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Valuation Vendetta: 2704 Regs Seek to Dump Discounts

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By

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Valuation Vendetta: 2704 Regs Seek to Dump Discounts

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A. Background

1. IRC § 2704(a): Treatment of Lapsed Voting or Liquidation Rights

a. <u>General Rule</u>. Generally, IRC § 2704(a) provides that, if there is a lapse of any voting or liquidation right in a corporation or partnership, and the corporation or partnership is family-controlled immediately before and after the lapse, then such lapse shall be treated as a gift, in the event of a lifetime lapse, or as a transfer includible in a decedent's gross estate, in the event that the lapse occurs at death. Treas. Reg. § 25.2704-1(a)(1); *see, e.g.*, *Estate of Rankin M. Smith, Sr. v. United States*, 109 A.F.T.R. 2d 2012-987 (Ct. Fed. Cl. 2012). The amount of the transfer is the excess of the value of the transferred interest before the lapse over the value of the interest after the lapse. IRC § 2704(a)(2); Treas. Reg. § 25.2704-1(d). Note that this subsection may apply to the sale of an interest in addition to a gift.

A lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. Treas. Reg. § 25.2704-1(c)(1). A lapse of a voting right occurs at the time a presently exercisable voting right is restricted or eliminated. Treas. Reg. § 25.2704-1(b).

This Section is sometimes referred to as the "anti-*Harrison*" rule. *See Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8. The perceived abuse that Congress was attempting to prevent with IRC § 2704(a) may be illustrated as follows: Parent owns shares of stock in a corporation. Pursuant to a stockholders' agreement, Parent has the right to withdraw from the corporation and receive back his investment at any time during his life, but this withdrawal right ceases to exist immediately upon Parent's death. Under his will, Parent's stock passes to Child. Parent dies and his estate takes the position for federal estate tax purposes that Parent's stock should be valued as if the withdrawal right, which lapsed at death, did not exist at his death, and, therefore, his stock should be entitled to a valuation discount, despite the fact that he had a withdrawal right until his death. IRC § 2704(a) attempts to thwart this type of arrangement by providing that certain lapses of either liquidation rights or voting rights will be deemed transfers subject to gift, GST or estate tax.

b. <u>Voting Rights and Liquidation Rights</u>. For purposes of IRC § 2704(a), a "voting right" means a right to vote with respect to any matter of the entity. In the case of a partnership, the right of a general partner to participate in partnership management is a voting right. Treas. Reg. § 25.2704-1(a)(2)(iv).

For purposes of IRC § 2704(a), a "liquidation right" means a right or ability to compel the entity to acquire all or a portion of the interest holder's equity interest in the entity, including

by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity. Treas. Reg. § 25.2704-1(a)(2)(v).

A voting right or liquidation right may be conferred by and may lapse by reason of state law, corporate charter or bylaws, an agreement or other means. Treas. Reg. § 25.2704-1(a)(4).

> **EXAMPLE:** Prior to D's death, D owned all the preferred stock of Corporation Y, and D's children owned all the common stock. At that time, the preferred stock had 60 percent of the total voting power and the common stock had 40 percent. Under the corporate by-laws, the voting rights of the preferred stock terminated on D's death. The value of D's interest immediately prior to D's death (determined as if the voting rights were non-lapsing) was $100X. The value of that interest immediately after death would have been $90X if the voting rights had been non-lapsing. The decrease in value reflects the loss in value resulting from the death of D (whose involvement in Y was a key factor in Y's profitability). IRC § 2704(a) applies to the lapse of voting rights on D's death. D's gross estate includes an amount equal to the excess, if any, of $90X over the fair market value of the preferred stock determined after the lapse of the voting rights. Treas. Reg. § 25.2704-1(f), Ex. 1.

2. IRC § 2704(b): Certain Restrictions on Liquidation Disregarded

a. General Rule. IRC § 2704(b) effectively disregards certain restrictions associated with business interests that would otherwise reduce the value of such a business interest for estate or gift tax purposes.

IRC § 2704(b) and the regulations thereunder provide that if:

1. There is a transfer (whether gift or sale) of an interest in a corporation or partnership (including a limited liability company ("LLC")) to (or for the benefit of) a member of the transferor's family;
2. The transferor and members of the transferor's family hold, immediately before the transfer, control of the entity; and
3. After the transfer, either (i) an "applicable restriction" lapses, in whole or in part, or (ii) the transferor or any member of the transferor's family, either alone or collectively, has the right to remove, in whole or in part, an "applicable restriction,"

then the "applicable restriction" is to be disregarded in determining the value of the transferred interest.

Generally, an "applicable restriction" is any restriction that: (i) effectively limits the ability of the corporation or partnership to liquidate; (ii) is more restrictive than the limitations

that would generally apply under state law in the absence of the restrictions in the governing instrument; and (iii) either the restriction by its terms will lapse at any time after the transfer, or the transferor (or the transferor's estate) and any members of the transferor's family can remove the restriction immediately after the transfer. Treas. Reg. § 25.2704-2(b). The proposed regulations, discussed below, would modify this definition.

> **EXAMPLE:** Family creates a family limited partnership ("FLP"). The limited partnership agreement provides that there must be unanimous consent of all of the partners to liquidate the FLP, while state law, on the other hand, requires only that partners owning at least 75% of the partnership interests consent to a liquidation. Because the agreement's restriction on liquidation is more restrictive than under state law, the liquidation restriction may be an "applicable restriction" under IRC § 2704(b).

The rationale for the rule is that such restrictions on liquidation are essentially illusory because they will either disappear or can be removed by the family members right after the transfer.

"Control" is defined in IRC § 2701(b)(2) and Treas. Reg. § 25.2701-2(b)(5), and, in general, requires majority ownership of the subject entity. The definition of control is amended by the proposed regulations, discussed below. In determining the interests held by any individual under IRC § 2704, such individual shall be treated as holding any interest to the extent such interest is held indirectly by such individual through a corporation, partnership, trust or other entity. IRC § 2704(c)(3). Members of a family are determined under IRC § 2704(c)(2) and Treas. Reg. § 25.2702-2(a)(1).

An applicable restriction does not include commercially reasonable restrictions on liquidation imposed by certain unrelated persons providing capital to the entity for the entity's trade or business operations. Treas. Reg. § 25.2704-2(b). Only a restriction on the ability to liquidate the entire entity may be an applicable restriction; a restriction on the ability to liquidate an individual interest is not an applicable restriction. *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*, 292 F.3rd 490 (5th Cir. 2002).

If an applicable restriction is disregarded under IRC § 2704(b), the transferred interest is valued as if the restriction did not exist and as if the rights of the transferor were determined under state law that would apply but for the restriction. Treas. Reg. § 25.2704-2(c). This provision, also, would be modified by the proposed regulations, discussed below.

3. Priority Guidance Plans and the Greenbook Proposals

In the 2003-2004 Priority Guidance Plan, the Internal Revenue Service ("IRS") listed a regulatory project under IRC § 2704. Reference to the project appeared in the Priority Guidance Plan for each year thereafter through the 2015-2016 plan year. Also, in the General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals (the "Greenbook"), released in May

2009, the Obama Administration included a proposal to amend IRC § 2704 to establish a new category of restrictions called "disregarded restrictions," the general description of which in the Greenbook is similar to the "disregarded restrictions" concept that appears in the proposed regulations, discussed below. The proposal appeared in each subsequent Greenbook through the Fiscal Year 2013 Greenbook released in February 2012, after which it was removed. The proposal was never included in any bill introduced in Congress.

B. Proposed Regulations, REG-163113-02 (August 4, 2016)

1. Introduction and Definitions

a. Promulgation. On Tuesday, August 2, 2016, the IRS made public a compilation of proposed regulations under IRC § 2704 (the "proposed regulations"). The proposed regulations were published in the Federal Register on Thursday, August 4, 2016. The proposed regulations are, in part proposed revisions of the original set of regulations under IRC § 2704 that were finalized on January 28, 1992 and are, in part, proposed new regulations.

b. Explicit Regulatory Authority. IRC § 2704(b)(4) provides that 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 interest to the transferee."

In the preamble to the proposed regulations, the IRS stated that these "other restrictions" include: (1) a restriction on the ability to liquidate a transferred interest; and (2) any restriction on the nature or extent of the property to be received in exchange for the liquidated interest or the timing of the payment of that property.

The IRS, in the preamble to the proposed regulations, explained that changes in state laws and other developments since the issuance of the current regulations under IRC § 2704 have rendered the current regulations "substantially ineffective."

c. Applicability. A threshold issue regarding the application of IRC § 2704 is whether the statute and regulations apply to the subject entity. The IRS stated that the regulations should be updated to reflect the fact that an entity's classification for federal tax purposes may be unrelated to the entity's structure under state law. Thus, the proposed regulations state that IRC § 2704 applies to corporations, partnerships, LLCs and other "business entities" under Treas. Reg. § 301.7701-2(a)&(b), regardless of: (1) whether the entity is domestic or foreign; (2) how it is classified for other federal tax purposes; and (3) whether the entity is a disregarded entity for federal tax purposes. Prop. Reg. §§ 25.2701-2(b)(5)(i); 25.2704-2(a); 25.2704-3(a).

d. **Source of Right or Lapse**. A voting right or a liquidation right may be conferred by, or lapse by reason of, state law, the governing documents, an agreement or otherwise. Prop. Reg. §§ 25.2704-1(a)(4), -2(b)(2), -3(b)(2).

e. **Ability to Liquidate**. Prop. Reg. § 25.2704-1(c)(2)(i)(B) would provide that whether an interest can be liquidated immediately after the lapse of a liquidation right is determined under applicable local law, as modified by the governing instruments of the entity, but without regard to any restriction (in the governing documents, applicable local law or otherwise) described in IRC § 2704(b) and the regulations thereunder. A family's ability to liquidate an interest would be determined without regard to the manner in which the liquidation may be achieved. Prop. Reg. §§ 25.2704-1(c)(2)(i)(B), -2(b)(3), -3(b)(3).

f. **Control**. Another threshold issue for the application of IRC § 2704(a) and (b) is the definition of "control," defined in IRC § 2701(b)(2) and Treas. Reg. § 25.2701-2(b)(5). The proposed regulations would add that an owner has control of an LLC or other entity that is not a partnership, corporation or limited partnership when holding at least 50% of either the capital or profits interests of the entity or any equity interest with the ability to cause a full or partial liquidation of the entity. For purposes of determining control, the form of an entity that is not a corporation would be determined under state law. Prop. Reg. § 25.2701-2(b)(5)(i). The definition of a "voting right" for purposes of IRC § 2704(a) also would be modified to state that, in the case of an LLC, the right of a member to participate in company management is a voting right. Prop. Reg. § 25.2704-1(a)(2)(iii). The proposed regulations regarding disregarded restrictions, discussed below, contain two examples that illustrate the definition of control. Prop. Reg. § 25.2704-3(g), Ex. 8-9.

For purposes of determining whether the group consisting of the interest holder, the interest holder's estate and members of the interest holder's family control the entity, a member of a group would also be treated as holding any interest held indirectly by such member through a corporation, trust or other entity pursuant to Treas. Reg. 25.2701-6. Prop. Reg. § 25.2704-1(a)(2)(i). This proposed rule would replace Treas. Reg. § 25.2704-1(a)(2)(iii), which states that an interest is directly or indirectly held only to the extent the value of the interest would have been includible in the gross estate of the individual if the individual had died immediately prior to the lapse (of a voting right or liquidation right).

2. Disregarded Restrictions

a. **In General**. A new category of restrictions, labeled "disregarded restrictions," would deal with restrictions on the liquidation or redemption of an individual interest in an entity, rather than a restriction on the liquidation of the entire entity.

The proposed regulations would move Treas. Reg. § 25.2704-3 (regarding the effective dates for the current regulations) to Prop. Reg. § 25.2704-4 and designate the new regulations concerning disregarded restrictions as Prop. Reg. § 25.2704-3.

A disregarded restriction would arise whenever: (i) there is a transfer of an interest in an entity to or for the benefit of a member of the transferor's family; and (ii) the transferor and/or members of the transferor's family control the entity immediately before the transfer. In such a case, any restrictions on an owner's right to liquidate the owner's interest in the entity will be disregarded if the restriction will lapse at any time after the transfer, or the transferor, the transferor's estate and/or the transferor's family members may remove the restriction. In determining whether the transferor and family members may remove the restriction, certain interests held by non-family members will not be considered, as more fully described below. Prop. Reg. § 25.2704-3(a)&(b).

b. **Definition**. A "disregarded restriction" is a restriction on an owner's right to liquidate or redeem the owner's interest in an entity that: (1) limits the ability of the interest holder to compel liquidation or redemption of the interest; (2) limits the liquidation or redemption proceeds to an amount that is less than a minimum value; (3) defers or permits deferral of the payment of the liquidation or redemption proceeds for more than six months; ***or*** (4) permits the payment of any portion of the liquidation or redemption proceeds in any manner other than in cash or other property. A note or other obligation issued by the entity or related parties would be considered "property" only: (1) if the entity is an active trade or business with at least 60% of its value consisting of the non-passive assets of that trade or business; (2) to the extent the liquidation proceeds are not attributable to passive assets within the meaning of IRC § 6166(b)(9)(B); and (3) if the note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates (not the applicable federal rate under IRC § 7872(f)(2)) and has a contemporaneous fair market value equal to the liquidation proceeds. Prop. Reg. § 25.2704-3(b).

The proposed regulations would define "minimum value" as the subject interest's share of the net value of the entity on the date of liquidation or redemption. Prop. Reg. § 25.2704-3(b)(1)(ii). "Net value" is fair market value reduced by the outstanding obligations of the entity. The only outstanding obligations of the entity that may be considered in determining "minimum value," however, are those that would be allowable (if paid) as deductions under IRC § 2053 if those obligations were instead claims against an estate. The IRS issued final regulations in 2009 (T.D. 9468) that generally limit deductions under IRC § 2053 to amounts actually paid by the estate in satisfaction of deductible claims, with a protective claim regime for uncertain or contingent claims. How does the "if paid" parenthetical in the proposed regulations play into the deductibility of certain contingent obligations? Similarly, how does the provision in Treas. Reg. § 20.2053-4(c)(1) apply for certain unpaid claims totaling not more than $500,000? What if the obligation is similar to the loan approved in *Estate of Graegin v. Commissioner*, T.C. Memo 1988-477? Does that mean there could be a reduction in value equal to all of the unpaid interest for the life of the loan? The IRS Priority Guidance Plan contains a project regarding the issuance of "time value of money" regulations for IRC § 2053 deductions that are expected to limit the benefits of *Graegin* loans.

The proposed regulations would mandate that any amount payable upon liquidation or redemption of an interest that is less than the minimum value shall be ignored for purposes of

determining transfer tax value. However, note that the minimum value may be in direct conflict with the actual amount that would be payable based on the legal rights of the interest holder under state law and the governing document.

The “interest’s share” is determined by taking into account any capital, profits and other rights inherent in the interest. 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 IRC § 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 IRC § 2704(b) and the regulations thereunder. Prop. Reg. § 25.2704-3(b)(ii).

Similar exceptions that would apply to applicable restrictions (Prop. Reg. § 25.2704-2(b)(4)), including the exception for restrictions that are imposed by federal or state law discussed below, also apply to disregarded restrictions. Prop. Reg. § 25.2704-3(b)(5).

A disregarded restriction would include a restriction imposed: (1) by the governing documents of the entity; or (2) under state law, regardless of whether that restriction may be superseded by the governing documents. Prop. Reg. § 25.2704-3(b)(2). As explained below, however, a restriction imposed or required to be imposed by federal or state law would not be a disregarded restriction. Prop. Reg. § 25.2704-3(b)(5)(iii).

For purposes of determining whether the ability to remove the subject restriction is held indirectly by any one or more of the transferor, the transferor’s estate or the transferor’s family, the attribution rules under Treas. Reg. § 25.2701-6 would apply, except to the extent the interest is held by a non-family member and is disregarded under Prop. Reg. § 25.2704-3(b)(4), discussed below. Prop. Reg. § 25.2704-3(b)(3).

The proposed regulations would include examples illustrating these new provisions on disregarded restrictions. Prop. Reg. § 25.2704-3(g).

Many practitioners expected rules similar to those set forth in the proposed regulations to apply to “investment companies” – that is, to family limited partnerships or similar entities funded primarily with marketable securities – but not to businesses with active operations. Whether intentional or not, however, there is no general exception to the applicability of the proposed regulations for active trade or businesses/operating businesses.

The proposed regulations provide that, if a decedent’s interest in an entity passes in part to one or more members of the decedent’s family and in part to one or more non-family members of the decedent, and if the part passing to the members of the decedent’s family is to be valued with restrictions being disregarded, then that part is treated as a single, separate property interest. The part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest. Prop. Reg. §§ 25.2704-2(f); -3(e).

c. Effect of Nominal Non-Family Held Interests. One of the reasons for the IRS' belief that the current regulations have been rendered "substantially ineffective" is because taxpayers have avoided its application by simply transferring a nominal interest to a non-family member such as a charity to ensure that the family does not have the unilateral power to remove a restriction under IRC § 2704. *See Kerr v. Commissioner*, 292 F.3d 490 (5th Cir. 2002). The IRS stated in the preamble to the proposed regulations that this type of interest should not allow taxpayers to avoid IRC § 2704(b) because "in reality, such nonfamily member interest generally does not constrain the family's ability to remove a restriction on the liquidation of an individual's interest."

Under Prop. Reg. § 25.2704-3(b)(4), a non-family member's interest would be recognized only where the interest is "economically substantial and longstanding." Specifically, a non-family member interest would be disregarded if the interest: (1) has been held less than three years before the date of transfer; (2) constitutes less than ten percent of the value of all of the equity interests; (3) when combined with all other non-family member interests constitutes less than twenty percent of the value of all of the equity interest; ***or*** (4) has no ability to put the interest to the entity or to other interest holders and receive a minimum value in cash and/or other property, as discussed above, with no more than six months prior notice, as detailed in Prop. Reg. § 25.2704-3(b)(6).

For the ten percent and twenty percent tests, when the property held by the corporation or other business entity is, in whole or in part, an interest in another entity, an individual, the individual's estate and members of the individual's family, as well as any other person, also are treated as holding any interest held indirectly by such person through a corporation, partnership, trust or other entity under Treas. Reg. § 25.2701-6. Prop. Reg. § 25.2704-3(b)(4)(iii), -3(d).

Prop. Reg. § 25.2704-1(c)(2)(i)(B) would modify the current regulations to conform with the above rule regarding non-family member interests in testing the ability to liquidate an interest after a lapse when the transferor held such interest directly or indirectly and could have liquidated the interest before the lapse (since IRC § 2704(a) does not apply if the transferor (or the transferor's estate) and the transferor's family cannot immediately after the lapse liquidate such interest (Treas. Reg. § 25.2704-1(c)(2)(i)(A)).

If the interest of the non-family member is disregarded, the determination of whether the family has the unilateral ability to remove the restriction will be made assuming that the family's interests are the sole interests in the entity. Prop. Reg. § 25.2704-3(b)(4)(ii).

3. Restrictions Imposed by any Federal or State Law

a. Proposed Amendments. As discussed above, IRC § 2704(b)(3)(B) provides that a restriction is not an applicable restriction if it is "imposed, or required to be imposed, by any Federal or state law." Treas. Reg. § 25.2704-2(b) further provides that an applicable restriction is "a limitation on the ability to liquidate the entity (in whole or in part) that

is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."

Before the promulgation of the current regulations under IRC § 2704, many state laws provided that a limited partner in a limited partnership had the ability to liquidate the partner's interest without consent of the other partners, unless otherwise provided in the partnership agreement. After the promulgation of the current regulations, many states modified their partnership laws to prevent a limited partner from liquidating the limited partner's interest unless the partnership agreement provides otherwise. The practical effect of these modifications has been that a restriction on a limited partner's ability to liquidate the limited partner's interest under a typical partnership agreement (providing, for example, that liquidation of a limited partner's interest shall occur only after consent of all partners) would not be considered an applicable restriction since the restriction on the ability to liquidate in the partnership agreement would not be more restrictive than that provided under default state law. *See* Treas. Reg. § 25.2704-2(b).

The proposed regulations include in both the section regarding applicable restrictions and the section regarding disregarded restrictions an exception for restrictions imposed by federal or state law. Prop. Reg. §§ 25.2704-2(b)(4)(ii); 25.2704-3(b)(5)(iii). A restriction would be considered required to be imposed by federal or state law under IRC § 2704(b)(3)(B) if the restriction could not be removed or overridden and is mandated by the federal or state law, is required to be included in the governing documents or otherwise is made mandatory.

A law that applies only to a narrow class of entities, such as those entities that would be subject to IRC § 2704, would not be a restriction that is imposed by federal or state law. In addition, a restriction would not be considered imposed by federal or state law if that law also provides an optional provision that does not include the restriction or that allows it to be removed or overridden or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction. The terms "federal" and "state" refer only to the United States, any state or the District of Columbia.

To determine the type of entity, only the three types of entities described in Prop. Reg. § 25.2701-2(b)(5) would be recognized: corporations, partnerships (including limited partnerships) and other business entities.

To determine whether an equity interest is subject to an applicable restriction, an individual, the individual's estate and members of the individual's family would be treated as also holding any interest held indirectly by such person through a corporation, partnership, trust or other entity pursuant to Treas. Reg. § 25.2701-6. Prop. Reg. §§ 25.2704-2(d). The manner in which the restriction may be removed would be irrelevant. Prop. Reg. § 25.2704-2(b)(3).

Since most state laws on the capital structure of partnerships and corporations and the legal relationship among the owners are default, rather than mandatory, rules, almost any

restriction in a business' governing documents will be an applicable restriction or a disregarded restriction under the proposed regulations and would not generate valuation discounts.

b. **Assignee Interests**. Taxpayers have claimed valuation discounts by designating a transferee's interest as a mere assignee interest, which allows the transferee to receive distributions from the partnership but does not grant voting rights. Taxpayers have claimed that the restrictions on an assignee's interest are not applicable restrictions, again relying on the exception for restrictions that are no more restrictive than restrictions provided under state law. *See Estate of Jones v. Commissioner*, 116 T.C. 121 (2001).

Prop. Reg. § 25.2704-1(a)(5) states that a transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while in the hands of the transferor is a lapse. This provision, then, would effectively eliminate valuation discounts resulting from assignee interests by providing that the transfer of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights of a partner is a lapse. In addition, due the changes described above regarding restrictions imposed by state law, the restrictions associated with an assignee interest would be applicable restrictions.

4. Put Rights

The proposed regulations would also provide that any restriction that would otherwise be considered an applicable restriction or a disregarded restriction will not be treated as such if each holder of an interest in the entity has a put right. Prop. Reg. §§ 25.2704-2(b)(4)(iv); 25.2704-3(b)(5)(v). A put right would be defined as a right to receive from the entity or from one or more other interest holders cash and/or other property with a value that is at least equal to the minimum value of the interest. The portion of the proposed regulations defining put rights would define "other property" in a manner similar to the way in which that term is defined in the portion of the proposed regulations defining disregarded restrictions, discussed above. "Minimum value," for put right definition purposes, cross references the "minimum value" definition in the portion of the proposed regulations defining disregarded restrictions. Prop. Reg. § 25.2704-3(b)(6).

If a prospective donor is contemplating transferring an equity interest to an individual or entity that is considered a non-family member, then consideration should be given to whether a put right should accompany the transfer. The put right would affect the value of the transfer and any associated charitable deduction for both income and transfer tax purposes, and the individual or charity may actually exercise the right.

If the proposed regulations become final, consideration should be given to incorporating a put right that could be exercisable by all equity interest holders. Any restriction on the interest would not be considered an applicable restriction or a disregarded restriction, meaning normal transfer tax valuation rules would apply. That value could be less than minimum value, thereby

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providing a valuation discount that would not exist if IRC § 2704(b) were to apply to the transfer.

5. The Three-Year Rule Under IRC § 2704(a)

A lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. After a transferor's interest, which includes a right to liquidate the transferor's interest, is transferred, even if the transferor no longer has the ability to exercise the liquidation right after the transfer, the liquidation right will not be considered to have lapsed for purposes of IRC § 2704 if the liquidation right itself has not been restricted or eliminated. Treas. Reg. § 25.2704-1(c)(1).

For example, D owns 84% of the single outstanding class of stock of Corporation Y. The by-laws require at least 70% of the vote to liquidate Y. D gives one-half of D's stock in equal shares to D's three children (14% to each). IRC § 2704(a) does not apply to the loss of D's ability to liquidate Y, because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer, even though D no longer has the ability to unilaterally liquidate Y. The liquidation right did not lapse; it was just split up among other interest holders. Treas. Reg. § 25.2704-1(f), Ex. 4.

The proposed regulations would change this result in certain circumstances. For transfers that occur near the transferor's death, the preamble states that "transfers [resulting in the lapse of a power to liquidate] generally have minimal economic effects, but result in a transfer tax value that is less than the value of the interest either in the hands of the decedent prior to death or in the hands of the decedent's family immediately after death." Prop. Reg. § 25.2704-1(c)(1) provides that the rule under the current regulations discussed above will apply only when the transfer occurs more than three years before the transferor's death.[1] A transfer that results in the lapse of a liquidation right and that occurs within three years of the transferor's death is deemed to occur at the transferor's death for purposes of IRC § 2704(a). The proposed regulations would update Example 4 to specify that the transfer was made more than three years before the transferor's death. A similar modification would be made to Treas. Reg. § 25.2704-1(f), Ex. 7.

If a lapse occurs within three years of death and an amount is deemed to be includible in the gross estate of the decedent, it is unclear as of what date the change in value is to be determined. The available alternatives seem to be date of transfer or date of death. Further, if an *inter vivos* transfer falls under IRC § 2704(b) but is also caught under the three-year provision of Prop. Reg. § 25.2704-1(c)(1), there is no mechanism to offset a "double counting" of a deemed increase in value for both gift and estate tax purposes. This seems to be an oversight in the proposed regulations. Transfers that fall under IRC § 2701 do have a mechanism to offset the increased gift tax value for estate tax purposes. *See* Treas. Reg. § 25.2701-5.

[1] Prop. Reg. § 25.2704-1(c)(1) would stand in direct opposition to Rev. Rul. 93-12, 1993-1 C.B. 202.

As with any situation in which IRC § 2704 applies to a restriction to which a decedent is subject at date of death, an additional, unexpected value for the subject business interest will be included in the gross estate, *i.e.*, in essence, a "phantom asset" that will not qualify for the marital or charitable deduction. The application of the three-year rule, since it deals with business interests that the decedent transferred before death, would seem to exacerbate this problem. Once this "phantom asset" is included in the gross estate, beneficiaries may object to the apportionment of the additional estate or generation-skipping transfer tax that arises from its inclusion. Of course, if the decedent's gross estate will not be subject to estate taxes, the inclusion of additional value in the estate should lead to an additional step-up in basis for the business interest. Belcher, Aucutt, "The Proposed Section 2704 Regulations: Is the Window Closing on Discounts in the Family Controlled Entity?" Webinar, August 11, 2016.

6. Coordination with Marital and Charitable Deductions

One of the difficulties presented with any provision of the Internal Revenue Code that mandates valuation of assets for transfer tax purposes in a manner different from that in which valuation of such assets would normally be determined under state law is to discern the value of such assets for marital and charitable deduction purposes. The preamble to the proposed regulations explains that, when any transfer of an interest that qualifies for the gift or estate tax marital deduction must be valued according to IRC § 2704(b), that value will apply in computing the marital deduction attributable to the interest.

The preamble further provides that IRC § 2704(b) does not apply to transfers to non-family members and has no application in valuing an interest passing to charity or to a non-family member. As mentioned above, the proposed regulations provide that any part of an interest passing to non-family members would be treated as a separate property interest. The fair market value of the part passing to the non-family members would be determined without the special valuation assumptions of IRC § 2704(b). Thus, if the sole non-family member receiving an interest were a charity, the interest generally would have the same value for both estate tax inclusion and charitable deduction purposes.

7. Public Hearing

Written comments to the IRS on the proposed regulations are due by November 2, 2016. A public hearing on the proposed regulations is scheduled for December 1, 2016. Presumably, after the hearing the IRS will begin analyzing potential changes to the proposed regulations and preparing the Treasury Decision that will finalize the regulations.

8. Effective Dates

The amendments to Treas. Reg. § 25.2701-2(b)(5) (regarding the definition of control and the entities subject to IRC § 2704) would be effective upon publication of the final regulations. The amendments to Treas. Reg. § 25.2704-1 (regarding the lapse of voting or liquidation rights) would apply to lapses of rights created after October 8, 1990 (the effective

date of Chapter 14 of the Internal Revenue Code), occurring on or after the publication of final regulations. The amendments to Treas. Reg. § 25.2704-2 (regarding applicable restrictions) would apply to transfers of property subject to restrictions created after October 8, 1990, occurring on or after the publication of the final regulations. Prop. Reg. § 25.2704-3, the new section on disregarded restrictions, would apply to transfers of property subject to restrictions created after October 8, 1990 occurring thirty or more days after the publication of final regulations.

9. Possible Court Challenges

If the proposed regulations are finalized in their current form, many observers expect them to be challenged in court, possibly in short order. Much of the discussion about possible court challenges has centered on whether the proposed regulations exceed the scope of the enabling legislation of IRC § 2704(b)(4), which provides that:

> "[t]he 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 interest to the transferee* [emphasis added]."

For example, several commentators have pointed out that the proposed regulations would require disregarding restrictions that do, in fact, reduce the value of transferred interests in the hands of transferee and that the regulations are therefore not authorized by IRC § 2704(b)(4). Commentators also have questioned whether the regulations really address "other" restrictions within the meaning of IRC § 2704(b).

However, in analyzing whether the regulations would survive challenge, it is important to keep in mind that the IRS has purported to issue the proposed regulations not only under IRC § 2704(b)(4) (as to Prop. Reg. §§ 25-2704-2 and 25.2704-3) but also IRC § 2704(a)(2) (as to Prop. Reg. § 25.2704-1) and IRC § 2701(e) (as to Prop. Reg. § 25.2701-2). Even more importantly, the IRS has purported to issue all of the proposed regulations under the general rulemaking authority conferred by IRC § 7805(a), which provides that "…the Secretary shall prescribe all needful rules and regulations for the enforcement of this title…."

In that regard, it is noteworthy that relatively recently the Supreme Court has clarified that Treasury regulations issued pursuant to the general rulemaking authority of IRC § 7805(a) must be granted significant deference. Specifically, in *Mayo Found. For Med. Educ. & Research v. United States*, 562 U.S. 44 (2011), the Supreme Court found that, where the IRS has issued regulations pursuant to IRC § 7805, the applicable standard for reviewing such regulations is the one articulated in *Chevron, U.S.A., Inc. v. National Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (as opposed to the less deferential standard articulated in *National Muffler Dealers Assn, Inc. v. United States,* 440 U.S. 472 (1979)).

Under the *Chevron* standard, a court must apply a two-part test to a challenged regulation. First, the court must ask "whether Congress has 'directly addressed the precise question at issue" (internal quote omitted). If so, "that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." In applying this first prong of the test, the court may examine the legislative history of the relevant statute. If, however, the court finds that Congress has not directly addressed the precise question at issue, then the court proceeds to the second part of the test, which is "whether the agency's answer is based on a *permissible construction* of the statute [emphasis added]." In elaboration of this second part of the test, *Chevron* holds that the regulations in question "are given controlling weight unless they are *arbitrary, capricious, or manifestly contrary to the statute* [emphasis added]."

It is interesting to note that the timing of *Mayo*, which was issued in January 2011, coincides closely with the disappearance of the Greenbook proposal for revisions to IRC § 2704 (to which several features of the proposed regulations bear a striking resemblance).

In any event, the judicial fate of the regulations appears to be very much an open question. Even under the high-deference *Chevron* standard, it is possible that the regulations could be found to be invalid at either step of the *Chevron* test. First, it is possible that a court could find that the regulations fail step one of the *Chevron* test because they are contrary to the legislative intent of IRC § 2704; the Conference Report associated with the enactment of IRC § 2704 states that the IRC § 2704 rules "do not affect minority discounts or other discounts available under present law." Second, even if the regulations are found to be consistent with legislative intent, it is possible that they fail even the "permissible construction"/"arbitrary and capricious" prong of the *Chevron* test, perhaps, for example, on the grounds that in many cases the "disregarded" restrictions do actually represent the genuine loss of property rights and have an impact on actual, provable fair market value. Ultimately, the right question for courts to ask may be whether the IRS, in chasing down what it deems to be an abusive "phantom discount," has also imposed a disproportionate transfer tax penalty on transactions where the discount reflects reality.

APPENDIX

The proposed regulations contain several examples which are useful as illustrations of what the IRS is thinking in this new regime. New examples under Treas. Reg. § 25.2704-1 are:

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

Example 7. D owns all 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. The transfer is not a lapse of a liquidation right with respect to the retained preferred stock because the preferred stock is not subordinate to the transferred common stock. 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.

Examples under Treas. Reg. § 25.2704-3 are:

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

(ii) By prohibiting the withdrawal of a limited partner, the partnership agreement imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor's family, acting collectively, by agreeing to amend the partnership agreement. Therefore, under section 2704(b) and paragraph (a) of this section, the restriction on a limited

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partner's ability to liquidate that partner's interest is disregarded in determining the value of each transferred interest. Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest determined under generally applicable valuation principles taking into account all relevant factors affecting value including the rights determined under the governing documents and local law and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. See paragraphs (b)(1)(i) and (f) of this section.

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

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

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

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

percent interest are subject to the same discount factor, the charitable deduction will equal four-ninths of the value of the 45 percent interest.

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

(ii) Under section 2704(b) and paragraph (a) of this section, the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of the transferred interests. Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest, determined under generally applicable valuation principles taking into account all relevant factors affecting value, including the rights determined under the governing documents and local law, and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. See paragraph (f) of this section.

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

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

of the value of the 32 percent limited partner interest as determined in Example 5 over the consideration received by D from the partnership.

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

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

Example 10. D owns a 1 percent general partner interest and a 74 percent limited partner interest in Limited Partnership X, which in turn holds a 50 percent limited partner interest in Limited Partnership Y and a 50 percent limited partner interest in Limited Partnership Z. D owns the remaining interests in partnerships Y and Z. A, an unrelated individual, has owned a 25 percent limited partner interest in partnership X for more than 3 years. The governing documents of all three partnerships permit liquidation of the entity on the agreement of the owners of 90 percent of the interests but, with the exception of A's interest, prohibit the withdrawal of a limited partner. A may withdraw on 6-months' notice and receive A's interest's share of the minimum value of partnership X as defined in paragraph (b)(1)(ii) of this section, which share includes a share of the minimum value of partnership Y and of partnership Z. Under the governing documents of all three partnerships, the approval of all partners is required to amend the documents. D transfers a 40 percent limited partner interest in partnership Y to D's children. For purposes of determining whether D and/or D's family members have the ability to remove a restriction after the transfer, A is treated as owning a 12.5 percent (.25 x.50) interest in partnership Y, thus more than a 10 percent interest, but less than a 20 percent interest, in partnership Y. Accordingly, under paragraph (b)(4)(i)(C) of this section, A's interest is disregarded for purposes of determining whether D and D's family hold the right to remove a restriction after the transfer (resulting in D and D's children being deemed to own 100 percent of Y for this purpose). However, if D instead had transferred a 40 percent limited partner interest in partnership X to D's children, A's ownership of a 25 percent interest in partnership X would not

have been disregarded, with the result that D and D's family would not have had the ability to remove a restriction after the transfer.

Example 11. (i) D owns 85 of the outstanding shares of X, a corporation, and A, an unrelated individual, owns the remaining 15 shares. Under X's governing documents, the approval of the shareholders holding 75 percent of the outstanding stock is required to liquidate X. With the exception of nonfamily members, a shareholder may not withdraw from X. Nonfamily members may withdraw on six months' notice and receive their interest's share of the minimum value of X as defined in paragraph (b)(1)(ii) of this section. D transfers 10 shares to C, a charity. Four years later, D dies. D bequeaths 10 shares to B, an unrelated individual, and the remaining 65 shares to trusts for the benefit of D's family.

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

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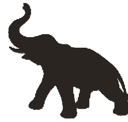

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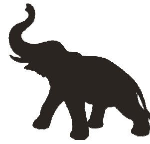

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