November 2, 2016


Ladies and Gentlemen:

We appreciate the opportunity to submit the enclosed comments, questions, and recommendations (“Comments”) on behalf of the Section of Real Property, Trust and Estate Law (“RPTE”) of the American Bar Association (“ABA”) pertaining to the Proposed Regulations under Internal Revenue Code Section 2704. These comments represent the views of RPTE only and have not been approved by the ABA’s House of Delegates or Board of Governors and therefore do not represent and should not be construed as representing the position of the ABA.

The enclosed Comments were prepared by the following members of RPTE: Todd Angkatavanich, Nathan Brown, Eric Fischer, Dana Foley, David Handler, James Hogan, Lou Mezzullo, Christine Quigley, Bill Sanderson, and Ryan Walsh. These Comments were reviewed by Stephanie Loomis-Price, Lester Law, Richard Franklin, and Steve Akers, on behalf of RPTE, and further reviewed by Dennis Belcher, on behalf of RPTE’s Committee on Government Submissions (“COGS”).

Although the attorneys who participated in preparing these Comments may have clients who may be affected by the legal issues addressed by the Comments, no such member (or firm or organization to which any such member belongs) has been engaged by a client to make this submission or to otherwise influence the development or outcome of the specific subject matter of these Comments.
RPTE appreciates the opportunity to submit these Comments, and we respectfully request that the Service consider our recommendations. We are available to meet and discuss these matters with the Service and its staff to respond to any questions. The principal contacts for discussion are:

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Very truly yours,

David J. Dietrich
Section Chair

Enclosure
The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The enclosed Comments were prepared by the following members of RPTE: Christine Quigley, Bill Sanderson, Ryan Walsh, Todd Angkatavanich, Eric Fischer, Nathan Brown, Dana Foley, James Hogan, David Handler, and Lou Mezzullo. These Comments were also reviewed by Stephanie Loomis-Price, Lester Law, Richard Franklin, and Steve Akers on behalf of RPTE, and further reviewed by Dennis Belcher on behalf of RPTE’s Committee on Government Submissions.

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1. BACKGROUND

Section 2704 of the Internal Revenue Code of 1986\(^1\) is one of four special transfer tax valuation rules added in 1990 as part of Chapter 14 of the Code.\(^2\) Congress added § 2704 in response to the Tax Court’s decision in *Estate of Harrison v. Commissioner*, T.C. Memo 1987-8. The special rules in § 2704 apply to interests in family-controlled corporations and partnerships, where those interests are subject to lapsing voting or liquidation rights or restrictions on liquidation. Section 2704(a) treats as a transfer the lapse of a

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\(^1\) All references the Internal Revenue Code of 1986 shall be to the “Code” or “IRC,” unless otherwise indicated. All references to sections within the Code, shall be to “§” or “Section,” unless otherwise indicated.

\(^2\) Chapter 14 is comprised of §§ 2701, 2702, 2703, and 2704 of the Code.
voting or liquidation right. Section 2704(b) disregards certain restrictions on liquidation in valuing certain intra-family transfers.

Under § 2704(a), if there is a lapse of a voting or liquidation right in a corporation or partnership and the individual holding the right immediately before the lapse and members of his or her family control the entity, the lapse is treated as a transfer. The amount of the transfer is the excess of the value of all interests in the entity held by the individual immediately before the lapse (determined as if the voting and liquidation rights were non-lapsing), over the value of such interests immediately after the lapse.

Under § 2704(b)(1), if there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor’s family, and the transferor and members of the transferor’s family hold, immediately before the transfer, control of the entity, then any “Applicable Restriction” is disregarded in determining the value of the transferred interest. Section 2704(b)(2) defines an Applicable Restriction as one “which effectively limits the ability of the corporation or partnership to liquidate,” and, with respect to which (i) either the restriction lapses, in whole or in part, after the transfer, or (ii) the transferor or any member of the transferor’s family, either alone or collectively, has the right after the transfer to remove, in whole or in part, the restriction. Section 2704(b)(3) provides that an Applicable Restriction does not include a commercially reasonable restriction which arises as part of financing with an unrelated person or “any restriction imposed, or required to be imposed, by any Federal or State law.”

Congress specifically gave the Secretary of the Department of Treasury authority to promulgate regulations under § 2704(b)(4), which provides as follows:

“The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor’s family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interests to the transferee.”

On August 2, 2016, relying in part on the foregoing enabling language, Treasury issued proposed regulations under §§ 2704 and 2701. In the “Background” section of the Preamble to the Proposed Regulations, Treasury indicates that the current Treasury Regulations under Chapter 14 “have been

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3 The Secretary of the Department of the Treasury shall hereinafter be referred to as the “Secretary,” unless otherwise provided. The Department of the Treasury shall hereinafter be referred to as “Treasury,” unless otherwise provided. The Internal Revenue Service shall hereinafter be referred to as the “Service.”


5 Hereinafter the preamble of the Proposed Regulations shall be referred to as the “Preamble”. 
rendered substantially ineffective in implementing the purpose and the intent of the statute” as a result of changes in state law and other subsequent developments, emphasizing the case of Kerr v. Commissioner, 113 T.C. 449 (1999), aff’d 292 F.3d 490 (5th Cir. 2002). Importantly, Kerr interpreted the term “Applicable Restriction” as a restriction on the ability to liquidate the entire entity; not a restriction on the ability to liquidate the transferred interest.

Treasury and the Service have identified a serious concern in the operation of the current regulations in drafting the Proposed Regulations. However, we respectfully submit that there remain several sections in the Proposed Regulations that require clarification and further definition. Therefore, we provide Treasury with our comments, questions and recommendations (collectively, the “Comments”). We note that certain Comments relate to technical questions and alternative interpretations under the Proposed Regulations, while other Comments relate to the practical adverse impact that the Proposed Regulations may have on taxpayers. Due to the technical complexity of the subject matter of the Proposed Regulations, we respectfully request that, after consideration of the Comments, Treasury withdraw and reissue new Proposed Regulations, allowing further opportunity for comment.

We have organized the Comments in the following manner:

   a. Comments with respect to the Implication of A Deemed Put Right in the Preamble and the Permitted Scope of Regulations under § 2704(b)(4);
   b. Comments with respect to Proposed Regulations under § 2701;
   c. Comments with respect to Proposed Regulations under § 2704; and
   d. Comments with respect to Ancillary Considerations: Consistency with Income Tax Basis

2. COMMENTS
   a. Comments with respect to the Implication of A Deemed Put Right in the Preamble and the Permitted Scope of Regulations under § 2704(b)(4)

The Preamble and the Proposed Regulations arguably could be read to imply that family members are deemed to have a right to put their interest back to the controlled entity (the “deemed put right”). We respectfully submit our opinion that there is no statutory authority for Treasury to create such a deemed put right in regulations. Furthermore, we believe it to be a convoluted reading of the Proposed Regulations, and possibly not what Treasury intended.

However, if Treasury believes it has authority under § 2704(b) to create such a deemed put right and the Proposed Regulations intend to do so, we respectfully request that the Final Regulations clarify Treasury’s intent in this regard by specifically incorporating such language in the Final Regulations, and that Treasury provide the statutory basis for creating such a deemed put right. Again, however, we believe that incorporating a deemed put right in the Chapter 14 regulations would be beyond the scope of the regulation-making authority granted to Treasury in § 2704(b).

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6 The term “current regulations” means the Treasury Regulations under Chapter 14 as they exist before the Proposed Regulations become Final Regulations.
Because we believe that Treasury did not intend this convoluted interpretation of the Proposed Regulations, we do not address the “deemed put” concept in the body of these Comments. We note, however, that we do not believe that Treasury would have the authority to impose such a deemed put right.

In any event, we identify the need for the Final Regulations to specify whether a deemed put exists to avoid the uncertainty that will otherwise arise.

b. Comments with Respect to Proposed Regulations under § 2701

The Comments under § 2701 are organized in the order of the Proposed Regulations insofar as possible, using the headings contained therein. Subsections for which there are no comments are in brackets.


Prop. Reg. § 25.2701-2(b)(5) Controlled entity –

General Comments.

Section 2701(b)(2) defines “control” for purposes of determining what constitutes an applicable retained interest as meaning, in the case of a corporation, the holding of at least 50% by vote or value of the stock in the corporation or, in the case of a partnership, the holding of at least 50% of the capital or profits interests in the partnership or any interest as a general partner of the partnership. Treasury Regulations § 25.2701-2(b)(5) expands on these statutory definitions with respect to corporations and partnerships.

Chapter 14 and its current regulations pre-date the “Check-the-Box” entity tax characterization rules finalized in December, 1996. In 1990 the only types of business entities for Federal tax purposes were corporations and partnerships as defined in Treasury Regulations under § 7701. The Code and regulations, therefore, are silent with respect to other entity types under state law, including the limited liability company (“LLC”). The IRS and the courts have disagreed in other Federal tax contexts how the LLC fits into provisions referencing partnerships, including whether one or more members of an LLC should be treated as general partners.

Issue #1 - Clarification of LLC as “Partnership” or “Other Business Entity”

Proposed Regulations § 25.2701-2(b)(5)(i) expands the description of a “controlled entity” beyond corporations and partnerships to include any other entity or arrangement that is classified as a business entity under Treas. Reg. § 301.7701-2(a), and which is controlled by the transferor, applicable family members, or lineal descendants of the parents of the transferor or the transferor’s spouse immediately before a transfer. We discuss below whether this “family member group” for purposes of determining whether an entity is “controlled” under § 2701 is the same family member group for purposes of determining whether an entity is “controlled” under any other section of Chapter 14 of the Code.

Proposed Regulations § 25.2701-2(b)(5) adds an additional category of business entity to corporations and partnerships for purposes of determining whether an entity is a controlled entity. The Proposed Regulations also adopt new definitions for partnerships and corporations by specifically referencing the Treasury Regulations under § 7701. Although Congress intentionally chose to use the terms partnership and corporation in Chapter 14, we agree it makes sense to amend these definitions in light of the Check-the-Box regulations and difficulties fitting the LLC within the tax definition of partnership.
Proposed Regulations § 25.2701-2(b)(5)(i) defines “corporation” consistently with Treas. Reg. § 301.7701-2(b)(1)-(8). However, because (b)(2) is omitted from the list of corporate entities, this Proposed Regulation excludes an “association taxed as a corporation” from the definition of a corporation. Because associations elect to be corporations, the purpose of this exception appears to be to exclude entities that are not corporations from electing to be corporations for purposes of § 2701. Despite this exception, an entity other than a corporation, such as a general partnership or LLC, will be treated as a corporation if it elects to be a subchapter S Corporation (hereinafter, “S corporation”). The reason for disparate tax treatment between non-corporate associations electing and not electing S corporation status is not apparent. The proposed regulation also characterizes a qualified subchapter S subsidiary (“QSSS”) as a “corporation separate from its parent corporation.” A QSSS is both a corporation for tax purposes and state law. Only a QSSS is referred to specifically as being separate from its parent. This language appears to be intended to override its income tax status as a disregarded entity under § 1361(b)(3)(A)(i). We believe that the Final Regulations should adopt a consistent position either following state entity law or the elected income tax character. We believe that the language referring to a QSSS being an entity separate from its owner should be applied to all disregarded entities.

The Proposed Regulations categorize a business entity under § 7701 other than a corporation based on its local law character, whether domestic or foreign, regardless of whether the entity is a respected or disregarded entity for tax purposes. Despite the breadth of state entity law, the Proposed Regulations divide tax law partnerships and disregarded entities between only two categories: first, state law partnerships, both general and limited, and second, “other business entities.” The Proposed Regulations actually refer to any other “business entity or arrangement.” Because the initial part of the definition in the Proposed Regulations specifically requires a business entity under § 7701, the “or arrangement” should be deleted in the Final Regulations.

The definition of control for purposes of a corporation or partnership is unchanged from the current Treasury Regulations. However, Prop. Reg. § 25.2701-2(b)(5)(iv) provides a different control test for the category of other business entities. Control is defined as the family member group holding at least 50% of profits or 50% of capital of the entity. It appears that control also can exist if the family member group holds the power to cause the liquidation of the entity or arrangement in whole or in part.

In addition to deleting any reference to an arrangement, we believe that the Final Regulations should clarify that the power to cause the liquidation of the entity, for purpose of determining control, means an actual power under the entity documents or state law; not a deemed or assumed right to liquidate the entity. We further request that Treasury consider adding a statement clarifying that, for purposes of determining control, the power to liquidate the entity in whole or in part does not mean an ability to liquidate the individual holder’s interest, but rather to liquidate the entity itself. We respectfully suggest that the existing language may be clearer if the phrase “in whole or in part” were removed, and in its place “(as opposed to a particular holder’s interest in the entity)” were added.

The purpose of the definition of “controlled entity” under § 2701 is limited: it applies only to determine whether a “distribution right” associated with an “applicable retained interest” is to be valued at zero or at
its fair market value.\(^7\) Therefore, the Proposed Regulations would continue to use the narrower obsolete definition of corporation or partnership to determine whether an equity interest is potentially subject to § 2701. Although we understand that the Proposed Regulations were primarily intended to fill gaps in the Treasury Regulations under § 2704, we respectfully submit that these modernized definitions should be applied for all purposes of Chapter 14, including Treas. Reg. §§ 25.2702-2(b)(1) and -5(c)(9).

We appreciate Treasury updating the test for controlled entities to reflect the change in entity classification resulting from the Check-the-Box regulations. In particular, the change providing a separate control test for an LLC is preferable to applying the partnership control test.

**Issue #2: Scope of Controlled Entity Definition.**

As noted above, Treas. Reg. § 25.2701-2(b)(5) defining “controlled entity” has a limited application under § 2701. Sections 2701(b)(2)(A) and (B) under which the regulation is promulgated define “control” not a “controlled entity”. The Treasury Regulations apparently combine the family member group in § 2701(b)(2)(C) with the “control” definition to define a “controlled entity.” However, the other provisions in Chapter 14 incorporating the “control” test have a different definition of family member group than under § 2701(b)(2)(C). For example, Treas. Reg. § 25.2702-5(c)(9) references a family member group consisting only of the grantor and the grantor’s spouse, and § 2704 references a family member group consisting of the transferor and members of the transferor’s family as defined in Treas. Reg. § 25.2702-2(a)(1). Accordingly, we respectfully request that the Final Regulations separate the definition of control from the family member group having the control so that any cross-reference to Treas. Reg. § 25.2701-2(b)(5) will refer only to the meaning of “control.” Alternatively, all cross-references to Treas. Reg. § 25.2701-2(b)(5) could instead reference §§ 25.2701-2(b)(5)(ii) – (iv) specifically.

[Prop. Reg. § 25.2701-8 Effective dates.]

We have no comments.

c. **Comments with Respect to Proposed Regulations under § 2704**

The Comments under § 2704 are organized in the order of the Proposed Regulations insofar as possible, using the headings contained therein. Subsections for which there are no comments are in brackets.

**Prop. Reg. § 25.2704–1 Lapse of certain rights.**

**General Comment.** The main purposes of the Proposed Regulations under § 2704(a) are stated to be: (1) to clarify that a transfer of a partnership interest that results in the creation of an assignee interest is a lapse (addressed in new Prop. Reg. § 25.2704-1(a)(5)); and (2) to address certain deathbed transfers that will be deemed to result in the lapse of a liquidation right, which otherwise would not be subject to § 2704(a) because no voting or liquidation rights are restricted or eliminated (addressed in Prop. Reg. §

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\(^7\) IRC § 2701(b)(2).
25.2704-1(c)). Certain additional changes, as discussed below, are also included in the Proposed Regulations.

**Prop. Reg. § 25.2704-1(a) Lapse treated as transfer –**

**Prop. Reg. § 25.2704-1(a)(1) In general.**

The Proposed Regulations are said to apply “[f]or purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes)…. “ However, § 2704(a) deems certain lapses of voting or liquidation rights to be transfers and subjects such lapses to transfer taxes on the loss in value of property resulting from the lapse. Because no transferee may receive an increase in value due to the lapse, applying § 2704(a) for GST tax purposes will be problematic in at least some circumstances. Because Congress specifically designed § 2704(a) to dispense with the requirement of a transfer of value or property, we recommend that § 2704(a) not apply for GST tax purposes. If Treasury determines that § 2704(a) should apply in those instances when the taxable lapse increases the value of interests in the entity held by other owners, it should provide an example showing when the GST tax would apply and when it would not.

We note that the current Treasury Regulations do not refer to a generation-skipping transfer only a transfer for gift or estate tax purposes.

Please see our Comments under Prop. Reg. § 25.2704-3(a) with respect to the definitions of corporations and partnerships.

**Prop. Reg. § 25.2704-1(a)(2) Definitions.**

**Prop. Reg. § 25.2704-1(a)(2)(i) Control.**

Please see our Comments under Prop. Reg. § 25.2701-2(b) above and § 25.2704-2(c) below.


Proposed Regulations § 25.2704-1(a)(2)(iii) provides in part as follows:

“[i]n the case of a limited liability company, the right of a member to participate in company management is a voting right.”

We respectfully submit that Treasury has clarified this issue in Prop. Reg. §§ 25.2701-2(b)(5)(i) and (iv) and this additional phrase may not be substantively additive, but rather may have the potential to create confusion, particularly with respect to the interaction with Prop. Reg. § 25.2704-3.

**Issue #1: Disparate Treatment of LLCs as Opposed to Partnerships and Corporations**

We respectfully submit that treating the rights of a member of a LLC to participate in the company management as a voting right (as set forth in Prop. Reg. § 25.2704-1(a)(2)(iii)) is incongruous with the treatment of shareholders (of corporations) and partners (of partnerships). In the case of a corporation, under state law shareholders are permitted to own stock but have no voting rights (i.e., so-called “non-voting shareholders”). Similarly, in the case of a limited partnership, limited partners typically do not have voting rights (but see, e.g. Florida Statutes § 620.1303, allowing limited partners to participate in the management and control of the limited partnership). In either a corporation or partnership, if a shareholder or limited partner does not have the right to vote according to the governing documents of the entity, there will be no voting right ascribed to that shareholder or limited partner. On the other hand, there would be a voting right ascribed to a member in a LLC if the member has the right to participate in
company management even if the member’s interest is non-voting, and regardless of the company’s agreements. Because LLC membership interests can be “non-voting,” we respectfully request Treasury consider removing the provision that ascribes voting rights to managers of LLCs regardless of whether such manager’s membership interest in the LLC includes voting rights. By so doing, regardless of the type of entity, the determination of an owner’s voting right would be based on the particular agreements of the entity and the relationships of the owners.

**Issue #2: Members of LLCs May Have the Right to Participate in Management Without Rising to the Level Equivalent to a Voting Interest**

We respectfully submit that the language in Prop. Reg. § 25.2704-1(a)(2)(iii) that “the right to participate in company management is a voting right” is overly broad. It is entirely possible for a member to be both an owner and an employee in a LLC, and such an employee could have a “right to participate in company management” without being named as a manager, officer, director, or to another official position. If a member did not have a right to vote (i.e., a non-voting member), but such member, as an employee of the company, was considered to have the right to participate in the management of the company, then Prop. Reg. § 25.2704-1(a)(2)(iii) would provide that the non-voting member would nonetheless have a voting right. We believe that in the current business environment, companies often have multiple layers of managers operating in various capacities, all of which could be said “participate in company management.” Increasingly, even large operating companies are structured as LLCs. We respectfully ask Treasury to consider whether a member “participate[s] in company management” only if he or she is actually named as a manager or officer of the company or serves on the board of directors. Alternatively, we ask Treasury to consider whether participation is dependent upon the types of decisions the member makes. By example, a member who happens to be the manager of the night shift of an assembly line, and as such makes decisions about the number of workers needed and how the assembly line operates, may “participate in company management,” but is quite removed from deciding on the direction the company will take, whether to make distributions, and the like. We respectfully submit that such a member would not have “voting rights” for purposes of § 2704(a). Thus, in light of the over-broad language, we respectfully request that Treasury examine the efficacy of this clause.

We also respectfully ask Treasury to consider the situation where a person who owns non-voting LLC interests and is an executive or manager of the entity who participates in management, retires from the employment of the LLC. Would such retirement from a role under which the non-voting member participated in company management result in a taxable lapse even though the value of his or her non-voting membership interest and all other membership interests in the LLC are not affected?

We note that the introductory sentence of Prop. Reg. § 25.2704-1(a)(2)(iii) amply captures the right of a member of a LLC to vote with respect to any matter of the entity as being a voting right; accordingly, we respectfully request Treasury consider eliminating or substantially narrowing the situations in which participation in LLC management will in itself be treated as a voting right.

[Prop. Reg. § 25.2704-1(a)(4) Source of right or lapse.]

We have no Comments.

**Prop. Reg. § 25.2704-1(a)(5) Assignee interests.**

**Issue #1: Distinguish Between Permanent Transfer to Assignees and Temporary Lapses**
Proposed Regulations § 25.2704-1(a)(5) provides that a transfer resulting in the restriction or elimination of the transferee’s ability to exercise the voting or liquidation rights associated with the interest while held by the transferor is a lapse of the voting or liquidation right. For example, the transfer of a partnership interest to an assignee who then is unable to exercise the voting and liquidation rights associated with the transferred interest is a lapse. We agree that this is often an appropriate result under § 2704(a). We are concerned, however, that the Proposed Regulations, as drafted, do not distinguish between a permanent lapse and a temporary lapse that may result from a transfer.

Many partnership agreements allow the partners to vote to admit an assignee as a partner. In situations in which an assignee is admitted as a partner shortly after the transfer, we recommend that the proposed lapse rule should not apply. For example, a partnership agreement often will provide that a transferee of a partnership interest may become a partner by accepting the terms of the partnership or with the approval of the general partner. A temporary lapse resulting from a transfer should not result in a deemed transfer under § 2704(a). If an individual partner dies, the partner’s estate may become an assignee, but the executor or heir may become a partner under the partnership agreement. If an assignee interest may be converted to a partnership interest, we recommend that the Final Regulations allow a grace period of six months\(^8\) to make the conversion. If the assignee interest is not converted to a partnership interest within the requisite period, the lapse should occur on the date of the transfer to avoid taxpayers being able to manipulate the timing of a lapse by providing the right to become a partner in the partnership agreement. We respectfully request that the Final Regulations should specify whether the admission of the partner must be retroactive to the date of the transfer or whether admission within the requisite time period is sufficient.

Prop. Reg. § 25.2704-1(c) Lapse of liquidation right

Issue #1: Appropriate Valuation Method for Purposes of Determining the Amount of the Transfer under Treas. Reg. § 25.2704-1(c)

The provisions relating to valuation under Treasury Regulations § 25.2704-1(c) are not being amended by the Proposed Regulations; however, the reference to the value of all interests in the entity of the holder before and after the lapse raises the question of how the “value” should be determined.

We respectfully submit that the value of a liquidation right may be attributed to an interest -- even after a lapse of the actual liquidation right -- as a result of disregarding provisions in the organizational documents or local law that constitute “Applicable Restrictions” under 2704(b)(2) or “Disregarded Restrictions” as defined in Prop. Reg. § 25.2704-3(b). If this happens, then the value would be the same both before and after the lapse.

Prop. Reg. § 25.2704-1(c)(1) In general.

[See also Prop. Reg. § 25.2704-1(f) Examples 4 and 7]

\(^8\) Six months is derived from the reasonable period allowed to redeem an interest in a corporation or partnership in Prop. Reg. §25.2704-3(b)(1)(iii). Alternatively, a period of 90 days for a lifetime transfer or 180 days for a testamentary transfer could be considered to be reasonable.
General Comments.

Section 2704(a)(1) provides that if there is a lapse of any voting or liquidation right in a corporation or partnership and the individual holding such right immediately before the lapse and members of such individual’s family control the entity both before and after the lapse, the lapse shall be treated as a transfer by gift or a transfer that is includible in the gross estate. Section 2704(a)(2) provides that, for purposes of § 2704(a)(1), the value of the lapse is the excess, if any, of (1) the value of all interests in the entity held by the individual described in § 2704(a)(1) immediately before the lapse (determined as if the voting and liquidation rights were non-lapsing) over (2) the values of the interests immediately after the lapse.

Treasury Regulations § 25.2704-1(c)(1) clarifies that a lapse of a liquidation right will not occur for purposes of § 2704(a) if the rights with respect to the transferred interest are not restricted or eliminated, regardless of whether the transfer causes the transferor to fall below a voting threshold for liquidation. As a result, an individual owner can make gifts of minority interests, effectively converting a controlling interest to a non-controlling interest during life, without § 2704(a) applying.

This is illustrated in Treas. Reg. § 25.2704-1(f), Example 4, which states 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 voting rights are not restricted or eliminated by reason of the transfer.”

In other words, it appears that the “loss of control over liquidation,” Preamble, p.5, is not a “lapse” as that term is used in § 2704(a).

Proposed Regulations § 25.2704-1(c) would change the meaning of the word “lapse” as used in the Code by treating a transfer that occurs within three years before the death of the transferor, which results in the transferor’s remaining interest falling below a voting threshold, as a lapse of a liquidation right upon the death of the transferor, even though the voting rights with respect to the transferred interests are not eliminated by reason of the transfer. Citing Estate of Murphy v. Commissioner, T.C. Memo. 1990-472, the Preamble indicates that the current Treasury Regulations should be changed so that the loss of voting control over liquidation occurring as a result of deathbed transfers shall be considered a lapse as of the death of the transferor.9

As a result, Prop. Reg. § 25.2704-1(c)(1) would create a “three-year look back rule” that would require the value of the loss of voting control over liquidation as a result of the transfer of an interest within three years of the transferor’s death to be “treated as a lapse occurring on the transferor’s date of death, includible in the gross estate pursuant to § 2704(a).” Presumably, the value of the lapse will be computed under the general rules of § 2704(a)(2).

Proposed Regulations § 25.2704-1(f) would change Example 4 to reflect the new 3-year 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 voting rights are not restricted or eliminated by reason of the transfer.”

9 81 Fed. Reg. at 51414.
liquidate Y. More than three years before D’s death, 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 voting rights are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D’s death. However, had the transfers occurred within three years of D’s death, the transfers would have been treated as the lapse of D’s liquidation right occurring at D’s death”.10

Issue #1: The Three-Year Look Back Rule May Be Unnecessary

As discussed above under Prop. Reg. § 25.2704-1(c), if the lapse of a liquidation right results in a lower value due to a restriction applying to the interest after the lapse, and that restriction is an Applicable Restriction or Disregarded Restriction, no diminution in value results from the transfer within three years of death or indeed ever. If the lower value is due to a restriction applying to the interest after the lapse, and that restriction is not an Applicable Restriction or Disregarded Restriction, the exception contained in Treas. Reg. § 25.2704-1(c)(2)(i) would apply and § 2704(a) would therefore not apply to the lapse at all.

Issue #2: The Three-year Look Back Rule, When Read In the Context of the Proposed Regulations, Is Not Additive But May Result in Double Taxation

We respectfully submit that if the value of the loss of voting control over liquidation is taxed as a lapse under the three-year look back rule in Prop. Reg. § 25.2704-1(c)(1), the same value will have been subject to the transfer tax twice. Unlike § 2701, neither § 2704, the current Treasury Regulations thereunder, nor the Proposed Regulations contain a provision to protect against double taxation.

We respectfully ask Treasury whether there will be relief provided by a computational adjustment under § 2001(b)? If so, would the portion of the lapsed liquidation value attributable to shares transferred within three years of death be excluded from the amount of adjusted taxable gifts that are included in the estate tax calculation?

Issue #3: As the Proposed Regulations Are Drafted, Calculation of the Amount Includable is Unclear

Proposed Regulations § 25.2704-1(c)(1) provides that:

10 The Proposed Regulations also amends Treas. Reg. §25.2704-1(f) Example 7 to reflect the 3-year rule as follows:

“D owns all of the stock of Corporation X, consisting of 100 shares of non-voting preferred stock and 100 shares of voting common stock. Under the by-laws, X can only be liquidated with the consent of at least 80 percent of the voting shares. More than three years before D’s death, D transfers 30 shares of common stock to D’s child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D’s death. However, had the transfer occurred within three years of D’s death, the transfer would have been treated as the lapse of D’s liquidation right with respect to the common stock occurring at D’s death”.
"the lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includable in the gross estate pursuant to section 2704(a)." (Emphasis added.)

Presumably, the amount of the transfer would be determined under Treas. Reg. 25.2704-1(d), which provides that:

"The amount of the transfer is the excess, if any, of—

"(1) the value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right was nonlapsing); over

"(2) the value of the interests described in the preceding paragraph immediately after the lapse (determined as if all such interests were held by one individual)."

If this is the case, we respectfully submit that the amount to be taxed under this provision is either not clear, or would always be zero. On their face, the Proposed Regulations appear to provide that the amount would be included in the decedent’s gross estate. If the lapse occurs on the date of the transferor’s death, the amount includable can only be the value of the interests owned by the holder at his or her death. Therefore, it appears that there would be no value to a lapse. The value determined immediately after the lapse – as if such interests were held by one individual - would presumably be the same as the value determined before the lapse. If all interests that were owned by the holder before the lapse are valued after the lapse as if held by one individual, that one individual would own enough of an interest to compel the liquidation of the entity; thus, no value would be included under §2704(a).

We believe that it would be possible to read the Proposed Regulations as meaning that the value of all interests owned by the transferor within three years of his or her death should be included in the taxable estate. However, if this is the case, it seems overly broad and raises a number of new questions, as follows:

1. What if the transferor made a gift to his or her spouse or to charity? How would the marital or charitable deduction be calculated?
2. What if the transferor made a number of gifts over time within three years of death? Is only the final gift (that caused a loss of voting control over liquidation) includable?
3. What if the gift that caused the lapse of a voting right was not the same gift that caused the lapse of a liquidation right?
4. On what date would the interest be valued? The date of the initial transfer, the date of all transfers or the date of the final transfer?

We respectfully request Treasury consider these questions and provide guidance in the Final Regulations specifically addressing each of the questions, including perhaps an example illustrating how the "(determined as if all such interests were held by one individual)" parenthetical applies.

**Issue #4: The Three-year Look Back Rule Taxes a Phantom Asset**

If the three-year rule under Prop. Reg. § 25.2704-1(c) causes inclusion of a value in the gross estate, it effectively causes the taxation of a phantom asset. This raises the question of who pays for the estate tax caused by the increase in the gross estate. We respectfully submit that the estate tax burden would fall as provided under the governing instrument, or if none, as provided under state law (which would typically cause the residuary beneficiaries to bear such tax).
Tax liability and payment aside, we believe if the asset were transferred to a spouse or charity during life, where the original transfer would have qualified for the marital or charitable gift tax deduction, if the three-year rule causes the valuation increase in the gross estate, there is no provision that would allow a marital or charitable deduction even though the original transfer would have so qualified. Accordingly, we respectfully submit that the three-year rule causes an additional tax, where one should not be assessed. For these reasons, we respectfully request that Treasury consider how to avoid this issue when the Final Regulations are issued.

**Issue #5: Three Years Is Too Long a Period**

The *Murphy* decision, on which Treasury relies, involved a true deathbed transfer, not a transfer years before death occurred. The provision in current Treas. Reg. § 25.2704-1(c) that a lapse does not occur due to gifts of common stock that cause the transferor to lose voting control over liquidation of the entity is not a matter of regulatory grace. Rather, this exception reflects the intent of Congress to dispense with “family attribution” with the enactment of Chapter 14. As discussed, Treasury acknowledged that Chapter 14 dispensed with family attribution when it released Rev. Rul. 93-12. We respectfully submit that the *Murphy* decision is a “thin reed” on which to impose a three-year rule that would change the essential meaning of the word “lapse” as used in § 2704(a).

Rather, we respectfully submit that a proper deathbed test is the one in Treas. Reg. § 25.7520-3(b)(3). This test properly focuses on whether death might be anticipated at the time of the transfer; not just on happenstance. By focusing on intent — guided by certain objective factors — this test respects the Congressional prohibition on family attribution and is more consistent with the facts of the *Murphy* decision.

**Issue #6: Such Inclusion in a Decedent’s Gross Estate May Be Challenged as Requiring a Statutory Change**

In § 2035, Congress limited the circumstances under which so-called “death-bed transfers” are includable in a decedent’s gross estate. For example, § 2035(b) requires the amount of the gross estate to be increased by the amount of any gift tax paid by the decedent or his estate on any gift made by the decedent or his spouse during the three-year period ending on the date of the decedent’s death. Congress added the gross-up rule in § 2035(b) to the Code to eliminate any incentive to make death-bed transfers to remove an amount equal to the gift taxes from the transfer tax base.\(^{11}\) Unlike § 2035(b), there is no language in § 2704(a) suggesting that Congress intended to include such an amount in the estate of a decedent who died within three years of a transfer. We respectfully submit that it appears that in drafting the language, Congress knew how to draft such an inclusion had it intended to do so.\(^{12}\)

Therefore, we respectfully submit that § 2704 cannot impose a tax. Like the remaining sections under Chapter 14, it provides valuation rules for the taxation of transfers that otherwise occur under the Code. As described above, the Proposed Regulations under § 25.2704-1(c)(1) and (f) entirely change the

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\(^{11}\) Staff of the Joint Committee on Taxation, 94\(^{th}\) Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976*, at 529.

meaning of the word “lapse” as that word is used in § 2704(a). These Proposed Regulations tax such a “lapse” that would not otherwise be treated as a transfer, absent these Proposed Regulations. Accordingly, we question the validity of the Proposed Regulations under § 25.2704-1(c)(1) and (f) regarding a three-year lookback period for transfers of interests where the rights associated with such interest are in no way restricted or eliminated. These Proposed Regulations appear to attempt to create—and then tax—a property right that does not otherwise exist.


See Comments below under Prop. Reg. § 25.2704-3(b)(4) with respect to disregarding non-family-member interests. The provision in Prop. Reg. § 25.2704-3(b)(4) disregarding certain non-family member interests relies on the grant of regulatory authority in § 2704(b)(4). That authority does not apply to § 2704(a), therefore, its inclusion in this Proposed Regulation appears to be an overreach. The lack of a similar provision in Prop. Reg. § 25.2704-2 disregarding non-family member interests supports this conclusion. We are unaware of any similar situation in which a specific family group defined by statute has been redefined by a regulation. We respectfully request that Treasury remove the reference to disregarded non-family member interests under Prop. Reg. § 25.2704-3(b)(4) for purposes of determining the application of the exception to § 2704(a) provided for in Treas. Reg. § 25.2704-1(c)(2)(i) when a family cannot obtain liquidation value.


Prop. Reg. § 25.2704-2(a) In general.

See Comment under Prop. Reg. § 25.2704-2(c) with respect to test for whether “the transferor and/or members of the transferor’s family control the entity immediately before the transfer.”

See Comment under Prop. Reg. § 25.2704-3(a) with respect to definition of a corporation or partnership.

Prop. Reg. § 25.2704-2(b) Applicable Restriction defined

[Prop. Reg. § 25.2704-2(b)(1) In general.]

We have no comments.


Prop Reg. § 25.2704-2(b)(4). Exceptions


Issue #1: Potential to Incentivize Leveraged Entities

Proposed Regulations § 25.2704-2(b)(4)(i) provides as follows:

"An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity’s trade or business operations, whether in the form of debt or equity."

We respectfully submit that, in light of the Proposed Regulations, there is concern that this section could result in effectively penalizing businesses that are not leveraged. To help to explain our position, we use the following example.

Partnership X is a limited partnership primarily involved in real estate development. In the course of carrying out Partnership X’s business, it is necessary for Partnership X to secure substantial amounts of financing from various third party financial institutions. Financial Institution A will not lend to Partnership X unless Partnership X amends its partnership agreement to include certain restrictions on the ability to liquidate Partnership X.

We believe that under Prop. Reg. § 25.2704-2(b)(4)(i), even though these restrictions may not be mandatory under the applicable governing law (so that the exception under Prop. Reg. § 25.2704-2(b)(4)(ii) does not apply), they are excepted from the definition of Applicable Restriction because they would arguably be considered “commercially reasonable.” As a result, in valuing an interest in Partnership X for transfer tax purposes, the restrictions on liquidation may be taken into account. On the other hand, the restrictions would be ignored if there was no leverage.

This Proposed Regulation may result in business entities that require commercial debt to operate being treated more favorably from a transfer tax valuation perspective than business entities that operate without commercial debt. We respectfully submit that if the governing documents of Partnership Y contained the same restrictions on liquidation as the governing documents of Partnership X, but Partnership Y has no debt (or the restrictions were not required by a lender), the same restrictions that were taken into account in valuing an interests in Partnership X would be disregarded in valuing an interest in Partnership Y.

We understand that the statute requires this commercially Applicable Restriction exception. We respectfully request that Treasury include in the Final Regulations a similar exception for comparable family restrictions with arms-length terms similar to § 2703(b). We believe this type of exception would be consistent with the intent of Congress in enacting Chapter 14.

Prop Reg. § 25.2704-2(b)(4)(ii) Imposed by Federal or state law

General Comments.
Section 2704(b)(3)(B) provides that an Applicable Restriction does not include any restriction “imposed, or required to be imposed, by any Federal or state law” (the “State Law Exception”). Treasury Regulations § 25.2704-2(b) interprets the statutory State Law Exception as excluding from the definition of Applicable Restriction any limitation on the ability to liquidate an entity (in whole or in part) that is no more restrictive than the limitations that would apply under the Federal or state law generally applicable to the entity in the absence of the restriction. Accordingly, under current law, a restriction on the ability to liquidate an entity contained in the entity’s governing documents will not be treated as an Applicable Restriction as long as such restriction is no more restrictive than the default rule that would apply under the applicable governing law if the governing documents were silent.

Proposed Regulations § 25.2704-2(b)(4)(ii) provides that an Applicable Restriction does not include a restriction imposed or required to be imposed by Federal or state law. However, such regulation modifies the current regulatory interpretation of the State Law Exception, which states that a provision of state law that applies only in the absence of a contrary provision in the governing documents or that may be superseded by a provision in the governing documents is not a restriction that is imposed or required to be imposed by Federal or state law. The effect of the Proposed Regulation is to limit the State Law Exception to only those provisions of law that are mandatory and cannot be overridden by the governing documents, whether or not any such provision is in fact overridden in any particular case.

Thus, even if the restriction in the entity’s governing documents is no more restrictive than the default provision under the applicable governing law, if such provision of law is not required in all circumstances, the State Law Exception will not apply and the restriction in the governing documents will be an Applicable Restriction that is disregarded in valuing the transferred interest. Moreover, even if a provision of law is mandatory, the Proposed Regulations set forth two circumstances under which such provision of law will be deemed to be non-mandatory for purposes of the State Law Exception and, thus, not imposed or required to be imposed by Federal or state law.

The first circumstance under which an otherwise mandatory provision of law will be deemed to be non-mandatory is if such provision is limited in its application to a certain narrow class of entities (such as family-controlled entities) most likely to be subject to transfers described in § 2704. For example, the Proposed Regulations provide that a law requiring a restriction that may not be removed or superseded (i.e., a mandatory restriction) and that applies only to family-controlled entities that otherwise would be subject to § 2704 is an Applicable Restriction. The purpose of this provision appears to be to prevent a situation where a particular type of entity (e.g., a partnership) is subject to two sets of restrictions on liquidation – mandatory restrictions if family control exists (so that absent this provision, the restrictions in the governing documents would not be disregarded as Applicable Restrictions) and non-mandatory restrictions if family control does not exist (so that any restriction in the governing documents would be disregarded).

The second circumstance where an otherwise mandatory provision may be deemed to be non-mandatory is if the applicable law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that: (1) does not include the restriction; (2) allows the restriction to be removed or overridden, or (3) provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction. In such cases the restrictions become optional or permit the restriction to be superseded.

The Preamble reasons that in each of the two above situations the restriction is, in effect, elective because another statute is available to be used to create the entity that does not require mandatory restrictions or the provision may be overridden.

**Issue #1: In Determining Provisions Deemed to Be Non-Mandatory, Proposed Regulations May Disregard Legitimate Business Decisions with Respect to Choice of Entity**
We are concerned that if the particular statute under which the entity is created mandates the restriction, but a similar type of entity could have been created under a different statute, the State Law Exception will not apply and the restriction in the governing documents will be treated as an Applicable Restriction. We are further concerned that the Proposed Regulations might be read as treating an otherwise mandatory provision as elective if state law is changed after the entity is created to allow the mandatory provision to be changed or a new entity type is authorized without the otherwise mandatory provision. We respectfully submit that a change in Federal or state law should not convert a mandatory provision into an elective provision.

Further, we respectfully submit that while another statute may technically be available for the creation of the entity, the practical realities of the business may make use of such other statute prohibitive. Consider the following example:

Let’s assume that three types of entities that can be formed under the laws of State X: (1) corporations, (2) partnerships (including limited partnerships), and (3) all other business entities. Assume further that a mandatory restriction exists under the limited partnership statutes of State X, but the same restriction is not mandatory under State X’s general partnership statutes.

In analyzing this example, we respectfully submit that there is an argument that the State Law Exception may not apply to the mandatory restriction under the limited partner statutes. If that is the case, such restriction will be treated as an Applicable Restriction.

Business owners select a particular type of entity for a number of tax and non-tax reasons. For instance, business owners may choose limited partnerships over general partnerships for asset protection, centralized management, concentration of control, and other valid business reasons. However, the Proposed Regulations appear to look at the less restrictive general partnership statute to determine whether a restriction was mandatory. Unfortunately, if this is the case, we respectfully submit that this provision does not reflect the practical realities of choice of entity decisions and could have the effect of driving choice of entity decisions under state law.

We respectfully ask Treasury to consider the following example that is based on the Illinois Business Corporation Act of 1983 (the “BCA”). Specifically, Article 2A of the BCA explicitly allows a close corporation to function without observing many of the corporate formalities by electing Close Corporation status. Article 2A of the BCA provides as follows:

“[t]he articles of incorporation of any close corporation may include a provision granting to any shareholder, or to the holders of any specified number or percentage of shares of any class, an option to have the corporation dissolved at will or upon the occurrence of any specified event or contingency.”

Close Corporation status is rarely elected in practice. As the law exists today in Illinois, and if the Proposed Regulations are finalized as is, we are concerned that an argument could be made that any shareholder in any family-controlled corporation would be deemed to have the liquidation provisions of the Close Corporation Act apply rather than the mandated restrictions applicable to non-Close Corporations. Although we recognize the impetus for the State Law Exception and the desire to disregard non-mandatory restrictions, we believe it is nonetheless important to allow taxpayers to make legitimate choices with respect to entity formation. We respectfully submit that these are unintended consequences of the Proposed Regulations. Further, we also believe that the statutory provisions targeted by the
Proposed Regulations are discrete, i.e., those state statutes that have been amended to require unanimity for dissolution in direct response to the enactment of § 2704.

The practical impact of recognizing only mandatory restrictions is unclear. For example, assume a taxpayer owns 49% of the stock of a corporation, and state law requires a majority vote to dissolve the corporation. Is the inability to compel liquidation because the taxpayer holds only 49% an applicable restriction because the majority vote requirement is not mandatory under state law and the owners could have overridden the general majority rule requirement for liquidation under state law and have given a mere 1% owner the power to dissolve the entity?

Accordingly, we respectfully recommend instead retaining the existing State Law Exception (as provided for under the current regulations) and removing the new provisions under the new Proposed Regulations. Further, we respectfully recommend that, if needed, the exception be modified. For example, the modification could provide that a state statute that mandates unanimity for dissolution be disregarded. This would effectively limit a state from changing its default law to allow a taxpayer to abuse the existing State Law Exception while nonetheless allowing taxpayers to make legitimate business entity choices.

**Issue #2: Respect for Choice of Jurisdiction**

We would appreciate clarification whether, under the Proposed Regulations, a mandatory restriction is disregarded if a statute in another jurisdiction were available for the creation of the same type of entity. We do not believe that such disregard for choice of jurisdiction was intended in the Regulations, but we believe it would be a viable reading of the proposed regulations. We respectfully submit, if this is the case, these new Proposed Regulations would have the effect of disregarding choice of jurisdiction decisions, which traditionally have been respected by the IRS.

We provide the following example to illuminate our concern.

Let’s assume the laws of State Z contain mandatory liquidation restrictions that are less restrictive than the mandatory liquidation restrictions of all other states.

Based on this example, it appears under the new Proposed Regulations, the mandatory liquidation restrictions of all states, other than State Z, would be disregarded.

We respectfully submit that this raises at least two very practical issues. First, to determine if the provisions of a particular state’s statute are less restrictive than another state’s statute would require every practitioner to review every state’s laws and compare them to the state where the entity was created, to determine if there is an Applicable Restriction. Second, it would then raise the collateral issue of whether, by reviewing the state laws of other states and rendering an opinion about whether another state has a more onerous restriction, the practitioner might be considered to practice law without a license in the other states.

In light of the foregoing, we respectfully request that the Proposed Regulations be revised to clarify what “other law” must be looked to in determining whether a restriction is mandatory. Specifically, the Proposed Regulations should clarify that the laws of another jurisdiction should not be taken into consideration.

**Issue #3: Foreign Law Impact**

Proposed Regulations § 25.2704-2(b)(4)(ii) extends the State Law Exception for mandatory provisions of law only to provisions required to be imposed under Federal laws or any state within the United States. It does not apply to any restriction required to be imposed by the laws of a foreign jurisdiction. Accordingly, if an entity is governed by the laws of a foreign jurisdiction, an unintended result under the
Proposed Regulations is that any restriction in the governing documents will be treated as an Applicable Restriction, even if, under the laws of such foreign jurisdiction, the restriction is mandatory. If this is the intent of the Proposed Regulation, we respectfully submit that it unjustifiably creates a disparity in the treatment of domestic and foreign entities. Accordingly, we respectfully suggest that Prop. Reg. § 25.2704-2(b)(4)(ii) be modified to include a provision applying the State Law Exception to provisions of law that are mandated by the laws of a foreign jurisdiction governing the entity at issue. Such a provision would put domestic and foreign entities on a level playing field.

**Issue #4: Proposed Regulation Fails to Account for Legitimate Restrictions Based on Type of Business**

The Proposed Regulations fail to account for restrictions that may be imposed by outside forces. In particular, franchise businesses and entities that are subject to licensing or regulatory requirements may be subject to restrictions on voting, transfer, and liquidation. These restrictions are imposed by unrelated third parties — whether a franchisor or licensing body. These entities are common at all economic levels. They may include restaurants, car dealerships, sports franchises, or financial institutions, to name only a few. Although family members might have complete control to remove the restrictions, the exercise of such control would jeopardize the entity. These restrictions would not qualify under the “commercially reasonable” exception of Prop. Reg. § 25.2704-2(b)(4)(i) because these third parties often don’t provide capital or financing to the entity. This presents an impossible dilemma for such entities that are family owned.

**Prop. Reg. § 25.2704-2(b)(4)(iii) Certain rights under § 2703.**

**General Comments.**

See Comments below under Prop. Reg. § 25.2704-3(b)(5)(iv), which contains a similar exception with respect to a “Disregarded Restriction.”

**Prop. Reg. § 25.2704-2(b)(4)(iv) Put right of each holder.**

See Comments below under § 25.2703-3(b)(6).

**Prop. Reg. § 25.2704-2(c) Other definitions.**

Proposed Regulations § 25.2704-2(c) provides a definitional section, as follows:

“c) Other definitions. For the definition of the term controlled entity, see § 25.2701-2(b)(5). For the definition of the term member of the family, see § 25.2702-2(a)(1).”

**Issue #1: The Definition of “Controlled Entity” is Internally Inconsistent.**

Proposed Regulations § 25.2704-2(c) directs the reader to Treas. Reg. § 25.2701-2(b)(5) for a definition of the term “controlled entity.” Treasury Regulations § 25.2701-2(b)(5) provides that a controlled entity is one in which “the transferor, applicable family members [meaning the transferor’s spouse, any ancestor of the transferor or the transferor’s spouse, and the spouse of any such ancestor], and any lineal descendants of the parents of the transferor or the transferor’s spouse” control the entity.

In light of the focus of these Comments on § 2704 and the Proposed Regulations, we limit our discussion of the Treasury Regulations under § 2701. This section of the Comments suggests amendments to the
Proposed Regulations that would conform with existing Treasury Regulations under § 2701. We note, however, that it is these current § 2701 Regulations that deviate from the statutory language of § 2701 itself, which speaks in terms of whether “the transferor and applicable family members hold (after application of subsection (e)(3) control of the entity).” In analyzing the Comments under this section, Treasury may alternatively wish to consider amending the current Regulations under § 2701 to conform to the statute.

It appears that Prop. Reg. §§ 25.2704-2(a) (relating to Applicable Restrictions) and 25.2704-3(a) (relating to Disregarded Restrictions) both disregard certain restrictions if an interest is transferred in an entity and “the transferor and/or members of the transferor’s family control the entity immediately before the transfer.” Although Prop. Reg. § 25.2704-2(a) speaks of “control” of an entity, Prop. Reg. § 25.2704-2(c) defines the term “controlled entity” by reference to Treas. Reg. § 25.2701-2(b)(5) (defining “controlled entity” for purposes of § 2701). We note that the term “controlled entity” does not appear in the current Treasury Regulations or the Proposed Regulations under § 25.2704-2, other than in Prop. Reg. § 25.2704-2(c) (and the term “control” is not defined).

The definition of “controlled entity” in Treas. Reg. § 25.2701-2(b)(5) already explicitly governs the identities of the persons whose interests should be considered – “applicable family members.” The additional test contained in Prop. Reg. § 25.2704-2(a) as to whether “members of the transferor’s family” control the entity (and the definition of “member of the family” in Prop. Reg. § 25.2702-2(a)(1)) create an inconsistency.

Proposed Regulations § 25.2704-2(c) defines the phrase “member of the family” by reference to Treas. Reg. § 25.2702-2(a)(1), which provides as follows:

“With respect to any individual, member of the family means the individual’s spouse, any ancestor or lineal descendant of the individual or the individual’s spouse, any brother or sister of the individual, and any spouse of the foregoing.”

The Proposed Regulations do not make clear whether family attribution for purposes of the control test should refer to “members of the family,” “applicable family members,” or both. These definitions include different family members. For example, “members of the family” of an individual include spouses of the individual’s brothers and sisters, and spouses of the individual’s or the individual’s spouse’s lineal descendants, while “applicable family members” do not include such persons. Conversely, “applicable family members” includes an individual’s spouse’s siblings and nieces and nephews, and the individuals’ nieces and nephews, while “members of the family” do not include those persons.

Section 2704(b)(1)(B) requires that “the transferor and members of the transferor’s family hold, immediately before the transfer, control of the entity.” For this reason, we respectfully request that the Proposed Regulations under § 25.2704-2(a) (and §25.2704-3(a)) also refer to members of the transferor’s family having “control” of an entity, but that Prop. Reg. § 25.2704-2(c) be revised to define “control” instead of defining “controlled entity” and that such definition reference specifically Treas. Reg. § 25.2701-2(b)(5)(ii) – (iv) (excluding § 25.2701-2(b)(5)(i)).

Prop. Reg. § 25.2704-2(d) Attribution

Proposed Regulations § 25.2704-2(d) provides for attribution of interests held through a corporation, partnership, trust, or other entity by reference to the attribution rules under Treas. Reg. § 25.2701-6. While we are amenable to attribution rules for interests held indirectly through corporations, partnerships, and other entities, the attribution rules for interests held in trust pose unique challenges for which reference to Treasury Regulations under § 2701 may be inadequate. We believe that the following example in Prop. Reg. § 25.2704-3(g), Example 2 illuminates the issue.
Prop. Reg. § 25.2704-3(g), Example 2, provides, in relevant part, as follows:

"... A’s partnership interests are held in an irrevocable trust of which A is the sole income beneficiary. The trustee is a publicly-held bank. A is treated as holding the interests held by the trust under the rules contained in § 25.2701-6..."

Unfortunately, we respectfully submit that the example does not provide a complete or accurate analysis in reaching its conclusion under Treas. Reg. § 25.2701-6, and raises the following issues:

**Issue #1: The Attribution Rules Do Not Adequately Provide for Attribution of Interests that Cannot Be Distributed to Ascertainable Beneficiaries**

Under Treas. Reg. § 25.2701-6(a)(4), a person is considered to hold an interest held in trust to the extent that his or her beneficial interest in the trust may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, based on the assumption that the trustee will exercise maximum discretion in favor of the person. However, a beneficiary who cannot receive any distribution with respect to an equity interest (including the income therefrom or the proceeds of a disposition) is not considered a holder of the interest, as would be the case, for example, if such an interest was earmarked for one or more beneficiaries to the exclusion of all others. Note, however, that a beneficiary will still be treated as the owner of an equity interest in an entity where he or she cannot own it or receive dividends or current distributions from it if he or she may receive a share of the proceeds realized from its future disposition. Accordingly, we respectfully submit that it is possible, for § 2701 attribution purposes, that an equity interest may be attributed 100% to the income beneficiary and 100% to the remainder beneficiaries of a trust (perhaps 100% to each remainder beneficiary too, if the trustee is permitted to make non-pro rata distributions), even though the remainder beneficiaries have no right to receive current distributions and no rights to accumulated income.

In addition, an individual is treated as holding any equity interest held by or for a trust if such individual is the owner of the trust under subpart E (i.e., the Federal income tax grantor trust rules). Treas. Reg. § 25.2701-6(a)(4)(ii)(C). As such, without the application of “tie-breaker” rules, the application of the “basic” attribution rules could result in an equity interest being 100% attributed to the grantor and each current and remainder beneficiary of a discretionary grantor trust. Therefore, under Prop. Reg. § 25.2704-3(g), Example 2, it is possible that the equity interest in question could be attributed not only to A, but also to the grantor of the trust or to the remainder beneficiaries of the trust. Under the Proposed Regulations, it is entirely possible to have a three-way attribution. We do not believe that this was intended by Treasury. We respectfully submit that this does not provide a workable attribution rule. Accordingly, since Example 2 does not appear to reach a clear conclusion and arguably does not address the possibilities raised herein, we respectfully request that Treasury review the provisions and resolve the unanswered questions resulting from what we believe to be unanticipated results.

We also respectfully request that Treasury consider the following collateral issues that may arise, which we believe are best understood by reviewing the following example:

**Trust provides for accumulation of income and distributions with respect to XYZ stock solely to O, during O’s life. At O’s death, the trust property is distributable to O’s children, if any (and O does not currently have children), or if none, to charity. Trust owns 5% of XYZ. There are no other non-family owners.**

In analyzing the above example, and reviewing the attribution rules and the example under Prop. Reg. § 25.2704-2(d), we are unable to determine the answers to the following questions, and, accordingly, respectfully request Treasury to consider the above examples and provide guidance:
To whom are the shares attributable?

Would the result be different (under the rules that disregard non-family ownership) if the Trust instead owned 25% of XYZ?

**Issue #2: The Attribution Rules of Treas. Reg. § 25.2701-6 with Respect to Interests Held in Trust Require the Existence of Junior and Senior Equity Interests**

As discussed above, because Treas. Reg. § 25.2701-6 provides that, with respect to a trust, interests are allocated assuming the maximum exercise of discretion in favor of each beneficiary, it is arguable that the same interests may be attributed to more than one person. Treasury Regulations § 25.2701-6(a)(5) addresses this by providing a set of tie-breaker rules that apply when the rules attribute ownership to more than one person. If an interest is an applicable retained interest (“senior interest”), Treas. Reg. § 25.2701-6(a)(5) resolves multiple attribution by attributing the interest to individuals in the following order:

- First, to the grantor if the trust is a grantor trust;
- Second, to the transferor;
- Third, to the spouse of the transferor; and
- Fourth, pro rata among applicable family members.

If an interest is a subordinate equity interest, however, Treas. Reg. § 25.2701-6(a)(5) resolves multiple attribution by attributing the interest to individuals in a different order, as follows:

- First, to the transferee;
- Second, pro rata among members of the transferor’s family;
- Third, to the grantor if the trust is a grantor trust;
- Fourth, to the transferor;
- Fifth, to the transferor’s spouse; and
- Sixth, pro rata among the applicable family members of the transferor.

These rules provide almost directly opposing results in an effort to prevent perceived shifts in value among senior- and junior-generation family members through the transfer of applicable retained interests and subordinate equity interests. Because this dynamic is not present in most transfers subject to § 2704(b), which typically involve transfers and retention of interests that are of a single economic class, we respectfully submit that it does not appear to be appropriate, nor does it appear to be workable to apply these multiple attribution tie-breaker rules under § 2704. Not only does a cross reference to the attribution rules under Treas. Reg. § 25.2701-6 conflate what appears to be differing policy objectives of § 2701 with that of § 2704(b),13 but the Proposed Regulations do not provide a tie-breaker in the absence of senior and junior equity interests.

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13 We respectfully pose the following question, “Does it make sense to attribute control of a limited partnership to a trust remainder beneficiary merely because the trust holds an interest as a general partner?” We do not believe that it does.
Moreover, we respectfully submit that the attribution rules in Treas. Reg. § 25.2701-6 go beyond those anticipated by Congress when it authorized Treasury to promulgate attribution rules by (1) using the income tax concept of the grantor trust for transfer tax purposes and (2) by attributing trust ownership differently based on the nature of the equity interest, rather than the nature of the beneficiary’s interest in the trust. Therefore, we respectfully request that Treasury use this opportunity to reexamine these attribution rules under § 2701.

The tie-breaker rules under Treas. Reg. § 25.2701-6, which provide different rules depending on whether the person is a transferor or transferee may be inappropriate under § 2701 as well as under § 2704(b). For example, the Proposed Regulations do not appear to address who should be treated as the “transferor” for purposes of resolving multiple attribution in trust to trust transactions. Without a mechanism for identifying an individual who should be treated as the transferor, the application of the multiple attribution tie-breaker rules do not appear to work, because the tie-breaker rules depend on the relationship of trust beneficiaries to the transferor of an applicable retained interest or subordinate equity interest.

For the foregoing reasons, we respectfully request that Treasury consider rewriting the attribution rules under Treas. Reg. § 25.2701-6 to eliminate the need for any tie-breaker provisions, or alternatively, address the following issues under § 2704(b):

- The multiple attribution of interests held in trust; and
- The difficulties inherent in identifying the transferor of an interest held in trust.

**Issue #3: The Proposed Regulations Do Not Provide for Attribution of Interests Held By an Estate**

We note that Treas. Reg. § 25.2701-6 also applies to attribute interests held by estates, while Prop. Reg. § 25.2704-2(d) referencing the attribution rules omits the word “estates”.

We respectfully request that the Final Regulations should be clarified to include “estates.”

**Issue #4: The Proposed Regulation Creates Confusion with Various Provisions for Attribution**

In addition to the general attribution rule of Prop. Reg. § 25.2704-2(d), which seems to apply for all purposes of Prop. Reg. § 25.2704-2, Prop. Reg. § 25.2704-2(b)(3) provides that for purposes of determining whether the ability to remove a restriction is held by members of the transferor’s family, members are treated as holding interests attributed to them under Treas. Reg. § 25.2701-6. Proposed Regulations § 25.2704-2(c) also provides definitions for the term “controlled entity” by reference to the definition provided in Treas. Reg. § 25.2701-2, which definition already incorporates the attribution rules of Treas. Reg. § 25.2701-6.

We respectfully submit that including separate provisions which seem to apply the attribution rules in specific contexts, in addition to a provision that applies the same rules generally for purposes of Prop. Reg. § 25.2704-2, could lead to confusion. Accordingly, we respectfully request that if the general application of the attribution rules is intended, the specific reference in Prop. Reg. § 25.2704-2(c) should be removed in the Final Regulations. Additionally, if the attribution rules are intended to apply only to particular facets of the Proposed Regulations, we respectfully request Treasury consider removing or limiting Prop. Reg. § 25.2704-2(d) to clarify such intent.

**Prop. Reg. § 25.2704-2(e) Valuation of Applicable Restriction.**

If an Applicable Restriction is disregarded, Prop. Reg. § 25.2704-2(e) provides,
“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.”

According to the Preamble, this results in the transferred interest being valued as if there were no restrictions on liquidation of the entity. The language in Prop. Reg. § 25.2704-2(e) raises two issues:

- What are “generally applicable valuation principles”; and
- Inconsistent cross-references in the current and Proposed Regulations.

We address these issues below.

**Issue #1: What are “Generally Applicable Valuation Principles?”**

The Proposed Regulations do not explain what “generally applicable valuation principles” are to be applied in valuing the transferred interest. We respectfully pose the following questions for Treasury to consider:

- Are valuation experts to now disregard the willing buyer willing seller fair market value determination set forth in Treas. Reg. § 25.2512-1 and Treas. Reg. § 20.2031-3?
- How, if at all, do these traditional valuation principles apply in light of the Proposed Regulation?

In responding to these questions, we respectfully recommend that the Proposed Regulations clarify what is meant by “generally applicable valuation principles” and provide an explanation of the manner in which the value of a transferred interest with a disregarded Applicable Restriction is to be determined.

**Issue #2: Inconsistent Cross References in Regulations under §§ 2031 and 2512**


**Prop. Reg. § 25.2704-2(f) Certain transfers at death to multiple persons.**

Please see the Comments below under Prop. Reg. § 25.2704-3(e).

**[Prop. Reg. § 25.2704-2(g) Examples.]**

Please note that we do not specifically address the examples under Prop. Reg. § 25.2704-2(g) in a particular section, since they are addressed in the Comments under the sections to which the examples apply.

**Prop. Reg. § 25.2704–3 Transfers subject to Disregarded Restrictions.**

**Prop. Reg. § 25.2704-3(a) In general.**

**General Comments.**

In general, Prop. Reg. § 25.2704-3 provides a new category of restrictions to be disregarded (“Disregarded Restrictions”) for all transfer tax valuation purposes when interests in a family-controlled
entity (determined immediately before the transfer) are being transferred from one family member to another.

We note that under the Proposed Regulations, there are issues with regard to the concept of “family control” which we have addressed in the Comments above under Prop. Reg. § 25.2701-2(b)(5), which have some overlap in the review of Prop. Reg. § 25.2704-3(a). In order not to be duplicative, the discussion of the definition of entity appears in this section, even though the concept also applies to both Prop. Reg. §§ 25.2704-1(a) and 25.2704-2(a).

From a historical perspective, the statutory provisions of Chapter 14 explicitly referred to “corporations” and “partnerships.” Chapter 14 was enacted to replace § 2036(c), which among other concerns used amorphous terms such as “enterprise”. Chapter 14 adopted standard tax terms with understood meanings, such as “corporations” and “partnerships”, which were defined under § 7701 for all tax purposes. Recall, when Chapter 14 was enacted in 1990, for Federal tax purposes business entities were characterized as either “associations” (i.e., corporations) or “partnerships”.

In December 1996, this certainty changed with the “check-the-box regulations” in Treas. Reg. §§ 301.7701-1 through 301.7701-3. Those regulations allow certain entities with one tax owner to be “disregarded” for Federal income tax purposes. Many family-owned businesses today are disregarded entities. This may occur, for example, if the founder of the business is the initial, sole owner and transfers interests in the entity to one or more irrevocable “grantor trusts” for the benefit of his or her family members, whether those family members are involved in the family-owned business or not. The grantor trust is separate from the transferor for state law purposes and for Federal transfer tax purposes, but the grantor trust is not separate from the donor for Federal income tax purposes. As a result, an entity may have several owners for state law purposes and Federal transfer tax purposes and still be a disregarded entity for Federal income tax purposes. The Proposed Regulations attempt to modernize the definitions of partnerships and corporations to respond to the Check-the-Box regulations.

Although Congress chose the terms corporation and partnership intentionally, changes in Federal tax regulations have altered their precise meaning. We believe this exercise of regulatory power to update the regulations to follow Congressional intentions is appropriate, although one might argue Congress should have changed the statutory law, or that Treasury should have updated the regulations when the Check-the-Box regulations were enacted.

However, we respectfully submit that the Prop. Reg. § 25.2704-3(a) raises many issues that we believe should be resolved before the regulations are finalized.

Issue #1: Disparate Treatment of Associations that Elect to be Taxed as C Corporations from Those that Elect to be Taxed as S Corporations

The term “corporation” is defined in Prop. Reg. § 25.2704-3(a) by reference to Treas. Reg. § 301.7701-2(b), except that an association taxed as a corporation is excluded from the definition of a corporation under the Proposed Regulations by omitting the cross-reference under Treas. Reg. § 301.7701-1(b)(2). The purpose of this exception appears to be to exclude entities that are not otherwise corporations from electing to be corporations for purposes of §§ 2701 and 2704. At the same time, under the Proposed Regulations, an entity other than a corporation, such as an entity organized as a general partnership or LLC under state law, will be treated as a corporation if it elects to be an S Corporation. We respectfully submit that the reason for this disparate tax treatment between a non-corporate entity electing to be an association or non-corporate entity electing to be a S corporation status is not apparent. Neither entity can distribute appreciated assets income tax-free so the reason does not appear to be its tax status. Accordingly, we respectfully request that the Final Regulations explain the reason for the disparate
treatment or alternatively define a corporation either by its state law character or its Federal income tax status.

**Issue #2: Qualified Subchapter S Subsidiaries Cannot Be Disregarded Entities for Purposes of IRC § 2704**

A qualified subchapter S subsidiary (“QSSS”) is characterized as a “corporation separate from its parent corporation” under Prop. Reg. § 25.2704-3(a). A QSSS is both a corporation for Federal tax and state law purposes. A QSSS specifically is referred to as being separate from its parent while no such specific statement is made for other disregarded entities. We respectfully submit that the language in the Proposed Regulations appears to be intended to override the Federal income tax status of a QSSS as a disregarded entity in § 1361(b)(3)(A)(i). We respectfully submit that the reason for this reference to a QSSS as being separate from its owner and any other non-corporate entity that is a disregarded entity as being separate from its owner is not apparent. Because the Proposed Regulations provide that a QSSS will be treated as a corporation separate from its parent corporation, but are silent as to whether a disregarded entity is treated as an entity separate from its owner, they open the door to an argument that a disregarded entity is not subject to § 2704. Accordingly, we respectfully request that the Final Regulations provide guidance on the purpose for the distinction and address specifically any issues that arise as a result of such distinction or provide that any disregarded entity is separate from its owner.

**Issue #3: Lumping Together Disparate Types of State Law Entities as Partnerships.**

The penultimate and last sentences of Prop. Reg. § 25.2704-3(a) provide as follows:

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

We respectfully believe that these sentences may cause confusion. The Proposed Regulations provide that a partnership is defined as any other business entity under Treas. Reg. § 301.7701-2(a) regardless of its Federal tax classification. Both an entity electing to be taxed as an association (for example, an LLC that elects to be taxed as a C Corporation) and a disregarded entity will be deemed to be a partnership for purposes of Prop. Reg. § 25.2704-3. This may lead to the confusing result of two entities, which have very different Federal tax and state law characteristics and neither of which has the qualities of a partnership for state law purposes, being deemed to be a “partnership” for purposes of § 2704. While the result may lead to the same treatment under the Proposed Regulations, we respectfully request that Treasury clearly define corporations and partnerships based on state law characteristics or Federal tax treatment, consistent with the scope of the Proposed Regulations.

Our concern is heightened because Prop. Reg. § 25.2702-2(b)(5) provides for three categories of entities: corporations, partnerships, and other business entities. We are concerned that lumping these very disparate types of entities in the partnership category in Prop. Reg. §§ 25.2704-2(a) and 25.2704-3(a) suggests that these very different types of state law entities are all to be lumped together for purposes of determining whether an entity has “Applicable Restrictions” or “Disregarded Restrictions.”

**Prop. Reg. § 25.2704-3(b) Disregarded Restrictions defined**

**Prop. Reg. § 25.2704-3(b)(1) In general**
General Comments on Disregarded Restrictions.

A “Disregarded Restriction” is defined in Prop. Reg. § 25.2704-3(b)(1) as:

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

Issue #1: Clarifying the Opening Sentences and Specific Restrictions

The opening sentences of Prop. Reg. § 25.2704-3(b)(1) describe, in general terms, the nature of the restrictions that will be disregarded without specific reference to whose ability to redeem or liquidate is being limited. These sentences also refer only to restrictions that are “limitations” on the rights to redeem or liquidate the interests. Subparagraphs (i) through (iv) of Prop. Reg. § 25.2704-3(b)(1) specifically reference the limitation on the holder of the interest and specifically describe restrictions that “limit or permit the limitation” of the rights described.

For the reasons discussed below, we respectfully request that the opening sentences should be revised to reflect the following:

- a restriction on the holder of an interest to redeem or liquidate the holder’s interest will be disregarded; and
- the Disregarded Restrictions are those that limit or permit the limitation of the rights described.

We believe that this would be consistent with the later subparagraphs. Additionally, we believe, it would be consistent with the intention of the Proposed Regulations, and also eliminate any inconsistency in the language of the opening sentences and the later subparagraphs.

We respectfully suggest that the introductory language to Prop. Reg. § 25.2704-3(b)(1) be modified to read:

“The term disregarded restriction means a restriction that is a limitation on the holder’s ability to redeem or liquidate an interest or permits the limitation on the holder’s ability to redeem or liquidate such interest...

Alternatively, we respectfully submit, if a restriction on the entity’s right to redeem or liquidate a holder’s equity interest (i.e., a call right) can be a Disregarded Restriction, an example should be included and the intersection with Prop. Reg. §§ 25.2704-2(b)(4)(iii) and 25.2704-3(b)(5)(iv) (both pertaining to rights described in § 2703) should be clarified.

Specific Restrictions that Can Become Disregarded Restrictions

For a restriction to become a Disregarded Restriction it must be described in one of four specific types of restrictions in Prop. Reg. § 25.2704-3(b)(i)-(iv). These restrictions will be disregarded whether they appear in the governing agreements of the entity or state law, including default state law.

Prop. Reg. § 25.2704-3(b)(1)(i)
If our recommendation described above is incorporated into the opening sentences of Prop. Reg. § 25.2704-3(b)(1), we believe that subsection (i) will be consistent with the opening sentences, and no further comment on this subsection is provided.

Prop. Reg. § 25.2704-3(b)(1)(ii)

General Comments.

Proposed Regulations § 25.2704-3(b)(1)(ii) includes a provision that “limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a minimum value” as a restriction that may become a Disregarded Restriction.

Proposed Regulations § 25.2704-3(b)(1)(ii) defines the “minimum value” of an equity interest to be that “interest’s share of the net value of the entity determined on the date of liquidation or redemption.” The language of that Proposed Regulation goes further to define the “net value of an entity” as “the fair market value … of the property held by the entity” reduced by certain “obligations of the entity” more fully described below.

Any provision in an entity agreement providing for the withdrawal of an owner or liquidation of an owner’s equity interest will be disregarded unless the price paid is “minimum value,” which is referred to as a “minimum value put.”

We believe that this definition of “minimum value” focuses the section of the Proposed Regulations on restrictions that have the effect of depressing, in real or other terms, the fair market value of the property of the entity. We believe this approach may be appropriate with an investment entity or holding company that owns easily-marketable assets and no obligations. In such a case, minimum value received in liquidation or redemption would be the value of the holder’s interest’s share of the total fair market value of the entity’s assets (less any allowed liabilities). We believe that this definition may be problematic in dealing with entities that hold illiquid assets or are operating businesses engaged in an active trade or business.

Issue #1: Application to Real Estate Entities and Other Entities with Illiquid Assets

Many family-owned businesses consist of entities that own real property or farmland that is not used in an operating company. For the purposes of this Comment, we will focus on real estate as an “illiquid” asset; however, the same principles apply to entities that hold artwork or other tangible personal property. Before the owners form an entity, the co-owners of the property would hold such illiquid assets as co-tenants. Although the nature and amount of the fractional interest discount in such property for transfer tax valuation purposes is often disputed, the value of a co-tenancy interest is less than its fraction of the sales price of the whole.

Our concern may be best illustrated by example: assume two sisters each own (in their individual names, and not through any type of an entity) an equal and undivided interest in farmland. If the sisters own the

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farmland as tenants-in-common, each sister’s interest in the farmland would be valued based on the fair market value of the underlying farmland, discounted for the fractional interest ownership.\textsuperscript{15}

If the sisters transfer the farmland to an entity, no such fractional interest discount would be allowable upon a transfer under the definition of “minimum value.” In addition, because of the definition of minimum value as “net value of the entity determined on the date of liquidation,” it is unclear the extent to which lack of marketability discounts should be allowed in valuing the interest. However, it is clear that a provision in an entity agreement giving an owner a put for his or her fractional share of an entity’s assets would be a Disregarded Restriction under the Proposed Regulations, because the fractional share would be discounted.

We believe the Final Regulations should not penalize co-owners of tangible or real property who form an entity to hold property, as opposed to holding it in co-tenancy. The entity not only provides a limitation on personal liability but provides for reasonable and efficient mechanisms for managing the property.

We believe, if the Final Regulations do not address this issue, family members will be forced to create burdensome legal structures to benefit from basic liability protection. Each family co-owner will have to convey his or her fractional interest to a wholly-owned LLC, and in doing so maintain both the liability protection and the reasonable discount for fractional ownership.\textsuperscript{16} The LLC is a disregarded entity under these facts, but a transfer of interests in the LLC remains potentially subject to § 2704(b). Minimum value, however, would be based on the fractional interest held by the LLC, preserving the fractional interest discount whatever it might be.

We respectfully submit that if this issue is not addressed, two unrelated individuals who own property in an LLC may benefit from restrictions in an agreement that reasonably address fractional ownership discounts, and family members in similar circumstances would not benefit from the same. This would appear to treat similarly situated taxpayers in a disparate manner.

Although, in some cases, it may be argued that a co-tenancy is an association that should be characterized as a partnership, “mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for Federal tax purposes.”\textsuperscript{17} The line between “mere co-ownership” and carrying on a trade or business often can be blurry; indeed, according to the Tax Court, “the distinction between mere co-owners and co-owners who are engaged in a partnership lies in the degree of business activity of the co-owners or their agents.”\textsuperscript{18}

\textbf{Issue #2: Application to Operating Businesses}

\textit{See, e.g., LeFrak v. Comm’r, 66 TCM 1297 (1993).}

\textsuperscript{16} In some jurisdictions, even this may be insufficient. For example, with respect to Florida LLCs, a single member LLC is expressly afforded less liability limitation than would be a multi-member LLC. Fl. Stat. Ann. 605.0503.

\textsuperscript{17} Rev. Proc. 2002-22, 2002-14 I.R.B. 733.

\textsuperscript{18} Cusick v. C.I.R., 76 T.C.M. (CCH) 241, 243 (1998) (finding rental real estate activities created a partnership).
The meaning of minimum value in the case of an operating business is significantly more complicated than in the case of an investment entity or holding company owning only liquid assets. By referring to the fair market value of property held by the entity, the Proposed Regulations seem to imply that the entity value is based on a liquidation sale of the assets of the operating business. However, Prop. Reg. § 25.2704-3(b)(1)(ii) continues to provide as follows:

“...if the entity holds an operating business, the rules of § 20.2031-2(f)(2) or § 20.2031-3 of this chapter apply in the case of a testamentary transfer and the rules of § 25.2512-2(f)(2) or § 25.2512-3 apply in the case of an inter vivos transfer”.

However, Treas. Reg. § 20.2031-2(f)(2) provides that the following factors are to be taken into consideration when determining the fair market value of stock in a corporation where bid and ask prices are not readily available:

“(2) In the case of shares of stock, the company’s net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the ‘other relevant factors’ referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company’s position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.”

Further, Treas. Reg. § 20.2031-3 provides as follows:

“The fair market value of any interest of a decedent in a business, whether a partnership or a proprietorship, is the net amount which a willing purchaser whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The net value is determined on the basis of all relevant factors including -

(a) A fair appraisal as of the applicable valuation date of all the assets of the business, tangible and intangible, including good will;

(b) The demonstrated earning capacity of the business; and

(c) The other factors set forth in paragraphs (f) and (h) of § 20.2031-2 relating to the valuation of corporate stock, to the extent applicable.
Special attention should be given to determining an adequate value of the good will of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money’s worth, that his interest passes at his death to, for example, his surviving partner or partners. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of examinations of the business made by accountants, engineers, or any technical experts as of or near the applicable valuation date.”

The above sections relate to valuation rules for testamentary transfers, and Treas. Reg. §§ 25.2512-2(f)(2) and 25.2512-3 provide comparable rules for the valuation of inter vivos transfers.

The reference in the Proposed Regulations to these provisions appears intended to clarify that in the case of an operating business, the net asset value approach will not be the sole determination of minimum value. A restriction that limits the redemption or liquidation value of a holder’s interest in an operating business will be disregarded unless it provides for a minimum value based on the factors set forth above.

Many family-owned companies are operating businesses, carrying on an active trade or business. These businesses cannot be easily valued based on liquidation, or “break-up” value, and any attempt to do so may significantly misrepresent the value of the entity. Valuation experts seem to agree that the so-called “going concern” value of the operating business is better represented by the income approach or market approach to valuation. We believe that the references to the Treasury Regulation sections described above are an attempt to provide some flexibility in determining “minimum value” with respect to family-owned operating businesses by allowing for the going concern value to be considered. Accordingly, we respectfully request that the Final Regulations explicitly state this, and provide that in the case of an operating business, the liquidation sale values will not be the only determination of minimum value.

Further, we respectfully believe that this will allow for a more accurate representation of the value of operating companies.

We acknowledge that it may be difficult to draft provisions that distinguish between operating companies (on the one hand) and investment or holding companies (on the other hand), but the Proposed Regulations already do so with respect to related party debt. This distinction may be unnecessary if liquid assets and illiquid assets owned by the entity are valued separately.

**Issue #3: Minimum Value as Safe Harbor**

One purpose of minimum value appears to provide a “safe harbor” value at which the fair market valuation regime can be reconciled with the transfer tax valuation regime under § 2704(b). As drafted, the Proposed Regulations disregard any put right that has an exercise price less than “minimum value.” The Proposed Regulations do not explicitly require, as some commentators have suggested, that the result of disregarding all liquidation restrictions will be to value the transferred equity interest at its minimum value. Minimum value is not a new valuation regime imposed by the Proposed Regulations. If state law or the governing agreements of an entity provide for liquidation or redemption at less than minimum value, it appears all such restrictions will be disregarded for Federal transfer tax purposes.

If minimum value is intended to be a “safe harbor,” the definition of minimum value should be understandable to business owners. If family-owned businesses chose to impose restrictions on liquidation or redemption value for valid business purposes, notwithstanding that the restrictions may be disregarded, transactions based on the governing agreements may create unintended transfer tax consequences.
Incorporating a put right at minimum value into business entity documents would synchronize fair market and transfer tax values. However, no business will do so if outstanding obligations must be defined with respect to concepts tied to not-widely applicable estate tax rules under § 2053.\(^{19}\)

Based on the foregoing, we respectfully suggest that Treasury consider removing the limitation when accounting for an entity’s debts and obligations to those that would be deductible under § 2053. We believe this approach would be in keeping with the standards of most family-owned businesses. Any concerns regarding taking into account obligations that would not be allowable as deductions under § 2053 creating taxpayer-friendly opportunities for valuation purposes could be addressed in the Final Regulations by specifying particular adjustments to be made to obligations. The Final Regulations could specifically address the deductibility of guarantees, contingent liabilities, debt incurred but not used within the entity, the current deductibility of a long-term liability without a present value adjustment, as well as any additional adjustments as may be required.

Proposed Regulations § 25.2704-3(b)(1)(ii) further provides:

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

Unlike referring to § 2053 to determine the amount of obligations for purposes of determining minimum value, the above provision referring to § 2704(b) seems to be more justified. Without this or a similar provision, the intention of the minimum value definition could be thwarted by transferring the equity interests in one entity to another entity. The meaning of “subject to section 2704(b)” or “subject to” any other Code section is often not very clear. Presumably, a family-controlled entity under § 2704(b) as to the transferor would be “subject to section 2704(b)” whether the entity had any Disregarded Restrictions. However, for property to be “determined and valued in accordance with the provisions of § 2704(b) and the regulations thereunder,” it should be clear in the Final Regulations that all lower tier interests would also be valued according to § 2704(b).

**Issue #4: Minimum Value Concepts Don’t Reflect State Law Presumptions**

The Proposed Regulations would disregard the right of an owner under an entity agreement to receive less than minimum value for his or her equity interest. Although shareholders under state law never have the right to withdraw from a corporation, certain partners have had the right to withdraw under limited circumstances. This withdrawal right existed in 1990 when § 2704(b) was enacted. The contemporaneous Treasury Regulations under § 2704(b) incorporating default state entity law recognized the right to withdraw that existed on that date.

State law is discussed below in these Comments under Prop. Reg. § 25.2704-3(b)(2). As explained in greater detail below, no state law uses a concept like minimum value to give an owner of an interest in an

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\(^{19}\) According to the Statistics of Income Division of IRS, 11,931 estate tax returns were filed in 2014. In public comments, Treasury expects a similar number of returns to be filed in future years.
entity with limited liability the right to receive a specific amount on withdrawing from an entity. This reflects business reality: a business cannot long survive if any owner can withdraw and be paid the minimum value for his or her equity interest. No state would provide a right to withdraw if the amount receivable would disrupt the continuation of the entity as paying minimum value would.

State law instead provides that a dissociating partner, member or shareholder does not have a right to distributions prior to winding up.\textsuperscript{20} Because fair value will always be less than minimum value, this universal provision in state entity law would be a Disregarded Restriction within the meaning of Prop. Reg. § 25.2704-3(b)(1)(ii). We respectfully hope, and thus submit, that it was surely not the intent of the Proposed Regulations to be divorced from business realities as reflected in state law. Accordingly, we respectfully submit that using minimum value as a measure of the value to be paid for an equity interest of an owner withdrawing from an entity is inappropriate. Such a state law restriction is not one which “has the effect of reducing the value of the transferred interest for purposes of this [Subtitle B] but does not ultimately reduce the value of such interest to the transferee.” See, § 2704(b)(4).

Prop. Reg. § 25.2704-3(b)(1)(iii)

Proposed Regulations § 25.2704-3(b)(1)(iii) includes as a Disregarded Restriction a provision that “defers or permits the deferral of the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder’s intent to have the holder’s interest liquidated or redeemed.” This provision refers to the “full” amount to be received being deferred so it operates independently of the restriction in (ii) establishing a minimum amount to be received.

Issue #1: Payment within Six Months May Not Be Feasible

With respect to any entity that holds readily marketable assets, the Disregarded Restriction described in this section may be of little concern. Six months provides adequate time for an entity or other individuals to create the necessary liquidity needed to meet the redemption or liquidation provisions based on a six-month timeline.

In the case of an entity that holds real or tangible property, an entity that is an operating business, or an entity that invests in operating businesses (including a private equity fund), additional time may be required to meet liquidation or redemption requirements. The statutory language and Preamble make it clear that the Proposed Regulations (and current regulations) are aimed at restrictions that may depress an entity value for transfer tax purposes but, with the agreement of family members, can be easily removed or ignored. This proposed Disregarded Restriction, however, would in reality unnecessarily burden and disadvantage family-owned businesses. In the case of an entity that owns real or tangible property that is not readily marketable, the assumption that an entity would be capable of redeeming or liquidating an equity holder within 6 months is unrealistic. To do so would likely require the entity to force a sale of assets at less-than favorable values or burden working capital.

Given the Code’s general approach of providing family-owned businesses the flexibility and time to address liquidity issues, we respectfully recommend that the Final Regulations either:

\textsuperscript{20} See, i.e., ULPA §503(b), ULLC § 404(b).
- provide an exception allowing a “reasonable time,” rather than a stated amount of time, for family-owned businesses that own illiquid assets or operate businesses when determining if a restriction will be disregarded; or
- provide that a Disregarded Restriction is one that defers payment of liquidation or redemption proceeds for 12 or 24 months rather than six months.

Prop. Reg. § 25.2704-3(b)(1)(iv)

Proposed Regulations § 25.2704-3(b)(1)(iv) includes as a Disregarded Restriction a provision that “authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property.” The provision continues to define a note from a “related party” as not property. The concept of related party note is discussed in detail below. By generally treating as a Disregarded Restriction any provision permitting an entity to redeem an equity interest using its own note, extending the six-month redemption period discussed under Prop. Reg. § 25.2704-3(b)(1)(iii) above is especially important.

Related Party Note.

Proposed Regulations § 25.2704-3(b)(1)(iv) is designed to prohibit the payment of the redemption or liquidation price by a related party note. The regulation also provides a limited exception for an operating business with 60% or more assets used in the conduct of the trade or business. Complicated concepts are borrowed from § 6166. However, we respectfully submit that there seems to be no reason to create such a narrow exception for operating businesses or other entities with illiquid assets.

The requirements in the Proposed Regulations for a related party note to be allowable for redemption or liquidation proceeds in the case of an entity at least 60% of whose value consists of non-passive assets of an active trade or business, are as follows: the note must be adequately secured, require periodic payments on a non-deferred basis, be issued at market interest rates, and have a fair market value on the date of liquidation or redemption equal to the liquidation proceeds.

These provisions guarantee that the face value of the note equals its fair market value. If the note’s face value and fair market value are the same, the related party note is not different than cash or other property. There is no potential abuse. We respectfully submit that the Final Regulations should permit a related party note as long as the face value and the fair market value are equal because it meets the above requirements.


This discussion is also applicable to the Comments above under Prop. Reg. § 25.2704-2(b)(2).
**Issue #1: Source of Limitation; Relationship to State Law**

Proposed Regulations § 25.2704-3(b)(2) provides that this restriction may be found in any entity document, buy-sell or other restriction agreement, transfer document or under state law.\(^{21}\) This list of potential sources seems comprehensive so that the source of the restriction does not matter under the Proposed Regulations.\(^{22}\)

**Prop. Reg. § 25.2704-3(b)(3) Lapse or removal of limitation.**

In addition to the requirement that a restriction be one of the four specified, a restriction must lapse or be subject to family removal before the restriction is a Disregarded Restriction. The meaning of lapse would seem self-evident, but the Final Regulations should provide that the lapse must occur *before the termination or liquidation of the entity* or it is not a lapse for purposes of § 2704(b). This point is made by Example 1 of Prop. Reg. § 25.2704-3(g) that requires the family have the power to remove a provision that otherwise would lapse with the termination of the entity.

**Prop. Reg. § 25.2704-3(b)(4) Certain interests held by non-family members disregarded.**

Proposed Regulations § 25.2704-3(b)(4) states that, when determining whether the transferor (or the transferor’s estate) or any member of the transferor’s family, either alone or collectively, may remove a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) of that section, certain interests held by non-family members are to be disregarded unless certain requirements are met. If disregarded, the rules of § 2704 are applied as if those non-family member interests did not exist. The interests held by non-family members will be disregarded unless all of the conditions in Prop. Reg. §§ 25.2704-3(b)(4)(i)(A) – (D) are satisfied.

We understand the proposed requirement that an unrelated third party whose consent is required to remove restrictions on liquidations and redemptions should own more than a *de minimis* interest. However, we believe that the Proposed Regulations as currently drafted are overly broad and would disregard the interests of many bona fide non-family owners. By requiring that a taxpayer meet all four tests, the Proposed Regulations capture too many *bona fide* structures within their net. We respectfully submit that further difficulty arises in determining how to value such interests.

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\(^{21}\) Prop. Reg. §25.2704-2(b)(2) similarly so provides.

\(^{22}\) Prop. Reg. §25.2704-3(b)(2) provides as follows:

“A disregarded restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation’s by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, which governs the applicability of the restriction.”
Issue #1: The Requirement of 10% Equity by a Single Owner Is Unnecessary; as is the Requirement of 20% Non-family Ownership

The Proposed Regulations would disregard the ownership of any third party, unless such third party owns at least 10 percent of the value of all equity interests in the entity, and such third party together with all other unrelated third parties collectively own at least 20 percent of the value of all equity interests in the entity. We respectfully submit that requiring both of these ownership thresholds is excessive. Unrelated investors in the entity of this magnitude (either one with 10 percent, or several aggregating to 20 percent) would probably be better viewed as having substantial (and not “insubstantial”) interests. The size of the third parties’ ownership interests should be sufficient protection against a straw man co-owner. Perhaps there should be an absolute floor (i.e., can it be said that a third party investment of $100,000 is not de minimis? $250,000? $1 million?) as an alternative to the percentage.

Furthermore, assume the following scenario: A and B, unrelated parties, go into business together. A owns 70%; B owns 30%. Assume both interests are entirely legitimate, but B does not have the same access to capital as A (and therefore owns less of the entity). Because A and B wish to have a “check and balance,” their agreement provides that the entity cannot be liquidated without the consent of 85% of the interests.

As part of her estate plan, B makes four separate, completed gifts, each of 7% of the entity, in trust for each of her four nieces and nephews. Setting aside the difficulty described above with respect to the mechanics of attribution of senior and junior equity interests under Treas. Reg. § 25.2701-6, assume that the holdings of each such trust are attributed to the primary beneficiary. As noted above, A and B are unrelated persons. A is entirely uninvolved in B’s estate planning.

After B’s gifts under the regulations as proposed, for purposes of determining whether A and A’s family may remove a restriction, B’s family’s 30% interest is disregarded (because no single non-family member owns greater than 10%). A’s interest is therefore deemed to hold 100% of the value, and, it would seem, A’s interest is ascribed a liquidation right that it does not – and has never – actually had. Thus, A is penalized for B’s estate planning. We cannot believe that this result was intended. Accordingly, we respectfully request that Treasury examine this provision and make necessary changes to avoid this unintended result.

Issue #2: The Three-Year Rule Is Excessive

Another requirement is that the non-family member whose consent is required to remove the restriction must have held the interest for at least three years before the transfer. For example, assume members of a family establish a business in the form of a partnership with an unrelated third party, X. The family and X each contribute 50% of the capital and receive interests totaling 50% of the capital and profits interests in the partnership. The entity cannot be liquidated without the consent of both the family and X. Redemptions and partial liquidations also require their consent. If one of the family members dies or transfers an interest in the partnership before three years have elapsed, the proposed regulation would disregard X’s interest, and the family would be treated as holding 100% of the partnership. As a result, the family will be treated as if they can remove the restrictions on liquidation and redemption without anyone else’s approval or consent, and the partnership interest transferred will be valued as if the transferor and transferee have the right to liquidate the interest. We respectfully submit that such a construct ignores the reality of the situation, and would value the partnership interest (for gift, estate, and GST purposes) in excess of fair market value, and at a value which is higher than the transferee could realize if s/he tried to sell the interest. The regulatory fiction of disregarding restrictions on liquidation rights should not operate as if it thereby creates actual liquidation rights. On the other hand, if the family member is fortunate to live at least three years or if she makes the transfer three years and one day later, then X’s interest will not be disregarded and the family member will have a very different tax result. We
do not believe that this result was intended by Treasury. Accordingly, we respectfully request Treasury eliminate the three year requirement, at least for entities in existence for less than three years.

Moreover, what if X sells or otherwise transfers his interest to another unrelated party during the three-year period? Does the three-year period restart? If so, the time requirement might never be satisfied. We respectfully request that there be a mechanism for “tacking” ownership of non-family members; as Prop. Reg. § 25.2704-3(b)(4)(i)(A) requires “the” non-family member to have held the interest for more than three years.

**Issue #3: Put Right Requirement Is Excessive**

Very few (if any) entities give all non-family owners a put right at minimum value (which would often exceed the fair market value of the interest). The purpose of the non-family restrictions should be to require that the non-family member’s interest is a non-\textit{de minimus} interest with substance – not to require that the non-family member own an interest with unusual provisions causing the interest to be worth significantly more than its actual fair market value. Because the non-family owner could exit the business at any time and receive more than his or her interest is worth, holding a minimum value put actually increases the likelihood that the non-family owner would be willing to block the liquidation of a family member exiting the business.

See Comments below under Prop. Reg. § 25.2704-3(b)(6).

**Prop. Reg. § 25.2704-3(b)(5) Exceptions.**

**Prop. Reg. § 25.2704-3(b)(5)(i) Applicable Restriction.**

This provision is generally appropriate. However, we respectfully request clarification with Treas. Reg. §§ 25.2704-2(b)(4)(iii) and 25.2704-3(b)(5)(iv) as discussed in the Comments above under Prop. Reg. 25.2704-2(b)(4)(iii).

**Prop. Reg. § 25.2704-3(b)(5)(ii) Commercially reasonable restriction.**


**Issue #1. Potential Conflict With Rules Governing Non-family Ownership.**

The exception for commercially reasonable restrictions has been expanded to cover not only debt financing, but also capital contributions from third parties. While we believe this expansion to be appropriate, we see a potential conflict with the bright line test of Prop. Reg. § 25.2704-3(b)(4), disregarding certain interests held by nonfamily members. A third party that provides capital contributions would be a non-family owner. If the third party did not meet the bright line tests under Prop. Reg. § 25.2704-3(b)(4), how would this exception apply?

We do not believe that the rules contained in Prop. Reg. § 25.2704-3(b)(4), which disregard certain interests held by nonfamily members, apply for purposes of determining whether an Applicable Restriction is disregarded. Therefore, we have not included this analysis under our discussion of Prop. Reg. § 25.2704-2(b)(4)(i) (the “commercially reasonable” exception for applicable restrictions). If we are mistaken in our understanding, then the same potential conflict would exist under that proposed regulation section as well.


We note that the introductory language of Prop. Reg. § 25.2704-2(b)(4)(iii) (“Certain rights under section 2703”) is slightly different from the introductory language of this section (“Certain rights described in section 2703”). The reason for this difference is not apparent to us. We respectfully request that Treasury conform the language or explain what is intended by the difference.

This discussion applies to Prop. Reg. §§ 25.2704-2(b)(4)(iii) and 25.2704-3(b)(5)(iv).

Proposed Regulations § 25.2704-3(b)(5)(iv) creates the following exception to what might otherwise be a “Disregarded Restriction”:

“An option, right to use property, or agreement that is subject to section 2703 is not a restriction for purposes of this paragraph (b).”

Although the current regulations provide a similar exception in Treas. Reg. § 25.2704-2(b), the interaction between §§ 2703 and 2704 and the respective regulations thereunder has not been addressed before now. The Preamble further attempts to clarify the interplay of §§ 2703 and 2704(b) as follows:

“Note that, although it may appear that sections 2703 and 2704(b) overlap, they do not. While section 2703 and the corresponding regulations currently address restrictions on the sale or use of individual interests in family-controlled entities, the proposed regulations would address restrictions on the liquidation or redemption of such interests.”

Section 2703 provides as follows:

“(a) General rule. For purposes of this subtitle, the value of any property shall be determined without regard to—

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

(b) Exceptions. Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arms’ length transaction."

The Preamble describes § 2703(a) as addressing “restrictions on the sale or use of individual interests in family-controlled entities.” Although this is a valid interpretation of § 2703(a)(2), we respectfully submit that the first prong of § 2703(a) is broader, applying to “any option, agreement, or other right to acquire or use the property at a price less than the fair market value ….” Because § 2703 applies to options, including puts, any overlap between § 2703 and § 2704 is more likely to occur with respect to Prop. Reg. § 25.2704-3 than with respect to Prop. Reg. § 25.2704-2, which applies to the liquidation of the entity.

**Issue #1: Interaction with “Put Right” Concept**

The Proposed Regulations state that an agreement that is subject to § 2703 is not an Applicable Restriction. A put or call right, for example, would constitute an agreement subject to § 2703. A buy-sell agreement might give the company a right to call shares at a fixed price that is less than fair market value in certain specified events. Alternatively, it might give a shareholder the right to put shares to the company at a fixed price that might be more or less than fair market value. The call right could be disregarded under § 2703(a), if it did not meet the requirements of an arms-length agreement under § 2703(b). It also argues places a price restriction on the redemption of shares that might be a Disregarded Restriction.

We respectfully submit that the Preamble incorrectly dismisses a possible overlap. Because a voluntary put right would not be a restriction on the shares, § 2703(a) should not apply. However, we note the argument that a put right may create a liquidation right, and that the fixed price should be a Disregarded Restriction. We respectfully request Treasury’s clarification of this issue.

**Issue #2: The Proposed Regulations Do Not Adequately Protect Legitimate Business Agreements, Comparable to those Entered into at Arm’s Length.**

We respectfully submit that § 2703(b) effectively permits terms in a buy-sell agreement that would be disregarded under § 2703(a) if the agreement would be viable in an arms’ length situation. This, we believe, is consistent with Chapter 14, which generally allows family business owners to arrange their affairs on the same terms as unrelated persons.24 Congressional intent to limit abusive transactions – not to penalize family business – is evident in the legislative history.25 We respectfully recommend that the Proposed Regulations be modified to afford analogous protections for family business owners consistent with both the statute and the remaining sections of Chapter 14.

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24 In addition to IRC § 2703(b), see, e.g., IRC § 2701(c)(3).

25 136 Cong. Rec. § 15679, 15681 (October 18, 1990) (“In developing a replacement for current IRC Section 2036(c) the Committee sought to accomplish several goals: (1) to provide a well defined and administrable set of rules; (2) to allow business owners who are not abusing the tax system to freely engage in standard intra-family transactions without being subject to severe transfer tax consequences; and (3) to deter abuse by making unfavorable assumptions regarding certain retained rights.”).
We respectfully submit that the pivotal language for this purpose is the phrase “subject to”:

“An option, right to use property, or agreement that is subject to section 2703 is not a restriction under this paragraph (b).” [Emphasis added] 

We believe, in this context, the phrase “subject to” could have one or more of three meanings:

- **Meaning #1**: Section 2704(b) will not apply to a restriction that § 2703(a) ignores;
- **Meaning #2**: Section 2704(b) will not apply to a restriction that could be subject to § 2703(a), but is not because of the arms-length exception in § 2703(b); or
- **Meaning #3**: Section 2704(b) will apply to a restriction that could be subject to § 2703(a), but is not because of the arms-length exception in § 2703(b).

In Meaning #1 it appears the restriction “is subject to” § 2703, because it applies to disregard the effect of the restriction. Either of Meaning #2 or Meaning #3 could be true, but not both. 

We respectfully request that Treasury adopt Meaning #2 in the Final Regulations as the correct interpretation, and clarify this in the Final Regulations. We respectfully submit, by so doing, Treasury would maintain a very limited arms-length exception that appears and is otherwise lost in these Proposed Regulations. Further, we respectfully request, if Treasury adopts Meaning #2, Treasury would also clarify that, if an agreement satisfies § 2703(b), then § 2704 would not apply.

**Prop. Reg. § 25.2704-3(b)(5)(v) Right to put interest to entity.**

See the Comments below under Prop. Reg. § 25.2704-3(b)(6).

**Prop. Reg. § 25.2704-3(b)(6) Put right.**

The following discussion also applies to Prop. Reg. §§ 25.2704-2(b)(4)(iv) and 25.2704-3(b)(5)(v).

An otherwise Disregarded Restriction will not be considered a Disregarded Restriction if each holder has a put right as described in Prop. Reg. § 25.2704-3(b)(6). Each holder must have the right to liquidate or redeem its interest in the entity upon six months’ notice, and must have the right to receive cash or other property. Property does not include a note, unless the interest is in an active trade or business at least 60 percent of the value of which consists of its non-passive assets, and the note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds.

**Issue #1: The Put Right Exception is Often Impractical, if not Impossible**

Requiring that a family that enters into a business arrangement with unrelated third parties and provides the third parties with put rights is an unrealistic and unworkable way to structure a business, and it has the effect of disregarding virtually all non-family held interests. In addition, put rights may be entirely disallowed, such as in regulated entities (i.e., banks). It would be impossible to attract investors to an

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26 IRC §2703.
entity if the other investors can withdraw their share of the business at any time. Similarly, the constant threat that capital will be abruptly withdrawn makes a long term business plan inconceivable.

If a holder were to withdraw, the entity or family must pay them the “minimum value,” which is the full value of the company multiplied by their percentage interest. A great portion, if not most, of the value of many businesses lies in the goodwill, hard assets and expected future returns. Amazon.com Inc. has a market capitalization of more than $300 billion, but if a 10% owner wanted his $30 billion, the liability itself would greatly impact Amazon’s cash flow, ability to invest, and ability to obtain future financing. The same would be true for any other business on a smaller scale. A business just can’t promise to payoff all investors who wants their money back.

**Issue #2: Giving Third Parties a Put Right Creates Seniority in Their Interests Over Family Interests**

Requiring a put right also would allow the non-family owners to convert their equity to debt at any time, effectively giving them a priority interest to the assets and income of the business. These requirements greatly hamper family-run businesses (the vast majority of all businesses), and would greatly jeopardize their ability to bring in capital from outside investors or to sell minority interests to third parties. If they do, they are either forced by these rules to grant put rights, or to have their interests valued at much higher values for gift and estate tax purposes than they could realize absent a sale of the entire company.

These rules would apply, for example, if a family sold one-third of a business to a private equity (PE) fund (a common occurrence). Typically, the PE fund will demand a certain amount of control and the family will certainly not be permitted to liquidate or redeem their interests at will. But under these rules, unless the PE fund has a put right to take its money out upon six months’ notice and has held the interest at least three years, not only will the put right “safe harbor” Prop. Reg. § 25.2704-3(b)(5)(v) not apply, but Prop. Reg. § 25.2704-3(4) will cause the PE fund’s interest to be disregarded, treating the family as if they can remove any Disregarded Restriction.

*Prop. Reg. § 25.2704-3(c) Other definitions.*

See the Comments above under Prop. Reg. § 25.2704-2(c).

*Prop. Reg. § 25.2704-3(d) Attribution.*

See the Comments above under Prop. Reg. § 25.2704-2(d).

We further note that the language in Prop. Reg. § 25.2704-3(d) is slightly different than in Prop. Reg. § 25.2704-2(d) – this section provides that “any other person” is also treated as holding an interest held indirectly by such person. We respectfully request that Treasury explain in Final Regulations that this difference is intended to apply the attribution rules to non-family interests.

*Prop. Reg. § 25.2704-3(e) Certain transfers at death to multiple persons.*

**General Comments on Mismatch Scenarios.**

Section 2704(b)(1) provides, in relevant part, that the special valuation rules of § 2704(b) apply “for purposes of [subtitle B].” The Proposed Regulations confirm this scope and, in examples, attempt to clarify the application of new valuation principles as they relate to transfers that qualify for the charitable deduction under §§ 2055 and 2522 and transfers that qualify for the marital deduction under §§ 2056 and 2523.
Proposed Regulations § 25.2704-3(g), Example 3 provides generally that in valuing an interest in a limited partnership passing outright from a decedent to the decedent’s surviving spouse, the value of the limited partnership interest for both inclusion and deduction purposes is determined in accordance with generally applicable valuation principles, taking into account all relevant factors, but assuming any Disregarded Restrictions do not exist.

Proposed Regulations § 25.2704-3(g), Example 4 provides generally that in valuing an interest in a limited partnership passing from a decedent to non-family members, the value of the limited partnership interest for inclusion purposes is determined in accordance with generally applicable valuation principles, taking into account all relevant factors. The example further provides that the allowable charitable deduction for an interest in the limited partnership passing to charity is valued in a “similar manner.”

These examples provide welcome explanation in a limited number of scenarios, but we respectfully submit that additional clarification is needed with respect to mismatch scenarios unaddressed by the Proposed Regulations and additional mismatch scenarios created by the new valuation regime imposed by Prop. Reg. § 25.2704-3(f) discussed below in the Comments.

**Issue #1: The Proposed Regulations Impose a New Valuation Regime that Conflicts with Established Notions of Fair Market Value**

In Revenue Ruling 59-60\(^{27}\), the IRS outlined and reviewed in general the approach, method and factors used in determining the value of interests in closely held businesses for estate and gift tax purposes. In so doing, the IRS noted that inclusion in a decedent’s gross estate, or value for gift tax purposes, is based on the value of the property transferred at the time of the death of the decedent, the alternate date if so elected or the date of the gift, as the case may be. Revenue Ruling 83-120\(^{28}\) amplified and supplemented this analysis, noting that the approach and factors used in valuing interests in closely held businesses are “directed toward ascertaining the true fair market value” of the transferred interest. Importantly, no part of the analytical framework set forth in these authorities requires appraisers to take into account the identity of the recipient of a transferred interest or the relationship of the recipient to the transferor. Indeed, Revenue Ruling 59-60 attempts to establish a methodology to determine fair market value as a reflection of what a hypothetical, unrelated willing buyer and willing seller would determine as being a fair market value.

By using fair market value as the measure of a property interest’s value for transfer tax purposes, the value of property is grounded in reality. By using a hypothetical buyer and seller to determine fair market value, a property interest’s value is divorced from the family ownership context. Rather, property interests are taxed the same for transfer tax purposes without regard to the identity of the other owners of the property or the relationship of the transferor or transferee. Fair market value, therefore, by definition correlates the value of property for transfer tax purposes with its actual value if sold in the market.

In 1990, Chapter 14 deviated from the use of fair market value as the measure of an equity interest’s transfer tax value. Congress recognized that using an artificial value for an equity interest in a family


business could result in unfairness to family business owners. Therefore, it designed Chapter 14 to eliminate “bells and whistles” that might be added to family business agreements, which unrelated persons would never use, for the purpose of reducing the transfer tax value of family business.

Congress did not intend to penalize the owners of family businesses who had only arms-length terms in their business documents. Rather, Congress designed Chapter 14 to respect the terms in the governing documents of a family business entity that were like those terms between unrelated parties. Section 2701 will respect the terms of preferred equity that are like those of unrelated parties, if the payments were made in accordance with those arms-length terms. Section 2703(b) explicitly respects the terms of buy-sell and option agreements that are the same as arms-length terms. Chapter 14 tweaked the fair market value concept, but it did not replace it with a new valuation regime as the Proposed Regulations purport to do.

If part of a decedent’s interest in an entity passes to members of the decedent’s family and part passes to non-family members, Proposed Regulations §§ 25.2704-2(f) and 25.2704-3(e) and (f) provide that, for purposes of Section 2704(b), such parts are to be valued as two separate property interests, each of which will be valued separately. The interest passing to the member of the decedent’s family shall be valued as if the Disregarded Restriction did not exist. The interest passing to non-family members shall be valued respecting those restrictions. For example, if D died owning all 100 shares of outstanding voting common stock in a corporation and bequeathed 50 shares to D’s surviving spouse and 50 shares to charity, the two interests would be valued differently for estate tax purposes, notwithstanding that they possess identical legal and economic entitlements and would be valued identically by a third party purchaser.

This disparity is representative of a new valuation regime adopted by the Proposed Regulations that applies to transfers among family members, which is inconsistent with the concept of fair market value. The valuation regime apparently attempts to confront perceived abuses by requiring valuation appraisers to not only make an objective determination of the economic value of an interest in a closely held business as between a hypothetical buyer and seller, but to distort that objective determination in light of the family relationship without any specific guidance how to do so. This represents a fundamental departure from the notion of fair market value as a measure for transfer tax purposes, reflecting a determination of a value that unrelated parties would negotiate amongst themselves in a third party transaction. We respectfully request that the Proposed Regulations be revised to eliminate unnecessary valuation distortions by:

- Addressing valuation mismatches created by the Proposed Regulations;
- Unifying valuation results under the Proposed Regulations and other provisions of the Code; and
- Making provisions for mismatch scenarios driven by external events.

**Issue #2: The Proposed Regulations Create New Mismatch Scenarios that Should Be Reconciled or Eliminated**

Proposed Regulations § 25.2704-1(c)(1) provides that the lapse of a voting or liquidation right as a result of a transfer of an interest within three years of the transferor’s death is treated as a lapse occurring on the transferor’s date of death, includible in the gross estate pursuant to § 2704(a) (the “three-year rule”). Proposed Regulations § 25.2704-4(b)(1) provides that the three-year rule applies to lapses of rights created after October 8, 1990 and occurring on or after the date the Proposed Regulations are finalized. Accordingly, assuming the Proposed Regulations are finalized in a timely manner, this new rule has the potential to impact transactions consummated before the issuance of the Proposed Regulations. See Comments below with respect to Prop. Reg. § 25.2704-4(b).
Consider the following example:

D is the owner of all 100 shares of outstanding voting common stock in corporation X. The bylaws require a majority vote to liquidate X. In year 1, prior to the issuance of Final Regulations under § 2704(a), D transfers 51 shares, representing 51%, to a grantor trust for the benefit of D’s children. For gift tax purposes, the 51 shares in X are valued by an independent appraiser under generally applicable valuation principles, taking into account all relevant factors. In year 2, after the issuance of Final Regulations under § 2704(a), D dies, bequeathing all of his remaining 49% interest in X to charity.

Proposed Regulations § 25.2704-1(c)(1) includes in D’s gross estate the value of the lapsed liquidation right. Accordingly, D’s gross estate includes both the value of the 49 percent interest passing to charity and the value of D’s lapsed liquidation right, thus resulting in a higher value for gross estate inclusion purposes. Notwithstanding this phantom inclusion, the charitable deduction permitted under § 2055 will be limited to a value not exceeding that of 49 shares in X as finally determined for estate tax purposes. Neither example included in Prop. Reg. § 25.2704-1 explains how the phantom liquidation right should be valued for estate tax purposes.

Example 1 presents a situation in which the charitable deduction permitted is less than the value of the interests in X included in D’s gross estate, despite the fact that D bequeathed all of his remaining interests in X to charity and despite the fact that D may have engaged in the year 1 transaction without any knowledge of the restrictions imposed by the Proposed Regulations. A corollary marital deduction mismatch would result if D left all of his remaining interests in X to D’s surviving spouse. In addition, the example identifies a potential instance of double taxation. As the interest in X transferred in year 1 was a controlling interest, the value of the liquidation right was already exposed to gift tax at that time. Nonetheless, the Proposed Regulations expose the same liquidation right to estate tax at D’s death.

We respectfully request that Treasury consider amending the Proposed Regulations to:

- prevent double taxation, a liquidation right subject to gift tax in a prior transaction will not be included in the decedent’s gross estate as a lapsed right;
- provide that for estates subject to the three-year rule, interests in an entity passing to charity or to a surviving spouse will be valued in a manner that unifies the valuation of deductions and inclusions with respect to the entity;
- provide an example to clarify the manner in which a liquidation right subject to the three-year rule is valued for estate tax purposes; and

29 Estate of Smith v. United States, 103 Fed. Cl. 533 (2012). In Smith, the court valued a liquidation right that lapsed at death by subtracting the value of the decedent's interest absent the liquidation right from the value of such interest with the liquidation right. This methodology is problematic in the context of the three-year rule, though, because interests other than the liquidation right (and any subsequent appreciation attributable thereto) may have been validly transferred in an earlier transaction and should not be included in the decedent's gross estate.
• prevent mismatch scenarios, including clarifying that the three-year rule will not apply to interests transferred prior to the issuance of the Proposed Regulations.

**Issue #3: The Interaction of the Proposed Regulations and Other Provisions of the Code Has the Potential to Create New Mismatch Scenarios**

Section 2036(a) provides that the value of a decedent’s gross estate shall include assets the decedent transferred during life, but over which the decedent retained certain impermissible controls. Section 2036(a) essentially causes the phantom inclusion of assets in a decedent’s gross estate regardless of whether the decedent actually owned the assets for property law purposes. The interaction of this provision with the new valuation rules of the Proposed Regulations could negatively impact estates eligible for the marital and charitable deductions, given that qualification for such deductions depends on an asset actually passing to the decedent’s surviving spouse or to charity, as the case may be.

Moreover, § 2055(d) provides that the amount of the estate tax charitable deduction shall not exceed the value of the transferred property required to be included in the decedent’s gross estate. In the marital deduction context, § 2056(a) merely provides that to qualify for the marital deduction, the asset passing from a decedent to or for the benefit of the decedent’s surviving spouse must be included in determining the value of the gross estate. Similarly, in the context of the Code’s basis consistency provisions, § 1014(f) provides only that the basis of any property passing from a decedent shall not exceed the value of such property as finally determined for Federal estate tax purposes.

While the Preamble purports to resolve all marital and charitable deduction mismatches through the application of Prop. Reg. § 25.2704-3(g), Examples 3 and 4, those examples provide only that interests in family held entities passing outright to a decedent’s U.S. citizen surviving spouse (but is silent as to interests passing into a marital deduction trust for the benefit of a U.S. citizen surviving spouse as we as to a Qualified Domestic Trust for the benefit of a Non-U.S. citizen surviving spouse) or to a non-family member will generally be valued for inclusion and deduction purposes in a manner consistent with the methodology of the Proposed Regulations. These examples notwithstanding, the Proposed Regulations fail to address mismatch scenarios occasioned through the intersection of the Proposed Regulations with other provisions of the Code, notably §§ 2036(a) and 1014(f).

Consider the following example:

A dies owning an interest in family limited partnership X. A’s interest in X is bequeathed outright to A’s U.S. citizen surviving spouse. The executor of A’s estate determines the fair market value of the X interest taking into account applicable valuation discounts and reports such value for both gross estate inclusion and marital deduction purposes on a timely filed Federal estate tax return. On audit, the IRS contends that A’s interest in X should be disregarded under § 2036(a) and that A’s estate should include the value of the underlying assets of X that A transferred into X during his lifetime. The IRS further argues that the value of the marital deduction should not equal the value of the underlying assets of X attributable to A’s transfer, but that the marital deduction should be limited to the discounted value of the asset actually owned by A at his death, a limited partnership interest in X.
In *Black*\(^{30}\), the decedent, together with his son and grandsons, transferred shares of stock to a family limited partnership. Following the decedent’s death, the IRS argued that § 2036(a) should include in the decedent’s estate the value of the shares he contributed to the family limited partnership, rather than the interest in the partnership itself. The IRS further argued that the marital deduction attributable to the family limited partnership interests the decedent left to his surviving spouse should be determined based on the discounted value of the partnership interest actually passing to the surviving spouse. The IRS made similar arguments in *Shurtz*.\(^{31}\)

While both cases were ultimately decided on other grounds, the arguments made by the IRS are instructive when considered in conjunction with the inconsistent valuation rules imposed for estate tax inclusion and deduction purposes. The Preamble indicates that to the extent an interest qualifies for the marital or charitable deduction, the same value “generally” will apply, but that other factors may justify a different value. At least one court, however, has recognized the logical inconsistency of this approach, noting as follows:

> “[There is,] certainly, an initial plausibility to the suggestion that fairness dictates that the same method of valuation be used in computing the gross estate and charitable deduction. This initial plausibility, however, does not survive a close second look. The statute does not ordain equal valuation as between an item in the gross estate and the same item under the charitable deduction. Instead, it states that the value of the charitable deduction “shall not exceed the value of the transferred property required to be included in the gross estate.”\(^{32}\)

In the example above, were the IRS to prevail in its argument under § 2036(a) so as to result in gross estate inclusion of assets that a decedent transferred into a family limited partnership during his lifetime, the result would be the inclusion in A’s estate of the value of the underlying assets of X attributable to A’s transfer into it, but a marital deduction equal to the discounted fair market value of the X limited partnership interest passing to A’s surviving spouse.

A similar mismatch could occur if A were to leave his X limited partnership interest to charity at death. The charitable deduction mismatch is even more salient in light of § 2055(d), which merely provides that the value of the estate tax charitable deduction “shall not exceed” the value included in the decedent’s gross estate but does not require consistent valuation. We recommend that the Proposed Regulations be revised to provide that, where an interest is eligible for the estate tax marital or charitable deduction, the value included in the decedent’s gross estate as determined under § 2704(b) shall equal, and shall in no event exceed, the deduction permitted under §§ 2055(a) or 2056(a), as the case may be. We further

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\(^{32}\) *Ahmanson Foundation v. United States*, 48 AFTR 2d 81-6317 (9th Cir. 1981).
respectfully request that Prop. Reg. § 25.2704-3(g), Example 3, be clarified to include transfers to a Qualified Domestic Trust or Qualified Terminable Interest Property Trust (as the case may be).

Issue #4: The Proposed Regulations Result in Mismatch Scenarios with Business Arrangements and Other Non-tax Motivated Scenarios

As discussed above, the new valuation regime imposed by the Proposed Regulations is intended to increase above fair market value the transfer tax value of equity interests that are transferred between family members -- a theoretical underpinning that contradicts reality and tax concepts of fair market value. In many (if not most) cases, transactions entered into by the owners of closely held businesses are motivated primarily by commercial and business factors, rather than a desire to escape the imposition of the Federal estate tax. These transactions, which may include redemptions, recapitalizations, cross-purchases, options, buy-sell agreements and similar commercial undertakings may result in estate tax mismatches under the valuation regime of the Proposed Regulations.

Consider the following example:

A is a voting shareholder in family owned corporation X, which is owned 75% by A and members of A’s family and 25% by unrelated third parties who are voting shareholders. Pursuant to a buy-sell agreement, upon A’s death, a mandatory redemption of A’s shares is triggered. The buy-sell agreement provides that A’s shares are to be redeemed for their fair market value as of the date of A’s death. The buy-sell agreement also contains various restrictions on the ability of a shareholder to transfer or liquidate his shares in X. The buy-sell agreement satisfies the exception provided in § 2703(b) and, accordingly, § 2703(a) does not apply to the buy-sell agreement. Under A’s will, all of A’s remaining property is left outright to A’s U.S. citizen surviving spouse.

Proposed Regulations § 25.2704-3(b)(5)(iv) provides that an agreement that is “subject to” § 2703 is not a Disregarded Restriction. The Preamble provides simply that there is no overlap between IRC § 2703, which governs the sale or use of interests in family controlled entities, and § 2704(b), which governs restrictions on the liquidation or redemption of such interests. Notwithstanding this statement, both the Tax Court and the 11th Circuit have applied § 2703 to a stock-purchase agreement imposing restrictions on the transfer of corporate stock and triggering a mandatory redemption on the death of a shareholder.33

In the example above, the buy-sell agreement imposes restrictions on shareholders that are restrictions described in Prop. Reg. § 25.2704-3. Although unrelated third parties hold a meaningful (25%) interest in X, the buy-sell agreement imposes restrictions that confirm that no shareholder has a minimum value put right in X and, therefore, the interests held by non-family members are nonetheless disregarded for valuation purposes under Prop. Reg. § 25.2704-3(b)(4). We respectfully submit, in essence, the Proposed Regulations’ requirement that third parties hold a minimum value put right establishes a default standard that is not in sync with commercial practice (in which, for example, an employee receiving equity compensation would be exceedingly unlikely to hold such a put right). Accordingly, despite the 25%

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interest in X held by third parties, the value included in A’s estate with respect to the X shares will take into account the *de facto* premium required by the Proposed Regulations.

Notwithstanding this valuation result, the executor of A’s estate is still obligated to acquiesce to the redemption of A’s shares in X at fair market value, a price that may take into account applicable valuation deductions for lack of control and/or lack of marketability. Because the Proposed Regulations do not control the property rights of parties to agreements, A’s estate will necessarily receive redemption proceeds that are likely less than the estate inclusion attributable to the redeemed interests. Since A’s executor can only claim a marital deduction for amounts actually passing to A’s surviving spouse, A’s estate will have a Federal estate tax liability, notwithstanding the fact that all of A’s remaining assets were bequeathed to A’s surviving spouse.

This example illustrates the multiple layers of uncertainty facing taxpayers who wish to engage in commercially reasonable agreements that do not represent the types of “sweetheart deals” that Chapter 14 was intended to prevent. First, as discussed above, existing case law seems to contradict the Preamble’s assertion that there is no overlap between §§ 2703 and 2704(b) in the context of buy-sell or stock-purchase agreements. Second, it is unclear whether a buy-sell, cross-purchase or other agreement between family shareholders and non-family shareholders can be deemed a commercially reasonable restriction imposed by an unrelated person providing capital to the entity within the meaning of Prop. Reg. § 25.2704-3(b)(5)(ii). Third, the example clearly presents a scenario in which a marital or charitable deduction mismatch could result from the interaction of the Proposed Regulations and non-estate planning motivated transactions.

At its core, this mismatch is a symptom of the incompatibility of the valuation principles imposed by the Proposed Regulations with commercial and tax notions of fair market value. To the extent the Treasury expects the owners of interests in closely held family businesses to enter into buy-sell, cross-purchase, and similar agreements taking into account the valuation principles imposed by the Proposed Regulations, unanswered questions exist with respect to whether corporate directors or trustees or other fiduciaries can agree to purchase interests in closely held entities at values exceeding fair market value without violating state law fiduciary duties.

By example, trustees of trusts, acting in a fiduciary capacity, may only be permitted under state law to pay fair market value for stock they intend to acquire, based on valid restrictions on redemption or liquidation value. If the restrictions are disregarded for transfer tax purposes, the trustees may have “underpaid” for the stock for transfer tax purposes, and the seller may have made an additional gift to the trust, even though the restriction on redemption or liquidation value may be a valid state law or governing agreement restriction. Further, many relationships with trust companies base fees on the fair market value of the property. When there is an artificial value as set forth in the Proposed Regulations, there may be a conflict on how trustee’s fees are calculated.

By further example, the fiduciaries could be the board of directors of the corporation who would be unable to redeem stock at a value higher than fair market value. On the other hand, a family shareholder forced to sell stock to the company for fair market value would face adverse gift tax consequences if he or she did so when the artificial value under § 2704(b) is higher.

We recommend that the Proposed Regulations be revised to provide exceptions for commercially reasonable transactions that meet standards similar to those under § 2703(b) and that existing exceptions for commercially reasonable restrictions imposed by unrelated parties be expanded and/or construed liberally in favor of taxpayers who enter into commercially reasonable transactions or arrangements.

The proposed regulations do not adequately address the valuation of a split interest gift, such as a charitable lead annuity trust (“CLAT”). On creation of a CLAT, the donor is entitled to a gift (or estate) tax deduction based on the value of the interest passing to charity. The Preamble provides:

“Section 2704(b) does not apply to transfers to nonfamily members and thus has no application in valuing an interest passing to charity or to a person other than a family member. If part of an entity interest includible in the gross estate passes to family members and part of that interest passes to nonfamily members, and if (taking into account the proposed rules regarding the treatment of certain interests held by nonfamily members) the part passing to the decedent's family members is valued under section 2704(b), then the proposed regulations provide that the part passing to the family members is treated as a property interest separate from the part passing to nonfamily members. The fair market value of the part passing to the family members is determined taking into account the special valuation assumptions of section 2704(b), as well as any other relevant factors, such as those supporting a control premium. The fair market value of the part passing to the nonfamily member(s) is determined in a similar manner, but without the special valuation assumptions of section 2704(b). Thus, if the sole nonfamily member receiving an interest is a charity, the interest generally will have the same value for both estate tax inclusion and deduction purposes. If the interest passing to nonfamily members, however, is divided between charities and other nonfamily members, additional considerations (not prescribed by section 2704) may apply, resulting in a different value for charitable deduction purposes. See, e.g., Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).”

The examples contained in the Proposed Regulations assume that the interests passing to charity are separate and distinct from the interests passing to family. Thus, they do not account for the value of successive interests in the same property. As such, the Proposed Regulations may increase the potential taxable gift to family members because the special valuation assumptions of § 2704(b) would apply only to the interest passing to the family. To the extent that the remainder value to the family members would be determined under the Proposed Regulations, the only way to achieve a zero remainder would be to pay annuity based on 100% of the value of the property transferred to the CLAT assuming applicability of the new rules. Even this, however, may not be sufficient because the charitable deduction could not exceed the amount allowable under § 2055(a), which, as noted above under Issue #3, may in itself result in a deduction mismatch. To clarify these potential mismatches, we respectfully request that Final Regulations incorporate an example of the application of Proposed Regulations § 25.2704-3(e) in the context of a split interest trust.


General Comments.

Proposed Regulations § 25.2704-3(f) reads as follows:
“(f) Effect of disregarding a restriction. If a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized.”

Proposed Regulations § 25.2704-3(f) is missing any substitute provision for the amount to be paid on withdrawal or liquidation. We respectfully submit that the Proposed Regulations appear to instead rely on silence. However, silence does not provide sufficient guidance to enable the valuation of equity interests in the entity now operating under altered terms. We respectfully request further guidance in the Final Regulations.

Issue #1: The Valuation Regime Imposed by Paragraph (f) Appears to Be Based on a Misunderstanding of State Law

We respectfully suggest that the Proposed Regulations appear to reflect a misunderstanding of state entity law. State laws of business organizations are the embodiment of a system to allow a group of persons (owners) to form an entity to jointly carry on a business or profit seeking venture. By default, most modern state law organizations have perpetual existence, so as to permit the business activity to continue on indefinitely. State law governing the formation of the entity, therefore, presumes that the entity will continue -- not liquidate or allow an owner to liquidate his or her interest in the entity. Thus, if state entity law permits an owner to withdraw, it authorizes withdrawal, not restricts or limits it. Similarly, if state entity law permits the owners to liquidate an entity, it authorizes liquidation of the entity, not restricts or limits it.

State corporation law has never offered a shareholder the option of withdrawing, dissociating or otherwise exiting the corporation. Unlike a shareholder, however, a general partner is personally liable for the obligations of the partnership. Therefore, a general partner always is entitled to withdraw from a partnership to stop personal liability for future obligations of the partnership. State law sometimes permits the partnership agreement to penalize a general partner who withdraws, but the general partner always may withdraw to escape future liabilities. Thus, shareholders and general partners are at opposite ends of the state law spectrum on withdrawal.

For example, under the Uniform Limited Partnership Act, adopted by 20 states, a limited partner does not have the right to withdraw before the completion and winding up of the partnership.34 By default, the duration of a limited partnership is perpetual.35 However, a limited partnership must have at least one general partner and, therefore, one partner always may withdraw. Similarly, LLC owners are not personally liable for the obligations of the company and, therefore, usually are not authorized to withdraw under state law. An owner’s personal liability for an entity’s obligations, therefore, generally determines whether state law authorizes an owner to withdraw from an entity.

34 ULPA § 601(a) (2001 Act). (The prior ULPA did generally give limited partners the right to withdraw and receive fair value unless the partnership was to last for a fixed term.)

35 ULPA § 110(c).
The Check-the-Box regulations dispensed with classifying an entity as a corporation or partnership for Federal income tax purposes based on whether the entity had more corporate or partnership characteristics. Prior to 1997, states tried to “foolproof” LLC statutes so that LLC’s automatically had the partnership characteristics of lack of transferability and lack of perpetual duration. After 1997, taxpayers could elect for an LLC to be a partnership or corporation for Federal income tax purposes. States then were freed to adopt statutory provisions best suited for the type of entity, rather than Federal income tax law.

The adoption of the Check-the-Box regulations was an important milestone in the development of state entity law. State law changes in response to these regulations are wholly distinct from the changes to state entity law described in the Preamble as rendering existing § 2704 regulations ineffective. Instead, the Check-the-Box regulations allowed states to design statutes governing entities to more closely resemble corporations in their treatment of owners who have no personal liability for an entity’s obligations.

If a general partner withdraws from a limited partnership, the effect of that withdrawal on the remaining partners depends on state law and the limited partnership agreement. Most default state laws authorize the remaining partners to continue the partnership. It would be extreme to categorize this authorization to continue the partnership as a “restriction on liquidation” under Prop. Reg. § 25.2704-2(b)(2), or as a limitation on the owner’s right to liquidate his or her interest under Prop. Reg. § 25.2704-3(b)(2), even though it is not “required” under state law. The effect of such an interpretation – which would be wholly consistent based only on the literal language of the Proposed Regulations – would be to ignore the very real organizational characteristics of an underlying entity.

The ability of the general partner to withdraw from a general or limited partnership is a right to liquidate his or her interest. A restriction on that right to withdraw would seem to be a restriction on the right of an owner to liquidate or redeem the general partner’s interest. However, state law does not permit such a restriction. State law does permit the limited partnership agreement to penalize a general partner who withdraws. The penalty presumably would be a restriction on liquidation, but a penalty is not a restriction. However, the right to withdraw is meaningless without a corresponding payment for the withdrawing partner’s equity interest.

In Delaware, for example, unless provided otherwise in the partnership agreement, a withdrawing partner “is entitled to receive, within a reasonable time after withdrawal, the fair value of such partner’s partnership interest in the limited partnership as of the date of withdrawal based upon such partner’s right to share in distributions from the limited partnership.” 6 Del.C. § 17-604 (West 2016).

This “fair value” is the definition of the value of a non-voting, non-marketable equity interest with no right to force distributions or liquidation. This value payable on a general or limited partner’s withdrawal has been consistent since 1990 when § 2704 was enacted. The amount of the payment was not reduced in response to its enactment. The amount receivable is the same whether the withdrawing partner was a general or limited partner.

No withdrawing partner has the right to receive the liquidation value of the partnership or the value of his or her voting or management rights. This value belongs to the partners remaining in the partnership, not to the resigning partner. If a resigning partner could receive liquidation or control value, the partnership would soon collapse and more of its value would belong to the withdrawing partners than the continuing partners.

A partner’s right to withdraw and the amount he or she receives on withdrawal are inextricably linked under state law. The Proposed Regulations should not be able to sever this linkage to keep the right to withdraw as the right of a partner to liquidate or redeem his or her partnership interest, but treat the
amount receivable as a “restriction” on the right to liquidate that is to be disregarded. The Proposed Regulations do not do so explicitly; however, the four specified restrictions that can become Disregarded Restrictions do so implicitly. Also, as discussed above, a concern exists that LLC’s would be lumped together with partnerships because they are both partnerships for income tax purposes, raising a concern that a non-existent right to withdraw may be read into the state entity law of LLC’s.

While we recognize Treasury’s intent with respect to restrictions that are more restrictive than would apply in the absence of state law, and while we also recognize that changes in state law have rendered certain such provisions less meaningful, we believe the Final Regulations should include agreements, even between family members, that are negotiated at arm’s length and have terms and conditions similar to the agreements that one would find between unrelated parties. This exception would allow family-owned businesses to operate on the same level and with the same benefits that businesses between unrelated parties operate on, so long as the facts and circumstances support such. We recognize that this approach may require a fact-based inquiry into the circumstances of each family-owned business, but we believe this is appropriate and in keeping with the general policy in the IRC for providing such benefits to family-owned businesses.

**Issue #2: Paragraph (f) Raises More Questions than It Answers**

Proposed Regulations § 25.2704-3(f) replaces fair market value as the transfer tax valuation regime for intra-family transfers of equity interests. Yet the paragraph raises more questions than it answers. For example:

1. As discussed above, state entity law authorizes liquidation rather than restricts it. How can disregarding liquidation restrictions increase the value of an equity interest?
2. How are different types of entities treated under this paragraph (f)?
3. Is the right to withdraw of a general partner somehow attributed to a limited partner who has no right to withdraw?
4. Is the right of a partner to withdraw attributed to a member in an LLC, because the LLC is a partnership for income tax purposes?
5. Is the right of a partner to withdraw respected under paragraph (f) while the limited amount the withdrawing partner can receive in liquidation ignored?
6. If all restrictions on liquidation are ignored under paragraph (f), how will the net asset value of the entity be determined?
   a. Will the fractional interest discounts resulting from pro rata liquidation be respected?
   b. Will the entity be valued as if its assets were sold in a liquidation sale?
   c. Will the goodwill and other intangible assets enhancing the value of a going concern be respected?
   d. If a competitor is willing to pay a premium for an ongoing business will the net asset value include that premium, although the business as an ongoing business would be less (and therefore what a hypothetical willing buyer would pay is less)?

Some commentators have concluded that the Proposed Regulations intend for paragraph (f) to supply “minimum value” as the put price or amount payable on withdrawal when other amounts under state law are disregarded. These commentators point to the regulations disregarding any put or withdrawal right that can be added to an entity agreement, except a put or withdrawal right paying minimum value.
Nonetheless, there are counter positions. First, if subsection (f) intends to set “minimum value” as the minimum value of an interest, it would be easy to say so explicitly. Second, as frequently discussed, § 2704(b)(4) under which Prop. Reg. § 25.2704-3 is promulgated does not authorize regulations thereunder to provide “substitute” provisions for the Disregarded Restrictions. Third, minimum value is an artificial price completely divorced from business realities not existing in any state’s law or in any entity agreement. The term “generally applicable valuation principles”\(^{36}\) could never be applied to such an artificial term as minimum value.

Therefore, we respectfully submit that there are open questions as to how interests subject to Disregarded Restrictions are to be valued, and how the Service or a court would interpret and apply the Proposed Regulations regarding the valuation of such interests. If there is no implied put right or actual requirement for payment of “minimum value,” there would be no rule under which to value an interest – neither a right to redemption nor a prohibition on redemption. In such a vacuum, the holder of the interest and the corporation, partnership, or other entity would be left to reach an agreement on a requested redemption and would negotiate a price, which might be discounted.

We believe the Final Regulations should clarify that, in valuing an interest with respect to which there is a Disregarded Restriction, there would be no limitation on the owner's and entity's ability to reach an agreement to redeem, and that the result of such an agreement, for example, could be to redeem an interest for less than “minimum value” or in exchange for a note with a term greater than six months.

We respectfully request that Treasury address the list of questions above and provide guidance in the Final Regulations that would be instructive on the valuation of interests in cases where a restriction is disregarded.

**Issue #3: Consistency Between Minimum Value Propositions and Valuation of Interests Subject to Disregarded Restrictions under Paragraph (f)**

The uncertainties in item #6 above with respect to the determination of net asset value apply to both “minimum value” and the value determined under paragraph (f). However, there are many other valuation issues specifically addressed in the determination of “minimum value” that are left unaddressed under paragraph (f). The following table contrasts the concept of minimum value with the valuation provision in Prop. Reg. § 25.2704-3(f), which applies to Disregarded Restrictions:

<table>
<thead>
<tr>
<th>Valuation Issue</th>
<th>Minimum Value</th>
<th>3(f) Disregarded Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Valuation</td>
<td>Interest’s share of net value of the entity</td>
<td>Perhaps implied</td>
</tr>
</tbody>
</table>

\(^{36}\) This phrase is reminiscent of GAAP or “generally applicable accounting principles”, but it is not a term used elsewhere in the tax regulations with one exception. The term is used in the examples in Treas. Reg. § 301.6501(c)-1(f) where it includes ordinary valuation discounts.
<table>
<thead>
<tr>
<th>Valuation Issue</th>
<th>Minimum Value</th>
<th>3(f) Disregarded Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net value</td>
<td>Fair market value of the property held by the entity</td>
<td>See potential meanings of liquidation value</td>
</tr>
<tr>
<td>Operating business valuation</td>
<td>References to Treas. Reg. §§ 20.2031-2(f)(2) and 20.2031-3 that imply consideration of earning capacity</td>
<td>Unclear</td>
</tr>
<tr>
<td>Allowed obligations</td>
<td>Only obligations allowed for Federal estate tax purposes are allowed</td>
<td>Not implicit or explicit</td>
</tr>
<tr>
<td>Lower tier entity valuation</td>
<td>Section 2704 applied to lower tier entities that would be subject to § 2704 if owned directly</td>
<td>Not explicit or implicit</td>
</tr>
<tr>
<td>Adjust for income taxes on liquidation</td>
<td>Unanswered Question</td>
<td>Unanswered Question</td>
</tr>
<tr>
<td>Valued as if fractional assets distributed</td>
<td>No</td>
<td>Maybe</td>
</tr>
</tbody>
</table>

An unanswered question under both the definition of minimum value and Prop. Reg. § 25.2704-3(f) is whether the Federal income taxes that would be incurred by a sale can ever be considered in determining liquidation or net asset value. Courts have held that a dollar-for-dollar discount is appropriate for built-in capital gains. We respectfully request that Treasury address these issues in the Final Regulations.

**Prop. Reg. § 25.2704-3(g) Examples.**

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37 See Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002); Estate of Jelke v. Commissioner, 507 F.3d 1317 (11th Cir. 2007).
The provisions of Prop. Reg. § 25.2704-3(g)(Examples) were discussed in the section of the Comments related to the particular example.

Prop. Reg. § 25.2704-4 Effective Date.

The effective date in the Proposed Regulations limiting their application to transfers and lapses after the publication of the Final Regulations is consistent with Treasury’s intent that regulations have only prospective application. However, we respectfully request that the Final Regulations clarify that such transfers occurring before the effective date are not subject to the three-year look back rule in Prop. Reg. § 25.2704-1(c)(1). We respectfully recommend that any transfer of an interest in a family controlled entity to another family member before the Proposed Regulations are finalized should be exempt from the three-year rule.

a. Comments with respect to Ancillary Considerations: Consistency with Income Tax Basis

Issue #1: Proposed Regulations Leave Open Questions with Respect to Basis Consistency

As currently drafted, the Proposed Regulations leave open the question of how to determine the income tax basis under § 1014 of an interest subject to § 2704. We believe that from a policy perspective, in order to prevent the subversion of the recently enacted basis consistency rules under § 1014(f), any special valuation assumptions mandated by § 2704 and the regulations thereunder with respect to determining the estate tax value of an interest subject to § 2704 must also apply for purposes of determining the income tax basis of such interest under § 1014(a).

Section 1014 and the regulations thereunder provide for what is commonly known as a “step up” or “step down” in basis of property received from a decedent. Section 1014(a) provides that the income tax basis of property acquired from a decedent is the fair market value of such property as of the date of the decedent’s death (or alternate valuation date under § 2032). Pursuant to Treas. Reg. § 1.1014-3(a), for purposes of the § 1014 and the regulations thereunder, “the value of the property as of the date of the decedent’s death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purposes, whichever is applicable, shall be deemed to be [the property’s] fair market value.”

Under the so-called “Doctrine of Consistency,” courts have held that taxpayers must report the same value of inherited property for income tax purposes as was reported on a decedent’s Federal estate tax return.38 This judicially created doctrine is aimed at eliminating the perceived abuse of reporting inconsistencies, whereby the executors of the decedent’s estate report a depressed value for estate tax purposes and the heirs of the decedent report an inconsistently higher position for income tax purposes that results in a greater step up in basis.

The public policy underlyin the Doctrine of Consistency was recently codified in § 1014(f) as part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015. Pursuant to the basis consistency provisions of § 1014(f)(1), the fair market value of inherited property (for purposes of

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38 See e.g., Janis v. Commissioner, 461 F.3d 1080, 2006-2 U.S. Tax Cas. (CCH) P 50512, 98 A.F.T.R.2d 2006-6075 (9th Cir 2006) (holding that the discounted valuation of an art collection for estate tax purposes also applied to the collection for purposes of calculating the heir’s cost of goods sold for personal income tax purposes).
determining the basis adjustment under § 1014(a)) “shall not exceed” the finally determined estate tax value of such property.\(^\text{39}\)

While § 1014(f)(1) only ascribes a maximum ceiling for Federal income tax purposes pegged to the value of the inherited property as finally determined for estate tax purposes, and does not go so far as to require equivalent reporting, the enactment of § 1014(f) nevertheless demonstrates Congress’ desire for consistent reporting of the value of property for both estate tax and income tax purposes. In order to further ensure consistent reporting, it is therefore necessary to extend any special valuation rules that would apply for estate tax purposes in determining the income tax basis of that same property under § 1014.

Section 2704 and the Proposed Regulations prescribe special valuation rules for valuing intra-family transfers of interests in family-controlled entities. While § 2704 only specifically applies for purposes of determining the value of such an interest for estate, gift and GST tax purposes,\(^\text{40}\) failure to extend these valuation rules for purposes of determining the income tax basis of that same interest under § 1014 would force taxpayers to take an inconsistent position for estate tax purposes from that which would be reported for income tax purposes. We respectfully submit that this would subvert the intent of the new basis consistency rules under § 1014(f). As such, we respectfully recommend that Treasury clarify that the special valuation rules prescribed under § 2704 and the Proposed Regulations will also apply in computing the basis adjustment for Federal income tax purposes under § 1014.

If Treasury believes that an explicit provision cross referencing the calculation of the basis adjustment under § 1014(a) is beyond the scope of regulations under § 2704, we believe that Treasury could accomplish the desired clarification in the Preamble to the Final Regulations by including a section similar to the “Coordination With Marital and Charitable Deductions” section in the Preamble to the Proposed Regulations.\(^\text{41}\) Specifically, we recommend that Treasury explicitly state that with respect to an interest subject to § 2704(b), the same fair market value determined under the special valuation assumptions of § 2704(b) for estate tax purposes will generally apply in connection with calculating any basis adjustment under § 1014.

Consider the following example:

A dies owning an interest in family limited partnership X. A’s interest in X is bequeathed outright to A’s U.S. citizen surviving spouse. The executor of A’s estate determines the fair market value of the X interest taking into account applicable valuation discounts and reports such value for both gross estate inclusion and marital deduction purposes on a timely filed Federal estate tax return. On audit, the IRS contends that A’s interest in X should be disregarded under § 2036(a) and that A’s

\(^{39}\) Note that the consistent basis requirements of IRC §1014(f)(1) apply only to property where the inclusion of such property in the decedent's gross estate increases the decedent's Federal estate tax liability.

\(^{40}\) IRC §2704(a)(1) explicitly states "[f]or purposes of this subtitle," referring to subtitle B (relating to estate, gift and GST taxes).

\(^{41}\) 81 Fed. Reg. 51418.
estate should include the value of the underlying assets of X that A transferred into X during his lifetime. The IRS further argues that the value of the marital deduction should not equal the value of the underlying assets of X attributable to A’s transfer, but that the marital deduction should be limited to the discounted value of the asset actually owned by A at his death, a limited partnership interest in X.

Following the conclusion of the audit, the executor of A’s estate reports the basis of the interest in X passing to A’s surviving spouse on Form 8971, taking into account the increased value determined by the IRS under § 2036(a). Five years later, A’s surviving spouse disposes of her interest in X and pays Federal income tax based on appreciation in excess of the basis reported on Form 8971. On audit, the IRS contends that the basis of A’s surviving spouse in X is not equal to the value included in A’s estate, but rather the discounted value eligible for the estate tax marital deduction.

This example describes a situation in which the application of the Proposed Regulations produces a result that directly contradicts the stated purpose of § 1014(f). Because § 1014(f) provides that the basis of an interest received from a decedent “shall not exceed” its estate tax value, assets received from a decedent are subject to a double standard in which taxpayers are forbidden from seeking favorable results while the IRS would be permitted to take inconsistent positions for basis and inclusion purposes. Were the IRS to prevail in its arguments, the value of the X interest included in A’s estate would exceed the stepped-up basis of the interest in the hands of A’s surviving spouse.

We recommend that the Proposed Regulations be revised to provide that an interest in an entity valued under § 2704(b) shall equal, and shall in no event exceed, the value of the stepped-up basis allowed under § 1014(a). More broadly, we recommend that Treasury engage in a close analysis of the Proposed Regulations in light of their potential to generate mismatch scenarios when considered in conjunction with other valuation rules in the Code. The existing rules impose significant uncertainty for taxpayers in the basis context, among others, despite the fact that the stated purpose of § 1014(f) is to unify valuation concepts for income and estate tax purposes.

CONCLUSION

We appreciate your consideration of our Comments in response to REG-163113-02 and would be pleased to answer any questions.