, it leaves not a metaphysical void but at least a space, if not a smudge.

[62] Treas. Reg. § 25.2704-2(c).

Again, we doubt that it is even possible, in principle, to disregard a restriction without positing some alternative assumption. The Service should reject the false dichotomy between "eraser" or "pencil." In any event, if the final regulations will disregard state law for valuation purposes, then they should explicitly state what federal valuation standard is substituted in its place. Failure to do so will create confusion and uncertainty.

4. *Estate of Holman* and *Estate of Lauder* do not provide guidance.

We understand that the Service looks to *Holman v. Commissioner*[63] and *Estate of Lauder v. Commissioner*[64] for guidance on how an entity interest should be valued where a restriction is disregarded. In *Holman*, a restriction was disregarded under section 2703(a) of the Code; in *Lauder*, a restriction was disregarded under Treasury Regulations § 20.2031-2(h). Unfortunately, as discussed below, we do not believe that either case will be helpful in applying the nonexistence assumption.

In *Lauder*, the decedent was party to an agreement that required shareholders, before transferring their stock to third parties, to offer the stock to the corporation and the other shareholders at a price based on the adjusted book value of corporate assets. The court held that the option price was a device to transfer the decedent's shares to the natural objects of his bounty for less than full and adequate consideration and, consequently, disregarded the option price under Treasury Regulations § 20.2031-2(h). Ultimately, the court allowed a forty percent discount to reflect the lack of a market for the shares.[65]

In *Holman*, the taxpayers made gifts of interests in a limited partnership holding only publicly traded Dell stock. The Tax Court held that various restrictions under the partnership agreement, including an option by the partnership to purchase interests transferred in violation of the partnership agreement, would be disregarded under section 2703 of the Code. Nevertheless, the court allowed some discount for lack of control and lack of marketability.

We understand that the Service sees *Holman* and *Lauder* as relevant because, in both cases, the courts took into account the probable desires of the other entity owners. Thus, in *Lauder*, the court, in a later decision,[66] allowed that, though the shareholders' agreement would be disregarded, a willing purchaser of the decedent's stock would still take into account the family's zeal to maintain control and prevent any third party from acquiring a controlling interest.[67] In *Hol-*

[63] 130 T.C. 170 (2008), *aff'd* 601 F.3d 763 (8th Cir. 2010).

[64] T.C. Memo 1992-736.

[65] T.C. Memo 1994-527.

[66] T.C. Memo 1994-527.

[67] T.C. Memo 1994-527.

man, the Commissioner's expert successfully argued that the discount for lack of marketability should be limited because the partners would always prefer to purchase a partner's interests at some discount than allow that partner to sell at a higher discount to a third party. A purchase for any discount, the expert argued, would increase the remaining partners' proportionate share of underlying Dell stock. Thus, the partnership and the other partners would always effectively compete to purchase any interest offered for sale, which in turn lessened the effects of the lack of a market for the transferred interests.

In neither *Lauder* nor *Holman*, however, did the intentions of other owners determine how an interest should be valued *once a restriction is disregarded*. In *Lauder*, for example, even if there had not been a shareholders' agreement, the court could still have valued the decedent's shares by taking into account the desire of the shareholders to maintain family control. Similarly, in *Holman*, even if the partnership agreement had not contained restrictions on transfer, the court would still have valued the interests by taking into account the rational desire of the other partners to buy the interests before they were sold to another party. In each case, in other words, the value of the transferred interest reflected the desires of other owners, but that was not because a restriction was disregarded. Rather, the courts considered the desires of other owners as a fact independent of the disregarded restriction. That a restriction was disregarded, in short, and that fair market value reflected the desires of other owners, was a coincidence in both cases.

Neither case, therefore, explains what substitute assumptions are to be applied when a restriction is disregarded under the Proposed Regulations. On the contrary, both the *Lauder* and *Holman* courts seem to have simply taken for granted that state law default rules applied. Indeed, in a footnote, the *Lauder* court corrected a valuation expert on whether shareholders had the right under state law to review corporate books and records.[68]

As best we understand it, the authors of the Proposed Regulations view *Lauder* and *Holman* as relevant to understanding the nonexistence assumption because, if there were a complete legal vacuum, the entity holders would attempt to reach an agreement on a rule that achieves their collective goals. Perhaps, under the nonexistence assumption, appraisers and courts would be required to substitute for a disregarded provision whatever hypothetical provision the parties would agree to adopt, if they were to form the entity from scratch. But that approach would require a speculative inquiry into what the parties would freely negotiate. Furthermore, negotiation always takes place against a backdrop of legal rights, which the nonexistence assumption would ignore. A negotiation in a world without law, like a world without law itself, is difficult to imagine. As with the assumption of a legal vacuum, therefore, we do not think the hypothetical outcome of a hypothetical negotiation in a world without law is a workable federal valuation standard.

[68] T.C. Memo 1994-527 at footnote 16.

5. Possible invalidity under step two of *Chevron*

As discussed, we understand that the Service fears that that the Treasury does not have the power to deem an interest holder to have rights that do not exist under the governing documents or state law. In doctrinal terms, an attempt to deem interest holders to have certain rights would, in the Service's view, fail step one of the test announced in the landmark case of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc*.[69] Under the *Chevron* framework, as more recently articulated in *Mayo Foundation v. United States*,[70] a court, in determining the validity of a regulation, must first ask whether Congress has directly addressed the precise question at issue; if the answer is no, then the agency's interpretation will be upheld unless arbitrary or capricious in substance, or manifestly contrary to the statute.

In drafting regulations designed to avoid running afoul of *Chevron* step one, the Service may have inadvertently cause the regulations to fail *Chevron* step two. The nonexistence assumption, that is, may create so much confusion and uncertainty that a court would ultimately invalidate the regulations as arbitrary and capricious.[71] The Service should take this risk into account when drafting final regulations.

6. Needless burdens on courts and the tax system

Our final objection follows from the others. The assumption of a legal vacuum, if adopted in the final regulations, would force taxpayers, appraisers, the Internal Revenue Service, and, ultimately, the courts to expend inordinate time, money, and effort in order to understand and implement it. As noted, for example, it is difficult even to imagine a hypothetical world where no relevant legal authority exists. There are no precedents or rules that would determine how valuation under that assumption would even proceed. Doubts as to validity would remain. To fill in gaps and resolve latent controversies would take many years. In light of these costs, the final regulations should not posit the existence of a legal vacuum.

[69] 467 U.S. 837 (1984).

[70] 562 U.S. 44 (2011).

[71] *Cf.* Balestra v. United States, 803 F.3d 1363 (Fed. Cir. 2015) (upholding a regulation under step two of *Chevron* while also requiring that an agency's path to achieving its goals be "reasonably discernible").

F. Alternative Approaches

In light of the flaws in the nonexistence assumption, we believe that the final regulations should take a different approach. We have three suggestions.

1. Review whether the Treasury has the power to deem interest holders to hold certain rights

First, the Service could reconsider whether the Treasury does, after all, lack the power to deem interest holders to hold certain rights. Views on that topic could first be solicited from the public and the bar. As argued above, the power to deem rights to exist may be implicit in the Treasury's power under Section 2704(b)(4) to disregard certain restrictions.[72]

2. Gift on formation rules

Second, the Service could consider adopting regulations that would cause a gift to occur on formation of an entity, unless the formation occurs in the ordinary course of business within the meaning of Treasury Regulations § 25.2512-8. By way of background, the Service had argued in the past that, where a donor and other family members contribute capital to an entity, and the donor's wealth is immediately depleted by post-contribution valuation discounts, a gift occurs on formation of the entity.[73] Several cases have since rejected the gift-on-formation argument.[74] By regulation, however, the Service could attempt to revive its position and provide that a gift, measured by the difference in value between each senior family member's capital contribution and the value of their interests issued in exchange, occurs on formation of an entity. To allow for legitimate nontax planning, such as where family members form an entity for business purposes, the Service could provide an exception to the general gift-on-formation rule in the case of entities that are formed in the ordinary course of business.[75]

Final regulations could anticipate and foreclose possible techniques for avoiding a gift on formation. For example, a senior family member and/or his or her spouse might attempt to form and capitalize an entity initially without the participation of any other family members. No gift

[72] As stated in the text, this Report takes no position on whether the Treasury has the authority under Section 2704(b)(4) to deem interest holders to possess certain rights.

[73] *See* TAM 9842003 (Oct. 16, 1998); FSA 199950014 (Sept. 15, 1999).

[74] *Est. of Strangi v. Comm'r*, 115 TC 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002); *Estate of Jones v. Comm'r*, 116 TC 121 (2001); *Church v. United States*, 268 F.3d 1063 (5th Cir. 2001).

[75] The Service could also consider permitting taxpayers to elect, in lieu of a gift on formation, to have interests in the entity valued without discounts when transferred at death or by gift.

would occur (absent other rules) because the mere formation of a single member entity (or two-member entity with the family member's spouse) would not cause a shift of wealth to any other person, other than, perhaps, a transfer to a spouse qualifying for the gift tax marital deduction.[76] Only after the entity has been formed would the senior family member transfer interests to junior family members.

This opportunity to avoid a gift on formation through clever sequencing could be foreclosed through a rule that a gift on formation will be deemed to occur if an entity is formed in contemplation of making gifts or transfers of entity interests at valuation discounts. To determine whether an entity was formed in contemplation of making gifts, the Service could by regulation adopt presumptions that an entity was formed in contemplation of making gifts if an entity interest is transferred to or for the benefit of family members within a certain period, such as three years from formation.

3. Exception to willing-buyer-willing-seller test

Finally, the final regulations could create an exception to the general willing-buyer-willing-seller test that traditionally has been used to value property for gift and estate tax purposes. As discussed in Part II of this Report, that test is the foundation of taxpayers' use of entity-level discounts in order to depress the value of their property for gift and estate tax purposes. The Service could consider mandating a more realistic measure of value in cases where a restriction is disregarded. For example, the final regulations could provide that, unless a restriction was created in the ordinary course of business, the value of the interest transferred is equal to the interest's share of minimum value. This approach would sidestep altogether the debate over whether the Treasury has the power to deem interest holders to possess certain rights.

[76] *See* Rev. Rul. 71-443.

IV. OTHER RECOMMENDATIONS

A. Entity Classification and Control

1. Clarification of status of contractual arrangements deemed to be entities under Treasury Regulations § 301.7701-1

The Proposed Regulations define a partnership, for purposes of Section 2704(a)-(b), as any business entity defined in Treasury Regulations § 301.7701-2(a) other than certain entities classified *per se* as corporations. For purposes of determining control, the Proposed Regulations also create a new rule that applies to business entities, such as limited liability companies, other than corporations, partnerships, or limited partnerships. The Proposed Regulations do not, however, address directly the status of joint ventures or other contractual arrangements that, even if not organized as separate legal persons under state law, are treated as business entities under Treasury Regulations § 301.7701-1(a). To ensure consistency with the check-the-box regulations, we recommend that the final regulations confirm that a contractual arrangement treated as an entity for federal tax purposes is treated as a partnership for purposes of Section 2704. We also recommend, for the same reason, that the final regulations confirm that the new control test for business entities other than corporations, partnerships, or limited partnerships applies to arrangements that are treated as business entities under Treasury Regulations § 301.7701-1(a).

2. Control of limited partnership where general partnership interest is held by an entity

Section 2704, like Section 2701, applies only to transactions involving entities controlled by the taxpayer and/or members of the taxpayer's family.[77] For purposes of Section 2704, the meaning of "control" is imported from Section 2701(b)(2).[78] In the case of a limited partnership, control is defined as either "the holding of at least 50 percent of the capital or profits interests" or "the holding of any interest *as* a general partner."[79] Section 2704 also imports the attribution rule set forth in Section 2701(e)(3), which provides that "an individual shall be treated as holding any interest to the extent such interest is held indirectly by such individual through a corporation, partnership, trust or other entity."

[77] *See* I.R.C. § § 2704(a)(1), 2704(b)(1) and 2701(b)(1).

[78] *See* I.R.C. § 2704(c)(1).

[79] I.R.C. § 2701(b)(2)(B) (emphasis added). *See also* Treas. Reg. § 25.2701-2(b)(5)(iii).

Neither the Proposed Regulations nor the existing regulations (whether under Section 2701 or Section 2704) address control where the general partner interest of a limited partnership is held through a separate entity, such as a corporation or a limited liability company (a "**GP Entity**").[80] Similarly, no authority addresses control where a managing membership interest is held through a separate entity (a "**Management Entity**"). Accordingly, there is some uncertainty as to whether a taxpayer or his or her family members hold an interest *as* a general partner (or managing member)—and therefore should be deemed to control a limited partnership (or limited liability company)—by reason of holding minority or non-controlling interests *in* the GP Entity (or Management Entity).

We recommend that the Service modify Treasury Regulations § 25.2701-2(b)(5) to clarify that holding a non-controlling interest in a GP Entity (or Management Entity) is not equivalent to holding an interest "as" a general partner (or managing member), and therefore does not give rise to control over the limited partnership (or limited liability company). Section 2701(b)(2) provides that the holding of any interest "as" a general partner constitutes control over the limited partnership. Similarly, Treasury Regulations § 25.2701(2)(b)(5)(iii) provide that, "in the case of a limited partnership, control means the holding of any equity interest *as* a general partner." This statutory and regulatory language suggests that control requires the taxpayer or his or her family members to be the general partner, or hold interests authorizing such individuals to act as general partner.

Indeed, the purpose of the control rule in Section 2704 (as imported from Section 2701) is to capture entities that a taxpayer and his or her family members in fact control, before and after a lapse or transfer. Because a general partner of a limited partnership generally has the power to bind the limited partnership, it is reasonable to treat a limited partnership as a family-controlled entity if the taxpayer (or his or her family members) acts as general partner. (The same reasoning applies with respect to a taxpayer who has the authority to act as managing member of a limited liability company.) By contrast, merely holding a minority or non-voting interest in a GP Entity (or Management Entity) would not in itself authorize the taxpayer or family members to control the limited partnership *as* general partner (or the limited liability company as managing member), and therefore should not give rise to control for purposes of Section 2704 (or Section 2701).

[80] In the case of a corporation, Section 2701(b)(2) provides that control means "the holding of at least 50 percent (by vote or equity) of the stock of the corporation." Prop. Reg. § 25.2701-2(b)(5) provides that, in the case of a limited liability company, control means holding at least 50 percent of either the capital interests or profits interests.

The Service has itself reached this conclusion when analyzing control for purposes of a transaction under Section 2701.[81] In PLR 9639054, the taxpayer and the taxpayer's applicable family members (as defined in Section 2701(e)(2)) held less than fifty percent of the capital or profits interest in a limited partnership, and further held less than fifty percent of the total voting power or equity of a corporation serving as general partner. The Service determined that the family did not control the limited partnership for purposes of Section 2701.[82]

To provide clarity on this issue, we recommend that the final regulations incorporate the conclusion of PLR 9639054. Specifically, if a taxpayer and the members of his or her family do not control a GP Entity, and are not otherwise able to exercise the powers of the general partner, such as special voting or liquidation powers, the limited partnership should not be deemed to be a family-controlled entity, so long as the taxpayer and family members also hold less than fifty percent of the equity or profits interests in the partnership. Similarly, a limited liability company should not be a family-controlled entity provided that the taxpayer and the members of his or her family do not control a Management Entity, and are not otherwise able to exercise the powers of the managing member, and hold less than fifty percent of the equity or profits interests in the partnership.

Control of the GP Entity or Management Entity may be determined by applying the same rules that generally apply for purposes of determining control of corporations, partnerships or other entities under Sections 2701 and Section 2704. Accordingly, in the case of a GP Entity or Management Entity that is a corporation, control would constitute holding at least fifty percent of the corporation's voting power or equity, and in the case of GP Entity or Management Entity that is a partnership, control would constitute holding at least fifty percent of the capital or profits interests. Where the GP Entity or Management Entity is a limited liability company, the new rule set forth in Proposed Regulations § 25.2701-2(b)(5)(iv) should apply, so that control would mean holding at least fifty percent of entity's capital or profits interests. Finally, in the absence of a GP Entity or Management Entity (or if the taxpayer and the taxpayer's family members hold no interests in the GP Entity or Management Entity), the limited partnership or limited liability company nevertheless should be deemed to be controlled if the taxpayer or members of the taxpayer's family otherwise hold powers similar to those of a general partner or managing member, such as special voting or liquidation powers, which would enable them to act "as" general partner or managing member.

[81] *See* PLR 9639054 (Sept. 27, 1996).

[82] *Id.*

B. Lapses of Liquidation and Voting Rights

1. Retroactivity of deemed lapse if transfer occurs within three years of death

Under current law, Section 2704(a) does not apply to transfers of entity interests so long as the rights with respect to the transferred interest are not restricted or eliminated.[83] Under the Proposed Regulations, by contrast, a transfer within three years of a decedent's death that results in a lapse of a voting or liquidation right is treated as a lapse occurring at death.[84] For example, if the decedent had sufficient voting units to compel an entity to liquidate, but, by transferring units within three years of death, lost the right to liquidate the entity, then the transfers (if the decedent and members of the decedent's hold control before and after the lapse[85]) are treated as the lapse of a liquidation right occurring at death. The Proposed Regulations modify two examples in Treasury Regulations § 25.2701-1(f) in order to illustrate the change.

The Proposed Regulations do not state whether a transfer made before their effective date could cause a deemed lapse at death if the transferor dies within three years of the transfer but after the Proposed Regulations are effective. Taxpayers who made transfers before the Proposed Regulations were issued could not have anticipated that their transfers would cause an additional amount to be included in their gross estates. Consequently, they may not have planned adequately for the possibility of unexpected additional estate tax.[86]

[83] The only exception under current law applies where the transferor retains a subordinate interest and loses the effective power to compel liquidation as a result of the transfer of a senior interest. Treas. Reg. § 25.2704-1(c).

[84] The Proposed Regulations appear to subtly expand the scope of the general rule that Section 2704(a) does not apply to transfers of entity interests. Whereas the current regulations provide that a transfer that results in the lapse of a liquidation right is not generally subject to Section 2704(a) (if the rights associated with the interest are not restricted or eliminated), the Proposed Regulations provide that a transfer that results in the lapse of a liquidation *or* voting right is not generally subject to Section 2704(a) (if the rights associated with the interest are not restricted or eliminated and the transfer occurs more than three years before death). Likewise, under the Proposed Regulations, a lapse of either liquidation *or* voting rights may be deemed to occur at death as a result of transfers within three years of death. It is unclear what the expansion of these rules to encompass lapses of voting rights is intended to accomplish. We suggest that Service clarify the intent in the preamble of the final regulations.

[85] Section 2704(a) does not apply unless the holder of the interest and members of the holder's family control the entity both before and after the lapse. We recommend that the final regulations clarify that, although the lapse is deemed to occur at death, family control is determined before and after the moment of transfer.

[86] In some cases, such as where a taxpayer dies with no other assets that can be liquidated in order to pay the tax, the three-year deemed lapse rule may cause the estate taxes due at death to exceed the value of the property out of which the tax can be paid.

Further, Proposed Regulations § 25.2704-4(b)(1) provide that the new Section 2704(a) rules apply to lapses "occurring on or after the date these regulations are published in the Federal Register." Although the new rules would deem a lapse to have occurred at death as a result of transfers made three years before death, the actual lapse of liquidation or voting rights would occur at the moment of transfer. Thus, the effective date provisions of the Proposed Regulations imply that the deemed-lapse-at-death rule will not apply to transfers made before publication of the final regulations. We suggest the Service clarify that a transfer made before publication of the final regulations will not cause a deemed lapse at death.

2. Date as of which the amount of a lapse deemed to occur at death is determined

Section 2704(a)(2) provides that the amount treated under Section 2704(a) as transferred by gift or at death is equal to the difference between the value of the interest immediately before and after the lapse. In the case of a deemed lapse at death, the Proposed Regulations do not address whether, for purposes of determining this amount, the lapse is deemed to occur at the time of transfer or at death. As the value of a lapsed right should be determined at the time that the lapse actually occurs, we recommend that the final regulations provide that, although the lapse is deemed to occur at death and is included in the transferor's gross estate, the amount of the lapse is still determined by reference to the moments before and after the actual transfer.

3. Computation of amount of lapse deemed to occur at death where Section 2704(b) also applies

It appears that the same transfer could be subject to the valuation rules of Section 2704(b) and yet still cause a deemed lapse at death if the transferor dies within three years. The Proposed Regulations do not address how the amount of the lapse is determined in that case. For the sake of consistency, we recommend that, if Section 2704(b) valuation rules apply to determine the value of the interest transferred, then the amount of any deemed lapse at death should also be computed after first applying those same valuation rules.

4. Transferees admitted as partners or members shortly after assignment

Many partnerships and limited liability companies limit the rights of transferees until the other partners or members agree to admit the assignee as a full partner or member. In practice, admission of a new partner or member is a formality commonly accomplished shortly after a partnership or membership interest is assigned. To avoid triggering Section 2704(a) unnecessarily in these cases, we suggest that the Service clarify in the final regulations that a transfer does not result in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights, if those rights are restored within a reasonable period, such as thirty or sixty

days. In those cases, the interest would be determined as if the holder possessed the rights of a partner or member at the moment of transfer.

5. Clarification of whether lapses of rights created on or before October 8, 1990, are grandfathered

OBRA provides that Section 2704 applies "to restrictions or rights (or limitations on rights) created after October 8, 1990").[87] Echoing this language, the Proposed Regulations provide that the new Section 2704(a) rules 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."[88] There is a subtle difference, however, in how the October 8, 1990, effective date applies in OBRA versus the Proposed Regulations. In OBRA, Section 2704 applies to both rights *and* restrictions (as well as to limitations on rights) created after October 8, 1990. In the Proposed Regulations, by contrast, the new Section 2704(a) rules apply only to *rights* created after October 8, 1990, if those rights lapse.

The difference between OBRA and the Proposed Regulations may create an inadvertent discrepancy between transfers of interests in entities created before and after October 8, 1990. To illustrate, consider the following two variations of Treasury Regulations § 25.2704-1(f), Example 4, as amended by the Proposed Regulations:

> *Variation 1*: *D* owns 84 percent of the single outstanding class of stock of Corporation *Y*, *which was created January 1, 2000*. The by-laws require at least 70 percent of the vote to liquidate *Y*. Within three years of *D*'s death, *D* transfers one-half of *D*'s stock in equal shares to *D*'s three children (14 percent each).
>
> *Variation 2*: *D* owns 84 percent of the single outstanding class of stock of Corporation *Y*, *which was created January 1, 1990, and whose governing documents have not since been modified*. The by-laws require at least 70 percent of the vote to liquidate *Y*. Within three years of *D*'s death, *D* transfers one-half of *D*'s stock in equal shares to *D*'s three children (14 percent each).

In Variation 1, a deemed lapse at death, as the Proposed Regulations provide, will occur as a result of *D*'s transfer. In Variation 2, by contrast, the outcome is uncertain. Although *D*'s transfer, as in Variation 1, results in a lapse of *D*'s liquidation power, the rights of shareholders were created before October 9, 1990. Consequently, under a strict reading of the Proposed Regulations' effective date provisions, a deemed lapse at death may not occur.

[87] Pub. L. 101-508 § 11602(e)(1)(A)(iii), 104 Stat. 1388, 1388–500 (1990).

[88] Prop. Reg. § 25.2704-4(b)(1) (emphasis added).

The OBRA effective date provisions do not necessarily compel such a discrepancy. Although, in Variation 2, *D*'s rights as a shareholder existed on or before October 8, 1990, the limitation on *D*'s right to liquidate was not created until after that date. That is, the limitation did not exist on October 8, 1990; it only came into being on the date of *D*'s transfers to his children. Thus, under the statutory effective date, Section 2704(a) should apply in both variations. In any event, there does not appear to be a policy justification, based on taxpayer reliance or otherwise, for foreclosing planning opportunities that arise from the mere act of transfer, but only where the transferred interest was created after October 8, 1990. We recommend, therefore, that the Service clarify that the new Section 2704(a) rules apply to *any* lapses, regardless of when the entity interest was created, that result from transfers occurring after the final regulations are published.[89]

C. Issues (Other than Determination of Value) Common to Applicable Restrictions and Disregarded Restrictions

1. Meaning of rights subject to Section 2703

Under the Proposed Regulations, an option, right to use property, or agreement that is "subject to section 2703" is neither an applicable restriction nor a disregarded restriction.[90] The Proposed Regulations do not explain what it means for a restriction to be "subject to" Section 2703. One possibility is that an option, right, or agreement is subject to Section 2703 only if it is ultimately disregarded under Section 2703. Alternatively, an option, right, or agreement may be subject to Section 2703 so long as it is described in Section 2703(a), even it successfully withstands scrutiny by satisfying the exception of Section 2703(b).[91]

[89] If the Service chooses to preserve an exception for transfers of interests in entities created on or before October 8, 1990, then we recommend that the final regulations define the circumstances, if any, where a post-October 8, 1990, modification to an entity or other agreement, or to applicable state law, causes the new rules to apply to an otherwise grandfathered lapse.

[90] Prop. Reg. § 25.2704-3(b)(5)(iv). Section 2703(a) generally provides that the value of property shall be determined without regard to (i) any option, agreement or other right to acquire or use the property at a price that is less than the property's fair market value (without regard to such option, restriction or right), and (ii) any restriction on the right to sell or use such property. Section 2703(b) creates an exception for an option, restriction, or agreement that meets certain requirements, *i.e.*, that it is a bona fide business arrangement, 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, and is comparable to similar arrangements entered into by persons in an arm's length transaction.

[91] The preamble to the Proposed Regulations claims that Section 2703 and Section 2704(b) do not overlap. We are not certain that this claim is correct. In Est. of Elkins v. Comm'r, 140 T.C. 86 (2013), *rev'd on other grounds*, 767 F.3d 443 (5th Cir. 2014), for example, the Tax Court held that an agreement waiving the owners' ability to compel a liquidation of property was disregarded under Section 2703. Conceivably,

The following examples illustrates the possible interaction of Sections 2703 and 2704(b).

> *Example 1*. The operating agreement of *E*, a limited liability company owned by *D* and *D*'s two children, contains both (i) buy-sell provisions defining the price at which a deceased member's interest shall be redeemed at death and (ii) provisions restricting liquidation and withdrawal without the consent of all members. The operating agreement, including the buy-sell provisions, satisfies the requirements of Section 2703(b). *D* assigns *D*'s membership interests in equal shares to *D*'s children.

Under the Proposed Regulations, several outcomes in this example are possible. First, because the operating agreement contains buy-sell provisions described in Section 2703(a), the operating agreement itself may be "subject to" Section 2703, with the result that none of its provisions would be disregarded under Section 2703(b). Second, it may be that only the buy-sell provisions are "subject to" Section 2703, with the result that the restrictions on liquidation and withdrawal would still be disregarded restrictions. Third, it may be that the operating agreement, because it survives Section 2703(b) scrutiny, is not "subject to" Section 2703 at all, with the result, once again, that the restrictions on liquidation and withdrawal are disregarded restrictions.

Suppose instead that, unlike in the foregoing example, neither the operating agreement nor the buy-sell provisions satisfies the requirements of Section 2703(b). In other words, consider the following example:

> *Example 2*. The operating agreement of *E*, a limited liability company owned by *D* and *D*'s two children, contains both (i) buy-sell provisions defining the price at which a deceased member's interest shall be redeemed at death and (ii) provisions restricting liquidation and withdrawal without the consent of all members. Neither the operating agreement nor the buy-sell provisions in particular satisfy the requirements of Section 2703(b). *D* assigns *D*'s membership interests in equal shares to *D*'s children.

Once again, several outcomes are possible. First, it may be that operating agreement itself is subject to Section 2703, in which case, ironically enough, the restrictions on liquidation and withdrawal would actually be respected. Second, it may be that only the buy-sell provisions are

the Service could provide by regulation that restrictions on compelling liquidation of an entity are likewise disregarded under Section 2703. *But cf.* Est. of Strangi v. Comm'r, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002) (declining to disregard the existence of a limited partnership under Section 2703); Church v. United States, 268 F3d 1063 (5th Cir. 2001), *aff'g per curiam* 2000 WL 206374 (W.D. Tex. 2000) (same).

subject to Section 2703, in which case restrictions on liquidation and withdrawal would be disregarded under Section 2704.

In light of these possibilities, the final regulations should clarify the effect of the Section 2703 exception. Presumably, in crafting the exception, the Service was merely trying to confirm its view that Section 2703 and Section 2704(b) do not overlap, but did not intend to cause restrictions to escape the application of Section 2704(b) artificially. The Service could avoid creating an unintended loophole by clarifying that Section 2703(a) does not apply to restrictions on liquidating an entity or redeeming an interest in an entity.

Alternatively, the Service could consider deleting altogether the exception for restrictions subject to Section 2703. If the Service is correct that Section 2703 and Section 2704(b) do not overlap, then the exception is unnecessary, because it merely restates existing law. But if Section 2703 and Section 2704(b) do overlap, then deleting the exception will avoid creating an unjustified exception to the rules of Section 2704(b).

2. Guidance on non-gift transfers

The Proposed Regulations do not provide guidance on the effect of disregarded or applicable restrictions when a trust transfers an interest in an entity.[92] Trusts may transfer interests in entities in a variety of common situations. To take three examples, a trust may transfer an entity interest (i) to the grantor in satisfaction annuity amounts due from a grantor-retained annuity trust (a "**GRAT**"), (ii) to the grantor or another individual in satisfaction of a debt obligation, or (iii) in exchange for other property, such where the grantor or another person exercises a power of substitution described in Section 675(4). Finally, a trust may exchange property with another trust. For example, a trust that is not exempt from GST tax may sell property to a trust that is exempt, in exchange for cash or other property. As discussed below, the valuation of entity interests in these situations may affect the integrity of the wealth transfer tax system.

For example, the Treasury could be whipsawed if Section 2704(b) applied to the valuation of entity interests transferred to the grantor in satisfaction of GRAT annuity amounts. Suppose that, before the final regulations become effective, an individual funds a GRAT with an interest in an entity that, after the application a minority interest discounts, is worth $1 million. As a result of the discount, the donor can, without increasing the amount of the donor's taxable gift, reduce the annuity amounts required to be paid to him or her. Nevertheless, if the annuity amounts are later in paid in kind with entity interests that are not discounted, then fewer entity units will be needed to satisfy the annuity amounts, and more property will pass tax-free to the

[92] The gift tax applies to transfers of property by individuals, but not to transfers of property by trusts. I.R.C. § 2501(a).

remainder men if the grantor survives the fixed term. In short, the donor is able to exploit discounts in funding the GRAT, yet exploit the lack of discounts when the annuity amounts are paid.[93]

On the other hand, a rule that Section 2704(b) does not generally apply to transfers of entity interests by trusts could sometimes whipsaw taxpayers. Suppose, for example, that a trust holds an entity interest worth $1 million without discounts but only $600,000 after traditional valuation discounts are applied. Suppose, further, that the grantor of the trust acquires the interest in exchange for cash equal to the value of the interest. If the entity interest is valued with discounts, then the grantor must pay the trust no more than $600,000 in order to avoid a part-gift-part-sale. But if the grantor thereafter transfers the interest by gift or at death, the interest could be deemed to be worth $1 million if valuation discounts are eliminated. In other words, in exchange for $600,000, the grantor would effectively receive $1 million of value. The amount subject to wealth transfer tax would be artificially increased by the $400,000 difference.

Finally, to turn the tables yet again, taxpayers could themselves sometimes exploit a general rule that Section 2704(b) does not apply to transfers of property by trusts. Suppose, for example, that a trust that is not exempt from GST tax holds an entity interest worth $1 million without discounts but only $600,000 after traditional valuation discounts are applied. If the interest is transferred to a skip person in a generation-skipping transfer, and the interest is valued without discounts, then a GST tax will be imposed on the amount of $1 million. But before that happens, suppose that a trust that is exempt from GST tax acquires the interest in exchange for cash equal to the value of the interest. If the interest is valued with discounts, then the non-GST-exempt trust can transfer $1 million of taxable value to the exempt trust, but in exchange for only $600,000 of cash. An amount equal to the $400,000 difference escapes GST tax.

In light of the foregoing complexities, we recommend that the Service study further how entity interests transferred by trusts should be valued in light of Section 2704(b). The Service could first solicit views on this interesting topic from the public and the bar.

3. Grandfathering of transfers of entity interests subject to restrictions created on or before October 8, 1990

The revised definition of applicable restriction and the new definition of disregarded restriction both apply only to "transfers of property subject to restrictions created after October 8, 1990." In the case of applicable restrictions, the new rules apply to transfers occurring on or after

[93] The opposite whipsaw effect is also possible: if entity discounts are reduced or eliminated on funding a GRAT, but are respected when valuing interests paid in kind to the grantor, then the annuity amounts must be increased in order to reduce the grantor's taxable gift, even as more entity units would be required to pay the annuity.

the date the final regulations are published; in the case of disregarded restrictions, the new rules apply to transfers occurring thirty or more days after the date the final regulations are published. The Proposed Regulations do not explain under what circumstances, if any, a post-October 8, 1990, modification or change in state law could cause a restriction to lose its grandfathered status. It would be helpful if Service were to provide clarity on this question. The Service could be guided by Treasury Regulations § 25.2703-2, which provide that the Section 2703 regulations apply to "any right or restriction created or substantially modified after October 8, 1990."

D. Applicable Restrictions

1. Examples of applicable restrictions

The Proposed Regulations make significant changes to the definition of "applicable restriction" yet do not provide any additional examples to illustrate the new rules. We suggest that the final regulations provide examples of applicable restrictions under the new rules.

2. Interests of nonfamily members

We note that, in contrast to the definition of disregarded restriction, the Proposed Regulations' revised definition of applicable restriction does *not* provide that interests held by nonfamily members are to be disregarded for purposes of determining whether the restriction may be removed by the transferor, the transferor's estate, and members of the transferor's family. Presumably, the difference is deliberate, and reflects the Fifth Circuit's holding in *Kerr* that even *de minimis* interests held by non-family members may be sufficient to avoid an applicable restriction, if non-family members have the right to veto removal of the restriction. It would be helpful if the preamble to the final regulations could confirm the conclusion that non-family member interests are respected for purposes of determining whether the transferor and members of the transferor's family can remove a restriction on the ability of the entity to liquidate.

E. Disregarded Restrictions

1. Effect of Section 2053 in determining minimum value

In general, the Proposed Regulations define a disregarded restriction as a limitation on the ability to redeem or liquidate an entity interest, if the limitation is described in any of paragraphs (b)(1)(i) through (iv) of Proposed Regulations § 25.2704-3. Those limitations include the following described in Proposed Regulations § 25.2704-3(b)(1)(ii):

> The provision limits or permits the limitation (such as through amendment) 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 for federal estate or gift tax purposes, as the case may be, 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 deductions instead were claims against an estate.*
>
> (emphasis added)

The last sentence incorporates Section 2053 principles into the determination of whether entity obligations reduce the net value of the entity. One of those principles is that, under Treasury Regulations § 20.2053-1(d)(a), a claim must be "actually paid" in order to be deducted.[94] By the parenthetical "(if paid)," however, the Proposed Regulations provide that the "actually paid" requirement of Treasury Regulations § 20.2053-1(d)(a) shall be deemed to have been satisfied.

We agree that the "actually paid" requirement should not be incorporated into the determination of minimum value.[95] It is uncertain, however, how the "(if paid)" parenthetical assumption should be applied in cases where the value of an obligation is uncertain. Suppose, for example, that a claim for $100,000 of damages has been alleged against an entity, but the claim has only a fifty percent probability of success. The final regulations should clarify that, in determining minimum value, it is not the face amount of the claim (*i.e.*, $100,000) but only its expected value (*i.e.*, $50,000) that is taken into account.

Alternatively, the final regulations could either (i) provide that the "actually paid" requirement for deducting claims under Section 2053 does not apply to the determination of the net value of an entity or (ii) incorporate Section 2053 concepts more narrowly. Under the latter approach, the final regulations would provide that obligations shall be respected only to the extent that they are enforceable obligations of the entity at the time of transfer and, if founded on a promise or agreement, are bona fide and contracted for full and adequate consideration in money

[94] If a claim is not actually paid, then, to deduct it for estate tax purposes, an estate must generally file a protective claim for refund. Not until the claim is actually paid may the estate claim the deduction, together with an estate tax refund.

[95] Applying the actually paid requirement to the determination of minimum value would create administrative complexity and would delay final determination of gift tax values, even as those values (as a result of the progressive rate structure of Section 2001(c) and the unified gift and estate tax credit) determine the amount of taxes due in later years and at death. It would also require resolution of ancillary issues, such the scope and application of exceptions to the actually paid requirement.

or money's worth. The meaning of those terms could be as defined in Section 2053 and Treasury Regulations § 20.2053-4. In addition, the Proposed Regulations could confirm that post-transfer events may be considered in determining an entity's net value.

2. Determination of Minimum Value

The Proposed Regulations define "minimum value" as follows:

> 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.[96]

The cross-references to Sections 2031 and 2512 and the applicable regulations provide a helpful benchmark. Nevertheless, some questions remain. In particular, the Service should clarify whether (i) "property held by the entity" is valued as a going concern taking into account goodwill, or instead should be based on net asset value as if all assets were liquidated and (ii) built-in gains are taken into account. The Service should also confirm that Section 2704(b) applies when valuing interests in lower-tier entities.

V. INTERACTION OF PROPOSED REGULATIONS TO SECTION 2704 AND BASIS RULES OF SECTION 1014

Under Section 1014, the basis of property acquired from a decedent is the fair market value of the property at the date of the decedent's death.[97] Section 2704, among other things, enhances the value of certain property transferred at death for estate tax purposes. Since the passage of Section 2704 in 1990, no case, guidance or other ruling has apparently addressed whether the special valuation rules under Section 2704 and its regulations set the basis under Section 1014. We recommend that Service clarify this issue in the final regulations to Section 2704 (or in a modification to the Section 1014 regulations). In the interest of fairness and simplicity, we believe the better approach is to treat the value of property, as established under Section 2704, consistently with the basis of such property for purposes of Section 1014.

Resolution of the issue ultimately turns on whether, with respect to transfers (or deemed transfers) at death, the special valuation rules under Section 2704 and its regulations, when applicable, establish fair market value at the time of death for purposes of Section 1014. On the one

[96] Prop. Reg. § 25.2704-3(b)(1)(ii).

[97] *See* I.R.C. § 1014(a).

hand, both Section 2704(a) and Section 2704(b) include introductory language stating that the provisions apply "for purposes of this subtitle."[98] Section 2704 appears in subtitle B, governing estate tax, gift tax, generation-skipping transfer tax and inheritance tax (applicable with respect to covered expatriates).

In contrast, Section 1014 is set forth in subtitle A, dealing with income tax. Furthermore, while Section 1014 provides that the basis of property is the property's fair market value at the decedent's death, Section 2704 does not include any specific reference to fair market value. Section 2704(b) states that "any applicable restriction shall be disregarded in determining the value of the transferred interest," but does not mention "fair market value."[99] Section 2704(a) provides that the amount of a deemed transfer is the value of all interests in the entity held by the individual before the lapse less the value of such interests after the lapse, but similarly does not refer to "fair market value."[100]

On the other hand, Treasury Regulations § 1.1014-1(a) expressly states that "the purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of Federal *estate tax*." (emphasis added).[101] Because Section 2704 enhances the value of property for estate tax purposes, it follows that this Section 2704 value should determine the Section 1014 basis of the property in the hands of the transferee. Moreover, while Section 2704 does not expressly refer to the term "fair market value," it is clear that the application of the statute (and its regulations) establishes fair market value for transfer tax purposes.

The Proposed Regulations provide that, if a restriction is disregarded, "the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist."[102] Further, Example 4 of Proposed Regulations § 25.2704-3(g) explains that, for purposes of calculating a decedent's estate tax inclusion and marital deduction, the value of an interest subject to Section 2704(b) is the fair market value of such interest, taking into account all relevant factors affecting value, while assuming any disregarded restriction does not exist. With respect to Section 2704(a), the proposed regulations provide that lapses subject to the statute are treated as taxable transfers for estate, gift and generation-skipping transfer tax purposes.[103] Therefore, for lapses deemed to occur at death, Section

98 *See* I.R.C. §§ 2704(a)(1) and 2704(b)(1).

99 *See* I.R.C. § 2704(b)(1).

100 *See* I.R.C. § 2704(a)(2).

101 Treas. Reg. § 1.1014-1(a); *see also* Rev. Rul. 54-97.

102 Prop. Reg. § 25.2704-3(f); s*ee also* Prop. Reg. § 25.2704-2(e).

103 *See* Prop. Reg. § 25.2704-1(a).

2704(a) establishes value for estate tax purposes, which generally is the fair market value. Moreover, while not directly on point, Section 1014(f) provides that, for tax and reporting purposes, the basis of property acquired from a decedent generally should be consistent with the estate tax value. This demonstrates a policy interest in ensuring basis consistency.

On balance we believe the better approach is to treat the basis of property transferred at death, which is subject to Section 2704, as equal to the value established for such property under Section 2704 and its regulations. Similarly, if, under Proposed Regulations § 25.2704-1(c)(1), a lapse is deemed to occur at death by reason of a transfer occurring within three years of death, the amount of the lapse, which establishes value for estate tax purposes, should be included in the transferee's basis under Section 1014. The foregoing may be addressed either in the final regulations to Section 2704 or by modifying the regulations to Section 1014. Adopting an approach that ensures consistency between basis for income tax purposes and estate tax value established under Section 2704 promotes fairness. Further, treating fair market value of interests determined under Section 2704 differently than fair market value for purposes of determining basis under Section 1014, or remaining silent on the issue, would create unnecessary complexity and confusion.[104]

[104] For similar reasons, we believe that the basis of property transferred by gift, for purposes of determining loss under Section 1015(a), should be equal to the value of such property established under Section 2704.