Don't Discount Discounts: Valuation of Closely Held Businesses in a Changing Regulatory Environment

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Don’t Discount Discounts:
Valuation of Closely Held Businesses in a Changing Regulatory Environment

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1) Introduction to Valuation Discounts

a) Valuation plays a key role in planning lifetime transfers. The first steps in planning lifetime transfers are to determine which property will be subject to the transfer tax and to determine the value of the property. Property transferred by gift must be valued to determine whether a taxable gift has been made. For gift tax purposes, the value of the property transferred is its fair market value. Cash and marketable securities are easily valued, although if an individual owns a large block of marketable securities, discounts may be available based on restrictions imposed by the securities laws. With closely held business interests and real property, valuation is more difficult and requires special consideration.

b) Determining the fair market value of interests in a family’ business is one of the more difficult and complex issues confronting the owner when planning to transfer the business. For estate and gift tax purposes, the fair market value of property, including an interest in a family business, is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts. Treas. Reg. section 20.2031-1(b).

c) Revenue Ruling 59-60, 1959-1 C.B. 237, sets forth the specific factors to be considered in valuing an interest in a family business for transfer tax purposes. These factors include:

i) The nature of the business and history of the enterprise;

ii) The economic outlook in general and the economic outlook of the specific industry;

iii) The book value of the stock and the financial condition of the business;

iv) The earning capacity of the business;

v) The dividend capacity of the business;

vi) The good will and other intangible value of the business;

vii) The size of the block of stock to be valued; and

viii) The value of companies engaged in similar businesses whose stock is publicly traded.

d) The valuation of interests in family businesses is further complicated by the application of various discounts available to reduce the value of such interests under certain circumstances. These discounts may be available if:
i) There is no market for the sale of the business interest, resulting in a lack of marketability.

ii) The business interest represents a minority interest in the business.

iii) The death of the owner results in the loss of a key man crucial to the financial well-being of the business.

e) By careful planning, the ownership of the business may be structured to make available these discounts, for example, by ensuring that the owner does not own a controlling interest in the business at his death.

2) Background of Chapter 14

a) Chapter 14 was enacted as part of the Omnibus Budget Reconciliation Act of 1990 on November 5, 1990. The effective date was October 9, 1990, the reported date of relevant Senate Finance Committee action. In addition to what became sections 2701, 2702, and 2703, the Senate version included a provision that would have (1) determined the value of property without regard to any restriction other than a restriction which by its terms will never lapse and (2) provided that, in valuing property for estate tax purposes, any right held by the decedent with respect to the property would be deemed exercisable by the estate even if it lapsed on the decedent’s death. The House-Senate Conference Report modified this provision to the current content of section 2704.

b) In 1990, Congress enacted I.R.C. § 2704, titled “Treatment of Certain Lapsing Rights and Restrictions,” in an effort to limit the valuation discounts for gift and estate tax purposes applicable in the case of intra-family transfers of interests in family-owned, or “closely held,” corporations and partnerships. If an individual and the individual’s family hold voting or liquidation control over a corporation or partnership, I.R.C. § 2704(a) provides, in general, that the lapse of a voting or liquidation right shall be taxed as a transfer subject to gift or estate tax. I.R.C. § 2704(b) provides, in general, that when an interest in a family-owned corporation or partnership is transferred within the family, if a restriction limits the ability of the corporation or partnership to liquidate and that restriction can be removed by the family, that restriction is disregarded in valuing the transferred interest for gift or estate tax purposes.

c) Finally, in I.R.C. § 2704(b)(4), Congress authorized Treasury to issue regulations providing “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.”

3) Background and Administrative Details of Proposed Regulations

a) Released August 2, 2016 as Proposed Regulations only (not as Temporary Regulations).

b) Proposed effective date: date of publication of final regulations, with a 30 day delay for transfers subject to disregarded restrictions.
c) The Treasury Department’s Preamble to the proposed regulations (the “Preamble”) indicated that the proposed regulations concern “the valuation of interests in corporations and partnerships for estate, gift, and generation-skipping transfer (GST) tax purposes,” specifically dealing with the treatment of certain lapsing rights and restrictions on liquidation in determining the value of the transferred interest.

d) I.R.C. 2704 provides special valuation rules for valuing intra-family transfers of interests subject to lapsing voting or liquidation rights and restrictions on liquidation.

e) Treasury and the IRS have determined that the current regulations “have been rendered substantially ineffective in implementing the purpose and the intent of the statute” by changes and state laws and other subsequent developments.

i) In discussing the relevant changes in state law, the Preamble provided that:

(1) I.R.C. § 2704(b)(3)(B) explicitly provides that “any restriction imposed, or required to be imposed, by any Federal or State law” is not an “applicable restriction” that would be disregarded under I.R.C. § 2704.

(2) Current regulations provide that an applicable restriction is one which is “more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction.” In Kerr v. Commissioner, 113 T.C. 449 (1999), aff’d 292 F.3d 490 (5th Cir. 2002), the court viewed this as a regulatory expansion of I.R.C. § 2704(b)(3)(B).

(3) The Preamble noted that, “[s]ince the promulgation of the current regulations, many state statutes governing limited partnerships have been revised to allow liquidation of the entity only on unanimous vote of all owners (unless provided otherwise in the partnership agreement), and to eliminate the statutory provision that had allowed a limited partner to liquidate his or her limited partner interest.” The Preamble goes on to state:

(a) “Instead, these jurisdictions typically now provide that a limited partner may not withdraw from the partnership unless the partnership agreement provides otherwise.” (Citing the Texas Business Organizations Code and the Uniform Limited Partnership Act.)

(b) Or states create “elective restrictions” on liquidation. (Citing the Nevada Uniform Limited Partnership Act.)

(c) As a result of such state law changes, many liquidation restrictions in partnership agreements are “no more restrictive than those under state law,” and therefore are not “applicable restrictions”

ii) In addressing “other subsequent developments” that have rendered the regulations “substantially ineffective,” the Preamble put special emphasis on the case of Kerr v. Commissioner (cited above). The Kerr court held that I.R.C. § 2704(b) applied only to restrictions on the ability to liquidate an entire entity; not to restrictions on the ability
to liquidate a transferred interest. “Thus, a restriction on the ability to liquidate an individual interest is not an applicable restriction under the current regulations.”

4) Stated Intent of Regulations.

a) Amend Treas. Reg. § 25.2704-1 to (i) address deathbed transfers that result in the lapse of a liquidation right; and (ii) clarify that a transfer that results in the creation of an assignee interest is a lapse;

b) Amend Treas. Reg. § 25.2704-2 to refine the definition of “applicable restriction” by eliminating the comparison to the liquidation limitations of state law; and

c) Add a new Treas. Reg. § 25.2704-3 (Disregarded Restrictions) to address (i) restrictions on the liquidation of an individual interest; and (ii) the effect of “insubstantial interests” held by nonfamily members.

5) Source of Authority.

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

i) Questions as to the validity of the regulations have largely focused on whether they “do not ultimately reduce the value of the interest to the transferee.”

ii) Before they were released, it was widely assumed based on prior Greenbook proposals that the proposed regulations would include a deemed put right or provide substitute valuation assumptions. It was speculated that this would have rendered them invalid.

6) The Three Year Lookback Rule.

a) Under the current deemed gift/estate inclusion provisions of I.R.C. § 2704(a):

b) If there is a lapse of a voting or liquidation right; and members of the individual’s family control the entity before and after the lapse; then the lapse is treated as a transfer. An inter vivos lapse is treated as a gift; a lapse at death is includable in the gross estate. I.R.C. §2704(a)(1).

i) “Liquidation right” is “the right or ability, including by reason of aggregate voting power, to compel the entity to acquire all or a portion of the holder’s equity interest, whether or not its exercise would result in complete liquidation of the entity.” Treas. Reg. § 25.2704-1(a)(2)(v).

c) The lapse is valued as the fair market value of all interests held immediately before the lapse (determined as if voting and liquidation rights were nonlapsing) over the fair market value of all interests after the lapse. I.R.C. § 2704(a)(2).
d) Current regulations provide an exception: “a transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated.” Treas. Reg. § 25.2704-1(c)(1).

i) The net result is that a majority owner can transfer minority interest inter vivos, and it is not treated as a lapse -- even though it results in the loss of the transferor’s controlling interest:

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. Treas. Reg. § 25.2704-1(f), Ex. 4.

ii) Citing *Estate of Murphy v. Commissioner*, T.C. Memo. 1990-472, the Preamble indicates that the exception in the present rule should not apply to an inter vivos transfer that results in the loss of the power to liquidate on a decedent’s deathbed. In *Murphy*, the decedent transferred a small amount of stock in a closely-held corporation that reduced the size of her remaining stock to less than 50 percent of the total outstanding stock. The court concluded that the substance of the transaction was to generate a minority discount for transfer tax purposes.

iii) Prop. Reg. § 25.2704-1 would create a bright line test to eliminate this result for transfers occurring within three years of death. Instead, transfers within three years of death that result in the lapse of a liquidation right would be treated as transfers occurring at death for the purposes of I.R.C. § 2704(a):

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 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. Prop. Reg. § 25.2704-1(f), Ex. 4.

iv) In addition, the proposed regulations:

(1) Adopt the proposed regulations elimination of the comparison to local law in determining restrictions on ability to liquidate;

(2) clarify that manner in which liquidation may be achieved is irrelevant; and

(3) conform to proposed regulation for disregarding certain nonfamily interests (discussed below).
v) Many commentators have speculated that this section of the proposed regulations is unnecessary at best, and has the potential to result in double taxation at worst. As a result of the “disregarded restrictions” discussed below, it appears that the value of an interest would be computed as if the transferee could liquidate the interest and receive the underlying value, regardless of percentage owned. As a result, if that same value were taxed under the three year look back, the result would be double taxation.

vi) The value to be included in the gross estate under this provision is unclear. Treasury Regulations Section 25.2701-1(d) 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. The date as of which the interest is to be valued (date of transfer or date of death) is unclear.

(1) 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, resulting in taxable inclusion valued at zero.

(2) Alternatively, the Proposed Regulations might clarify 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. It is unclear how this might account for gifts subject to marital or charitable deduction.

vii) That the effect of this provision would be taxation of a phantom asset.

viii) This provision may require a statutory change to I.R.C. § 2035.

7) Disregarding Provisions of Code Section 2704(b) (Applicable Restrictions).

a) I.R.C. § 2704(b)

i) The overall effect of I.R.C. § 2704(b) is that specified restrictions are disregarded in valuing such an interest for gift or estate tax purposes when that interest is transferred to a family member.

ii) Subsection (1) provides: “For purposes of this subtitle, if (A) 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 (B) the transferor and members of the transferor’s family hold, immediately before the transfer, control of the entity, any applicable restriction shall be disregarded in determining the value of the transferred interest.”

iii) Subsection (2) defines the applicable restriction as one “which effectively limits the ability of the corporation or partnership to liquidate, and (B) with respect to which either of the following applies: (i) [t]he restriction lapses, in whole or in part, after the transfer referred to in paragraph (1) [or] (ii) [t]he transferor or any member of
the transferor’s family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.”

iv) Subsection (3) provides an exception to the rule for disregarding applicable restrictions in valuing an interest transferred to a family member. If an otherwise applicable restriction is “a commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either” or is a “restriction imposed, or required to be imposed, by any Federal or State law” the restriction can be considered in determining the value of the interest transferred.

b) Existing Treasury Regulations Section 25.2704-2

i) Current regulations define an applicable restriction as “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.”

ii) Many state laws regarding withdrawal from a partnership, or the right of a partner to compel liquidation of the partnership, are as restrictive as possible. In the Preamble to the proposed regulations, Treasury specifically cites: Tex. Bus. Orgs. Ann. § 153.110 (West 2016) (limited partner may withdraw as specified in the partnership agreement); Uniform Limited Partnership Act (2001) § 601(a), 6A U.L.A. 348, 448 (Supp. 2015) (limited partner has no right to withdraw before completion of the winding up of the partnership); Nev. Rev. Stat. § 87A.427 (2016) (limited partnership electing to be restricted limited partnership may not make any distributions for a 10-year period). Under most default state laws pertaining to partnerships and limited liability companies, owners cannot withdraw or dissociate in some cases at all, or in many cases without the unanimous consent of all other owners. Similar restrictions exist with respect to the right of an owner to compel liquidation. Any restrictions imposed by governing documents would be more restrictive than state law, and since they would be as restrictive as or less restrictive than state law, they are not “applicable restrictions” under the existing regulations and can be considered in determining the value of the entities.


i) The proposed regulations would make significant changes to the valuation for transfer tax purposes of interests in a family-controlled entity that are subject to applicable restrictions on redemption or liquidation – that is, subject to limitations on the ability of the owner of the interest to require the entity or other owners to redeem or buy out that owner.

ii) In the background discussion of the proposed regulations, Treasury acknowledges that state law has essentially gutted the meaning of “applicable restriction,” and the proposed regulations are responding directly to those changes that have provided for
the most restrictive possible default terms with respect to withdrawal and liquidation:

iii) “Since the promulgation of the current regulations, many state statutes governing limited partnerships have been revised to allow liquidation of the entity only on the unanimous vote of all owners (unless provided otherwise in the partnership agreement), and to eliminate the statutory default provision that had allowed a limited partner to liquidate his or her limited partner interest. Instead, statutes in these jurisdictions typically now provide that a limited partner may not withdraw from the partnership unless the partnership agreement provides otherwise...[T]hese statutes are designed to be at least as restrictive as the maximum restriction on liquidation that could be imposed in a partnership agreement. The result is that the provisions of a partnership agreement restricting liquidation generally fall within the regulatory exception for restrictions that are no more restrictive than those under state law, and thus do not constitute applicable restrictions under the current regulations.”

iv) The implication in the background discussion to the proposed regulations is that family controlled entities have relied on these very restrictive default provisions in state law to provide cover for otherwise illusory restrictions imposed in the governing documents of those same entities to create the best possible valuation discounts.

v) The proposed regulations seek to substantively changes the definition of applicable restriction to address the evolution of state statutes with very restrictive default provisions.

(1) Applicable Restriction redefined. The definition of applicable restriction under the proposed regulations would include all applicable restrictions, regardless of whether they are as restrictive, more restrictive, or less restrictive than state law:

(a) “The term applicable restriction means a limitation on the ability to liquidate the entity, in whole or in part (as opposed to a particular holder’s interest in the entity), if, after the transfer, that limitation either lapses or may be removed by the transferor, the transferor’s estate, and/or any member of the transferor’s family, either alone or collectively.” Prop. Reg. § 25.2704-2(b)(1).

(i) Source of limitation. Rather than focusing on applicable restrictions defined in the governing documents of the entity, under the proposed regulations, applicable restrictions will be disregarded, no matter the source of the restriction. If an owner’s rights to withdraw or liquidate are limited by state law, governing documents, or side agreements, the limitation will be disregarded for transfer tax valuation purposes. According to the background material provided, “this proposed rule is intended to ensure that a restriction that is not imposed or required to be imposed by federal or state law is disregarded without regard to its source.”
(b) "An applicable restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation’s by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(4)(ii) of this section.” Prop. Reg. § 25.2704-2(b)(2)

(c) The proposed regulations include four exceptions to the definition of applicable restriction.

(i) Prop. Reg. § 25.2704-2(b)(4)(i) – Commercially Reasonable Exception. Maintaining language from the existing regulations, a restriction that is commercially reasonable restriction will be not be disregarded when valuing an interest for transfer tax purposes. This acknowledges that family businesses, like any commercial arrangement, may be compelled to restrict its activity during the normal course of business to attract capital. A commercially reasonable restriction is a “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.” Prop. Reg. § 25.2704-2(b)(4)(i).

(ii) Prop. Reg. § 25.2704-2(b)(4)(ii) – Required by Law Exception. Expanding the language of the existing regulations, the proposed regulations would provide an exception to a definition of applicable restriction, so that a restriction that is imposed or required to be imposed by state or federal law would not be disregarded in valuing the interest for transfer tax purposes. The proposed regulations make much effort to avoid the impact of state law restrictions that are default restrictions only, and that can be removed or overridden by the later action of family members. Prop. Reg. § 25.2704-2(b)(4)(ii).

1. For purposes of this exception, federal and state law include the laws of the United States, any state of the United States, and the District of Columbia. The laws of territories or foreign jurisdictions will not meet the test for this exception.

2. The proposed regulations identify the following as laws that are not imposed or required to be imposed by federal law, and as such, would not meet the exception set out in
a. A law that applies only in the absence of a contrary provision in the governing documents is not a restriction that is imposed or required to be imposed by federal or state law.

b. A law that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law.

c. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in I.R.C. § 2704 is not a restriction that is imposed or required to be imposed by federal or state law.

d. If law allows for an entity to be created, organized, or governed under a different set of statutes that does not mandate the restriction, makes the restriction optional, or permits the restriction to be overridden it is not a restriction that is imposed or required to be imposed by federal or state law. In this case the restriction is optional because, under the theory of the proposed regulations, the transferor or the transferor’s family could change the law by which the entity is governed after the transfer to remove the effect of the restriction.

(iii) Prop. Reg. § 25.2704-2(b)(4)(iii) – 2703 Exception. As in the existing regulations, an exception exists for an option, the right to use property, or an agreement that is subject to section 2703. Such rights are applicable restrictions that are disregarded for purpose transfer tax purposes under section 2704. Prop. Reg. § 25.2704-2(b)(4)(iii)

(iv) Prop. Reg. § 25.2704-2(b)(4)(iv) – Put Right Exception. The proposed regulations provide a put-right exception. Some believe it is intended to be a safe harbor, as discussed below. If state law or the governing documents include a restriction that would otherwise be deemed to be an applicable restriction to be disregarded in valuing the interest for transfer tax purposes, the restriction will not be disregarded if the holder of the interest has a put right as described in § 25.2704-3(b)(6). This put right would ensure that the holder of the interest has the right to convert his or her interest to real value, at least equal to “minimum value” as described later, without interference, and as such, would allow any otherwise stated restriction to be considered. Prop. Reg. § 25.2704-2(b)(4)(iv)

vi) In keeping with the existing regulations and the statute, an applicable restriction is only such if it lapses after the transfer or can be removed after the transfer by the transferor, the transferor’s estate, or members of the transferor’s family. Prop. Reg. § 25.2704-2(b)(3)
8) The “Assignee” Issue.

a) Under state law, an assignee of a membership or partnership interest is generally not automatically admitted as a member or partner, but instead is merely entitled to a share of profits. As a result, the assignee has no power to liquidate the entity.

b) The Preamble indicates that Treasury views this change as being in line with the change to the elimination of the test of whether an applicable restriction is “no more restrictive than state law.”

c) Under Prop. Reg. § 25.2704-1(a)(5), a “transfer that results in the restriction or elimination of the transferee’s ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights. For example, the transfer of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest.”

d) The proposed regulation does not distinguish between a temporary lapse (i.e., the period between the death of the partner and the time his or her estate is admitted as a substitute partner) and permanent lapses.

9) Nonfamily Interests.

a) The Preamble suggests that taxpayers have avoided the application of I.R.C. § 2704(b) through the transfer of a nominal partnership interest to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a restriction, again citing Kerr.

b) To avoid such results, the Preamble notes that Treasury and the IRS have concluded that the grant of “an insubstantial interest” to a nonfamily member should not preclude the application of I.R.C. § 2704(b) because “in reality, such nonfamily member interest generally does not constrain the family’s ability to remove a restriction on the liquidation of an individual interest” and “does not affect the family’s control of the entity, but rather, when combined with a requirement that all holders approve liquidation, is designed to reduce the transfer tax value of the family-held interests.”

c) Accordingly, Prop. Reg. § 25.2704-3(a)(4) would create a bright-line test to determine whether a nonfamily member’s interest should be disregarded for purposes of determining whether the family acting alone may remove a disregarded restriction following a transfer. The stated purpose of the bright-line test is to ensure that a nonfamily member’s interest is an economically substantial and longstanding one that is likely to have a substantive effect, and to avoid the fact intensive inquiry underlying a determination of whether the interest of a nonfamily member effectively constrains the family’s ability to liquidate the entity.

d) Under Prop. Reg. § 25.2704-3(a)(4), a nonfamily member’s interest will be disregarded for purposes of determining whether the family acting alone may remove a disregarded restriction following a transfer unless all of the following requirements are met:
i) The interest has been held by the nonfamily member for at least 3 years immediately before the transfer.

(1) The 3 year requirement seems excessive and can cause very different tax results based on an arbitrary period. For example, if members of a family and an unrelated party (X) form a business in which each collectively owns 50% and that requires the consent of both the family and X for partial liquidations or redemptions, then X’s interest will be disregarded if one of the family members dies or transfers an interest in the business within 3 years of formation. As a result, the family will be treated as if they can remove the restriction on partial liquidation and redemptions without anyone else’s approval or consent, and the interest transferred will be valued as if the transferor and transferee have the right to redeem the interest. On the other hand, if the family member is fortunate enough to live at least 3 years after formation, or if the family member makes the transfer 3 years and 1 day after formation, then X’s interest will not be disregarded and the family member will have a very different tax result.

(2) Does the three year period restart if a nonfamily member sells or otherwise transfers an interest to another nonfamily member? If so, the time requirement might never be satisfied. Or, is there a mechanism for “tacking” ownership?

ii) On the date of the transfer: (a) the nonfamily member’s interest constitutes at least 10% of the value of all equity interests and (b) the total equity interests held by all nonfamily members constitutes at least 20% of the value of all equity interests.

(1) Requiring both a single nonfamily owner to own 10% and all nonfamily owners to own 20% is excessive. If nonfamily members are investors in the entity of this magnitude (either one with 10%, or several aggregating to 20%), it can hardly be said their interests are insubstantial.

(2) In applying the 10% and 20% tests, the attribution rules of Prop. Reg. § 25.2704-3(d) and Treas. Reg. § 25.2701-6 apply in determining the interest held by a nonfamily member and in measuring the interest such person owns indirectly through other entities. However, the interest of a nonfamily member and all of the interests held by such nonfamily member’s family in the same entity are not aggregated for purposes of the 10% and 20% tests.

By way of example, 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 to each of her four nieces and nephews. After B’s gifts under the regulations as proposed, B’s family’s 30% interest is disregarded (because no single
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.

iii) All nonfamily members have a “put right” (not just the nonfamily member whose consent is required to ensure that the family alone does not have the power to remove a restriction) to receive cash and/or other property with a value at least equal to the “minimum value” of such interest within 6 months of providing notice of the intent to withdraw.

(1) Requiring a family that enters into a business arrangement with unrelated third parties to provide 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 nonfamily held interests. It would be impossible to attract investors to an entity if the other investors can withdraw their share of the business at any time. Similarly, a long-term business plan is inconceivable while under immediate threat of withdrawal at all times. In addition, put rights may be entirely disallowed, such as in regulated entities (i.e., banks).

(2) 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 obtain future financing. The same would be true for any other business on a smaller scale. A business just can’t promise to pay any non-family investor who wants his money back.


a) Control. Under I.R.C. § 2704(c)(1), “[t]he term “control” has the meaning given to such term by section 2701(b)(2). Section 2704 only applies if a family “controls” the entity before and after the transfer/event.

i) Prop. Reg. §§ 25.2704-2(c) and 25.2704-3(c) each provide: “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).”


(1) “Control” means holding at least 50% by vote or value of the stock in the corporation or holding at least 50% of the capital or profits interests in the partnership or any interest as a general partner of the partnership. Treas. Reg. § 25.2701-2(b)(5). There is currently no separate test for LLCs.
(2) Prop. Reg. § 25.2701-2(b)(5)(i) expands the description of a “controlled entity” to include not only corporations and partnerships, but any other entity or arrangement that is classified as a business entity under Treas. Reg. § 301.7701-2(a) that 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.

(a) This section of the Proposed Regulations also clarifies that an entity other than a corporation is classified in accordance with local law, regardless of how the entity is classified for federal tax purposes (including entities disregarded for federal tax purposes).

(3) Prop. Reg. § 25.2701-2(b)(5)(iv) provides the applicable test for control of entities other than corporations or partnerships, such as limited liability companies. Consistent with the test for partnerships and corporations, “control” means the holding of at least 50% of the capital or profits interests in the entity. An additional definition of control includes the holding of any equity interest with the ability to cause the liquidation of the entity in whole or in part.


(1) Prop. Reg. §§ 25.2704-2(a) (relating to applicable restrictions) and 25.2704-3(a) (relating to disregarded restrictions) each 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.”

(2) Because “control” is defined with reference to existing Treas. Reg. § 25.2701-2(b)(5), which already explicitly governs the identities of the persons whose interests should be considered, the additional test as to whether “members of the transferor’s family” control the entity is not entirely clear.

(3) Prop. Reg. § 25.2704-2(c) and 25.2704-3(c) provide that the phrase “member of the family” is as defined in Treas. Reg. § 25.2702-2(a)(1) which identifies such persons as being an 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 spousethe foregoing.”

b) Attribution

i) Under I.R.C. § 2704(c)(3), “[t]he rule of section 2701(e)(3) shall apply for purposes of determining the interests held by any individual.”
ii) Prop. Reg. §§ 25.2704-2(d) and -3(d) provide that “An individual, the individual’s estate, and members of the individual’s family are treated as also holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6”

iii) Treas. Reg. § 25.2701-6 contains unique attribution rules with respect to trusts that cannot be superimposed on I.R.C. § 2704:

(1) Unascertainable 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 at the exclusion of all others. Accordingly, it is possible that, for I.R.C. § 2701 attribution purposes, an equity interest may be fully attributed to the remainder beneficiaries of a trust, even though they have no right to receive current distributions and no rights to accumulated income.

(2) In addition, an individual is treated as holding any equity interest held by or for a trust if the individual is the owner of the trust under subpart E. As such, without the application of “tie-breaker” rules in Treas. Reg. § 25.2701-6(a)(5), 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. The tie breaker presuppose the existence of senior and junior equity interests by attributing interests among generations based on the class of equity.

11) Voting Right as Including the Right of LLC Member to Participate in Company Management.

a) If there is a lapse of a voting right and members of the individual’s family control the entity before and after the lapse, then the lapse is treated as a transfer. An inter vivos lapse is treated as a gift and a lapse at death is includable in the gross estate. I.R.C. §2704(a)(1).

b) While I.R.C. § 2704 speaks only in terms of corporations and partnerships, the proposed regulations clarify that “partnerships” are broadly defined to include any “business entity” within the meaning of Treas. Reg. § 301.7701-2(b)(1), regardless of how that entity is classified for federal tax purposes. Thus, for example, the term “partnership” includes a limited liability company whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

c) In the case of limited liability companies, the proposed regulations modify the definition of a “voting right” in Treas. Reg. § 25.2704-1(a)(2)(iii) to include the “right of a member to participate in company management.”
i) This is incongruous with the treatment of partners and shareholders. In the case of a corporation, certain classes of shareholders may not have voting rights while others do not. Similarly, in the case of a limited partnership, limited partners typically do not have voting rights (but see, e.g. Florida Statutes section 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 such a voting right ascribed to a member in a limited liability company. We do not understand the purpose for the distinction between the default voting rights of members of LLCs and the default voting rights of shareholders of a corporation.

ii) The first sentence of current Treas. Reg. § 25.2704-1(a)(2)(iii) (“Voting right means a right to vote with respect to any matter of the entity.”) amply captures the right of a member of an LLC to vote with respect to any matter of the entity as being a voting right. And thus, the reference to “the right of a member to participate in company management” is presumably not limited to participation in the member’s capacity as a member.

   (1) If an LLC member happens to be a manager, officer, or executive of the LLC, would the member be treated as having a voting right for purposes of I.R.C. § 2704(a)?

   (2) If so, when the executive or manager resigns or quits, a lapse would occur but the value of their LLC interest would not have changed so there would be no taxable transfer by reason of the lapse. Given the fact that no taxable transfer would result in such scenario, what is the purpose of the additional “participation in company management” language for LLCs? Is it merely extraneous?

12) Disregarded Restrictions.

   a) Prop. Reg. § 25.2704-3 creates a new class of disregarded restrictions for transfer tax purposes. Like an “applicable restriction,” any of these “disregarded restrictions” will be ignored for purposes of valuing an interest conveyed that is subject to transfer tax.

   b) Treasury identifies I.R.C. § 2704 for its authority to create this new class of restrictions. That section provides: “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.” Treasury also cites the Tax Court’s position that Congress granted Treasury discretion under this section to create regulations that identify restrictions not already covered by section 2704(b) that should be disregarded for transfer tax valuation purposes because those restrictions adversely impact the transfer tax value of an interest but that do not reduce the value of the interest to the family-member transferee. Kerr v. Commissioner, 113 T.C. 449, 473 (1999), aff’d, 292 F.3rd 490 (5th Cir. 2002)
c) In the Preamble to the proposed regulations, Treasury distinguishes these new disregarded restrictions under I.R.C. § 2704 from the restrictions and limitations addressed in § 2703. Section 2703 addresses the sale or use of family controlled entities; Section 2704(b), and the new disregarded restrictions under Prop. Reg. § 25.2704-3 would address the liquidation or redemption of interests in family-controlled entities.

d) In carrying out the discretion to create new kinds of disregarded restrictions, and thus further limit nature and extent of valuation discounts available to family-controlled entities, IRS and the Treasury Department take aim at any restriction on the ability of a partner, shareholder, member, or owner to liquidate the transferred interest and any restrictions “attendant upon the nature or extent of the property to be received in exchange for the liquidated interest, or the timing of the payment of that property.”

e) The threshold element of the new type of disregarded restriction is still the fact that after the transfer of an interest in a family-controlled entity, the restriction will lapse or can be removed by the transferor or any member or members of the transferor’s family. But rather than describing the kinds of such lapsing or removable restrictions that will be disregarded in making valuations, the proposed regulations define those restrictions with reference to the effect they would have on gift or estate tax value.

f) The disregarded restrictions will apply to any transfer of an interest in a corporation or partnership from a transferor to or for the benefit of a member of the transferor’s family if the transferor and/or the transferor’s family control the entity immediately before the transfer. Prop. Reg. § 25.2704-3.

   i) The disregarded restrictions apply for all transfer tax purposes, which are defined to include estate tax, gift tax, and generation-skipping transfer tax.

   ii) Corporation and partnership are defined broadly, to include all forms of entities. A corporation includes (1) any business entity described in Reg. § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, (2) an S corporation within the meaning of section 1361(a)(1), and (3) a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). A qualified subchapter S subsidiary is deemed to be separate from its parent corporation for this definition. A partnership is defined to include any other business entity within the meaning of § 301.7701-2(a), regardless of entity classification. The regulations specifically clarify that “partnership” includes a limited liability company organized under state law that is not an S corporation, regardless of its entity classification or disregarded status.

g) The effect of disregarding a restriction under Prop. Reg. § 25.2704-3(f) is that the fair market value of the interest is determined assuming the restriction did not exist, either in the governing documents or applicable law. Many commentators have expressed concern about the application of the new disregarded restrictions.

h) Prop. Reg. § 25.2704-3(b) identifies four specific limitations on the right to redeem or liquidate an entity that will be classified as disregarded restrictions, if the limitation either
lapses after the transfer or can be removed by the transferor or any member of the
transferor’s family. The four disregarded restrictions are:

i) Prop. Reg. § 25.2704-3(b)(i) – Limitation on Liquidation or Redemption. If a
provision limits or permits the limitation of the ability of the holder of the interest
to compel liquidation or redemption of the interest, the restriction will be classified
as a disregarded restriction.

ii) Prop. Reg. § 25.2704-3(b)(ii) – Minimum Value. If a provision limits or permits the
limitation of the liquidation or redemption proceeds to an amount that is less than
minimum value, as later defined, the restriction will be a disregarded restriction. For
a more complete discussion of “minimum value,” see below.

iii) Prop. Reg. § 25.2704-3(b)(iii) – Deferral of Payment. If a provision defers or permits
the deferral of payment of liquidation or redemption proceeds for more than 6
months after the holder of the interest gives notice of the liquidation or redemption
action, the restriction will be a disregarded restriction.

iv) Prop. Reg. § 25.2704-3(b)(iv) – Manner of Payment. If a provision permits the
payment of liquidation or redemption proceeds in any manner other than with cash
or property, the restriction will be a disregarded restriction.

(1) Notes and obligations of related parties are not considered property for purposes of
these provisions. The proposed regulations provide that a note issued by the entity,
the holder of an interest, or a related party to the entity or a holder will not suffice
to be considered property. The purposes of carving out notes as an unacceptable
form of redemption or liquidation proceeds must be to prevent disguised restrictions
in debt instruments that could otherwise mirror disregarded restrictions.

(2) Active Trade or Business Exception for Notes. An exception to the “no note” rule
is made for active trade or businesses, with a cross-reference to I.R.C. §
6166(b)(9)(B), provided the note is adequately secured, has market interest,
requires payments, and has a fair market value on the date of issue to the value of
the redemption or liquidation proceeds.

i) “Other Property”

(1) Prop. Reg. § 25.2704-3(b)(iv) contains the general rule that “property” does not
include a note or other obligation issued directly or indirectly by the entity, holders
of an interest in the entity, or persons related to either the entity or any of holder of
an interest in the entity. For this purpose, “related” persons are persons having a
relationship described in I.R.C. § 267(b), with a carve out for publicly held
corporate fiduciaries.

(2) An exception to this general rule is made for entities engaged in an active trade or
business, at least 60% of whose value consists of the non-passive assets of that trade
or business. For such entities, “to the extent the liquidation proceeds are not
attributable to passive assets,” proceeds may include a note or other obligation if
such note or other obligation is (a) adequately secured, (b) requires periodic payments on a non-deferred basis, (c) is issued at “market interest rates”, and (d) has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds.

(a) For an entity engaged in an active trade or business, a note may be used to pay the liquidation proceeds but only up to to the percentage of the entity’s non-passive assets.

(b) “Passive assets,” as defined in I.R.C. § 6166(b)(9)(B), are all assets other than those used in carrying on the trade or business.

(i) This typically includes stock in another corporation unless that corporation is engaged in an active trade or business and at least 80% of each corporation is attributed to the trade or business and either the parent corporation owns 20% or more in value of the subsidiary stock or the subsidiary has 45 fewer shareholders. I.R.C. § 6166(b)(9)(B)(iii).

(ii) Whether real property will qualify as an active or passive asset depends on the person’s activities with respect to the property, as well as the activities (or lack thereof) of management companies and third parties. See, e.g., Rev. Rul. 2006-34, 2006-26 I.R.B. 1171 (June 26, 2006) (containing a list of factors the IRS will consider to determine whether an interest in real property is an interest in an asset used in an active trade or business).

(c) What is meant by “market interest rates” (AFR or something else) and fair market value equal to liquidation proceeds?

(d) After stating that the note must be market rate, adequately secured, require periodic payments and have a fair market value equal to the liquidation proceeds, the proposed regulation says to “See Reg. § 25.2512-8” without further explanation. This regulation generally states that when consideration is given for the transfer, but the consideration is worth less than the value of the transferred property, a gift is made of the excess value. This regulation also provides that insufficient consideration will not result in a gift if the transaction was made in the ordinary course of business. Without further explanation, it is unclear what is meant by the citation in the proposed regulations.

j) “Minimum Value” Defined

i) Prop. Reg. § 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, meaning the interest’s share of the “net value of the entity determined on the date of liquidation or redemption.”

(1) The proposed regulation goes further to define the “net value of an entity” as “the fair market value … of the property held by the entity,” determined under I.R.C. §§
2031/2512 and the regulations thereunder, reduced by certain “obligations of the entity.”.

(a) The only outstanding obligations that may be taken into account are those that would be allowable if paid as deductions under 2053 if they were claims against an estate.

(b) It is unclear what this really means for an operating business or, for example, a business that holds significant real estate or other illiquid assets.

ii) There is concern that this definition would penalize those who hold their non-business interests in LLC or other entity format, as opposed to co-tenancy. In the absence of an entity, owners would be entitled to fractional interest discounts.

(1) Example: Assume two sisters each own an equal and undivided interest in farmland. If the sisters own the 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. If the sisters transfer the farmland to an entity, no such fractional interest discount would be allowable upon a transfer. 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.

(2) The net effect of this may be to:

(a) Deprive family-owners of the management efficiencies offered by a structure;

(b) Deprive or minimize the creditor protection available to family owners; and

(c) Favor unrelated individuals who co-own property over families.

(3) It would be appropriate to note that, in some cases, the IRS may successfully argue that a co-tenancy is an association that should be characterized as a partnership, for example, if the co-tenants are carrying on a trade or business. See, e.g., *Cusick v. C.I.R.*, 76 T.C.M. (CCH) 241, 243 (1998) (finding rental real estate activities created a partnership).

iii) Application to Operating Businesses

(1) By referring to the fair market value of property held by the entity, the proposed regulations imply that the entity value is based on a liquidation sale of the assets of the operating business.

(2) However, Prop. Reg. § 25.2704-3(b)(1)(ii) continues: ...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.
(3) Treas. Reg. § 20.2031-2(f)(2) provides as follows with respect to the 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.

(4) 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.

(6) This seems to imply that the net asset value will not be the sole determination of minimum value in the case of an operating business. Nonetheless, the circular references in the Regulations under I.R.C. §§ 2512 and 2031 back to I.R.C. § 2704 make the actual impact less than clear.

iv) Minimum Value as a Safe Harbor

(1) To the extent that the proposed regulations intended minimum value to be a safe harbor, there may be unintended consequences of these valuation determinations. 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.

(a) Trustees of trusts, acting in a fiduciary capacity, may only be permitted under state law to pay fair market value for stock it intends to acquire, based on valid restrictions on redemption or liquidation value.

(i) 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.

(ii) 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.

(iii) 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 I.R.C. § 2704(b) is higher.

v) Reconciliation of Minimum Value with Value of Interests Subject to Disregarded Restrictions

(1) 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>
<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 valuation business</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>I.R.C. §2704 applied to lower tier entities that would be subject to I.R.C. §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>

13) Exceptions to the New Disregarded Restrictions.

a) Prop. Reg. § 25.2704-3(b) identifies restrictions that will be disregarded if certain factors are present. If a restriction in a governing instrument for an entity does not meet the test of a disregarded restriction, that restriction may be considered when determining the value of an interest for transfer tax purposes.

i) If a redemption of liquidation provision provides that the full amount of redemption or liquidation proceeds must be paid within 6 months after the holder of an interest gives notice of intent to liquidate all or part of the interest or withdraw from the entity, the restriction is not a disregarded restriction.

ii) If a redemption or liquidation provides that the property to be used to satisfy the redemption or liquidation action does not include a note or obligation issued directly
or indirectly by the entity, by one or more holders of interests in the entity, or by a person related either to the entity or any holder, the restriction is not a disregarded restriction.

iii) While these restrictions may still qualify and be considered in determining value, it is unclear how such provisions may impact value. It is possible that the restrictions would have some impact on value but would it would be expected to be far less than is currently available under the existing regulations.

b) In addition to substantively meeting the requirements of Prop. Reg. § 25.2704-3(b)(5) includes 5 exceptions to the new class of disregarded restrictions. One of the exceptions is definitional and the other four are identical to the exceptions for. Those exceptions are:

i) Prop. Reg. § 25.2704-3(b)(5)(i) – Applicable Restriction Exception. If a restriction is an “applicable restriction” under Prop. Reg. § 25.2704-2(b)(4), the restriction is not a disregarded restriction.

ii) Prop. Reg. § 25.2704-3(b)(5)(ii) – Commercially Reasonable Restriction. If a restriction is commercially reasonable, the restriction is not a disregarded restriction.

iii) Prop. Reg. § 25.2704-3(b)(5)(iii) – Required by Law Restriction. If a restriction is imposed or required to be imposed by federal or state law, the restriction is not a disregarded restriction.

iv) Prop. Reg. § 25.2704-3(b)(5)(iv) – 2703 Exception. If a restriction related to an option right, the right to use property, or any other agreement subject to I.R.C. § 2703, the restriction is not a disregarded restriction.

v) Prop. Reg. § 25.2704-3(b)(5)(v) – Put Right Exception. If a restriction is in place but the holder of the interest has a put right as described in the proposed regulations, the restriction is not a disregarded restriction.

vi) See Section 5(c)(v)(1)-(4) (above) for additional discussion on the exceptions identified in (ii)-(v) above.

14) Coordination with Marital and Charitable Deductions.

a) I.R.C. § 2704(b) applies to all intra-family transfers for purposes of estate, gift and GST taxes, including transfers that qualify for the gift or estate tax marital deduction. Thus, Chenoweth issues should be negated. For example, if 100% of a corporation’s stock was includible in decedent’s estate and 30% was transferred to decedent’s surviving spouse and 70% to decedent’s children, the minority interest transferred to the surviving spouse should not be discounted at the date of funding, and an underfunding of the marital deduction amount should not occur.

b) I.R.C. § 2704(b) does not apply to transfers to nonfamily members such as charities, so assets passing to non-family will be subject to discounts for both gift and estate tax valuation purposes (amount included) and for computing the gift or estate tax charitable
deduction. However, if a controlling interest passes among multiple charities, then “additional considerations (not prescribed by section 2704) may apply, resulting in a different value for charitable deduction purposes.” Citing, *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). For example, if 100% of a corporation’s stock was includible in decedent’s estate and the stock was transferred equally among 4 separate charities, then the discounted value of the stock passing to each charity may result in the underfunding of the charitable deduction amount.

c) Under Prop. Reg. § 25.2704-2(e), if part of an interest in an entity passes upon a person’s death to family members and part to nonfamily members, then the part passing to family members is treated as a single, separate property interest valued using the special valuation assumptions under I.R.C. § 2704(b) and the part passing to nonfamily members is also treated as a single, separate property interest valued without the special valuation assumptions under I.R.C. § 2704(b).

i) Valuing an interest differently depending on the recipient presents complexities in administering estates. If a fiduciary has the authority under a testamentary instrument to allocate section 2704 assets to family or nonfamily members, should the fiduciary seek to reduce the estate’s overall estate tax burden? Is it fair for a fiduciary to apportion a higher percentage of the estate tax to family members receiving section 2704 assets than would have been apportioned to nonfamily members that could have received the same assets? What if the fiduciary has not determined (or cannot determine) how the section 2704 assets will be distributed at the time the estate tax return is required to be filed?

ii) Consider the following: decedent’s estate includes $25 million of marketable securities and a minority interest in a family owned corporation that would be valued for estate tax purposes at $10 million if the special valuation assumptions of section 2704(b) apply (i.e., no discounts) or $6.5 million if the special valuation assumptions of section 2704(b) do not apply (i.e., discounts are applied).

Decedent’s estate plan leaves 50% of his estate to family members and 50% to friends. However, depending on how the stock is allocated, the amount allocated to the family members and friends may not be equal.
### Assume all of the stock is allocated to the family’s share of the estate

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Estate</strong></td>
<td>$35,000,000 ($25m securities + $10m stock)</td>
</tr>
<tr>
<td><strong>Estate Tax Rate</strong></td>
<td>40%</td>
</tr>
<tr>
<td><strong>Estate Tax Payable</strong></td>
<td>$14,000,000</td>
</tr>
<tr>
<td><strong>Residue of Estate</strong></td>
<td>$21,000,000</td>
</tr>
<tr>
<td><strong>Stock to Family</strong></td>
<td>$10,000,000</td>
</tr>
<tr>
<td><strong>Other Assets to Family</strong></td>
<td>$500,000</td>
</tr>
<tr>
<td><strong>Stock to Friends</strong></td>
<td>$0</td>
</tr>
<tr>
<td><strong>Other Assets to Friends</strong></td>
<td>$10,500,000</td>
</tr>
</tbody>
</table>

### Assume all of the stock is allocated to the friend’s share of the estate

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Estate</strong></td>
<td>$31,500,000 ($25m securities + $6.5m stock)</td>
</tr>
<tr>
<td><strong>Estate Tax Rate</strong></td>
<td>40%</td>
</tr>
<tr>
<td><strong>Estate Tax Payable</strong></td>
<td>$12,600,000</td>
</tr>
<tr>
<td><strong>Residue of Estate</strong></td>
<td>$18,900,000</td>
</tr>
<tr>
<td><strong>Stock to Family</strong></td>
<td>$0</td>
</tr>
<tr>
<td><strong>Other Assets to Family</strong></td>
<td>$9,450,000</td>
</tr>
<tr>
<td><strong>Stock to Friends</strong></td>
<td>$6,500,000</td>
</tr>
<tr>
<td><strong>Other Assets to Friends</strong></td>
<td>$2,950,000</td>
</tr>
</tbody>
</table>

### Assume the stock is divided equally among the family’s share and friend’s share of the estate

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Estate</strong></td>
<td>$33,250,000 ($25m securities + $5m non-disc stock + $3.25m disc stock)</td>
</tr>
<tr>
<td><strong>Estate Tax Rate</strong></td>
<td>40%</td>
</tr>
<tr>
<td><strong>Estate Tax Payable</strong></td>
<td>$13,300,000</td>
</tr>
<tr>
<td><strong>Residue of Estate</strong></td>
<td>$19,950,000</td>
</tr>
<tr>
<td><strong>Stock to Family</strong></td>
<td>$5,000,000</td>
</tr>
<tr>
<td><strong>Other Assets to Family</strong></td>
<td>$4,975,000</td>
</tr>
<tr>
<td><strong>Stock to Friends</strong></td>
<td>$3,250,000</td>
</tr>
<tr>
<td><strong>Other Assets to Friends</strong></td>
<td>$6,725,000</td>
</tr>
</tbody>
</table>

So, the family and friends each received 50% of the stock but the family only received $4.975m of securities while the friends received $6.725m.
15) Assessing the Impact of the Proposed Regulations. To the extent the Regulations are enacted in a format substantially similar to what has been proposed:

a) How will fiduciaries calculate fees based on the value of trust assets or trust distributions?

b) Will we see more Preferred Partnerships under I.R.C. § 2701?

c) What level of disclosure will be required on gift tax returns with respect to transfers in family-controlled entities occurring after 8/2/16?

d) How many more entities will turn to commercial financing (so as to have legitimate restrictions respected under Treas. Reg. § 25.2704-2(b)?

e) Will this impact charitable giving?

f) Will it impact choice of law and entity formation?

16) Epilogue and Burdensome Regulations

a) The drama that defines Washington politics these days has implicated a closely-watched estate and gift tax guidance project in an unprecedented review. The regulations on valuation discounts under section 2704, proposed a year ago, are one of eight regulation projects selected for reexamination in response to an Executive Order to identify unduly burdensome or complex regulations issued since the beginning of 2016.

b) The Proposed Regulations were released on August 2, 2016, and published in the Federal Register on August 4. They were instantly controversial. They produced severe contention, not only between estate planning professionals and the IRS, but among estate planning professionals themselves, who have not reached a consensus on what effect the Proposed Regulations would have if finalized or what the Proposed Regulations even mean. The IRS reportedly received over 28,000 comments from members of the public, many very cursory and clichéd of course, but many deeper and broader and sometimes bitter. There were 36 speakers at the all-day public hearing on December 1.

c) Executive Order 13789 was issued on April 21, 2017, and published in the Federal Register on April 26. It directed the Treasury Department to identify tax regulations issued on or after January 1, 2016, “that (i) impose an undue financial burden on United States taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the Internal Revenue Service.” It directed that such regulations be identified in an interim report to the President within 60 days, or by June 20, 2017.

d) Notice 2017-38 was the initial response of Treasury and the IRS to the Executive Order. It was issued on July 7, about two and a half weeks after its due date (although it may have been submitted to the President earlier). It identified eight regulations, including the section 2704 Proposed Regulations, that it said “meet at least one of the first two criteria specified by … Executive Order 13789” – that is, undue financial burden or undue complexity. The Notice included this about the section 2704 Proposed Regulations:
Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens. Commenters were also concerned that the proposed regulations would make valuations more difficult and that the proposed narrowing of existing regulatory exceptions was arbitrary and capricious.

e) Understandably, the IRS did not concede that any of its regulations met the third criterion in the Executive Order because they “exceed the statutory authority of the Internal Revenue Service.” But it would be at least noteworthy, if not surprising, that the IRS would admit that the Proposed Regulations impose “undue” financial burden or add “undue” complexity to the tax laws. That would beg the question of why the IRS ever issued the Proposed Regulations in the first place. But, to be fair, an IRS response that “we don’t think anything we have done was undue” would not really have captured the spirit of the Executive Order. One way to read Notice 2017-38 is merely as an acknowledgment that if any regulations potentially create undue burdens or complexity, then the eight regulations identified in the Notice are the most likely candidates. Another way to read the Notice is that it simply measures undue burden by the intensity of the public reaction, which, in the case of the section 2704 Proposed Regulations, is reflected in the Notice’s focus on what “commenters” have said.

f) The Notice asked for comments from the public by August 7. Many features of the Proposed Regulations have been severely criticized, in professional meetings, in the press, in communications to Congress, and in the tsunami of over 28,000 public comments.

g) Executive Order 13789 also directed the Treasury Department to “prepare and submit a report to the President that recommends specific actions to mitigate the burden imposed by the regulations identified in the interim report.” It directed that this second report be submitted within 150 days of the Executive Order, or by September 18, 2017.

h) Many critics of the Proposed Regulations have called for – or at least hoped for – some formal announcement from the IRS that it has heard the cries for relief and will ensure that the final regulations will provide it. So far those pleas have not been answered. But the Executive Order does ask for a report by September 18. That may be interesting. As of the date of publication of these materials, no such report has been issued.