NEW PROPOSED REGULATIONS RESTRICT VALUATION DISCOUNT PLANNING: WHERE ARE ALL THOSE DISCOUNTS YOU PROMISED ME?!

by

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I. Introduction

From 2010 – 2013, Treasury attempted to convince Congress to amend Section 2704 to restrict the use of partnerships and other entities to generate valuation discounts. Department of Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" at 121 (May 11, 2009); Department of Treasury, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals" at 124 (Feb. 1, 2010); Department of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" at 127 (Feb. 14, 2011); Department of Treasury, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals" at 79 (Feb. 13, 2012). Neither house of Congress showed the slightest interest in making these changes.

In 2013, Treasury quit requesting these statutory changes, but it never gave up on its desire to tighten Section 2704 in order to restrict valuation discount planning. On August 2, 2016, the IRS proposed regulations that, when finalized, may dramatically expand the scope of Section 2704, and equally dramatically restrict the availability of valuation discounts for many entities. REG-163113-02, 81 Fed. Reg. 51413-02 (Aug. 4, 2016). These proposals are similar to, but broader than, those that Treasury submitted to Congress, and when finalized they will dramatically curtail what has become a very common means of reducing a client's estate tax obligations.

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II. A Brief Summary of Section 2704

A. Enactment

Section 2704 was enacted as part of new Chapter 14, in 1990. Pub. L. No. 101-508, §§ 11601-11602, l0lst Cong., 2d Sess. (1990).

B. Legislative History

The legislative history of Section 2704 states that *Harrison* and "similar" cases typically involved a taxpayer successfully sustaining a relatively low value for an interest in a business by valuing the business as a going concern notwithstanding an effort by the IRS to value it as if liquidated. See Explanation of the Recommendations of the Committee on Finance, submitted by letter of October 15, 1990, from Senator Lloyd Bentsen, Chairman of the Senate Committee on Finance, to Senator Jim Sasser, Chairman of the Senate Committee on the Budget, reprinted in 136 Cong. Rec. S15629, S15679-Sl5683 (daily ed. Oct. 18, 1990) ("Senate Explanation"); and H.R. Rep. No. 964, l0lst Cong., 2d Sess. (1990) ("Conference Report”).

C. Anti-Lapse Rules of Section 2704(a)

1. Generally

Section 2704(a)(1) states that a lapse of voting or liquidation rights in a corporation or partnership will be a taxable transfer, if the individual holding such right immediately before the lapse and members of such individual’s family hold, both before and after the lapse, control of the entity. The amount of the transfer is the fair market value of all interests held by the individual immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing) over the fair market value of such interests after the lapse. A transfer under Section 2704(a) takes the form of a taxable gift (if the lapse occurs during the holder's lifetime) or as an addition to the holder's gross estate (if the lapse occurs at the holder's death).

2. Background

Section 2704(a) addresses issues raised by the Tax Court’s decision in *Estate of Harrison v. Comm’r*, T.C. Memo. 1987-8, which involved the estate tax valuation of a majority interest in a family limited partnership. The general partners were given the right to compel the liquidation of the partnership at any time, and thereby recoup their capital accounts. These

rights were personal, nontransferable, and terminated at death. The IRS contended that, because these rights gave value to the interests, they could not be ignored for estate tax valuation purposes, even though they did not survive the partner's death.

The Tax Court disagreed, noting that the estate tax is imposed on only the value of property that can be transferred at death, and that a power that lapses at death cannot, therefore, be considered in valuing a business interest. Thus, the decedent's partnership interest was dramatically diminished in value for estate tax purposes, although it had significant value up until death.

D. “Applicable Restrictions” Ignored Under Section 2704(b)

Section 2704(b), on the other hand, disregards an "applicable restriction" when valuing an interest in a corporation or partnership that is transferred to or for the benefit of a family member, if the transferor and his or her family control the entity immediately before transfer. There are important exceptions. First, if there is no provision calling for the restriction to lapse and neither the transferor nor the transferor’s family can remove the restriction, it is not an applicable restriction. Second, if the restriction includes is “imposed, or required to be imposed, by any Federal or State law,” it is not an applicable restriction. Int. Rev. Code § 2704(b)(3)(B).

III. Proposed Regulations Affecting Both Sections 2704(a) and 2704(b)

A. Extension to New Types of Entities

IRS correctly noted that the regulations under Section 2704 needed to be updated to reflect various new types of entities that were created after 1990. In particular, limited liability companies have become very popular, but the existing regulations (and the Code) still refer only to corporations and partnerships. The proposed regulations provide that Section 2704 applies to corporations, partnerships, LLC’s, and other domestic or foreign entities or arrangements that are business entities under Treas. Reg. § 301.7701-2(a), regardless of how the entity or arrangement is classified for other federal tax purposes, and regardless of whether the entity or arrangement is disregarded as an entity separate from its owner for other federal tax purposes. Prop. Treas. Reg. §§ 25.2701-2(b)(5)(i), 25.2704-1(a), 25.2704-2(a), 25.2704-3(a).

1. The Two Entity Rule

a) Generally

The Code refers only to corporations and partnerships, and the proposed regulations generally maintain this two-entity rule. The explanation of how LLCs and other entities that are not partnerships or corporations should be treated "repairs" a serious gap in the guidance that left practitioners trying to make sense of whether and, if so, how the partnership rules might apply to an LLC. This part of the proposed regulations should be welcome. The rest of the proposed regulations, perhaps, not so much.

b) Corporations

(1) Generally

The proposed regulations state that a "corporation," for purposes of Section 2704, includes:

- any business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;
- any business entity organized under a State statute that describes or refers to the entity as a joint-stock company or joint-stock association;
- an insurance company;
- a State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act or a similar federal statute;
- a business entity wholly owned by a State or any political subdivision thereof;
- a business entity wholly owned by a foreign government or any other entity described in Regulations Section 1.892-2T;

- a business entity that is taxable as a corporation under a provision of the Code other than Section 7701(a)(3); and
- certain foreign entities.

(2) **S Corporations**

A "corporation" also will include an S corporation and a qualified subchapter S subsidiary, which subsidiary is treated as a corporation that is separate from its parent for this purpose. The regulations expressly exclude from the definition of a corporation an unincorporated association that is taxable as a corporation. Prop. Treas. Reg. §§ 25.2701-2(b)(5)(i), 25.2704-1(a), 25.2704-2(a), 25.2704-3(a).

2. Partnership Defined

Generally, the proposed regulations state that a partnership is any business entity that is not a corporation, regardless of how it is classified for federal tax purposes. Thus, a partnership includes a limited liability company that is not an S corporation, whether or not it is a disregarded entity for tax purposes. Prop. Treas. Reg. §§ 25.2701-2(b)(5)(i), 25.2704-1(a), 25.2704-2(a), 25.2704-3(a).

B. Exception from Two-Entity Rule

1. Generally

The regulations break from the statutory reference to just corporations and partnerships in two situations for purposes of the tests to determine control of an entity and to determine whether a restriction is imposed under state law.

a) Unincorporated Business Entities

The form of a business entity or arrangement that is not a corporation will, for these purposes, be determined under local law, regardless of how it is classified for other federal tax purposes, and regardless of whether it is disregarded as an entity for federal tax purposes.

b) Local Law

In these cases, local law means the law of the domestic or foreign jurisdiction under which the entity or arrangement is created or organized. Thus, in applying these two tests, there are three types of entities: corporations, partnerships (general and limited partnerships), and other business entities (including LLCs that are not S corporations). Prop. Treas. Reg. §§ 25.2702-2(b)(4)(ii), 25.2702-3(b)(5)(iii).

2. Control

Section 2704(c)(1) defines control using the definition found in Section 2701(b)(2). The proposed regulations clarify that control of an LLC or any other entity or arrangement that is not a corporation, partnership, or limited partnership, means holding at least 50% of either the capital or profits interests of the entity or arrangement, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. Prop. Treas. Reg. §25.2701-2(b)(5)(iv). Cf. Section 2701(b)(2)(B)(ii) (control of a limited partnership means the holding of any interest as a general partner).

IV. Proposed Regulations Under Section 2704(a)

A. Current Rules, Generally

Section 2704(a) applies to the lapse of voting and liquidation rights.

1. Definition of "Liquidation Right"

The current regulations define a "liquidation right" as the power (including one associated with aggregate voting power), to compel the entity to acquire all or part of the holder's equity interest, whether or not this would result in the complete liquidation of the entity. Treas. Reg. § 25.2704-1(a)(2)(v).

2. Definition of a "Lapse"

The current regulations also state that a lapse of a liquidation right is the restriction or elimination of a presently exercisable liquidation right. Treas. Reg. § 25.2704-1(c)(1).

3. Exceptions

Section 2704(a) does not, however, apply to a transfer that does not restrict or eliminate a liquidation or voting right with respect to the transferred interest. For example, a gift of a minority interest by the holder of a controlling interest sufficient to compel liquidation, is not itself a lapse under Section 2704(a), even though the transferor no longer has sufficient voting control to compel liquidation. See 81 Fed. Reg. at 51414.

B. Proposed Changes

The proposed regulations would make several changes in Section 2704(a) to expand its application.

1. Transfer to an Assignee

The proposed regulations would confirm the a transfer of a partnership interest to an assignee who 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. Prop. Treas. Reg. § 25.2702-1(b)(5).

a) A Mere Confirmation?

The Preamble to the proposed regulations explains that this change merely confirms that a transfer that results in the restriction or elimination of a voting or liquidation right associated with the transferred interest is a lapse under Section 2704(a). 81 Fed. Reg. at 51416.

b) Querry

It is not, however, clear whether this rule will apply where the transferee becomes a partner only upon the vote of the remaining partners within a reasonable time after the transfer is made, so it may be preferable to have the other partners approve the transferee as a new partner before the interest is transferred, to avoid an unintended lapse.

2. Three-Year Rule for Exception for Certain Lapses

a) Background

Present Reg. § 25.2704-1(c)(1) states that a lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. Under this rule, a transfer of an interest that results in the lapse of a liquidation right generally is not taxable if the rights with respect to the transferred interest "are not restricted or eliminated." The result of the "not restricted or eliminated" exception is that a gift of a minority interest by the holder of a majority interest is not treated as a taxable lapse, even though the transfer results in the loss of the transferor's presently exercisable liquidation right. The transferor's liquidation rate is neither restricted nor eliminated, and continues to be exercisable by the transferees collectively.

b) The Change

Proposed Reg. § 25.2704-1(c)(1) states that transfers occurring within three years of death that result in the lapse of a liquidation right should be treated as transfers occurring at death, for purposes of Section 2704(a). They specify that the "not restricted or eliminated" exception will not apply to transfers within 3 years of death.

c) Phantom Asset

This would result in an additional inclusion of a "phantom asset" in the gross estate equal to the difference between the value of the donor's total interest before the gift and the value of the donor's total interest after the gift, thus eliminating the minority interest discount usually associated with such a gift.

d) Example

Treas. Reg. § 25.2704-1(f), Example 4, is modified to illustrate the breadth and impact of this change. In Example 4, D, an individual, owns 84% of the stock in Corporation, whose by-laws require at least 70% of the vote to liquidate. D gives one-half of D's stock in equal shares to D's children. If the gifts transfers occurred within three years of D's death, they will have been treated as if the lapse of the liquidation right occurred at D's death. This result appears to be the equivalent of including in D's gross estate an additional

nondeductible asset equal to the minority and marketability discounts of the three gifts.

e) Rationale

(1) **IRS's Point**

IRS explained that this change was appropriate to avoid death bed tax planning. The Preamble to the regulations cites *Estate of Murphy v. Comm'r*, T.C. Memo. 1990-472, which did in fact reject deathbed "attempts to avoid taxation of the control value of stock holdings through bifurcation of the blocks." 81 Fed. Reg. at 51414.

(2) **Note**

The preamble to the proposed regulations did not, however, cite a contrary holding on identical facts in *Estate of Frank v. Comm'r*, T.C. Memo. 1995-132. Nonetheless, IRS states that such deathbed transfers "generally have minimal economic effects, but result in a transfer tax value that is less than the value of the interest either in the hands of the decedent prior to death or in the hands of the decedent's family immediately after death." 81 Fed. Reg. at 51414. That statement is difficult to refute. The IRS also stated that the three-year "bright-line test" is desirable because it avoids "the fact-intensive inquiry underlying a determination of a donor's subjective motive which is administratively burdensome for both taxpayers and the Treasury." *Id.*

f) Operation of the Three Year Rule

(1) **Generally**

It is unclear exactly what is included in a decedent's gross estate under the three year rule. Treas. Reg. § 25.2704-1(f), Ex. 4, discussed above, should result in increasing Parent's gross estate by the undiscounted value of the retained 42% interest and the discounts claimed on the interests given to the children. Unfortunately, the proposed regulations are not clear on this point. The proposed regulations could be read as including the entire undiscounted value of the interest given away in Parent's gross estate, even though Parent has already been treated as making a taxable gift of the discounted value. This would make no logical sense, but it

may be a mistake to insert logic into a reading of these regulations. Hopefully, the final regulations will be clearer.

(2) **Gift of 100% Interest**

Some commentators have suggested that the three-year rule would not apply if the donor gives away all of his or her interest in the entity. It is hard to see how this rule would not apply equally to a gift of the entire interest held by the controlling donor. Neither of the examples added by the proposed regulations help in this regard.

(3) **Effective Date**

The effective date rules say that this change applies "to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register."

(a) Gift Now, Death After Final Regulations are Published

Thus, if a gift occurs now and the death occurs within three years and after the final regulations are published, there should be a tax under this new rule.

(b) Liquidation Rights Created Before October 8, 1990

The proposed regulations apply the three-year rule only to rights to liquidate that were created after the October 8, 1990 effective date of Section 2704. It is unclear what, if any, amendments to a partnership agreement or other organic document, if made after October 8, 1990, would bring an older liquidation right under the scope of the three-year rule. The cautious estate planner should avoid making any modifications to an effective-date-protected instrument, other than with respect to purely administrative issues, even if this change does not directly affect the right to compel liquidation.

(4) **Interaction of Section 2704(a) and Section 2704(b)**

Things get fuzzier if the initial gifts are valued with smaller or no discounts, because under Section 2704(b), the gift tax value ignores applicable or, with respect to post-final regulation transfers, disregarded restrictions. If the gift is made within three years of the deceased donor's death, the donor's gross estate should logically include only the undiscounted value of the retained interest, because no discount was claimed with respect to the interests given away. Unfortunately, again the proposed regulations are not clear; hopefully, the final regulations will be clearer here, too.

g) Double Counting Under the Three-Year Rule

The application of the transfer within three years of death rule and the Disregarded Restriction rules may result in an unintended double counting. This may be illustrated with the following example. Assume T owns 51% of the stock in Corporation and T's children own the remaining 49%. Corporation has a liquidation value of $100 and the 51% holding gives T the right to liquidate Corporation and receive 51% of Corporation's liquidation value, or $51. T makes a gift to T's children of two percent of the stock and T thereby loses the right to liquidate Corporation. The loss of the liquidation right reduces the value of the 51% interest that T held prior to the gift interest to $40, or an $11 reduction in value which will be treated as transferred at T's death and be add to the value of T's gross estate, under the transfer within three years of death rule. When T dies, T's remaining 49% -- all other things being equal -- will be valued with an assumed put right meaning it will be worth $49. The total in T's gross estate will be $11, attributable to the transfer within three years of death rule, plus $49 for the 49% of the stock, for a total of $60. If T had retained the 51% of the stock until death, only its value which would be $51.

Certainly, the Treasury's proposals will have to be amended to prevent such a double counting of value effect. Perhaps, if these changes will be extensive, probably new proposed regulations with respect to that should be issued, so the public may comment on them, rather than embedding them into the final regulations.

3. Conforming Section 2703(a) to New Section 2704(b)

The proposed regulations would conform Section 2704(a) to certain changes made primarily with respect to Section 2704(b). Specifically, the proposed regulations would:

- conform the existing provision for testing a family's ability to liquidate an interest with a proposed elimination of the comparison with local law;
- clarify that the manner in which liquidation may be achieved is irrelevant; and
- conform the lapse rules of Section 2704(a) with the proposed provision for disregarding certain nonfamily-member interests in testing the family's ability to remove a restriction that may be a disregarded restriction.

Prop. Treas. Reg. § 25.2704-1(c)(2)(i)(B).

4. Attribution Rules Broadened

The proposed regulations would adopt new attribution rules with respect to the determination of family control for purposes of Section 2704(a), which would deem an individual, his or her estate, and members of his or her family, to own, for this purpose, any interest held indirectly by him or her through a corporation, partnership, trust, or other entity, under the rules contained in Treas. Reg. § 25.2701-6. This appears to eliminate the previous limitation on attribution that permitted attribution only of interests that would be included in the individual's gross estate if he or she died immediately before the lapse. This could result in a much greater attribution of ownership and control for purposes of Section 2704(a), because it would attribute to an individual interests owned by a trust of which that individual is merely a beneficiary and over which the individual holds no general power of appointment.

V. Proposed Regulations Under Section 2704(b)

The most dramatic changes under the proposed regulations relate to the operation of Section 2704(b).

A. Rationale

IRS explained in the Preamble that the effectiveness of Section 2704(b) has been limited because:

- Practitioners have made a point of transferring a partnership interest to an assignee, rather than to a partner, which together with state legislation that restricts the rights of assignees, decreases the gift and estate tax value of a partnership interest transferred. *Kerr v. Comm'r*, 113 T.C. 449, 473 (1999), *aff'd*, 292 F.3rd 490 (5th Cir. 2002); and *Estate of Jones v. Comm'r*, 116 T.C. 121, 129-30 (2001).

- Courts have held that Section 2704(b) applies only to restrictions on the ability to liquidate an entire entity, and not to restrictions on the ability to liquidate a transferred interest in that entity (*Kerr, supra*.);

- State limited partnership (or similar) statutes 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, so that a limited partner will not ordinarily be able to withdraw from the partnership, or have imposed other elective restrictions on liquidation; and

- Taxpayers have avoided the application of Section 2704(b) by transferring a nominal partnership interest to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a restriction (*Kerr, supra*.)

IRS, therefore, proposes to impose stricter rules on determining what is an applicable restriction under Section 2704(b), and to create an entirely new class of disregarded restrictions that are not applicable restrictions, but that will be disregarded in valuing an transferred entity interests under Section 2704(b).

B. Expansive New Rules on Applicable Restrictions

The proposed regulations would make several significant changes in the treatment of applicable restrictions.

1. Confirming Meaning of Applicable Restriction

The proposed regulations confirm that an applicable restriction only includes a restriction on the holder's ability to liquidate the entity (in whole or in part), as opposed to a restriction on the holder's ability to liquidate his

or her own interest. Treas. Prop. Reg. § 25.2704-2(b)(1). This confirms the holding in Kerr, at least on this point. See, however, discussion of "disregarded restrictions," below.

2. Federal and State Law Clarified

The proposed regulations clarify that the exception for restrictions "imposed, or required to be imposed, by any Federal or State law" includes only restrictions imposed by the United States, any state, or the District of Columbia. Treas. Prop. Reg. § 25.2704-2(b)(4)(ii). This appears to exclude restrictions that are imposed by a locality, quasi-governmental body, foreign country, or subdivision of a foreign country.

3. Only Mandatory State and Federal Restrictions Considered

a) Generally

(1) The Code

Section 2704(b)(3) states that the applicable restriction rules do not apply to a restriction that is "imposed or required to be imposed by federal or state law."

(2) Existing Regulations

The existing regulations treat a default rule adopted by state or federal law as being "imposed or required to be imposed." Treas. Reg. § 25.2704-2(b).

(3) Proposed Regulations

The proposed regulations change this, stating that a restriction is imposed or required to be imposed by Federal or state law only if it cannot be removed or overridden and is mandated by the applicable law, is required to be included in the governing documents, or otherwise is made mandatory. Treas. Prop. Reg. § 25.2704-2(b)(4)(ii).

(4) Is This Right

(a) The Argument

One argument that has been raised in the on-going debates over the phrase "imposed or required to be imposed" is that "required to be imposed" must have

a different meaning from "imposed," and that it must, therefore, refer to default rules. This, unfortunately, is not a good analysis.

(b) "Imposed" Defined

Merriam-Webster.com defines "impose" as "to cause (something, such as a tax, fine, rule, or punishment) to affect someone or something by using your authority. : to establish or create (something unwanted) in a forceful or harmful way. : to force someone to accept (something or yourself)." Imposed thus refers to restrictions that are made mandatory by Federal or state law.

(c) "Required to be Imposed" Defined

"Required to be imposed" does, indeed, have to be different, but its plain language seems to refer not to default rules, but rather to rules that require that the entity's governing instruments include such restrictions.

(d) Analysis

Therefore, a restriction on one's ability to liquidate an entity in which one holds an interest could be granted automatically by state or Federal law ("imposed") or such a law could require that the governing instrument grant it ("required to be imposed"). The IRS appears to have the authority to define "imposed or required to be imposed" as referring only to mandatory restrictions, and to exclude default rules that can be varied by the governing instrument.

b) Why This is Important

This represents a dramatic change in the present rules, which treat default provisions of state laws, that can be waived or varied by the governing instrument, as exempt from the definition of applicable restrictions. Under the new rules, restrictions such as those on liquidation or transfer of a partnership interest under laws like the Revised Uniform Limited Partnership Act, will now be classified as applicable restrictions, and ignored for purposes of valuing business

interests for estate, gift and generation-skipping transfer tax purposes.

c) Implies a Right to Compel Liquidation and Eliminates All Minority and Most Marketability Discounts

(1) **Effect on Minority and Marketability Discounts**

The change in the exception from applicable restriction classification for restrictions that are mandatory under state or federal law, as opposed to those that are default rules, appears to reduce significantly (or eliminate) most marketability and all minority discounts for all family-owned entities.

(2) **Every Business Interest Now Includes a Right to Compel Liquidation**

(a) Generally

No state or federal law prohibits an entity from giving every one of its equity-owners a right to compel liquidation of the entire entity at any time. Therefore, any provision that permits liquidation only by a majority of the owners (let alone a super-majority) would be ignored under the proposed regulations. Thus, a right to compel liquidation must be imputed to every family-owned entity under Treas. Prop. Reg. §§ 25.2704-2(a) and 25.2704-2(b)(4)(ii).

(b) Proposed Regulations Contain No Examples of Implied Right to Liquidate

Note that none of the examples in the proposed regulations involve entities that are silent on the ability of an owner to withdraw and have the interest redeemed by the entity. Nonetheless, since the entity could grant such rights, its failure to do so or its express rejection of this grant must be ignored, under the proposed regulations. See Gans & Blattmachr, "Recently Proposed Section 2704 Regulations," Leimberg Estate Planning Email Newsletter #2441 (August 5, 2016) ("What would be the outcome in

Example 1 if the partnership agreement had been silent on the put-right issue? Assuming no mandatory provision in state or federal law precluding the partnership from granting a put right, and it is difficult to imagine such a provision under state or federal law, the failure to include a put right would presumably be disregarded.")

(3) **All Interests are Valued Without Minority Discounts**

Arguably, this imputed right to compel liquidation of the entire entity means that the interest is valued without any minority discount for lack of control, because if you can compel liquidation, control should not matter. Some appraisers have suggested, however, that a lack of control discount should still be available for lack of control over day-to-day operations (up to about 10%) and for the six months delay in receiving the liquidation payout (up to about 5%).

(4) **Smaller Marketability Discounts Should Survive**

(a) Why Marketability Discounts Are Allowed Anyway

Even a controlling interest in a closely-held entity is entitled to a marketability discount, because there is no ready market for the interest. This discount reflects the fact that the hypothetical "willing buyer" in an arm's-length transaction will insist on reducing the purchase price to reflect the lack of a ready market for the interest and the additional expenses, such as legal, accounting, and underwriting or syndication fees, that are inherent in marketing a non-publicly-traded entity's interest. See *Estate of Andrews v. Comm'r*, 79 T.C. 938, 953 (1982). It also reflects the degree of uncertainty inherent in a business that does not undergo the scrutiny that attends being publicly traded. See J. A. Bogdanski, *Federal Tax Valuation*, ¶ 4.04 (Thomson-Reuters/WG&L); Barron, "When Will the Tax Court Allow a Discount for Lack of Marketability?" 86 J. Tax'n 46 (1997); Fellows & Painter, "Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth

Syndrome, 30 Stan. L. Rev. 895, 916–921 (1978); Reilly & Rotkowski, "The Discount for Lack of Marketability: Update on Current Studies and Analysis of Current Controversies," 61 Tax Law. 241 (2007); Robak, "Recent Cases Suggest How to Maximize the Marketability Discount," 31 Est. Plan. 605 (Dec. 2004).

(b) The Underlying Assets Really Matter

In *Estate of Jephson v. Comm'r*, 87 T.C. 297 (1986), a decedent died owning all of the stock in two investment companies, the assets of which were primarily unleveraged portfolios of marketable securities with readily ascertainable fair market values. The estate sought 28-percent and 31.3-percent lack of marketability discounts to the net asset values of the corporations, comparing the net asset value of ten publicly-traded closed-end investment funds with similar portfolio profiles. The Tax Court disallowed the marketability discount entirely, while allowing a reduction in net asset values for costs of liquidation, in large part because the assets of the corporations were liquid. The court did, however, allow a 20-percent discount for the "costs of liquidation" (which did not include income taxes, as this case was before the repeal of Section 337). *Compare, Dougherty v. Comm'r*, T.C. Memo. 1990-279 (decedent's revocable trust held all of the stock of a company, the assets of which were principally real estate and other illiquid assets, and the Tax Court, distinguishing *Estate of Jephson*, allowed a 25%-discount); and *Estate of Bennett v. Comm'r*, T.C. Memo. 1993-34 (15%-discount allowed for lack of marketability of a controlling interest in a corporation that owned and actively-managed real estate).

(c) Marketability Discounts for Controlling Interests Tend to be Smaller

Generally, the discounts for controlling interests are usually smaller than those for minority interests, because it is more difficult to compel liquidation. See Rubin, "The Lack of Marketability Discount in

the 100-Percent Ownership Situation," 61 Tax Notes 733 (Nov. 8, 1993). The size of the discrepancy in discounts, however, is inconsistent.

(d) Controlling Interest Analysis vs. Deemed Right to Liquidate Entity

The same analysis that applies to determine the discount for a controlling-interest in a closely-held entity should apply where the donor or decedent is deemed to be able to compel liquidation, since the underlying assets, including going concern value, still must be sold, and the holder of this deemed right can compel the sale.

(e) No Offsetting Premium

Also, when a donor or decedent owns an actual controlling-interest, the marketability discount is often offset by a control premium. See J. A. Bogdanski, *Federal Tax Valuation*, ¶ 4.04[1][e][i] (Thomson-Reuters/WG&L); and *Hutchens Non-Marital Trust v. Comm'r,* T.C. Memo. 1993-600 (court taking both lack-of-marketability discount and control premium into account in valuing 83% interest in closely-held manufacturing corporation); *Estate of Winkler v. Comm'r*, T.C. Memo. 1989-231 (25% lack-of-marketability discount offset by 10% "swing-vote" premium); *Estate of Folks v. Comm'r*, T.C. Memo. 1982-43 (taxpayer's expert, with whom court largely agreed, stated that lack-of-marketability and control premium "effectively canceled each other out"); *Wallace v. United States*, 566 F. Supp. 901, 914–915 (D. Mass. 1981) (control premiums offset, partially or totally, any lack-of-marketability discounts for interests in corporation and partnership whose shares were held by subject investment companies).

d) No Alternate Entities Allowed

(1) Generally

The proposed regulations state that a restriction imposed by a state law and that cannot be removed or overridden is still an applicable restriction in two situations:

- If the state law is limited in its application to certain narrow classes of entities, particularly family-controlled entities; and

- If the law under which the entity was created also provides (either at the time the entity was organized or thereafter) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded. Treas. Prop. Reg. § 25.2704-2(b)(4)(ii).

This precludes a state from avoiding the impact of Section 2704(b) by creating a new class of entity that includes mandatory limitations on liquidation and transfer, if there is another form of entity available that has no similar restrictions.

(2) What is an Alternate Entity?

The regulations refer to the existence of a second statute for creating "that same type of entity." It is not clear what constitutes "that same type of entity" for this purpose. For example, a law imposing a mandatory restriction on liquidation or voting might not be the "same type of entity" as one that makes such restrictions optional, if the two entities have significantly different features, such as duration and the number and identity of permissible members. It is hoped that this will be clarified in the final regulations.

4. Exception for Certain Put Rights

a) Generally

The proposed regulations state that an applicable restriction does not include a restriction if each holder of an interest in the entity has a put right that:

- is enforceable under applicable local law;
- entitles each holder to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest;
- within six months after the date the holder gives notice of the holder's intent to withdraw;
- cash and/or other property;
- with a value that is at least equal to the "minimum value" of the interest determined as of the date of the liquidation or redemption. See discussion of "minimum value" below, with respect to disregarded restrictions.

Prop. Treas. Reg. §§ 25.2704-2(b)(4)(iv) and 25.2704-3(b)(6).

b) Drafting

If this provision remains part of the final regulations, many family limited partnerships and limited liability companies may expressly include such a put right, to alert appraisers that this is the way in which the interest must be valued.

5. Partially-Controlled Entities

The proposed regulations state that, for purposes of Section 2704(b), if part of a decedent's interest in an entity includible in his or her gross estate passes by reason of death to both members of the decedent's family and persons who are not members of the decedent's family, and under Section 2704(b) the part passing to the members of the decedent's family is to be valued by disregarding an applicable restriction, then that part is treated as a single, separate property interest. In such cases, 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. Treas. Reg. § 25.2704-2(f).

Thus, the valuation discounts usually associated with the interest passing to the non-family members should be preserved.

Section 2704(b) applies only to a family-controlled entity, however, which is defined as one in which family members directly or indirectly own 50% or more of the entity. This is not really family control, because two equal unrelated co-owners would each be deemed to have family control for this purpose. IRC §§ 2704(c)(1) and 2701(b)(2).

VI. The New Classification -- Disregarded Restrictions

The most dramatic change in Section 2704(b) is the creation of a new category of "disregarded restrictions" apart from applicable restrictions.

A. Rationale

The purpose of this change is to ignore in valuing a business interest many of the restrictions that have been used in the past to reduce the value of such interests, but which, for various reasons, are not themselves "applicable restrictions." 81 Fed. Reg. at 51414-51415. This overrides one of the positions taken by the Tax Court in Kerr, that the liquidation rights referred to in Section 2704(b) are only those entitling the holder of the interest to liquidate the entire entity, not those entitling the holder to liquidate his or her own interest.

B. General Impact

The fair market value of an interest in an entity is determined assuming that all disregarded restrictions did not exist; fair market value of such entity is determined under generally accepted valuation principles, including any appropriate discounts or premiums.

C. "Disregarded Restriction" Defined

1. Generally

Treas. Prop. Reg. § 25.2704-3 states that any restriction in a family-controlled entity that limits an owner's right to liquidate his or her interest in the entity will be disregarded, if it will lapse at any time after the transfer, or if the transferor, or his or her family members, without regard to certain interests held by nonfamily members, can remove or override the restriction.

2. Specific Examples

A disregarded restriction includes one that:

- limits the ability of the holder of the interest to liquidate the interest;
- limits the liquidation proceeds to an amount that is less than a minimum value (discussed below);
- defers the payment of the liquidation proceeds for more than six months; or
- permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.

Prop. Treas. Reg. §§ 25.2704-3(b)(1).

3. Payments May be Deferred for Only Up to Six Months

The proposed regulations state that a disregarded restriction includes any limit on the time and manner of payment of the liquidation proceeds. Thus, provisions permitting deferral of full payment beyond six months or permitting payment in any manner other than in cash or property would be disregarded restrictions.

a) "Property" Defined -- Generally

For this purpose, "property" does not include a note or other obligation issued directly or indirectly by the entity, other holders of an interest in the entity, or persons related to either.

b) "Property" Defined – Active Businesses

Property does, however, include the note of an entity engaged in an active trade or business to the extent that:

- the liquidation proceeds are not attributable to passive assets (see Section 6166(b)(9)(B)); and
- the note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value (when discounted to present value) equal to the liquidation proceeds.

Prop. Treas. Reg. §§ 25.2704-3(b)(1)(iii), 25.2704-3(b)(1)(iv).

4. Exceptions to Disregarded Restrictions

a) Applicable Restriction Exceptions Carried Over

Exceptions that apply to applicable restrictions under the current and proposed regulations would also apply to disregarded restrictions, including:

- commercially reasonable restrictions on liquidation imposed by an unrelated person providing capital to the entity;
- requirements imposed by federal or state law; and
- an option, right to use property, or agreement that is subject to Section 2703.

Prop. Treas. Reg. § 25.2704-3(b)(5).

b) "Put" Right Exceptions

(1) Generally

Disregarded restrictions do not include an enforceable put right held by each holder of an interest in the entity, if:

- the right entitles the holder to receive, on liquidation or redemption of the holder's interest, cash or other property with a value that is at least equal to the minimum value discussed above;
- the full amount of such cash and other property must be paid within six months after the holder gives notice to the entity of the holder's intent to liquidate any part or all of the holder's interest or withdraw from the entity; and
- the other property that must be paid within six months does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related either to the entity or to any holder of an interest in the entity.

Prop. Treas. Reg. § 25.2704-3(b)(6).

(2) **All Interests in Family-Controlled Entities Now Must be Valued as if a Put Right Existed**

The result will be the same whether or not the governing instruments expressly give the owners a put-right. Assuming no mandatory provision in state or federal law precluding the entity from granting a put right, and it is difficult to imagine such a provision under state or federal law, the proposed regulations would disregard the failure to grant a put right and would deem every owner to have a right to compel the liquidation of his or her interest. In other words, the proposed regulations read into to every entity's governing documents a put right, unless there is mandatory state or federal law precluding it. Thus, the proposed regulations eliminate any minority discount and dramatically suppress marketability discounts.

(3) **Active Businesses**

If the entity is engaged in an active trade or business, at least 60% of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets, the proceeds of such a put may include a note or other obligation if such note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of the liquidation or redemption equal to the liquidation proceeds. *Id*.

(4) **Local Law**

For purposes of this put right, "local law" is the law of the domestic or foreign jurisdiction that governs liquidation or redemption rights with regard to interests in the entity. Prop. Treas. Reg. §§ 25.2704-2(b)(4)(iv) and 25.2704-3(b)(6).

(5) **Other Property**

For purposes of this put right, "other property" does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or to any holder of an interest in the entity. *Id*. Other property also does not include a note or other obligation if: (a) the

entity is engaged in an active trade or business, at least 60% of whose value consists of the non-passive assets of that trade or business, to the extent that the liquidation proceeds are not attributable to passive assets (as defined in Section 6166(b)(9)(B), relating to the option to pay estate tax attributable to certain closely-held business for an extended period after death); and (b) the note or obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. *Id*.

(6) **Example**

Prop. Treas. Reg. § 25.2704-3(g), Ex. 1 illustrates the application of the new put-right concept. Parent gives a 33% limited partnership interest to Child A and an equal interest to Child B. 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: (a) liquidation will occur in 2066, unless all of the partners unanimously agree to an earlier liquidation; (b) no limited partner may withdraw from the partnership; and (c) the approval of all partners is required to amend the agreement. None of these provisions is mandated by local law.

The example states that the prohibition on withdrawal is a disregarded restriction, because it imposes a restriction on the ability of the partner to compel a liquidation (redemption) of his or her interest, and it is not mandated by state or federal law. Family members could remove the restriction after the transfer, so the interest given to each child must be valued without taking into account the partnership agreement provision that prevents a limited partner from compelling a redemption of his or her interest. This was the position of the courts in *Kerr*, supra., but the regulations now would clearly adopt the position that a disregarded restriction is one that restricts the ability of the holder of an interest to liquidate it.

c) Effect of the Put Right

(1) Eliminating Minority Discounts and Maybe Marketability Discounts

This deemed put right should have the effect of denying any minority discount and also largely reducing or eliminating any lack of marketability discount. The IRS states that the discount for lack of marketability reflects the fact that "a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock." Rev. Rul. 59-60, § 4.02(g), 1959-1 C.B. 237, 242; see also Rev. Rul. 80-213, § 4.08, 1980-2 C.B. 102, 103 (in valuing closely held stock with reference to prices of comparable stocks sold on open exchanges, "it is generally necessary to adjust the preliminary value in recognition that the shares of the comparative companies are publicly traded while the shares to be valued are not"). Also, it has been noted that, "[i]n addition to being harder to sell, shares of closely held firms are far less suitable than their publicly traded counterparts for use as collateral for a loan. Bogdanski, Federal Tax Valuation, ¶ 4.04[1][a] (2009 & Supp.2016); also see LaPray, "Hypothecation Impairment as a Component of a Discount for Lack of Marketability," 21 Bus. Val. Rev. 142 (2002). Because the proposed regulations would essentially grant each transferee a deemed right to demand a proportion value of the "minimum value," which is the value of the underlying net assets, there may be little or no lack of marketability discount for the interest transferred. Nonetheless, the underlying assets of the entity might be valued with a lack of marketability discount (e.g., where the entity owns an interest in a closely-held business). If the holder of an interest in the entity is deemed to have a right to compel the redemption of his or her interest, the value of that interest is less significantly affected by lack of marketability or lack of control. In appropriate circumstances, however, one might be able to argue that the value of assets inside the entity should be reduced to reflect a lack of marketability for those assets. See, e.g., *Estate of Jameson v. Comm'r*, T.C. Memo 1999-43, *rev'd on other grounds*, 267 F.3d 366 (5th Cir. 2001) (marketability discount for 98% interest in corporation, because of the nature and marketability of the corporation's assets; discount low because timberland, the corporation's primary asset, was certain to sell quickly).

(2) **Example**

For example, assume Parent, who owns all of the outstanding shares of Corporation, and makes a lifetime gift to Daughter of one share. The gift is made more than three years before Parent's death (thus avoiding the new deathbed lapse rule under Proposed Regulations Section 25.2704-1(c)(1). The governing documents provide that no shareholder can force a redemption of his or her interest (or are silent on this issue). Under traditional valuation rules, the stock given to Daughter would be valued as a minority interest that cannot compel a redemption. That is not the result under the proposed regulations. The prohibition on redemptions (or the absence of an express authority to redeem) is ignored, and the stock given to Daughter is valued as if it had the right to compel a redemption of the share. Put simply, even in this classic case of a gift of a minority interest, a minority discount would not be allowed.

(3) **A Contingent Liability and Additional Discount**

One might, however, argue that if the entity actually gives the investors a right compel redemption of their own interests, there should be an additional creates an additional contingent liability for the entity to fund such a redemption, thereby reducing the value of the going concern. Such a required reserve would tie up the company's operating capital and could cripple its future earnings. This could entitle the holders of interests to a "lack of continuity" discount.

(4) **Active Businesses, Too**

Nothing in the proposed regulations suggests a different result would apply for an active business than for a holding company. The deemed right to compel liquidation treats the holder of the interest as if he or she were entitled to receive a proportionate share of "the fair market value . . .of the property held by the entity, reduced by the outstanding obligations of the entity." With an active business, the assets would include not only the real property and tangible personal property, but also the intangible assets, such as goodwill, customer lists, patents, trademarks, and going

concern value. The net value of the individual's interest would be the same whether the business is a holding company or a going concern.

d) Limited Use of Non-Family Member Interests for Disregarded Restrictions

(1) **Generally**

In determining whether the transferor and/or the transferor's family can remove a disregarded restriction, any interest in the entity held by a person who is not a member of the transferor's family is disregarded if, at the time of the transfer, the interest:

- has been held by such person for less than three years;
- constitutes less than 10% of the value of all of the equity interests in a corporation, or constitutes less than 10% of the capital and profits interests in a partnership, LLC, or similar business entity described in Treas. Reg. § 301.7701-2(a);
- when combined with the interests of all other persons who are not members of the transferor's family, constitutes less than 20% of the value of all of the equity interests in a corporation, or constitutes less than 20% of the capital and profits interests in a business entity other than a corporation (for example, less than a 20-percent interest in the capital and profits of a partnership); or
- any such person, as the owner of an interest, has no enforceable right to receive in exchange for such interest, on no more than six months' prior notice, the minimum value referred to in the definition of a disregarded restriction.

Prop. Treas. Reg. § 25.2704-3(b)(4).

(2) **Odd Put Requirement**

The last of these requirements, that the non-family-member have a put right, is noteworthy on several levels. First, it is

a severe and unnecessary requirement to impose, if the goal is merely to avoid using nominal interests to avoid the requirements of Section 2704(b) with respect to Disregarded Restrictions. A 10% interest (with aggregate non-family interests of 20%) would appear to be sufficient to accomplish this task.

Second, this will force practitioners to be forced to modify the organic instruments for entities that are not owned entirely by a family. These instruments will need to include an actual put right, and cannot rely on the imputation of a put right in order to assure that the nonfamily-members' interests are taken into account in determining whether the transferor and/or the transferor's family can remove a Disregarded Restriction.

(3) **Disregarded Restrictions vs. Applicable Restrictions**

The proposed regulations adopt this rule only with respect to disregarded restrictions; it does not apply to applicable restrictions. Therefore, a deemed right to liquidate the entity can be removed from the operation of Section 2704(b) if it can be eliminated only with the consent of a non-family member who holds a small interest in the entity and has held it only a short time.

(4) **Power to Remove Restrictions**

The determination of whether the family can remove the restriction in a disregarded interest is made by assuming that the remaining interests are the sole interests in the entity. Prop. Treas. Reg. § 25.2704-3(b)(4)(iii).

(5) **Attribution**

In applying the ten-percent and 20-percent tests described above, when the entity holds an interest in another entity, the attribution rules of Prop. Treas. Reg. § 25.2704-3(d) apply both in determining the interest held by a nonfamily member, and in measuring the interests owned through other entities. Under these attribution rules, an individual, his or her estate, and members of the individual's family, as well as any other person, also are treated as holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules of Treas. Reg. § 25.2701-6.

5. Commercially Reasonable Restriction Exception

The exception for commercially reasonable restrictions may be important for active businesses. A loan from an independent lender secured for *bona* fide business reasons and paired with lender-imposed restrictions on liquidation of the entity, transfer of interests, and redemption of interests, may be excluded from Section 2704(b) entirely. The requirement that the restriction be "commercially reasonable" does not open the door to a wide array of restrictions, but requirements that the investors not withdraw is not an uncommon restriction and would undercut the entire revision of Section 2704(b).

D. Coordination with Marital and Charitable Deductions

1. The Problem

Section 2704(b) applies to intra-family transfers for all estate, gift and GST tax purposes. Where and to the extent that an interest in an entity qualifies for the gift or estate tax marital deduction and must be valued by taking into account the applicable restriction and disregarded restriction rules of Section 2704(b), the same value generally would apply in computing the marital deduction attributable to that interest. The value of the estate tax marital deduction may be further affected, however, by other factors justifying a different value, such as the application of a control premium. *See, e.g., Estate of Chenoweth v. Comm'r*, 88 T.C. 1577 (1987).

2. The Solution

a) Section 2704(b) Does Not Apply to Interests Passing to Charity

The proposed regulations state that Section 2704(b) does not apply to transfers to nonfamily members and so does not affect the value of an interest passing to charity or to a person other than a family member. If part of an entity interest includible in the gross estate passes to family members and part of that interest passes to nonfamily members, and if (taking into account the proposed rules regarding the treatment of certain interests held by nonfamily members) the part passing to the decedent's family members would be valued under Section 2704(b), the proposed regulations provide that the part passing to the family members would be treated as a property interest separate from the part passing to nonfamily members. Prop. Treas. Reg. § 25.2704-3(f).

b) Part Passing to Family Members

The fair market value of the part passing to the family members is determined taking into account the special valuation assumptions of Section 2704(b), as well as any other relevant factors, such as those supporting a control premium.

c) Part Passing Outside the Family

The fair market value of the part passing to the nonfamily members is determined without the application of Section 2704(b). Thus, if the sole nonfamily member receiving an interest is a charity, the interest generally will have the same value for both estate tax inclusion and deduction purposes.

d) Interests Divided Between Family Members and Non-Family Members

If the interest passing to nonfamily members, however, is divided between charities and other nonfamily members, considerations other than Section 2704 may apply, resulting in a different value for charitable deduction purposes. *See, e.g., Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

VII. Effective Dates

A. Section 2701

The changes relating the extension of Section 2701 (estate freezing recapitalizations) to entities other than corporations and partnerships would be effective on and after the date of publication of the final regulations in the Federal Register. Prop. Treas. Reg. § 25.2701-8(b).

B. Section 2704(a)

The changes relating to the lapse of a voting or liquidation right under Section 2704(a) will apply to the lapse of rights created after October 8, 1990, to the extent that the lapse occurs on or after the date the date of publication of the final regulations in the Federal Register. Prop. Treas. Reg. § 25.2704-4(b)(1).

C. Section 2704(b) -- Applicable Restrictions

The changes relating to applicable restrictions under Section 2704(b) would apply to transfers of property subject to restrictions created after October 8, 1990, to the extent that the transfer occurs on or after the date of publication of the final regulations in the Federal Register. Prop. Treas. Reg. § 25.2704-4(b)(2).

D. Section 2704(b) – Disregarded Restrictions

The new rules on disregarded restrictions will apply transfers of property subject to restrictions created after October 8, 1990, to the extent that the transfer occurs 30 or more days after on or after the date of publication of the final regulations in the Federal Register. Prop. Treas. Reg. § 25.2704-4(b)(3).

E. Caveat

The proposed regulations do not provide any rules for restrictions created before October 9, 1990, that are amended after October 8, 1990. One should anticipate that any substantial change in an effective-date-protected restriction will be deemed to create a new restriction that falls under the proposed regulations. It is less clear, however, whether a post-October 8, 1990 change in a pre-October 9, 1990 instrument that does not itself change the restriction will cause the proposed regulations to apply. Generally, practitioners should be wary about any changes to a pre-October 9, 1990 instrument that contains a restriction to which the proposed regulations might otherwise apply.

VIII. Validity of the Proposed Regulations

A. Generally

IRS took pains to explain how the proposed regulations are authorized by the Code, possibly anticipating arguments that the proposed regulations exceed the scope of the Code itself.

1. Section 2704(a) Authority

IRS noted that Section 2704(a)(3) authorizes IRS "by regulations [to] apply this subsection to rights similar to voting and liquidation rights."

2. Section 2704(b) Authority

Section 2704(b)(4) authorizes IRS "by regulations [to] 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."

B. *Chevron* Deference

1. History

Traditionally, the courts distinguished between a general-authority and a specific-authority regulation. A general-authority regulation is an interpretative regulation issued under the authority of Section 7405. A specific-authority is a "legislative" regulation issued under express authority. *See Walton v. Comm'r*, 115 T.C. 589, 598-599 (2000) (indicating that a general-grant regulation is reviewed more deferentially than a specific-grant regulation). This distinction, however, has been largely, if not entirely, erased by *Mayo Found. For Med. Educ & Research v. United States*, 562 U.S. 44 (2011); *McDonald v. Comm'r*, T.C. Memo 2015-169 (indicating that both types of regulation are reviewed under the same Mayo standard).

2. The Real Issue

a) *Chevron/Mayo* Deference

Under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984) and *Mayo*, which extended Chevron to tax regulations, a regulation is valid unless:

- Congress has directly spoken to the precise question at issue, and the regulations are inconsistent with Congress's unambiguously expressed intent; or
- the regulation "is arbitrary or capricious in substance, or manifestly contrary to the statute."

Mayo, 562 U.S. at 53. This is, obviously, a very high level of deference, and a very high bar to a challenge to the regulations.

b) Traditional Tools of Statutory Construction

Chevron states that the traditional tools of statutory construction must be employed in determining if the Congress has spoken to the issue. "If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." 467 U.S. 837 at 843, fn. 9. This clearly includes the legislative history.

3. Legislative History

a) Background -- Family Attribution

Before the enactment of Section 2704, the IRS had argued vigorously in the courts against discounts where family was involved, essentially asking the courts in effect to adopt a family-attribution principle.

(1) *Estate of Bright*

In *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the decedent's undivided community property interest in shares of stock, together with the corresponding undivided community property interest of the decedent's surviving spouse, constituted a control block of 55% of the shares of a corporation. The court held that, because the community-held shares were subject to a right of partition, the decedent's own interest was equivalent to 27.5% of the outstanding shares and, therefore, should be valued as a minority interest, even though the shares were to be held by the decedent's surviving spouse as trustee of a testamentary trust. The court stated that the stock must be deemed to be held by hypothetical seller who was related to no one.

(2) Rev. Rul. 81-253

Rev. Rul. 81-253, 1981-1 C.B. 187 stated that, ordinarily, no minority shareholder discount is allowed with respect to transfers of shares of stock between family members if, based upon a composite of the family members' interests at the time of the transfer, control (either majority voting control or de facto control through family relationships) of the corporation exists in the family unit. The ruling also stated that the IRS would not follow the decision of the Fifth Circuit in *Estate of Bright*.

(3) **More Losses**

The IRS continued to raise this argument and be rebuffed by the courts. See *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Andrews v. Comm'r*, 79 T.C. 938 (1982); and *Estate of Lee v. Comm'r*, 69 T.C. 860 (1978), *nonacq*.,1980-2 C.B. 2 (the corporation shares owned by other family members cannot be attributed to an individual family member for determining whether the individual family member's shares should be valued as the controlling interest of the corporation.) In particular, see also *Estate of Minihan v. Comm'r*, 88 T.C. 492 (1987), where the Tax Court went so far as to criticize the IRS for continuing to raise the same issue that they have rejected repeatedly, and assessed attorney fees against the government.

(4) **Rev. Rul. 93-12**

The IRS appeared to throw in the towel in Rev. Rul. 93-12, 1993-1 C.B. 202, in which Donor owned all of the stock of X Corporation and gave the shares to Donor's five children, in equal blocks of 20% each. Recognizing the losses it had sustained, the IRS stated that

> in the case of a corporation with a single class of stock, notwithstanding the family relationship of the donor, the donee, and other shareholders, the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest.

The IRS also stated that:

> [f]or estate and gift tax valuation purposes, the Service will follow *Bright*, *Propstra*, *Andrews*, and *Lee* in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest. Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held

by family members, would be a part of a controlling interest. This would be the case whether the donor held 100% or some lesser percentage of the stock immediately before the gift.

b) Conference Report

(1) **General Declaration**

The Conference Report issued in connection with the 1990 enactment of Section 2704 states: "[t]hese rules do not affect minority discounts or other discounts available under present law." H.R. Rep. No. 101-964, 101st Cong., 2d Sess. 1137 (1990).

(2) **Example 8**

Example 8 in the Conference Report explained:

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

(3) **What Congress Knew and When It Knew It**

Congress was presumably aware of the family-attribution litigation when it made these statements, and this legislative history may have influenced the IRS decision to concede the family attribution issue in Rev. Rul. 93-12.

4. Analysis

a) Legislative History Matters

The legislative history appears to preclude regulations that would entirely eliminate minority and marketability discounts for family-controlled corporations, partnerships, and similar entities, as the proposed regulations appear to attempt. In *General Dynamics Corp. v. Cline,* 540 U.S. 581 (2004), the Court applied Chevron, making explicit reference to legislative history, and concluded that Congress' intent was sufficiently unambiguous to displace an agency interpretation. *See also United States v. Home Concrete & Supply, LLC*, 132 S.Ct. 1836, 182 L.Ed.2d 746, 109 A.F.T.R. 2d 2012-1692 (2012) ("examination of legislative history ... [can lead to the conclusion that Congress had decided the question definitively], leaving no room for the agency to reach a contrary result").

b) Where Legislative History Fits in the *Chevron* Analysis

The role of legislative history in *Chevron* and *Mayo* is not entirely clear. *See Balestra v. United States*, 803 F.3d 1363 (Fed. Cir. 2015) ("Under the *Chevron* framework, we begin by using the ordinary tools of statutory construction to determine whether Congress's intent is clear regarding the precise question at issue. . . . These tools include the statute's text, structure, cannons of statutory construction, and legislative history"); and *Cohen v. JP Morgan Chase & Co.*, 498 F.3d 111 (2nd Cir. 2007) ("a high level of clarity" is required to find that legislative history, purpose or structure is sufficiently unambiguous to constrain an agency in the *Chevron* context).

c) Are the Regulations Valid?

(1) **Section 2704(b)(4)**

The IRS may argue in reply that the statute itself contemplates a modification of discount principles in calling for the disregard of certain restrictions and that the proposed regulations will not affect entities that are not family-controlled. Section 2704(b)(4) does authorize IRS "by regulations [to] 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." The only way in which the disregarded restrictions would "not ultimately reduce the

value of such interest to the transferee," however, is if you assume family attribution, which the statute does not do.

(2) **Best Analysis**

Unless the final regulations rein in these provisions significantly, their validity will be called into question. Ultimately, the courts are likely to be asked to decide whether the Congress' statement of its intent is sufficiently clear to prevent the IRS from implementing its new approach. Given Congress' apparent understanding that discounts would not be affected by the enactment of Section 2704, it seems hard to sustain the proposed regulations; they have gone too far in imputing into every interest in a family-controlled entity both a right to compel liquidation of the entity and a right to compel liquidation of the holder's own interest.

d) **Inconsistency and Disagreeing With Court Holdings is Fine**

Those who wonder about the ability of the IRS to issue regulations that take a new approach that is inconsistent with prior guidance or to overrule the outcome in a prior case, like *Kerr*, *Chevron* seems to provide a complete answer. Under *Chevron* and *Mayo,* agency inconsistency is not a basis for invalidating a new approach. See *Mayo*, 562 U.S. at 55 ("We have repeatedly held that '[a]gency inconsistency is not a basis for declining to analyze the agency's interpretation under the *Chevron* framework.'"). *Chevron* also permits, as a general matter, agencies to overrule court decisions. *See, e.g., National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U.S. 967 (2005).

IX. Planning

There are several key issues to planning under the proposed regulations.

A. Uncertainty

The proposed regulations are not a model of clarity, despite what appears to have been an extraordinary amount of effort to produce a meaningful change in the law. Part of this is because the real impact will be decided by so many parties. The IRS and Treasury will decide what the final regulations provide and when they are published. The courts will decide what types of restrictions are deemed not to exist

and what types of rights are deemed to exist under the final regulations. The appraisal industry will determine the real effect of these deemed rights and restrictions. Oh, and the new President and Congress will determine whether to overturn or applaud these regulations, whether to keep or kill the estate tax, and whether, if the estate tax is kept, to reduce exemptions and tighten other techniques.

You can counsel clients right now to take advantage of the current law, but you really cannot tell them with any degree of certainty what the new rules will be.

B. Effective Date Planning

1. Act Now, or Forever Hold Your Peace

The effective date of the proposed regulations invites taxpayers to create and take advantage of restrictions on the liquidation of an interest or entity before the final regulations are published in the Federal Register.

a) Section 2704(a)

The effective dates for the changes in Section 2704(a) relate to when the lapse occurs, with respect to rights created after October 8, 1990. Thus, to avoid this rule, one must actually give or sell the interest in question (or die) before the final regulations are published, and live at least three years.

b) Section 2704(b)

The effective date rules for both applicable restrictions and disregarded restrictions under Section 2704(b) relate to the date on which transfer occurs, with respect to restrictions that are created before the 1990 effective date of Section 2704. Thus, to avoid the new rules, one must not only create the restrictions (or take advantage of applicable state or Federal default rules), but make the relevant transfers, before the regulations are finalized.

2. When Might the Final Regulations Be Issued

There is no known date when the final regulations will be published in the Federal Register. Public hearings on these proposed regulations are scheduled for December 1, 2016. Even assuming that the IRS hears nothing at the hearings that convinces it to change any part of the regulations, it seems unlikely that the final regulations could be published before the end of 2016. As there are likely to be extensive comments, and at least some of these comments will likely result in a change in the regulations or, at least, a written explanation in the preamble to the final regulations. Often,

regulations take one or two years to progress from proposed to final form, and these regulations seem likely to be particularly contentious. Even if the IRS makes these regulations a top priority, it seems unlikely that final regulations will be published before the middle of 2017. Of course, no guarantees can be offered (either to you or your clients) about when the regulations will be finalized.

It would be a welcome reprieve for practitioners if the final regulations were delayed as long as those on the income taxation of private annuities, which were proposed ten years ago (but are still in the latest Priority Guidance List), or those on Section 2036(b), which were proposed in 1983. We should not hold out much hope of such a long reprieve.

3. What to Do Until Then

Before this time, clients can still create family limited partnerships or LLCs or S corporations, taking advantage of the favorable state statutes and tax case law, and make transfers of those interests. These transfers may be to irrevocable trusts or outright to donees. The transfers may be either gifts or sales. Practitioners must prompt those clients who are otherwise good candidates for discount planning to act now, rather than continuing to contemplate their options. *Tempus is fugiting*.

C. Discount Planning After the Final Regulations

If the final regulations are issued in a form similar to the proposed regulations, it will be virtually impossible to obtain a valuation discount for marketable assets merely by placing them in a family controlled entity. Even active businesses will be affected.

1. Appraisals Remain the Name of the Game

a) Generally

Assuming that the final regulations continue to deem every owner of an interest in an entity to have a right to compel liquidation and a 6-month put right, there may still be some discounts available. These will be determined by the appraisers, rather than the estate planners

b) Massive Appraisal Business Before the Final Regulations

Appraisers should expect an enormous amount of new business before the final regulations. These new valuations will look at what a hypothetical reasonable unrelated buyer would pay for a share of the entity's underlying assets is the entity were liquidated, what the interest is worth in light of a

6-month put right at the ratable share of the value of the underlying assets, what intangible assets should be included in tat calculation. See Prop. Reg. § 25.2704-3(g), Ex. 5.

2. Planning for Tangible Assets

The regulations should not affect the marketability discount associated with ownership of tangible real or personal property as a tenant in common or as community property.

a) Discounts Are Pretty Good

The courts have routinely found that such partial interests are entitled to significant valuation discounts, because there is a far smaller market for partial interests than for full ownership of an asset. With respect to partial interests in real estate, *see, e.g., Estate of Mitchell v. Comm'r*, T.C. Memo. 2011-94 (by stipulation, 19% discount for 95% interest in rented beachfront house, 32% discount for the five percent interest in same property, 35% discount for 95% interest in ranch property, and 40% discount for remaining five percent interest in same ranch); *Estate of Baird v. Comm'r*, 416 F3d 442 (5th Cir., 2005), *rev'g and rem'g* T.C. Memo. 2002-299 (60% combined discount for lack of marketability and control for fractional interest in Louisiana timberland); *Propstra v. United States*, 680 F2d 1248 (9th Cir. 1982) (15% discount for lack of marketability of community property interest in land); *Lefrak v. Comm'r*, T.C. Memo. 1993-526 (30% discount for lack of marketability and control in partial interests in certain apartment buildings); *Estate of Cervin v. Comm'r*, T.C. Memo. 1994-550 (20% discount for undivided fractional interest in farm); *Estate of Stevens v. Comm'r*, T.C. Memo. 2000-53 (25% discount for undivided fractional interest in improved real estate); *Williams v. Comm'r*, T.C. Memo. 1998-59 (44% discount for undivided one-half interest in real estate; assessing attorneys fees against IRS for continuing to assert that discount is limited to cost of partitioning); *Estate of Forbes v. Comm'r*, T.C. Memo. 2001-72 (30% discount). With respect to partial interest in artwork, see *Estate of Elkins v. Comm'r*, 757 F.3d 453 (5th Cir., 2014), *aff'g in part, rev'g in part* 140 T.C. 86 (2013) (44.75% discount for a 73.055% undivided partial interests in an art collection); *Estate of Scull v. Comm'r*, T.C. Memo. 1994-211 (5% discount for undivided 65% interest in pop art collection); and *Stone v. United States*, 2007 WL 1544786, 99 A.F.T.R. 2d 2007-2992 (N.D. Ca. 2007), *supplemented by* 2007 WL 2318974, 100 A.F.T.R. 2d 2007-5512 (N.D. Ca. 2007), *aff'd, Stone ex rel. Stone Trust Agreement v. United States*, 2009 WL 766497,

103 A.F.T.R.2d 2009-1379 (9th Cir. 2009) (5% discount for undivided 50% interest in art collection).

b) Be Careful Not to Become a Partnership

Of course, one must be careful that a tenancy-in-common not be a partnership for tax purposes.

(1) **Generally**

Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created for tax purposes, without regard to state law.

(2) **Uniform Partnership Act**

Section 202(c) of the Uniform Partnership Act states:

> In determining whether a partnership is formed, the following rules apply:
>
> (1) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property.
>
> (2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived.
>
> (3) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:
>
> (i) of a debt by installments or otherwise;

(ii) for services as an independent contractor or of wages or other compensation to an employee;

(iii) of rent;

(iv) of an annuity or other retirement or health benefit to a beneficiary, representative, or designee of a deceased or retired partner;

(v) of interest or other charge on a loan, even if the amount of payment varies with the profits of the business, including a direct or indirect present or future ownership of the collateral, or rights to income, proceeds, or increase in value derived from the collateral; or

(vi) for the sale of the goodwill of a business or other property by installments or otherwise.

(3) **Internal Revenue Code Definition**

Code § 7701(a)(2) defines a "partnership" for all tax purposes as follows:

> The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

(4) **Regulations Definition**

Treas. Reg. § 301.7701-1(a)(2) elaborates on the Code definition, stating:

(2) Certain Joint Undertakings Give Rise To Entities For Federal Tax Purposes. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

(5) **The IRS Rulings Position**

In Rev. Proc. 2002-22, 2002-1 C.B. 733, the IRS provided guidelines on when it would rule that a tenancy in common owning rental property was not taxable as a partnership. Rev. Proc. 2002-22 states that the IRS will issue a private ruling that an undivided fractional interest in rental real property is not an interest in a business entity, under Treas. Reg. § 301.7701-2(a), which applies for estate and gift tax, as well as income tax purposes. Specifically, the IRS states that it will issue a ruling to this effect if:

(1) Each co-owner holds title to the property (either directly or through a disregarded entity) as a tenant in common under local law.

(2) There are no more than 35 co-owners (each of whom is a "person" as defined in Section 7701(a)(1), except that a married couple are treated as one person and all persons who acquire interests from a co-owner by inheritance are treated as one person).

(3) The co-ownership cannot file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). the co-owners generally cannot hold interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.

(4) The co-owners may have a "limited co-ownership agreement" covering such issues as providing that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition, or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50% of the undivided interests in the Property.

(5) The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien, and any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50% of the undivided interests in the Property.

(6) Each co-owner must generally have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person. There may, however, be restrictions on the right to transfer, partition, or encumber interests in the Property if they are required by a lender and that are consistent with customary commercial lending practices are not prohibited. The co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. Also, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

(7) If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

(8) Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

(9) The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

(10) A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage

interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

(11) The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an charity from qualifying as rent for unrelated business taxable income purposes. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. Activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

(12) The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. Such a management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. The manager must, however, disburse to the co-owners their shares of net revenues within three months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property, and to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering

the Property, subject to the approval of the co-owners.

(13) All leasing arrangements must be bona fide leases for federal tax purposes, and all rents must reflect the fair market value for the use of the Property, and may not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales).

(14) The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property. and

(15) The amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

(6) **Caveat**

Creating a tenancy in common that is not a partnership is not difficult. Running it so that it does not become a partnership is difficult, if the property is actively managed. It requires professional management and attention to detail. See *Methvin v. Comm'r*, T.C. Memo. 2015-81 (co-ownership of oil and gas interests was taxable as a partnership).

(7) **An LLC of Tenants in Common**

There appears to be no reason why each of the tenants-in-common who owns a tangible asset cannot establish his or her own LLC to hold that interest. There would be no greater discount under Section 2704, but there should be no lesser discount, either, and better asset protection. The separate LLCs could then enter into a single LLC, for even better asset protection, but, again, no additional discounts. The master LLC could then hire a professional to oversee the

operation and assure that the underlying tenancies in common do not themselves become a partnership.

3. Using a Family Holding Company for Nontax Purposes

The family holding company also remains useful for many nontax reasons, including asset protection and consolidation of management of multiple assets. Families desiring such entities, after the final regulations are published, should consider giving each owner a put right that complies with the requirements of the Section 2704(b) regulations. This will avoid the application of Section 2704(b), though it will provide little, if any, valuation discounts. Of course, a put is not always practical, because the entity may lack sufficient cash or borrowing power to satisfy an exercise of the put, and because some of the owners cannot be relied on not to exercise their puts. In such cases, the practitioner can create the same entities he or she has traditionally used, but the estate and gift tax valuation discounts will be largely unavailable under the new regime of Section 2704.

4. Basis Results

a) Generally

The proposed regulations could actually be beneficial for estates that will owe no estate tax because of the unified credit and marital deduction, even if valuation discounts are not available under Section 2704. The beneficiaries of such estates may find themselves with higher estate tax values, but with concomitantly higher income tax bases. See Rev. Rul. 54-97, 1954-1 C.B. 119; Treas. Reg. § 1.1014-3(a). If the higher estate tax value does not generate additional tax, the higher income tax basis may significantly reduce federal and state income tax liabilities.

b) Caveat

Section 2704 applies only "for purposes of" the subtitle that includes the wealth transfer taxes. The basic consistency rules under Section 1014(f) state that the fair market value of assets for purposes of Section 1014(a) cannot exceed the estate tax value. The IRS could argue that the fair market value rules applied for this purpose do not include Section 2704.

5. Life Insurance

One of the key reasons that business owners and some investors buy life insurance is to provide liquidity to replace the money that is used to pay

estate taxes. If the proposed regulations are finalized in a form similar to the proposed regulations, and if the courts sustain their validity, the fair market value of most of these entity interests will increase by at least one-third, and often by much more, because of the elimination of valuation discounts. This increases the potential estate tax bill significantly, and should be addressed, where possibly, by additional life insurance held in an irrevocable life insurance trust.

6. Using Nominal Unrelated Business-Owners to Avoid Applicable Restrictions

As discussed above, in determining whether the transferor and/or the transferor's family can remove a disregarded restriction, any interest in the entity held by a non-family member is disregarded if, at the time of the transfer: (a) the interest it has been held by that person for less than three years; (b) it constitutes less than 10% of the value of all of the equity interests; (c) when combined with the interests of all other persons who are not members of the transferor's family, constitutes less than 20% of the value of all of the equity interests; or (d) such non-family member has no enforceable right to receive in exchange for such interest, on no more than six months' prior notice, the minimum value referred to in the definition of a disregarded restriction. Prop. Treas. Reg. § 25.2704-3(b)(4). This rule relates to disregarded restrictions, but it does not apply to applicable restrictions. It is not entirely clear whether any discounts survive the new rules on disregarded restrictions, but if they do, they can avoid the more stringent deemed right to liquidate the entire entity under Section 2704(b), if a non-family member holds a brief and modest interest that permits him, her, or it to prevent removal of the deemed right to liquidate the entity.

7. GRATs and Sales to an Intentional Grantor Trust

a) General Considerations

A low interest rate environment like the one we are currently enjoying makes both GRATs and sales to an intentional grantor trust (IGT) very appealing.[2] Often, the assets given to a GRAT or sold to an IGT are first placed in an entity, so that the value of the asset transferred is discounted, while the amount of income and gains generated remains stable. This tends to make the entire transaction more appealing and more favorable. The Section 2704 proposed regulations will have a significant impact on these techniques.

[2] Obviously, if you live off of the interest paid by T-bills and bonds, you are not "enjoying" the current environment, and you have both my admiration for your financial security and my sympathy for your diminished income stream.

b) **Post-Final Regulations Transactions: Discounts Will Disappear on Entity Interests Transferred, Increasing Going-In Values**

The beneficiaries of a GRAT or an IGT are deemed to have received the transfer for purposes of determining whether Section 2704 applies, so if the beneficiaries are members of the transferor's family, discounts against the values of the transferred entity interest will be reduced or eliminated after publication of the final regulations.

c) **Post-Final Regulations Transactions: Values of Interests Distributed by the Trustees Will Also Lose their Discounts**

Section 2704(a) and 2704(b) may also apply to interests in a partnership or other entity that are held by a GRAT or IGT, and distributed to the grantor as payment for the annuity or installment payments on the promissory note.

(1) **Family Members**

Again, the interests are deemed owned by the trust's beneficiaries before the distribution, and by the grantor after the distribution. Thus, if the grantor is a member of the family of the beneficiaries, the distributions of entity interests should trigger the operation of Section 2704(b). This, at least, would balance the inflated value going in by an inflated value going out.

(2) **Section 2704(a) Problems**

If the trustee of the GRAT or IGT becomes an assignee, rather than a partner or member of the entity, there could be a lapse under Section 2704(a), resulting in a gift equal to at least the difference between the discounted value and the undiscounted value of the transferred interest.

d) **Pre-Final Regulations Planning**

(1) **Effective Date Issues**

The proposed regulations state that the new rules under Section 2704(b) will apply to transfers after the final regulations are published. This ties the availability of valuation discounts to the date the GRAT is funded or the date the asset is retransferred, rather than the date on which

the entity was created (although, it must have been created before the 1990 effective date of Section 2704).

(2) **Application of Section 2704 “For Purposes of this Subtitle”**

Section 2704 applies “[f]or purposes of this subtitle.” Int. Rev. Code § 2704(a)(1)(A). “This subtitle” includes only the estate, gift, and generation-skipping transfer taxes, the special valuation rules (Sections 2701-2704), and the rules for gifts and transfers from expatriates.

(a) No Gift Required

Section 2704 does not, however, require that there be a gift. Any transfer will be subject to Section 2704, to the extent that it could produce a gift tax, an estate tax, or a GST tax.

(b) GRATs and IGTs

- If fund a GRAT or IGT with interests in a partnership, LLC, or corporation and you complete the transfer before the final regulations are published, you can value the assets contributed with all relevant discounts.

- Distributions from the GRAT of the annuity amount that occur after the final regulations are published should be valued under the new rules of Section 2704, to determine how many units of interest are equal in value to the amount that must be distributed. The distribution is a "transfer," though not a gift, and one needs to value the interests being distributed for purposes of "this subtitle" to determine: (a) did the grantor accept too few units of interest, thereby making a taxable gift to the remainder beneficiaries; (b) did the grantor accept too few units of interest, thereby making a prohibited second transfer; (c) did the trustees misadminister the trust, thereby depriving it of status as a qualified annuity interest.

- The use of interests in the underlying entity to satisfy the obligation to repay the trustees' debt to the grantor of an IGT should also be valued under Section 2704(b), to determine whether or not the distribution of too few interests creates a taxable gift.

- Similarly, an exercise of a swap power under Section 675(4)(C) requires the valuation of the assets transferred to and from the trust under Section 2704, in order to determine whether there has been a taxable gift. For purposes of the income tax treatment of the exchange under Sec. 675(4)(C) and the fiduciary duties of the trustees, the equivalent value standard does not involve the application of Section 2704. The trustees, of course, want to transfer to the grantor as little as possible, so applying Section 2704 helps them and the other trust beneficiaries. The grantor has arguably transferred assets with a value above that of the assets received, but only for income tax and fiduciary law purposes. For those purposes, we just do not much care.

8. Buy-Sell Agreements

Interests in an entity that are subject to a buy-sell agreement that complies with Section 2703 should still be valued under those agreements, even if those transfer restrictions are "applicable restrictions" or "disregarded restrictions". Prop. Reg. §§ 25.2704-2(b)(4)(iii); 25.2704-3(b)(5)(4). The preamble to the proposed regulations states that:

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

X. Conclusions

These are just proposed regulations, but if the final regulations closely resemble the proposed regulations, minority and marketability discounts will become largely unavailable for family-owned entities. Practitioners should alert their clients of the need to act before the regulations are finalized, if they wish to take advantage of most of the discount planning that has become so popular a part of modern estate planning.

XI. Appendix – The Proposed Regulations

81 FR 51413-02, 2016 WL 4126002(F.R.)
PROPOSED RULES
DEPARTMENT OF THE Treasury
Internal Revenue Service
26 CFR Part 25
[REG-163113-02]
RIN 1545-BB71
Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest
Thursday, August 4, 2016

AGENCY: Internal Revenue Service (IRS), Treasury.

***51413** ACTION: Notice of proposed rulemaking and notice of public hearing.

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

DATES: Written and electronic comments must be received by November 2, 2016. Outlines of topics to be discussed at the public hearing scheduled for December 1, 2016, must be received by November 2, 2016.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-163113-02), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:LPD:PR (REG-163113-02), Courier's Desk, Internal Revenue ***51414** Service, 1111 Constitution Avenue NW., Washington, DC 20224, or sent electronically via the Federal eRulemaking portal at www.regulations.gov (Treasury REG-163113-02). The public hearing will be held in the Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue NW., Washington, DC 20224.

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

SUPPLEMENTARY INFORMATION:

Background

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

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

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

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

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

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

The Treasury Department and the IRS, however, believe that this exception should not apply when the inter vivos transfer that results in the loss of the power to liquidate occurs on the decedent's deathbed. Cf. Estate of Murphy v. Commissioner, T.C. Memo. 1990-472 (rejecting "attempts to avoid taxation of the control value of stock holdings through bifurcation of the blocks"). Such transfers generally have minimal economic effects, but result in a transfer tax value that is less than the value of the interest either in the hands of the decedent prior to death or in the hands of

the decedent's family immediately after death. See Harrison, supra. The enactment of section 2704 was intended to prevent this result. See Informal S. Rep. on S. 3209, supra; H.R. Conf. Rep. No. 101-964, supra. See also section 2704(a)(3) (conferring on the Secretary broad regulatory authority to apply section 2704(a) to the lapse of rights similar to voting and liquidation rights). The Treasury Department and the IRS have concluded that the regulatory exception created in § 25.2704-1(c)(1) should apply only to transfers occurring more than three years before death, where the loss of control over liquidation is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of a donor's subjective motive which is administratively burdensome for both taxpayers and the IRS. Cf. section 2035(a) (replacing the contemplation of death presumption of prior law with a bright-line, three-year test). Accordingly, the proposed regulations treat transfers occurring within three years of death that result in the lapse of a liquidation right as transfers occurring at death for purposes of section 2704(a).

Section 2704(b)(1) provides generally that, if a transferor transfers an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any "applicable restriction" is disregarded in valuing the transferred interest. Under section 2704(b)(2), an applicable restriction is defined as a restriction that effectively limits the ability of the entity to liquidate, but which, after the transfer, either in whole or in part, will lapse or may be removed by the transferor or the transferor's family, either alone or collectively. Section 2704(b)(3)(B) excepts from the definition of an applicable restriction any restriction "imposed, or required to be imposed, by any Federal or State law."

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

Section 25.2704-2(b) provides, in part, that an applicable restriction "is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law ***51415** generally applicable to the entity in the absence of the restriction."

The Treasury Department and the IRS have determined that the current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws and by other subsequent developments. First, courts have concluded that, under the current regulations, section 2704(b) applies only to restrictions on the ability to liquidate an entire entity, and not to restrictions on the ability to liquidate a transferred interest in that entity. Kerr v. Commissioner, 113 T.C. 449, 473 (1999), aff'd, 292 F.3rd 490 (5th Cir. 2002). Thus, a restriction on the ability to liquidate an individual interest is not an applicable restriction under the current regulations.

Second, as noted above, the current regulations except from the definition of an applicable restriction a restriction on liquidation that is no more restrictive than that of the state law that would

apply in the absence of the restriction. The Tax Court viewed this as a regulatory expansion of the statutory exception to the application of section 2704(b) contained in section 2704(b)(3)(B) that excepts "any restriction imposed, or required to be imposed, by any Federal or State law." Kerr, 113 T.C. at 472. Since the promulgation of the current regulations, many state statutes governing limited partnerships have been revised to allow liquidation of the entity only on the unanimous vote of all owners (unless provided otherwise in the partnership agreement), and to eliminate the statutory default provision that had allowed a limited partner to liquidate his or her limited partner interest. Instead, statutes in these jurisdictions typically now provide that a limited partner may not withdraw from the partnership unless the partnership agreement provides otherwise. See, e.g., Tex. Bus. Orgs. Ann. § 153.110 (West 2016) (limited partner may withdraw as specified in the partnership agreement); Uniform Limited Partnership Act (2001) § 601(a), 6A U.L.A. 348, 448 (Supp. 2015) (limited partner has no right to withdraw before completion of the winding up of the partnership). Further, other state statutes have been revised to create elective restrictions on liquidation. See, e.g., Nev. Rev. Stat. § 87A.427 (2016) (limited partnership electing to be restricted limited partnership may not make any distributions for a 10-year period). Each of these statutes is designed to be at least as restrictive as the maximum restriction on liquidation that could be imposed in a partnership agreement. The result is that the provisions of a partnership agreement restricting liquidation generally fall within the regulatory exception for restrictions that are no more restrictive than those under state law, and thus do not constitute applicable restrictions under the current regulations.

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

Finally, taxpayers have avoided the application of section 2704(b) through the transfer of a nominal partnership interest to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a restriction. Kerr, 292 F.3rd at 494.

As the Tax Court noted in Kerr, Congress granted the Secretary broad discretion in section 2704(b)(4) to promulgate regulations identifying restrictions not covered by section 2704(b) that nevertheless should be disregarded for transfer tax valuation purposes. 113 T.C. at 474. The Treasury Department and the IRS have concluded that, as was recognized by Congress when enacting section 2704(b), there are additional restrictions that may affect adversely the transfer tax value of an interest but that do not reduce the value of the interest to the family-member transferee, and thus should be disregarded for transfer tax valuation purposes. H.R. Conf. Rep. No. 101-964, supra, at 1138. The Treasury Department and the IRS have determined that such restrictions include: (a) A restriction on the ability to liquidate the transferred interest; and (b) any restrictions

attendant upon the nature or extent of the property to be received in exchange for the liquidated interest, or the timing of the payment of that property.

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

Finally, since the promulgation of §§ 301.7701-1 through 301.7701-3 of the Procedure and Administration Regulations (the check-the-box regulations), an entity's classification for federal tax purposes may differ substantially from the entity's structure or form under local law. In addition, many taxpayers now utilize a limited liability company (LLC) as the preferred entity to hold family assets or business ***51416** interests. The Treasury Department and the IRS have concluded that the regulations under section 2704 should be updated to reflect these significant developments.

Explanation of Provisions

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

Covered Entities

The proposed regulations would clarify, in §§ 25.2704-1 through 25.2704-3, that section 2704 applies to corporations, partnerships, LLC's, and other entities and arrangements that are business entities within the meaning of § 301.7701-2(a), regardless of whether the entity or arrangement is domestic or foreign, regardless of how the entity or arrangement is classified for other federal tax purposes, and regardless of whether the entity or arrangement is disregarded as an entity separate from its owner for other federal tax purposes.

Classification of the Entity

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

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

Control of the Entity

Section 2704(c)(1) incorporates the definition of control found in section 2701(b)(2). Control of a corporation, partnership, or limited partnership is defined in sections 2701(b)(2)(A) and (B). The proposed regulations would clarify, in § 25.2701-2, that control of an LLC or of any other entity or arrangement that is not a corporation, partnership, or limited partnership would constitute the holding of at least 50 percent of either the capital or profits interests of the entity or arrangement, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. Cf. section 2701(b)(2)(B)(ii) (defining control of a limited partnership as

including the holding of any interest as a general partner). Further, for purposes of determining control, under the attribution rules of existing § 25.2701-6, an individual, the individual's estate, and members of the individual's family are treated as holding interests held indirectly through a corporation, partnership, trust, or other entity.

Lapses Under Section 2704(a)

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

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

Applicable Restrictions Under Section 2704(b)

The proposed regulations would remove the exception in § 25.2704-2(b) that limits the definition of applicable restriction to limitations that are more restrictive than the limitations that would apply in the absence of the restriction under the local law generally applicable to the entity. As noted above, this exception is not consistent with section 2704(b) to the extent that the transferor and family members have the power to avoid any statutory rule. The proposed regulations also would revise § 25.2704-2(b) to provide that an applicable restriction does include a restriction that is imposed under the terms of the governing documents, as well as a restriction that is imposed under a local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. In applying this particular exception to the definition of an applicable restriction, this proposed rule is intended to ensure that a restriction that is not imposed or required to be imposed by federal or state law is disregarded without regard to its source.

Further, with regard to the exception for restrictions "imposed, or required to ***51417** be imposed, by any Federal or State law," in section 2704(b)(3)(B), the proposed regulations would clarify that the terms "federal" and "state" refer only to the United States or any state (including the District of Columbia (see section 7701(a)(10)), but do not include any other jurisdiction.

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

If an applicable restriction is disregarded, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction does not exist (that is, as if the governing documents and the local law are silent on the question), and thus, there is deemed to be no such restriction on liquidation of the entity.

Disregarded Restrictions

A new class of restrictions is described in the proposed regulations that would be disregarded, described as "disregarded restrictions." This class of restrictions is identified pursuant to the authority contained in section 2704(b)(4). Note that, although it may appear that sections 2703 and 2704(b) overlap, they do not. While section 2703 and the corresponding regulations currently address restrictions on the sale or use of individual interests in family-controlled entities, the proposed regulations would address restrictions on the liquidation or redemption of such interests.

Under § 25.2704-3 of the proposed regulations, in the case of a family-controlled entity, any restriction described below on a shareholder's, partner's, member's, or other owner's right to liquidate his or her interest in the entity will be disregarded if the restriction will lapse at any time after the transfer, or if the transferor, or the transferor and family members, without regard to certain interests held by nonfamily members, may remove or override the restriction. Under the proposed regulations, such a disregarded restriction includes one that: (a) Limits the ability of the holder of the interest to liquidate the interest; (b) limits the liquidation proceeds to an amount that is less than a minimum value; (c) defers the payment of the liquidation proceeds for more than six

months; or (d) permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.

"Minimum value" is the interest's share of the net value of the entity on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate. For example, and subject to the foregoing limitation on outstanding obligations, if the entity holds an operating business, the rules of § 20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of § 25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer. The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. For this purpose, the interest's share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity.

A disregarded restriction includes limitations on the time and manner of payment of the liquidation proceeds. Such limitations include provisions permitting deferral of full payment beyond six months or permitting payment in any manner other than in cash or property. For this purpose, the term "property" does not include a note or other obligation issued directly or indirectly by the entity, other holders of an interest in the entity, or persons related to either. An exception is made for the note of an entity engaged in an active trade or business to the extent that (a) the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), and (b) the note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value (when discounted to present value) equal to the liquidation proceeds. A fair market value determination assumes a cash sale. See Section 2 of Rev. Rul. 59-60, 1959-1 C.B. 237 (defining fair market value and stating that "[c]ourt decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing to trade . . ."). Thus, in the absence of immediate payment of the liquidation proceeds, the fair market value of any note falling within this exception must equal the fair market value of the liquidation proceeds on the date of liquidation or redemption.

Exceptions that apply to applicable restrictions under the current and these proposed regulations also apply to this new class of disregarded restrictions. One of the exceptions applicable to the definition of a disregarded restriction applies if (a) each holder of an interest in the entity has an enforceable "put" right to receive, on liquidation or redemption of the holder's interest, cash and/or other property with a value that is at least equal to the minimum value previously described, (b) the full amount of such cash and other property must be paid within six months after the holder gives notice to the entity of the holder's intent to liquidate any part or all of the holder's interest and/or withdraw from the entity, and (c) such other property does not include a note or other obligation issued directly or ***51418** indirectly by the entity, by one or more holders of interests in the entity, or by a person related either to the entity or to any holder of an interest in the entity. However, in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section

6166(b)(9)(B), such proceeds may include a note or other obligation if such note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of the liquidation or redemption equal to the liquidation proceeds. A similar exception is made to the definition of an applicable restriction in proposed § 25.2704-2(b)(4).

In determining whether the transferor and/or the transferor's family has the ability to remove a restriction included in this new class of disregarded restrictions, any interest in the entity held by a person who is not a member of the transferor's family is disregarded if, at the time of the transfer, the interest: (a) Has been held by such person for less than three years; (b) constitutes less than 10 percent of the value of all of the equity interests in a corporation, or constitutes less than 10 percent of the capital and profits interests in a business entity described in § 301.7701-2(a) other than a corporation (for example, less than a 10-percent interest in the capital and profits of a partnership); (c) when combined with the interests of all other persons who are not members of the transferor's family, constitutes less than 20 percent of the value of all of the equity interests in a corporation, or constitutes less than 20 percent of the capital and profits interests in a business entity other than a corporation (for example, less than a 20-percent interest in the capital and profits of a partnership); or (d) any such person, as the owner of an interest, does not have an enforceable right to receive in exchange for such interest, on no more than six months' prior notice, the minimum value referred to in the definition of a disregarded restriction. If an interest is disregarded, the determination of whether the family has the ability to remove the restriction will be made assuming that the remaining interests are the sole interests in the entity.

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

Coordination With Marital and Charitable Deductions
Section 2704(b) applies to intra-family transfers for all purposes of subtitle B relating to estate, gift and GST taxes. Therefore, to the extent that an interest qualifies for the gift or estate tax marital deduction and must be valued by taking into account the special valuation assumptions of section 2704(b), the same value generally will apply in computing the marital deduction attributable to that interest. The value of the estate tax marital deduction may be further affected, however, by other factors justifying a different value, such as the application of a control premium. See, e.g., Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987).

Section 2704(b) does not apply to transfers to nonfamily members and thus has no application in valuing an interest passing to charity or to a person other than a family member. If part of an entity interest includible in the gross estate passes to family members and part of that interest passes to nonfamily members, and if (taking into account the proposed rules regarding the treatment of certain interests held by nonfamily members) the part passing to the decedent's family members is valued under section 2704(b), then the proposed regulations provide that the part passing to the family members is treated as a property interest separate from the part passing to nonfamily

members. The fair market value of the part passing to the family members is determined taking into account the special valuation assumptions of section 2704(b), as well as any other relevant factors, such as those supporting a control premium. The fair market value of the part passing to the nonfamily member(s) is determined in a similar manner, but without the special valuation assumptions of section 2704(b). Thus, if the sole nonfamily member receiving an interest is a charity, the interest generally will have the same value for both estate tax inclusion and deduction purposes. If the interest passing to nonfamily members, however, is divided between charities and other nonfamily members, additional considerations (not prescribed by section 2704) may apply, resulting in a different value for charitable deduction purposes. See, e.g., Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).

Effective Dates

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

Special Analyses

Certain Treasury regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. The proposed regulations affect the transfer tax liability of individuals who transfer an interest in certain closely held entities and not the entities themselves. The proposed regulations do not affect the structure of such entities, but only the assumptions under which they are valued for federal transfer tax purposes. In addition, any economic impact on entities affected by section 2704, large or small, is derived from the operation of the statute, or its intended application, and not from the proposed regulations in this notice of proposed rulemaking. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) ***51419** copies) or electronic comments that are submitted timely (in the manner described in ADDRESSES) to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be available at www.regulations.gov, or upon request.

A public hearing on these proposed regulations has been scheduled for December 1, 2016, beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC 20224. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit comments by November 2, 2016, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 2, 2016.

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

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

List of Subjects in 26 CFR Part 25
Gift taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations
Accordingly, 26 CFR part 25 is proposed to be amended as follows:

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954
Paragraph 1. The authority citation for part 25 is amended by adding entries in numerical order to read in part as follows:

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

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

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

Sections 25.2704-2 and 25.2704-3 also issued under 26 U.S.C. 2704(b).
* * * * *26 CFR § 25.2701-2
Par. 2. Section 25.2701-2 is amended as follows:

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

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

The revision and additions read as follows:
26 CFR § 25.2701-2
§ 25.2701-2 Special valuation rules for applicable retained interests.
* * * * *
(b) * * *

(5) * * *

(i) * * * For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of § 301.7701-2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse. The form of the entity determines the applicable test for control. For purposes of determining the form of the entity, any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B) is a corporation. For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. In the case of any business entity that is not a corporation under these provisions, the form of the entity is determined under local law, regardless of how the entity is classified for federal tax purposes or whether it is disregarded as an entity separate from its owner for federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under whose laws the entity is created or organized. * * *
* * * * *
(iv) Other business entities. In the case of any entity or arrangement that is not a corporation, partnership, or limited partnership, control means the holding of at least 50 percent of either the capital interests or the profits interests in the entity or arrangement. In addition, control means the holding of any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part.

* * * * *26 CFR § 25.2701-8

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

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

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

The revision and addition reads as follows:
26 CFR § 25.2701-8
§ 25.2701-8 Effective dates.

(a) Except as provided in paragraph (b) of this section, §§ 25.2701-1 through 25.2701-4 and §§ 25.2701-6 and 25.2701-7 are effective as of January 28, 1992. * * *

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

26 CFR § 25.2704-1

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

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

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

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

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

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

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

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

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

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

10. In paragraph (f) Example 4, the third and fourth sentences are revised and a sentence is added at the end.

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

12. In paragraph (f) Example 7, the third and fourth sentences are revised and a sentence is added at the end.

The revisions and additions read as follows:
26 CFR § 25.2704-1
§ 25.2704-1 Lapse of certain rights.

(a) * * *

(1) * * * For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), the lapse of a voting or a liquidation right in a corporation or a partnership (an entity), whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right

immediately prior to its lapse (the holder) to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is controlled by the holder and/or members of the holder's family immediately before and after the lapse. For purposes of this section, a ***51420** corporation is any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of § 301.7701-2(a) of this chapter regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes. * * *

(2) * * *

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

* * * * *

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

* * * * *

(4) Source of right or lapse. A voting right or a liquidation right may be conferred by or lapse by reason of local law, the governing documents, an agreement, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs voting or liquidation rights.

(5) Assignee interests. A transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights. For example, the transfer of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest.

(c) * * *

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

(2) * * *

(i) * * *

(B) Ability to liquidate. Whether an interest can be liquidated immediately after the lapse is determined under the local law generally applicable to the entity, as modified by the governing documents of the entity, but without regard to any restriction (in the governing documents, applicable local law, or otherwise) described in section 2704(b) and the regulations thereunder. The manner in which the interest may be liquidated is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, revising the governing documents, merging the entity with an entity whose governing documents permit liquidation of the interest, terminating the entity, or otherwise. For purposes of making this determination, an interest held by a person other than a member of the holder's family (a nonfamily-member interest) may be disregarded. Whether a nonfamily-member interest is disregarded is determined under § 25.2704-3(b)(4), applying that section as if, by its terms, it also applies to the question of whether the holder (or the holder's estate) and members of the holder's family may liquidate an interest immediately after the lapse.

* * * * *

(f) * * *

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

* * * * *

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

26 CFR § 25.2704-2

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

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

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

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

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

5. The third sentences of newly designated paragraph (g) Example 1. and Example 3. are removed.

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

The revisions and additions read as follows:
26 CFR § 25.2704-2
§ 25.2704-2 Transfers subject to applicable restrictions.

(a) In general. For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any applicable restriction is disregarded in valuing the transferred interest. For purposes of this section, a corporation is any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of § 301.7701-2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

(b) Applicable restriction defined—(1) In general. The term applicable restriction means a limitation on the ability to liquidate the entity, in whole or in part (as opposed to a particular holder's interest in the entity), if, after the transfer, that limitation either lapses or may be removed by the transferor, the transferor's estate, and/or any member of the transferor's family, either alone or collectively. See § 25.2704-3 for restrictions on the ability to liquidate a particular holder's interest in the entity.

(2) Source of limitation. An applicable restriction includes a restriction that is ***51421** 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.

(3) Lapse or removal of limitation. A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the restriction may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family. For purposes of determining whether the ability to remove the restriction is

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

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

(i) Commercially reasonable restriction. An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

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

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

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

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

(d) Attribution. An individual, the individual's estate, and members of the individual's family are treated as also holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in § 25.2701-6.

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

(f) Certain transfers at death to multiple persons. Solely for purposes of section 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are not members of the decedent's family, and if the part passing to the members of the decedent's family is to be valued pursuant to paragraph (e) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest. See paragraph (g) Ex. 4 of § 25.2704-3.

(g) * * *

Example 5. * * * The preferred stock carries a right to liquidate X that cannot be exercised until 1999. * * *
* * * * *26 CFR § 25.2704-3
§ 25.2704-3 [Redesignated as § 25.2704-4]
26 CFR § 25.2704-326 CFR § 25.2704-4
Par. 6. Section 25.2704-3 is redesignated as § 25.2704-4.
26 CFR § 25.2704-3
Par. 7. New § 25.2704-3 is added to read as follows.
26 CFR § 25.2704-3
§ 25.2704-3 Transfers subject to disregarded restrictions.

(a) In general. For purposes of subtitle B (relating to estate, gift and generation-skipping transfer taxes), and notwithstanding any provision of § 25.2704-2, if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any restriction described in paragraph (b) of this section is disregarded, and the transferred interest is valued as provided in paragraph (f) of this section. ***51422** For purposes of this section, a corporation is any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section

1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of § 301.7701-2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

(b) Disregarded restrictions defined—(1) In general. The term disregarded restriction means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to paragraph (b)(4) of this section), either alone or collectively.

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

(ii) The provision limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a minimum value. The term minimum value means the interest's share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate. For example, and subject to the foregoing limitation on outstanding obligations, if the entity holds an operating business, the rules of § 20.2031-2(f)(2) or § 20.2031-3 of this chapter apply in the case of a testamentary transfer and the rules of § 25.2512-2(f)(2) or § 25.2512-3 apply in the case of an inter vivos transfer. The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. For this purpose, the interest's share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity. If the property held by the entity directly or indirectly includes an interest in another entity, and if a transfer of an interest in that other entity by the same transferor (had that transferor owned the interest directly) would be subject to section 2704(b), then the entity will be treated as owning a share of the property held by the other entity, determined and valued in accordance with the provisions of section 2704(b) and the regulations thereunder.

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

(iv) The provision authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property. Solely for this purpose, except as provided in the following sentence, a note or other obligation

issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related to either the entity or any holder of an interest in the entity, is deemed not to be property. In the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See § 25.2512-8. For purposes of this paragraph (b)(1)(iv), a related person is any person whose relationship to the entity or to any holder of an interest in the entity is described in section 267(b), provided that for this purpose the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

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

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

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

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

(B) On the date of the transfer, in the case of a corporation, the interest ***51423** constitutes at least 10 percent of the value of all of the equity interests in the corporation, and, in the case of a business entity within the meaning of § 301.7701-2(a) of this chapter other than a corporation, the interest constitutes at least a 10-percent interest in the business entity, for example, a 10-percent interest in the capital and profits of a partnership;

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

(D) Each nonfamily member, as owner, has a put right as described in paragraph (b)(6) of this section.

(ii) Effect of disregarding a nonfamily-member interest. If a nonfamily-member interest is disregarded under this section, the rules of this section are applied as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.

(iii) Attribution. In applying the 10-percent and 20-percent tests when the property held by the corporation or other business entity is, in whole or in part, an interest in another entity, the attribution rules of paragraph (d) of this section apply both in determining the interest held by a nonfamily member, and in measuring the interests owned through other entities.

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

(i) Applicable restriction. A disregarded restriction does not include an applicable restriction on the liquidation of the entity as defined in and governed by § 25.2704-2.

(ii) Commercially reasonable restriction. A disregarded restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

(iii) Requirement of federal or state law. A disregarded restriction does not include a restriction imposed or required to be imposed by federal or state law. For this purpose, federal

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

(iv) Certain rights described in section 2703. An option, right to use property, or agreement that is subject to section 2703 is not a restriction for purposes of this paragraph (b).

(v) Right to put interest to entity. Any restriction that otherwise would constitute a disregarded restriction under this section will not be considered a disregarded restriction if each holder of an interest in the entity has a put right as described in paragraph (b)(6) of this section.

(6) Put right. The term put right means a right, enforceable under applicable local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs liquidation or redemption rights with regard to interests in the entity. For purposes of this paragraph (b)(6), the term other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or to any holder of an interest in the entity. However, in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), the term other property does include a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See § 25.2512-8. The minimum value of the interest is the interest's share of the net value of the entity, as defined in paragraph (b)(1)(ii) of this section.

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

(d) Attribution. An individual, the individual's estate, and members of the individual's family, as well as any other person, also are treated as holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in § 25.2701-6.

(e) Certain transfers at death to multiple persons. Solely for purposes of section 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are nonfamily members of the ***51424** decedent, and if the part passing to the members of the decedent's family is to be valued pursuant to paragraph (f) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest. See paragraph (g) Example 4 of this section.

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

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

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

(ii) By prohibiting the withdrawal of a limited partner, the partnership agreement imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor's family, acting collectively, by agreeing to amend the partnership agreement. Therefore, under section 2704(b) and paragraph (a) of this section, the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of each transferred interest. Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest determined under generally applicable valuation principles taking into account all relevant factors affecting value including the rights determined under the

governing documents and local law and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. See paragraphs (b)(1)(i) and (f) of this section.

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 ***51425** 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.

26 CFR § 25.2704-4

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

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

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

3. Paragraph (b) is added.

The addition reads as follows:
26 CFR § 25.2704-4
§ 25.2704-4 Effective date.
* * * * *
(b)(1) With respect to § 25.2704-1, the first six sentences of paragraph (a)(1), the last sentence of paragraph (a)(2)(i), the third sentence of paragraph (a)(2)(iii), the first and last sentences of paragraph (a)(4), paragraph (a)(5), the second and last sentences of paragraph (c)(1), paragraph (c)(2)(i)(B), and Examples 4, 6 and 7 of paragraph (f), apply to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register.

(2) With respect to § 25.2704-2, paragraphs (a), (b), (c), (d), and (f), the first sentence of paragraph (e), and Examples 1, 3 and 5 of paragraph (g) apply to transfers of property subject to restrictions created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register.

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

John Dalrymple,
Deputy Commissioner for Services and Enforcement.
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