REPORT OF THE ESTATE AND GIFT TAXATION COMMITTEE ON THE SECTION 2704 PROPOSED REGULATIONS

The New York City Bar Association, through its Estate and Gift Taxation Committee (the "Committee"), respectfully submits this memorandum setting forth the City Bar's comments in response to the notice of proposed rulemaking and notice of public hearing (the "Notice") issued by the IRS and Treasury Department on August 4, 2016.[1] The Notice contained proposed regulations (the "Proposed Regulations") under sections 2701 and 2704 of the Internal Revenue Code of 1986, as amended (the "Code"), concerning the valuation of interests in certain family owned entities for estate, gift and generation-skipping transfer ("GST") tax purposes.[2]

This memorandum is divided into three parts. In the first part, the City Bar expresses its concern that, in issuing the Proposed Regulations concerning "disregarded restrictions" under Prop. Treas. Reg. § 25.2704-3, [i] Treasury has exceeded Congress's grant of authority to it under the plain language of section 2704(b)(4) and [ii] Treasury has not performed adequate agency fact-finding to support its *conclusive presumption* that certain restrictions will *never* reduce the value of a transferred interest to a transferee, notwithstanding any special facts and circumstances that may be presented.[3]

In the second part, the City Bar provides additional information and analysis regarding the nature of the federal estate, gift and GST taxes and the legislative history and structure of section 2704. The analysis in this part raises significant questions as to whether additional aspects of the Proposed Regulations exceed Treasury's rulemaking authority, particularly when applied to the valuation of interests in family owned entities that conduct an active trade or business. The City Bar hopes this analysis will assist Treasury in evaluating the proper scope of its regulatory authority under section 2704.

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1 Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest, 81 Fed. Reg. 150, 51413 (proposed August 4, 2016) (to be codified at 26 C.F.R. pt 25).

2 Section 2704 is part of Chapter 14 of the Code and contains special valuation rules that apply when valuing transfers of interests in family controlled corporations and partnerships for federal estate, gift and GST tax purposes. The relevant family control test is contained in Code section 2701. The terms "corporation" and "partnership" are defined in Code section 7701(a). The definitions under section 7701(a) are to be applied for all purposes of the Code, including for estate, gift and GST tax purposes "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." 26 U.S.C. § 7701(a).

3 Unless otherwise indicated, section references in this memorandum are to the Code and Treasury Regulations promulgated thereunder.

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK
42 West 44th Street, New York, NY 10036
212.382.6600 | www.nycbar.org

In the third part, the City Bar assumes that the adoption of the Proposed Regulations is within the scope of the relevant regulatory authority, and in that context requests additional guidance, and suggests possible improvements, with respect to the matters discussed in that part.

PART ONE

The City Bar is concerned that, in issuing the Proposed Regulations concerning disregarded restrictions under Prop. Treas. Reg. § 25.2704-3, Treasury has exceeded Congress's grant of authority to it under the plain language of section 2704(b)(4). That Code section provides that Treasury may issue regulations allowing a certain restriction to be disregarded only "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*." Before issuing regulations to disregard such restrictions, section 2704(b)(4) requires Treasury to do two things:

> **<u>FIRST</u>**, Treasury must determine that such restriction "has the effect of reducing the value of the transferred interest for purposes of this subtitle" (*i.e.*, for estate, gift and GST tax purposes), and
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> **<u>SECOND</u>**, Treasury must determine that such restriction "*does not ultimately reduce the value of such interest to the transferee*."

Prop. Treas. Reg. § 25.2704-3 makes no distinction, however, between (1) an active trade or business, (2) a situation in which there is 50% ownership by non-family members, (3) a situation where family members are hostile to each other and may even be embroiled in protracted litigation with each other, or (4) family-controlled entities with "friendly" family situations that hold nothing but passive assets and do not engage in any trade or business. Rather, the Proposed Regulations effectively treat these circumstances as exactly the same *and conclusively presume – without any fact-finding -- that in none of these situations will the restriction reduce the value of the transferred interest to the transferee.* This absence of reasoned analysis appears to be arbitrary and capricious, and if the Proposed Regulations were finalized in their present form, they might well be determined to be invalid under section 706 of the Administrative Procedure Act (the "APA"), 5 U.S.C. § 551 *et seq.*

Section 706 of the APA[4] sets forth the standards governing a court's review of agency rulemaking, and requires a court to invalidate agency action that is "arbitrary, capricious, an

[4] The full text of 5 U.S.C. § 706 is set forth below.

> To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall –
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> (1) compel agency action unlawfully withheld or unreasonably delayed; and
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> (2) hold unlawful and set aside agency action, findings, and conclusions found to be –
> (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

abuse of discretion, or otherwise not in accordance with law."[5] In *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.*,[6] ("*State Farm*"), the United States Supreme Court explained that an agency must have engaged in reasoned decision making, which means that the agency must examine the relevant data and articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made.[7]

The Supreme Court further elaborated upon this standard in *Chevron v. Natural Resources Defense Council*,[8] adopting a two-part test for evaluating the validity of an agency's action. Under the first step, the Court must determine whether Congress has specifically addressed the question at issue. If Congress has not addressed the issue, or if the statute is ambiguous, the second part of the test requires the Court to determine whether the agency's determination is based on a "reasonable" or "permissible" construction of the statute. [9]

In *Altera Corp. v. Comm'r*,[10] ("*Altera*"), a unanimous Tax Court found that Treasury failed to engage in reasoned decision making under the APA and *State Farm* in connection with Treasury's issuance of regulations under section 482. These regulations required participants in qualified cost-sharing agreements to include stock-based compensation costs in the cost pool to comply with the arm's length standard of section 482. Specifically, the Court concluded that Treasury had engaged in arbitrary and capricious decision making by failing rationally to connect the regulations with the facts. In addition, Treasury had failed to engage in material fact finding or to follow evidence-gathering procedures, and the regulatory record lacked any

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(B) contrary to constitutional right, power, privilege, or immunity;
(C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;
(D) without observance of procedure required by law;
(E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or
(F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.

In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error.

[5] 5 U.S.C. § 706(2)(A).

[6] 463 U.S. 29 (1983).

[7] *See id*. at 42-44.

[8] 467 U.S. 837 (1984).

[9] *See id*. at 842-43. In *Mayo Found. For Med. Educ. & Research v. United States*, 562 U.S. 44, 57 (2011), the Supreme Court made clear that the APA applies to tax rules and regulations.

[10] 145 T.C. No. 3 (2015).

evidence to support the result adopted in the Treasury regulations.[11] Accordingly, the Tax Court held that Treasury's section 482 regulations were invalid.

In short, the Tax Court held in *Altera* that tax regulations must be the product of reasoned decision making. Accordingly, such regulations must have a basis in fact, Treasury must demonstrate a rational connection between the facts found and the choice made in the regulations, Treasury must respond to all significant comments, and the final rule may not be contrary to the evidence presented before the final rule is issued.[12]

The Proposed Regulations present a similar situation to *Altera*.[13] The Proposed Regulations, including the Preamble, fail to articulate any factual basis to support Treasury's across-the-board conclusive presumption that, notwithstanding the particular facts and circumstances surrounding the transfer of an interest in any specific entity to a family member, *the restriction in question will never cause any reduction in the value of the transferred interest to the transferee*. Otherwise stated, Treasury has "'entirely failed to consider an important aspect of the problem'"[14] that is presented in section 2704(b)(4). In creating a bright line test, Treasury has failed to identify restrictions that do "*not ultimately reduce the value of such interest to the transferee*" under various circumstances.[15]

Congress imposed a mandate in section 2704(b) that there be no reduction in the value of the transferred interest to the transferee. However, in the Proposed Regulations, Treasury has lumped together (1) active businesses, (2) situations in which there is 50% ownership by non-family members, (3) situations where family members are hostile to each other and may even be embroiled in protracted litigation with each other, and (4) friendly family-controlled entities that hold nothing but passive assets and do not engage in any trade or business. Each of these scenarios is treated identically under the Proposed Regulations with no fact-finding, notwithstanding the highly differing circumstances faced by a transferee who subsequently

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11 *See Altera*, 145 T.C. No. 3, at 49-59. The Tax Court also found that Treasury failed to respond to significant comments when it issued its section 482 regulations, and that Treasury's conclusion that its section 482 regulations were consistent with the arm's-length standard in fact was contrary to all of the evidence before it. *See Altera*, 145 T.C. No. 3, at 59-69.

12 *See Altera*, 145 T.C. No. 3, at 49-69. *See also Dominion Resources Inc. v. U.S.*, 681 F.3d 1313 (Fed. Cir. 2012) (applying the arbitrary and capricious standard to invalidate Treasury regulation section 1.263A-11(e)(1)(ii)(B) on the ground that Treasury failed to provide an explanation of the reasons behind the regulation).

13 *Altera* is currently on appeal to the United States Court of Appeals for the Ninth Circuit and the City Bar does not express any view with respect to this pending appeal. The City Bar notes, however, that the analysis in *Altera* is based upon the APA's reasoned decision-making standard that was promulgated by the Supreme Court in *State Farm*, and also notes that the Supreme Court in *Mayo Found. For Med. Educ. & Research v. United States*, 562 U.S. 44, 57 (2011), applied the APA's reasoned decision-making standard to tax rules and regulations. Accordingly, the City Bar's analysis in this Part One of this memorandum would remain the same even if the *Altera* case had never been decided by the Tax Court.

14 *Altera*, 145 T.C. No. 3, at 37 (quoting *State Farm*, 463 U.S. at 43).

15 26 U.S.C. § 2704(b)(4).

wishes to liquidate or redeem such transferee's interest but is subject to one or more of such restrictions in the governing instrument. The failure to distinguish among these sharply differing scenarios is highly problematic -- indeed, in the first three of the above-described scenarios, restrictions on the ability to liquidate or redeem an entity interest can and likely will significantly reduce the value of such interest to the transferee.[16] Accordingly, the City Bar respectfully submits that as written, Prop. Treas. Reg. § 25.2704-3 likely exceeds Congress's grant of authority to Treasury under the plain language of section 2704(b)(4). If finalized in its current form, the City Bar believes that such regulation may be deemed invalid as arbitrary and capricious under *State Farm* and its progeny.

PART TWO

For the reasons explained in section III of this part, the City Bar respectfully suggests that certain aspects of the Proposed Regulations exceed Treasury's regulatory rulemaking authority, particularly when applied to the valuation of interests in a family controlled entity that is conducting an active trade or business.

In order to understand the proper scope of Treasury's regulatory authority under section 2704, it is first necessary to understand the generally applicable valuation rules that were applied in *Estate of Harrison v. Commissioner*[17] and how Congress subsequently modified the Code by enacting section 2704.[18] As explained in sections I and II below, section 2704 was specifically structured to prevent the estate tax results in *Estate of Harrison*, and to avoid similar results in the gift and GST tax contexts, without changing the generally applicable rules relevant to the determination of minority discounts and other discounts in the valuation of property for federal estate, gift and GST tax purposes.

I. Valuation of Transferred Property for Federal Estate, Gift and GST Tax Purposes In General

A. Structure of the Federal Estate, Gift and GST Taxes

The federal estate, gift and GST taxes under Chapters 11, 12 and 13 of Subtitle B of the Code are not direct taxes on the ownership of property prior to its transfer. The Federal government is prohibited from imposing a direct tax on property, such power being reserved to

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16 Prop. Treas. Reg. § 25.2704-3 fails to withstand scrutiny under both the first and the second steps of the *Chevron* analysis. Congress has spoken on the precise question at issue in setting forth a standard to govern Treasury rulemaking (which has not been heeded here). In addition, Treasury's action is not "based on a permissible construction of the statute." *Chevron*, 437 U.S. at 842-43.

17 52 T.C.M. (CCH) 1306 (1987).

18 Part Two of this memorandum is intended to provide additional background and context that is missing from the preamble to the Proposed Regulations and which Treasury therefore may have failed fully to consider as part of the process leading up to the issuance of the Proposed Regulations.

the individual States comprising the United States.[19] Instead, as explained in *Estate of Harrison v. Commissioner*, and the cases cited therein, the Federal estate tax is an excise tax on the transfer of property at death. The tax on the act of transferring property is, in turn, calculated based on the value of property owned at death that is the subject of a transfer.[20]

Similarly, the federal gift tax is not a direct tax imposed on the value of the property owned by a donor immediately prior to its transfer to one or more donees. Instead, it is a tax on the transfer of property by a donor during the donor's lifetime. This tax, in turn, is calculated based on the value of the property that is the subject of the transfer to the particular donee. The GST tax is an additional tax likewise calculated based on the value of the property that is the subject of the relevant transfer.

B. General Rules for Valuing Property for Federal Estate, Gift and GST Tax Purposes

The generally applicable federal estate, gift and GST tax rules under which property is valued apply a hypothetical willing buyer-willing seller standard in valuing the relevant property.[21] Under this standard, the taxable, fair market value is the price at which the transferred property would change hands between a willing buyer and a willing seller. The generally applicable willing buyer-willing seller standard is an objective test to be applied without reference to a specific donor, decedent, or his or her beneficiaries. In the case of the estate tax, it is clear that "the valuation [under the basic willing buyer-willing seller standard] is made as of the moment of death and must be measured by the interest that passes, as contrasted with the interest held by the decedent before death or the interest held by the legatee after death."[22]

Generally, the valuation of the shares of a corporation, or of an interest in a partnership, that is part of a decedent's estate does not take into consideration the status of the recipient of those interests, much less the holdings of other members of the decedent's family who may not inherit any property from the decedent's estate. In fact, neither the willing seller nor the willing buyer is assumed to own any additional interests or to be a family member of the other. The

[19] "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." U.S. Const. Art. I, sec. 9 cl. 4.

[20] The estate tax is "'an excise tax on the transfer of property at death and is not a tax on the property transferred.'" *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306 (T.C. 1987) (quoting 26 C.F.R. § 20.2033-1(a)).

[21] Treas. Reg. § 20.2031-1(b) ("The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."); Treas. Reg. § 25.2512-1 ("The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.). "The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves." *United States v. Cartwright*, 411 U.S. 546, 551 (1973).

[22] *Estate of Bonner v. United States*, 84 F.3d 196, 198 (5th Cir. 1996).

hypothetical willing buyer-willing seller test precludes any such inquiry.[23] Correspondingly, for gift tax purposes, the value of the relevant property transferred during lifetime generally is determined as if both the transferor and the transferee did not own any property other than the transferred property and were not family members.[24]

Differences of opinion may exist as to the reasonableness of these valuation assumptions in the family context. For example, if one assumes that members of a family will act in unison as a profit maximizing unit, one is likely to view the hypothetical willing buyer-willing seller valuation assumptions to be unreasonable when applied in a family context. Conversely, if one assumes some level of family discord, one is likely to view with suspicion any valuation methodology under which one family member is attributed ownership of interests held by anyone other than that particular family member.

Regardless, the generally applicable willing buyer-willing seller standard permits the application of valuation discounts when property is transferred among family members and their estates.[25] Chapter 14 of the Code, of which section 2704 is a part, creates limited exceptions to this objective test.

II. Significance of *Estate of Harrison v. Commissioner*

A. Limited Legislative History

As mentioned in the preamble to the Proposed Regulations (the "Preamble"), there is limited legislative history with respect to the enactment of section 2704. That limited legislative history can effectively be summarized in the following excerpt from the Conference Report that accompanied H.R. 5825. The excerpt states, in pertinent part:

> The conference agreement modifies the provision in the Senate amendment regarding the effect of certain restrictions and lapsing rights upon the value of an interest in a partnership or corporation. These rules are intended to prevent results similar to that of *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306 (1987). These rules do not affect minority discounts or other discounts available under present law. The conferees intend that no inference be drawn regarding the transfer tax effect of restrictions and lapsing rights under present law.

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23 *See Smith ex rel. Estate of Smith v. United States*, 391 F.3d 621, 628 (5th Cir. 2004) ("[T]he willing buyer-willing seller test is an objective one. Thus, the hypothetical parties are not the Estate and the beneficiaries."). "The buyer and seller are hypothetical, not actual persons." *Estate of Jameson*, 267 F.3d at 370.

24 *See, e.g.,* Rev. Rul. 93-12, 1993-1 C.B. 202 (1993) (applying the willing buyer-willing seller standard to hold that when "a donor transfers shares in a corporation to each of the donor's children, the factor of corporate control in the family is not considered in valuing each transferred interest" and that "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" because the IRS does not "assum[e] 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.").

25 *Id.*

H. Conf. Rept. 101-964, at 1137 (1990), 1991-2 C.B. 560, 606.

As an agency of the federal government, Treasury is permitted to elucidate a specific provision of the Code by regulation, and Treasury's interpretation is given controlling weight unless it is "arbitrary, capricious, or manifestly contrary to the statute."[26] Moreover, Treasury's interpretation of the scope of its regulatory authority is entitled to *Chevron* deference.[27] Nevertheless, "a statute may foreclose an agency's preferred interpretation despite such textual ambiguities if its structure, legislative history, or purpose makes clear what its text leaves opaque."[28]

Unfortunately, the Preamble does not explain how the sweeping Proposed Regulations are appropriate given the legislative history regarding section 2704 and the findings in *Estate of Harrison v. Commissioner*. The Preamble mentions the willing buyer-willing seller standard only in passing, despite the importance of this standard in assessing minority discounts in the family context. The City Bar respectfully suggests that an appropriate analysis of the scope of Treasury's regulatory authority under, and with respect to, section 2704 must include an appropriate analysis of these important issues.

B. *Estate of Harrison* and Corresponding Provisions of Section 2704

Estate of Harrison involved a situation in which a decedent and two of his children each held general partnership interests in a Texas limited partnership, Harrison Interests, Ltd., immediately before the decedent's death. The decedent also held all of the limited partnership interests in the partnership.

As explained in the Tax Court's decision, under the Harrison Interests, Ltd. partnership agreement, any living general partner could elect to liquidate the partnership during that partner's lifetime, and thereby cause all partners to obtain the full value of such partner's general and limited partnership interests, if any. Each general partner's right to liquidate the partnership lapsed on the death of that partner.

In addition, under the Texas limited partnership statute in effect both at the time of the decedent's death in 1980 and the subsequent enactment of section 2704 in 1990, a Texas limited partnership liquidated upon the death of any general partner unless the remaining general partners continued the business (i) under a right to do so stated in the certificate of limited partnership, or (ii) with the consent of all of the limited partners.[29] Under the terms of the

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26 *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 844 (1984).

27 *City of Arlington v. Federal Communications Commission*, 133 S. Ct. 1863, 1879 (2013).

28 *Catawba County, N.C. v. EPA*, 571 F.3d 20, 35 (D.C. Cir. 2009).

29 Tex. Rev. Civ. Stat. art 6132a § 10(a)(7) (1991) ("[W]ithout the written consent or ratification of the specific act by all the limited partners, a general partner or all of the general partners have no authority to . . . (7) [c]ontinue the business with partnership property on the death, retirement or insanity of a general partner, unless the right so to do is given in the certificate.); § 21 (The retirement, death or insanity of a general partner dissolves the partnership, unless the business is continued by the remaining general partners. . . . (a) Under a right so to do stated in the certificate, or (b) With the consent of all members.").

partnership agreement as described by the Tax Court, the death of any general partner would cause the partnership to liquidate unless the remaining general partners elected to continue the partnership. Accordingly, the provisions of the Harrison Interests, Ltd. partnership agreement restricted the ability of the partnership to liquidate under otherwise applicable Texas law. Under the terms of the partnership agreement, if such an election was made, the deceased general partner whose death would have otherwise caused the liquidation of the partnership was entitled to receive the payment he would have received in respect of his general partnership interest if the partnership had in fact liquidated. Apparently, in this case, such deceased general partner was not entitled to any such payment in respect of any limited partnership interest he also held.

Under these circumstances, the application of the willing buyer-willing seller valuation rules mentioned above had the following results for Federal estate tax purposes,[30] each of which is addressed in a corresponding provision of Section 2704.

1. Section 2704(a)

In determining the estate tax value of Mr. Harrison's limited partnership interest, the Tax Court concluded that his right to liquidate the partnership (and thus readily to obtain the full value of both the general and limited partnership interests) during lifetime could not be taken into account under the willing buyer-willing seller test because that right lapsed at death, and therefore a willing buyer would not pay the willing seller for any increased value attributable to that right held during Mr. Harrison's lifetime. This estate tax valuation result (and results similar to that result under the gift and GST taxes) are addressed under section 2704(a).[31]

2. Sections 2704(b)(1)-(3)

In determining the estate tax value of Mr. Harrison's limited partnership interest, the Harrison family's ability to control the partnership following Mr. Harrison's death and to remove the restriction on the ability of the partnership to liquidate was also held by the Tax Court not to be relevant under the willing buyer-willing seller test. Accordingly, the interest transferred on the death of Mr. Harrison had an estate value that was less than its value in both the hands of the decedent immediately before death (when he had the property law rights that lapsed at death) and

[30] As a technical matter, the parties stipulated to the value of Mr. Harrison's interest as a general partner (which was stipulated to be the full liquidation value payable in respect of that interest under the terms of the partnership agreement) such that the remaining issue to be determined by the Tax Court was the value to be attributed to the limited partnership interest.

[31] Section 2704(a)(1) provides that "if there is a lapse of any voting or liquidation right in a corporation or partnership, and the individual holding such right immediately before the lapse and members of such individual's family 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 of the decedent, whichever is applicable, in the amount [determined under 2704(a)(2) that results in an aggregated value for the transferred property that is that same as the value determined under the normal willing buyer-willing seller test as if there had been no lapse of the relevant right]". Under section 2704(a)(3), Treasury may by regulation apply sections 2704(a)(1) and (2) to rights similar to voting and liquidation rights, *i.e.*, the Secretary may by regulation cause lapsed rights (*e.g.*, put rights) to be taken into consideration in valuing property for transfer tax purposes even though such lapsed rights are not among the rights received by the willing buyer and thus are not taken into consideration under the generally applicable willing buyer-willing seller standard.

the hands of his family as a whole immediately after his death (when the family could exercise their ability as a whole to remove the relevant restriction). This estate tax valuation result (and similar results under the gift tax and GST tax) is addressed under sections 2704(b)(1)–(3).[32]

3. Section 2704(b)(4)

In determining the estate tax value of Mr. Harrison's limited partnership interest, the fact that each family member who inherited a limited partnership interest was already a general partner with the ability to cause the partnership to liquidate, even if the transferred limited partnership interest did not itself include any such right, also was deemed not relevant under the willing buyer-willing seller test. Accordingly, the transferred interest had an estate tax value that was less than its value (a) in the hands of the decedent immediately before death, (b) in the hands of his family as a whole immediately after death, and (c) in the hands of each particular family member that inherited an interest.

To prevent this valuation result (and results similar to that result under the gift and GST taxes) section 2704(b)(4) provides as follows:

> The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.[33]

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32 Sections 2704(b)(1)–(3) provide for the attribution to the hypothetical willing buyer of the family's power as a whole to remove certain liquidation restrictions so long as the transferor and/or members of the transferor's family hold control of the relevant corporation or partnership immediately before the transfer and can remove such restriction after the transfer. This attribution is accomplished by disregarding any "applicable restriction" as part of the valuation process, which is the equivalent of treating the transferee as if the transferee could remove any relevant applicable restriction.

Under section 2704(b)(2), the term "applicable restriction" is defined to mean any restriction which effectively limits the ability of the relevant corporation or partnership to liquidate, and with respect to which either of the following applies:

(i) The restriction lapses, in whole or in part, after the relevant transfer; or

(ii) The transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.

Section 2704(b)(3), however, contains two exceptions from this statutory definition of an applicable restriction. Under section 2704(b)(3)(A), the term "applicable restriction" does not include any commercially reasonable restriction which arises as part of any third party financing. For example, if the commercially reasonable terms of a loan to a partnership restrict the ability of the partnership to liquidate, that restriction is not disregarded as part of the valuation process, even if the family could technically repay the loan and thereby remove the restriction. Under section 2704(b)(3)(B), the term "applicable restriction" also does not include any restriction "imposed, or required to be imposed, by any Federal or State law."

33 26 U.S.C. § 2704(b)(4).

Under the particular facts and circumstances at issue in *Estate of Harrison*, disregarding the applicable restriction on the partnership's ability to liquidate under section 2704(b)(1)-(3) would have been sufficient to result in the "full" valuation of Mr. Harrison's transferred interests.

III. Possible Implications

The City Bar believes that a proper analysis of the relevant legislative history and structure of the federal estate, gift and GST taxes raises significant questions as to whether the following provisions of the Proposed Regulations are within the scope of the Treasury's regulatory authority:

1. The "Transfers of Voting Rights Within Three Years of Death Rule" under Prop. Treas. Reg. § 25.2704–1(c)(1);

2. The "All State Laws That Family Can Modify are Disregarded Rule" under Prop. Treas. Reg. § 25.2704–2(b)(4)(ii);

3. The "Attribution of Additional Family Powers Rule" under Prop. Treas. Reg. § 25.2704–2(b)(3); and

4. The "Modified Tax Entity Classification Rule " under Prop. Treas. Regs. §§ 25.2704-1(a)(1), 25.2704-2(a), 25.2704-3(a) and 25.2701-2(b)(5)(i).

If Treasury continues to utilize the approach reflected in the Proposed Regulations, the City Bar respectfully suggests that the preamble to the final regulations specifically explain Treasury's understanding of the full legislative history quoted above, including the references therein to "results similar to that of *Estate of Harrison*."[34]

A. Transfers of Voting Rights Within Three Years of Death Rule

Under the proposed Transfers of Voting Rights Within Three Years of Death Rule, the current regulations under section 2704(a) are amended to achieve the results described in the following examples under Treas. Reg. § 25.2704-1(f) as modified by the Proposed Regulations:

> Example 4: D owns 84% of the stock of Corporation Y. The by-laws require at least 70% of the vote to liquidate Y. More than three years before D's death, D transfers one-half of his stock in equal shares to his three children (14% to each). Section 2704 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 transfer occurred within three years of D's death, the transfer would have been treated as the lapse of D's liquidation right occurring at D's death*.

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[34] The Preamble mentions a number of cases that do not appear in the above quoted legislative history, and which therefore do not appear to be relevant to an appropriate analysis of the meaning of that legislative history.

> Example 7: D owns all the stock of Corporation X, consisting of 100 shares of non-voting preferred stock and 100 shares of voting common stock. Under the by-laws, X can only be liquidated with the consent of at least 80 percent of the voting shares. More than three years before D's death, D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D's death. *However, had the transfer occurred within three years of D's death, the transfer would have been treated as the lapse of D's liquidation right with respect to the common stock occurring at D's death*. The transfer is not a lapse of a liquidation right with respect to the retained preferred stock because the preferred stock is not subordinate to the transferred common stock.[35]

Although not explicit in the Proposed Regulations, it would appear if D were to die within three years of making the relevant transfer, the effect would be to increase the estate tax value of the 42% of the stock retained by D in example 4, and the 70 shares of common stock retained by D in example 7, by pretending that D continues to hold a liquidation right at death with respect to those retained shares.[36]

One difficulty with this approach, however, is that under the circumstances described in modified examples 4 and 7, there is no actual lapse of any property right of the kind at issue in *Estate of Harrison.* Instead, all of the property law rights associated with the interests transferred during lifetime in the hands of the transferor are taken into consideration under the normal willing buyer-willing seller test. Similarly, all of the property rights associated with the interest owned by the decedent immediately prior to death are also fully valued under the normal willing buyer-willing seller test. There is simply no lapse of the type at issue in *Estate of Harrison*, and therefore there appears to be no basis upon which to change the otherwise

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35 81 Fed. Reg. at 51420 (emphasis added).

36 *See* 26 U.S.C. § 2704(a)(2) (calculating the additional value includible in the gross estate by reason of a lapse by reference to the value of all interests in the entity held by the individual immediately before the lapse). While the proposed Transfers of Voting Rights Within Three Years of Death Rule purports to identify a lapse at death, it does not purport to include in decedent's estate any property other than the property actually owned by the decedent at death (this is in keeping with the fact that section 2704 contains special valuation rules as opposed to special estate tax inclusion rules).

generally applicable valuation rules in the manner suggested under the proposed Transfers of Voting Rights Within Three Years of Death Rule.[37]

In this regard, while the Secretary does have authority under 2704(a)(3) to subject rights in addition to voting and liquidation rights to sections 2704(a)(1) and (2), such rights must still "lapse" in order to trigger any increase in the value subject to tax in connection with the relevant transfer. Under the circumstance described in the examples there is simply no "lapse" within the meaning of section 2704.

The understanding that the fact patterns described in the above examples do not involve a lapse is confirmed by the current regulations under section 2704(a) which provide, in relevant part, as follows:

> Except as otherwise provided, a transfer of an interest that results in the lapse of a liquidation right is not subject to this section [i.e., is not a lapse subject to the special valuation rule under section 2704(a)] if the rights with respect to the transferred interest are not restricted or eliminated. However, a transfer that results in the elimination of the transferor's right or ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest is a lapse of a liquidation right with respect to the subordinate interest.[38]

The Preamble attempts to explain the current regulations by characterizing the first line of the language quoted above as an exception to some otherwise applicable general rule, perhaps because this line begins with the word "Except." However, the first line is not the exception but is rather reflective of the fact pattern in *Estate of Harrison*, and the Congressional admonition in the legislative history that the rules under section 2704 were not intended generally to change the rules applicable to the determination of valuation discounts.

Presumably the rationale for the limited exception for preferred/common capital structures is that ownership of both those interests together is essentially ownership of a single equity interest. For example, in the case of a corporation or partnership with a preferred/common capital structure, ownership of 10% of the total outstanding preferred equity interests together with 10% of the outstanding common equity interests in that same entity is the economic equivalent of owning 10% of that entity. Under these circumstances, the current

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[37] As a further illustration of the fact that there is no lapse within the meaning of section 2704, we note once again that *Estate of Harrison* involved the situation in which the lapse of a right at death in the context of the applicable willing buyer-willing seller valuation test caused property to be worth less in the hands of the decedent's estate than it was worth in the hands of the decedent immediately prior to death. Under the proposed Transfers of Voting Rights Within Three Years of Death Rule, if death occurs within three years of a transfer, the property includible in the decedent's estate would be deemed to have a value for estate tax purposes *in excess* of the value it had in the hands of the decedent immediately prior to death. We further note that section 2035 already contains rules under which Congress has directed that certain transfers, and lapses of rights, occurring within three years of death be treated as if they had been made in contemplation of death with the specific consequences set forth therein. Such consequences do not include those intended to result from the proposed Transfers of Voting Rights Within Three Years of Death Rule.

[38] Treas. Reg. § 25.2704–1(c)(1).

regulations treat a transferor's preferred and subordinate common interests as a single equity interest. Therefore, when a transferor transfers a preferred interest that includes all of the rights associated with that interest, it is treated as if the rights associated with the preferred interest also had been part of the retained common interest and lapsed in connection with the transfer of the preferred interests as to the retained common interests.[39]

The current regulations under section 2704(a) likely do not address the converse situation, a preferred/common capital structure where there is a transfer of common interests and the retention of preferred interests, because that type of transfer is subject to a separate set of special valuation rules under section 2701 that specifically addresses that "estate freeze" fact pattern.

Accordingly, based on the available legislative history understood in the context of the Federal transfer tax system as it functioned in 1990, and as it continues to function today, it would appear to be difficult to conclude that the Transfers of Voting Rights Within Three Years of Death Rule is an appropriate interpretation of the meaning of the word "lapse" or within the regulatory authority granted under section 2704(a)(3).[40]

B. All State Laws That Family Can Modify Are Disregarded Rule

Under the proposed All State Laws That Family Can Modify Are Disregarded Rule (the "State Law Rule"), the current regulations relating to section 2704(b)(3)(B) are to be amended. The State Law Rule purports to clarify what provisions of state law are "imposed or required to be imposed" within the meaning of section 2704(b)(3)(B) and therefore are not "applicable restrictions" within the meaning of section 2704(b)(2). As explained in the Preamble, under the proposed State Law Rule:

> A restriction is imposed or required to be imposed by law [only] 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

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[39] We also note that, if it were valid, it is unclear how the proposed Transfers of Voting Rights Within Three Years of Death Rule would function if a donor died within three years of transferring a preferred interest that had already resulted in (i) an actual lapse with respect to a retained common interest and (ii) a corresponding increase in the value subject to gift tax under section 2704(a)(2). Presumably, the proposed rule should not apply in that context, as the decrease in value intended to be subjected to estate tax would have already been subjected to gift tax during lifetime, with the further inclusion in the decedent's estate of any gift tax paid within three years of death under the normal rules applicable under section 2035.

[40] This does not mean that in all cases property law rights must cease to exist for there to be a lapse within the meaning of section 2704(a). For example, if under applicable law a lifetime transfer of a partnership interest in contravention of the terms of the partnership agreement resulted in the assignee being entitled to all of the distributions in respect of the transferred interest (i.e., the economic rights) but the voting and other non-distribution rights previously associated with that interest were retained by the transferor, those non-distribution rights would not have ceased to exist as a property law matter (but instead would have been retained by the transferor). Nevertheless, those rights would have been severed from the transferred interest immediately prior to the application of the normal willing buyer – willing seller test such that their retention by the transferor would be the transfer tax equivalent of the situation at issue in *Estate of Harrison*, and therefore might appropriately be treated as a "lapse" within the meaning of section 2704(a).

> 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.[41]

Stated more simply, a State law restriction would not be treated as being "imposed or required to be imposed" within the meaning of section 2704(b)(3)(B) if family members could remove that restriction by, for example, agreeing to negate that restriction by including a different provision in a partnership agreement.

One difficulty with this approach is that it would appear to render section 2704(b)(3)(B) meaningless. As indicated above, section 2704(b)(2) defines the term "applicable restriction" as any restriction (i) which effectively limits the ability of the corporation or partnership to liquidate, and (ii) with respect to which either of the following applies: (A) the restriction lapses, in whole or in part, after the relevant transfer or (B) the transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove the restriction, in whole or in part. The statute then provides for two exceptions to this rule, including the exception set forth in section 2704(b)(3)(B) for "any restriction imposed, or required to be imposed, by any Federal or State law."

If the category of state law restrictions under section 2704(b)(3)(B) is so narrowly defined as to include only restrictions that "cannot be removed or overridden and . . . [are] mandated by the applicable law, . . . [are] required to be included in the governing documents, or otherwise . . . [are] made mandatory," it loses any meaning as an exception to what would otherwise be included within the meaning of the term "applicable restriction." Such laws would never in the first place lapse or be capable of removal by family members, and therefore would not constitute applicable restrictions within the meaning of section 2704(b)(2).

[41] 81 Fed. Reg. at 51417.

Moreover, we respectfully submit that, when the provisions of section 2704(b)(3) are analyzed in the context of corresponding provisions under section 2703(b),[42] Congress's underlying intentions become clear. In each case, Congress intended what would otherwise be reasonable business restrictions to be given effect for valuation purposes, even in the family context and even if family members could have entered into alternate arrangements. In the case of section 2704(b)(3)(B), Congress simply appears to have made the affirmative decision to delegate to the States, and not to Treasury, the authority to determine what restrictions are reasonable. The States can do so through the enactment of state law statutory default rules for relevant business entities. The City Bar finds the application of the State Law Rule to the valuation of an interest in a family controlled entity that is conducting an active trade or business to be particularly troubling.

Accordingly, based on the available legislative history of Chapter 14 understood in the context of the Federal transfer tax system in 1990 and today, it would appear difficult to conclude that the State Law Rule is within the Treasury's regulatory authority.

C. Attribution of Family Power to Remove Additional Restrictions Rule

As explained in the Preamble, under the proposed Attribution of Family Power to Remove Additional Restrictions Rule (the "Family Power Rule"):

> 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.[43]

The creation of the Family Power Rule is an attempt to exercise the regulatory authority granted under section 2704(b)(4). Section 2704(b)(4), however, is not an authorization to expand the family attribution rules under sections 2704(b)(1)–(3) that modify the relevant willing buyer-willing seller test. One cannot treat hypothetical persons as having the ability to remove a restriction just because a family as a whole would have that ability. Instead, as explained above,

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[42] Section 2703 is a separate provision of Chapter 14 of the Code under which certain rights to acquire or use property, and restrictions on the right to sell or use property, may be disregarded as part of the process of valuing the relevant transferred property. Under section 2703(b), a restriction on property that might otherwise be disregarded under section 2703(a)(2) is not to be disregarded so long as the restriction is a bona fide business arrangement, is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and so long as its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

[43] 81 Fed. Reg. at 51417 (emphasis added).

section 2704(b)(4) provides regulatory authority for Treasury to address situations in which the particular transferee who receives a transferred interest can immediately thereafter realize additional value without the involvement of other family members by, for example, exercising a pre-existing put right held by that particular transferee that extends to the transferred property once received by the transferee. This section does not authorize Treasury to attribute the possession of property law rights (such as a put right) from one family member to another family member.[44]

Correspondingly, a restriction that is part of the bundle of property law rights being valued under the willing buyer – willing seller test must *necessarily* "ultimately reduce the value of such interest to the transferee" within the meaning of section 2704(b)(4) if the transferee does not immediately after the transfer have the unilateral ability to remove the relevant restriction or otherwise render that restriction meaningless from a valuation standpoint.[45] In this regard, we believe there is a blanket assumption underlying certain of the proposed regulations relating to the Family Power Rule. Treasury has assumed that in every relevant situation, one or more other family investors (or an unrelated investor with a small company interest and/or a brief period of investment) will voluntarily come to the aid of a transferee who does not have the ability to remove a restriction and assist such transferee in realizing additional value with regard to the transferred interest. The City Bar respectfully submits this is an arbitrary and capricious factual assumption that, in the context of the rulemaking process, may in and of itself undermine the validity of the related proposed regulations.[46]

For the reasons alluded to above, we further find that applying the assumption to the valuation of an interest in a family controlled entity conducting an active trade or business to be particularly troubling.

Moreover, to the extent that the combination of the State Law Rule and the Family Power Rule attempts to create a regulatory valuation rule that is not dependent on state law, we note once again that a comparison of sections 2704(b) and 2703(b) reflects a specific Congressional determination to defer to the judgment of state legislatures as to what is a commercially

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[44] The regulatory authority is nevertheless significant. For example, if at the time of transfer a favored child has a right that was not already a right to remove an "applicable restriction" (e.g., a put right with respect to such child's current and future holdings, or voting power to modify a state law provision reducing the value of a transferred interest that was not an "applicable restriction"), but a less favored child does not have a similar right, Treasury could adopt a regulation to cause shares passing from a parent to the favored child to have a greater value for transfer tax purposes than shares passing from the same parent to the less favored child. However, Treasury could not (under section 2704(b)) attribute the rights held by the more favored child to the less favored child.

[45] Even if a restriction lapsed by its own terms with the passage of time, that factor would reduce the value of the transferred interest to the transferee since the transferee might need or otherwise want to sell the transferred interest prior to the lapse and, at the time of the sale, presumably would be able to realize less from the sale than if the restriction did not exist.

[46] *See Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015) (appeal pending in Ninth Circuit Court of Appeals, Dkt. Nos. 006253-12 and 009963-12).

reasonable provision to include in the organizational documents of a corporation or partnership in lieu of creating, or authorizing the creation of, some alternate statutory or regulatory test.[47]

Accordingly, based on the available legislative history of Chapter 14, understood in the context of the Federal transfer tax system in 1990 and today, it would appear difficult to conclude that the Family Power Rule is within the Treasury's regulatory authority.

D. Modified Tax Entity Classification Rule

Under the Modified Tax Entity Classification Rule (the "Classification Rule"), certain state law entities (and possibly other arrangements) that would otherwise be treated as disregarded entities, and not partnerships, under the generally applicable section 7701(a) definitions and related classification rules by reason of having a single owner[48] are nevertheless to be treated as "partnerships" for purposes of section 2704 and related provisions of section 2701.

We respectfully submit that the adoption of these proposed regulations[49] would be inconsistent with the language of section 7701(a) directing that the definitions under section 7701(a), and thereby the check-the-box classification rules promulgated thereunder, be applied for all purposes of the Code, including for estate, gift and GST tax purposes "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." Instead, we suggest that consideration be given to clarifying what we believe to be a proper application of the check-the-box classification rules in the transfer tax context.

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[47] Treasury may, of course, consider alternative strategies to address issues associated with changes in state law mentioned in the Preamble, including by examining the corporate and partnership law provisions that existed in 1990 and considering whether only such provisions of state law should continue to fall within the meaning of section 2704(b)(3)(B). In that regard, Treasury should also consider whether Congress did or did not delegate such authority to Treasury under section 2704(b). In addition, with respect to family controlled partnerships holding only cash and/or marketable securities, Treasury could consider the extent, if any, to which, after the application of section 2704, it might be appropriate further to subject transfers of interests in that particular category of partnerships to the special valuation rules under 2703. Treasury might also seek further legislation.

[48] Subsequent to the enactment of section 2704 and the issuance of the current regulations thereunder in 1992, Treasury promulgated the so called "check-the-box regulations" under Treas. Reg. §§ 301.7701–1 through 301.7701–3. Under these regulations, which became effective January 1, 1997, a "business entity" that is not otherwise required to be treated as a corporation for Federal tax purposes may elect to be treated as a corporation (irrespective of the number of equity owners), a partnership (if there are two or more equity owners) or a disregarded entity (if there is a single equity owner). Whether an arrangement is an "entity" that may constitute a business entity within the meaning of the check-the-box regulations is a matter of Federal tax law and does not depend on whether the organization or arrangement is recognized as an entity under local law. Accordingly, both limited liability companies, which are recognized as entities under local law, and other arrangements such as common law business trusts that may not be recognized as entities under local law, can for these purposes be business entities.

[49] The Proposed Regulations modify the otherwise applicable entity classification rules by including within the category of "partnerships" for purposes of section 2704 all business entities and arrangements that are eligible to elect classification as a corporation, partnership or disregarded entity under Treas. Reg. § 301.7701–3 and that are not S corporations or subchapter S subsidiaries, even if they would simply be disregarded (i.e., be neither corporations or partnerships under these rules).

If, after giving effect to the relevant transfer, there are for transfer tax purposes two or more owners of the relevant business entity, the transferred interests in that entity should be treated for transfer tax purposes as interests in either a partnership or a corporation because a business entity with two or more transfer tax owners cannot qualify for treatment as a disregarded entity under the check-the-box regulations. This approach is consistent with (i) the application of the willing buyer-willing seller standard, because the willing buyer understands that, once owned by the willing buyer, the business entity will have two or more owners and will value it as such, (ii) the decision of the Tax Court in *Pierre v. Commissioner* ("*Pierre I*"), 133 T.C. 24 (2009),[50] and (iii) the results intended under the Classification Rule when there are two or more post transfer owners (i.e., the special valuation rules under section 2704 would apply to the valuation of those transferred interests).

Under this alternative approach, however, a transfer of the entire ownership interest in a disregarded entity from the original single owner to a single transferee (including at death to the owner's estate) would continue to be treated as a transfer of an interest in something that is not a corporation or a partnership. We respectfully submit this is the correct result (since no corporation or partnership would ever exist for tax purposes) and that, in lieu of valuation under the special valuation rules under section 2704, the transferred interest might instead be treated as a transfer of an interest in something that is neither a corporation, a partnership nor a trust.[51]

It would be helpful if Treasury would issue final regulations similar to those of Prop. Treas. Reg. § 25.2701–2(b)(5)(iv) to clarify when owning an equity interest in an entity or arrangement that is a partnership under the normal entity classification rules (as applied for transfer tax purposes in the manner described above), but is not a state law partnership or limited partnership, is for purposes of the relevant control tests under section 2701 the equivalent of owning a general partnership interest in a limited partnership. The reason for this equivalency should be because ownership of such equity interest confers on the holder the ability to cause the liquidation of the entity or arrangement in whole or in part without regard to its associated voting

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50 This case involved gifts and sales of interests in what was a single-member limited liability company in the hands of the donor (and therefore a disregarded entity under the generally applicable check-the-box regulations) made to multiple transferees for transfer tax purposes. The transferees were "grantor trusts" for income tax purposes, meaning that the grantor was for income tax purposes treated as the owner of the trust property and, for income tax purposes, there was a single income tax owner after the relevant transfers and the limited liability company continued to be treated as a disregarded entity for income tax purposes. Under these circumstances, the Tax Court held that the transferred interests did not constitute the transfer tax equivalent of transfers of the entity's underlying assets to the relevant transferees. We respectfully submit that an additional rationale in support of the holding in *Pierre* is that, while the post transfer limited liability company had a single owner for income tax purposes (and therefore continued to be a disregarded entity for such purposes), it had multiple owners for transfer tax purposes and therefore could not be treated as a disregarded entity for such purposes. In this regard, it is readily apparent that a transfer by a grantor to a trust that otherwise results in a transfer subject to gift tax must be treated for transfer tax purposes as a transfer to a person other than the grantor since, if the grantor were instead to be treated as transferring property to himself, there would be no gift.

51 *See, e.g.*, Rev. Rul. 2008-35, 2008-29 I.R.B. 116 (July 21, 2008) (addressing the transfer tax valuation of property held in an account governed by a restricted management agreement and holding that property in any such account would be valued for transfer tax purposes by reason of the application of section 2703 and other Code provisions not including section 2704 without any reduction or discount for the restrictions imposed by the restricted management agreement).

power that is in proportion to its percentage ownership interest in the profits or capital of the partnership as a whole. Such final regulations should also further expressly confirm that when ownership of the general partnership interest in a limited partnership, or such other similar equity interest, is attributed to family members through an intervening entity by operation of section 2701(e)(3), such interest is not held by any of those family members "as a general partner" within the meaning of section 2701(b)(2)(B)(ii) unless that intervening entity is itself a family controlled corporation or partnership within the meaning of section 2701(b)(2).[52]

Similarly, the City Bar understands Treasury's concerns relating to charitable planning that involves donating an interest to charity for purposes of eliminating a disregarded "applicable restriction" within the meaning of sections 2704(b)(1)-(3). However, the City Bar respectfully suggests that there may be more appropriate mechanisms to address those concerns than those reflected in the Proposed Regulations.[53] For example, one alternate approach Treasury might wish to consider would be to focus on the ownership attribution rules under section 2701(e)(3), and to consider whether it might be appropriate to treat the rights associated with interests transferred to charity for less than adequate and full consideration as continuing to be held by the family member who made the charitable contribution. If treated in that fashion, the family as a whole might be deemed to continue to hold the related voting power (or interest "as a general partner") that can cause a restriction to be treated as a disregarded "applicable restriction" under sections 2704(b)(1)-(3).

PART THREE

I. Disregarded Restrictions

A. Overview of Prop. Treas. Reg. § 25.2704-3

Prop. Treas. Reg. § 25.2704-3 establishes a new category of restrictions known as "disregarded restrictions." Prop. Treas. Reg. § 25.2704-3(a) provides that "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*." (emphasis added) The Proposed Regulations clarify that these rules apply to limited liability companies, in addition to partnerships and corporations, and that the detailed family attribution rules of Treas. Reg. § 25.2701-6 apply as well.

Prop. Treas. Reg. § 25.2704-3(b)(1) states that, in general, "[t]he term <u>disregarded restriction</u> means a restriction that is a limitation on the ability to redeem or liquidate an interest

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52 *See*, *e.g.*, I.R.S. P.L.R. 9639054 (Sept. 27, 1996).

53 In this regard, we note that some might consider it odd for Treasury to exercise authority under section 2704(b)(4) for the purpose of modifying the definition of what constitutes an applicable restriction under section 2704(b)(2)(B)(ii). This is the effective result of Prop. Treas. Reg. § 25.2704–3(b)(4)(B), which provides that interests held by nonfamily members will be disregarded if the interest is less than 10% of a business entity.

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." (emphasis in original):

(i) The provision limits or permits the limitation (such as through amendment) 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 (such as through amendment) of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a "*minimum value*." The term "minimum value" means the interest's share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined for federal estate or gift tax purposes, as the case may be, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those deductions were claims against an estate.

(As further discussed below, the implications of this cross-reference to section 2053 are not entirely clear.)

(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. The only exception to the exclusion of a note or other obligation as property arises in the case of an entity that is 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, in which case to the extent that the liquidation proceeds are not attributable to passive assets, 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.

For purposes of determining whether the restriction either lapses after the transfer or can be removed by the transferor or any member of the transferor's family either alone or collectively, Prop. Treas. Reg. § 25.2704-3(b)(4) provides that the interests of nonfamily members are themselves "disregarded" unless (A) the interest has been held by the nonfamily member for at least three years immediately before the transfer; (B) the nonfamily member holds at least a 10% equity interest in the entity; (C) the total of the equity interests held by all nonfamily members constitutes at least 20% of all equity interests in the entity; *and* (D) each nonfamily member has a "put right" to obtain a pro-rata share of the entity's "minimum value" within six months of providing notice of an intent to withdraw.

Prop. Treas. Reg. § 25.2704-3(b)(5) provides that the following types of restrictions will ***not*** be considered "disregarded restrictions," and therefore can potentially be considered in valuing the transferred interest:

(i) an "applicable restriction" as defined in Prop. Treas. Reg. § 25.2704-2;

(ii) "a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations in the form of debt or equity" (whether a person is considered "unrelated" is generally determined by reference to section 267(b));

(iii) certain very limited restrictions imposed or required to be imposed by federal or state law;

(iv) an "option, right to use property, or agreement that is subject to section 2703" (as further discussed, the implications of this cross-reference to section 2703 are not entirely clear); and

(v) certain rights to put interests to the entity that are described in Prop. Treas. Reg. § 25.2704-3(b)(6). The term "put right" is defined to mean a right on liquidation or redemption of the holder's interest, enforceable under applicable local law, to receive cash and/or other property from the entity or from one or more other holders within six months after the date the holder gives notice of the holder's intent to withdraw 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, 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, except in the case of certain entities engaged in trades or businesses that meet certain criteria. (Prop. Treas. Reg. § 25.2704-3(b)(6))

According to Prop. Treas. Reg. § 25.2704-3(f), if a restriction is disregarded under Prop. Treas. Reg. § 25.2704-3, then "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."

The new rules of Prop. Treas. Reg. § 25.2704-3 governing "disregarded restrictions" are 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." (Prop. Treas. Reg. § 25.2704-4(b)(3))

B. Comments

1. Determination of Minimum Value – Prop. Treas. Reg. § 25.2704-3(b)(1)(ii) -- Effect of Cross-Reference to Section 2053

Prop. Treas. Reg. § 25.2704-3(b)(1) states that, in general, "[t]he 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." (emphasis in original) These restrictions include the following one that is set forth in Prop. Treas. Reg. § 25.2704-3(b)(1)(ii):

> "The provision limits or permits the limitation (such as through amendment) of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a "minimum value." The term "minimum value" means the interest's share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined for federal estate or gift tax purposes, as the case may be, of the property held by the entity reduced by the outstanding obligations of the entity. **Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those deductions instead were claims against an estate."** (Prop. Treas. Reg. § 25.2704-3(b)(1)(ii)) (emphasis added)

It is unclear what the last sentence of the above quoted provision means in the context of these Proposed Regulations. Among other things, what is the effect, if any, of the general requirement of Treas. Reg. § 20.2053-1(d)(1) that a claim must be "actually paid" in order to be deducted? It would appear that, by using the parenthetical "(if paid)" in Prop. Treas. Reg. § 25.2704-3(b)(1)(ii), Treasury's intent is to dispense with the "actually paid" general requirement of Treas. Reg. § 20.2053-1(d)(1). If this construction is correct, it should be clarified.

Another issue warranting clarification arises from the fact that Treas. Reg. § 20.2053-1(d)(5) authorizes a "protective claim for refund" to preserve the estate's right to claim a refund in connection with claims that are not paid by the estate until after the federal estate tax return has been filed. Such claims do not meet the requirement for deductibility for estate tax purposes at the time the estate tax return is filed -- due for example, to either their contingent nature or the fact that their amounts were not ascertainable when the estate tax return was filed -- but then may later become ascertainable due to subsequent events. Treasury should consider incorporating this aspect of the section 2053 regulations into the Proposed Regulations as well.

Further, clarification is warranted concerning the incorporation of Treas. Reg. § 20.2053-4(b) with respect to counterclaims. This provision states that "[i]f a decedent's gross estate includes one or more claims or causes of action and there are one or more claims against the decedent's estate in the same or a substantially related matter, or, if a decedent's gross estate includes a particular asset and there are one or more claims against the decedent's estate integrally related to that particular asset, the executor may deduct on the estate's United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) the current value of the claim or claims against the estate, even though payment has not been made," provided that certain requirements have been satisfied. Among other requirements is that "the aggregate value of the related claims or assets included in the decedent's gross estate exceeds 10 percent of the decedent's gross estate." (Treas. Reg. § 20.2053-4(b)(vi)) This 10 percent of gross estate threshold requirement does not lend itself well to the context of the Proposed Regulations. We therefore recommend that the Proposed Regulations clarify that this 10 percent threshold does not apply for purposes of the incorporation by reference of Section 2053.

2. Meaning of right "subject to section 2703" – Prop. Treas. Reg. § 25.2704-3(b)(5)(iv)

Prop. Treas. Reg. § 25.2704-3(b)(5) provides that certain categories of restrictions will *not* be considered "disregarded restrictions," and therefore can potentially be considered in valuing the transferred interest. Included among them is an "option, right to use property, or agreement that is subject to section 2703." (Prop. Treas. Reg. § 25.2704-3(b)(5)(iv)) This raises the question of what it means for an option, right to use property, or agreement to be "subject to section 2703." Does this refer to an option, right to use property, or agreement that is subject to review under section 2703 and is ultimately disregarded for transfer tax purposes under that section? Or, alternatively, does it also extend to an option, right to use property, or agreement that is subject to scrutiny under section 2703 and successfully withstands such scrutiny? We note that the Preamble asserts (on page 16) that there is no overlap between section 2703 and section 2704(b). Taking into account the language of the Preamble, it would appear that the former (and more limited) interpretation may have been intended by Treasury, and if so, that interpretation should be clarified.

3. Guidance on Valuation where there is a Disregarded Restriction — Prop. Treas. Reg. § 25.2704-3(f)

a. General Guidance on Valuation Principles

Guidance is needed on how interests are to be valued where there is a disregarded restriction. According to Prop. Treas. Reg. § 25.2704-3(f), if a restriction is disregarded under Prop. Treas. Reg. §25.2704-3, "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."

This raises a host of questions, and there has been considerable speculation that the implication of the Proposed Regulations is to read "deemed put rights" into the governing documents and local law for valuation purposes as if the interest holder were granted the affirmative right to withdraw its interest in exchange for a pro-rata share of the entity's "minimum value" upon six months' notice. Such an interpretation, however, does not appear to be indicated by the Proposed Regulations. The Proposed Regulations seem to suggest that the disregarded restriction is simply to be "disregarded" by an appraiser who shall accordingly assume that an arm's length negotiation will then ensue between the entity's fiduciaries and other interest holders in the entity on the one hand, and the transferee on the other hand, concerning the terms of redemption or withdrawal, taking into account the relative lack of bargaining power that the transferee may possess under those hypothetical circumstances. Presumably, the appraiser would be required to apply the traditional willing buyer – willing seller test to this hypothetical negotiation, as set forth in Treas. Reg. § 20.2031-1(b) for estate tax purposes (and in Treas. Reg. § 25.2512-1 for gift tax purposes).

In applying the willing buyer – willing seller test to this hypothetical negotiation, the appraiser presumably will need to take into account the following factors:

- Whether, and to what extent, the entity is engaged in an active trade or business;
- The extent to which the assets of the entity are liquid or illiquid;
- The risk that the holder of the interest may be unable to negotiate a favorable buyout;
- The risk that a hypothetical willing buyer would incur in dealing with an unrelated family;
- The transferee's lack of ability to control or influence the entity as a going concern;
- In the case of an operating business, the illiquidity or other obstacles to the business's redemption of the interest;
- In the case of an entity that holds real estate, the length of time required for a partition action;
- In the case of an operating business, the possible relevance of an asset-based approach to valuation; and
- In the case of both an operating business and an entity that holds real estate, the fact that the managers or majority owners may not consider a partial liquidation to be in the best interests of the entity.

b. Effect of Disregarded Restriction on Other Interest Holders in Valuing the Disregarded Restriction

The effect of a disregarded restriction upon other holders of interests in the entity is also relevant to the valuation analysis. It would appear that, for valuation purposes, the hypothetical demands of other interest holders to have their respective interests redeemed or liquidated in exchange for a proportionate share of the entity's assets should likewise be taken into account without regard to the disregarded restriction. Generally applicable valuation principles would then construe the ensuing hypothetical negotiation to bid up the value of the entity's assets. As a result, the transferee, facing this competition from the other interest holders, would likely be willing to accept a reduced payout (*i.e.*, a further discount) in exchange for its interest.

4. Guidance on Non-Gift Transfers

It would also be helpful if Treasury could provide guidance that specifically addresses the effect of disregarded restrictions on transactions that would not otherwise constitute gifts within the meaning of section 2511 and the regulations thereunder. In this connection, Prop. Treas. Reg. § 25.2704-3(g), Example 6 provides as follows:

> "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 [A&B] 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."

The application of these same principles to the following transactions would appear to be fully consistent with this Example 6, and, accordingly, this should be clarified:

- The satisfaction in kind of an annuity amount by a grantor retained annuity trust (GRAT) with an entity interest that has a disregarded restriction;

- The satisfaction in kind of a debt obligation with an entity interest that has a disregarded restriction; and

- The exercise of a power of substitution within the meaning of section 675(4)(C) that involves the exchange of an interest in an entity that has a disregarded restriction.

5. Grandfathering for Transfers of Property Subject to Restrictions Created on or before October 8, 1990

The rules of Prop. Treas. Reg. § 25.2704-3 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." (Prop. Treas. Reg. § 25.2704-4(b)(3)) It is unclear how these rules could potentially apply to transfers of property subject to restrictions created *on or before October 8, 1990.* More specifically, it is unclear under what circumstances, if any, a post-October 8, 1990 modification to an entity or other agreement, or to applicable state law, could be deemed to implicate these proposed rules with respect to an otherwise grandfathered transfer. Accordingly, clarification of this point is needed.

6. Extending the Effective Date for Disregarded Restrictions to 90 Days after Final Regulations are Published in the Federal Register

Finally, Prop. Treas. Reg. § 25.2704-4(b)(3) calls for an effective date with respect to the disregarded restrictions of Prop. Treas. Reg. § 25.2704-3 that is 30 days after final regulations are published in the Federal Register. Given the tremendous complexity of these proposed new rules, the City Bar respectfully submits that a 90 day period would be much more reasonable to allow both taxpayers and their advisors a sufficient amount of time to digest fully the final regulations, so that they can properly comply with the new rules.

II. Applicable Restrictions

A. Overview of Prop. Treas. Reg. § 25.2704-2

The Proposed Regulations expand the scope of an "applicable restriction" under Treas. Reg. § 25.2704-2. Prop. Treas. Reg. § 25.2704-2(a) provides that if an interest in 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." The Proposed Regulations clarify that these rules apply to limited liability companies, in addition to partnerships and corporations, and that the detailed family attribution rules of Treas. Reg. § 25.2701-6 apply as well.

Prop. Treas. Reg. § 25.2704-2(b)(1) defines the term "applicable restriction" as "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." (By contrast, Prop. Treas. Reg. § 25.2704-3 governs restrictions on the ability to liquidate a particular holder's interest in the entity.) The applicable restriction may be imposed under the entity's governing documents or by local law.

Prop. Treas. Reg. § 25.2704-2(b)(4) provides that the following restrictions on the ability to liquidate an entity are *excluded* from the definition of an applicable restriction:

- (i) "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 defined by reference to section 267(b));
- (ii) certain restrictions imposed by federal or state law;
- (iii) an "option, right to use property, or agreement that is subject to section 2703" (as further discussed, the implications of this cross-reference to section 2703 are not entirely clear); and
- (iv) a "put right" as defined in Prop. Treas. Reg. § 25.2704-3(b)(6).

Prop. Treas. Reg. § 25.2704-2(e) addresses the consequences of an applicable restriction and provides that "[i]f 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." (Prop. Treas. Reg. § 25.2704-2(e)) The provisions of the Proposed Regulations dealing with applicable restrictions 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.

B. Comments

1. Meaning of right "subject to section 2703" – Prop. Treas. Reg. § 25.2704-2(b)(4)(iii)

Prop. Treas. Reg. § 25.2704-2(b)(4) provides that certain categories of restrictions will *not* be considered "applicable restrictions," and therefore can potentially be considered in valuing the transferred interest. Included among them is an "option, right to use property, or agreement that is subject to section 2703." (Prop. Treas. Reg. § 25.2704-2(b)(4)(iii)) This provision raises the question of what it means for an option, right to use property, or agreement to be "subject to section 2703." Does this provision refer to an option, right to use property, or agreement that is subject to review under section 2703 and is ultimately invalidated for transfer tax purposes under that section? Or, alternatively, does it also extend to an option, right to use property, or agreement that is subject to scrutiny under section 2703 and successfully withstands such scrutiny? We note that the preamble to the Proposed Regulations asserts (on page 16) that there is no overlap between section 2703 and section 2704(b). Taking into account the language of the preamble, it would appear that the former (and more limited in scope) interpretation may have been intended by Treasury. If this construction is correct, it should be clarified.

2. Guidance on Non-Gift Transfers

It would also be helpful if Treasury could provide guidance that specifically address the effect of applicable restrictions on transactions that would not otherwise constitute gifts within the meaning of section 2511 and the regulations thereunder. This would include the following:

- The satisfaction in kind of an annuity amount by a grantor retained annuity trust (GRAT) with an entity interest that has an applicable restriction;
- The satisfaction in kind of a debt obligation with an entity interest that has an applicable restriction; and
- The exercise of a power of substitution within the meaning of section 675(4)(C) that involves the exchange of an interest in an entity that has an applicable restriction.

3. Grandfathering for Transfers of Property Subject to Restrictions Created on or before October 8, 1990

The rules of Prop. Treas. Reg. § 25.2704-2 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." (Prop. Treas. Reg. § 25.2704-4(b)(2)) It is unclear how these rules could potentially apply to transfers of property subject to restrictions created *on or before October 8, 1990*, and more specifically, under what circumstances, if any, a post-October 8, 1990 modification to an entity or other agreement, or to applicable state law, could be deemed to implicate these proposed rules with respect to an otherwise grandfathered transfer. Accordingly, clarification of this point is required.

III. Lapses of Voting or Liquidation Rights

A. Overview of Prop. Treas. Reg. § 25.2704-1

The Proposed Regulations expand the lapse provisions of Treas. Reg. § 25.2704-1 and create a bright-line rule that can potentially produce estate tax inclusion of the value that is attributable to lapsed voting or liquidation rights if a person transfers an interest in a family-controlled entity and dies within three years of such transfer. As currently written, the Proposed Regulations could cause this addition in value to apply to transactions occurring up to three years before the date that the Proposed Regulations are published as final regulations in the Federal Register. If true, this addition in value could potentially apply to transactions occurring substantially before the date of issuance of the Proposed Regulations.

Prop. Treas. Reg. § 25.2704-1(a)(1) provides that "the lapse of a voting or liquidation right in an [entity], whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse 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 this lapse." Once again, the term "entity" for this purpose includes corporations, partnerships and limited liability companies, and the detailed family attribution rules of Treas. Reg. § 25.2701-6 apply as well. In the case of a limited liability company (an "LLC"), the right of a member to participate in the management of the LLC is a voting right. A voting right or a liquidation right may be conferred by or lapse by reason of local law, the LLC Operating Agreement, or otherwise.

Prop. Treas. Reg. § 25.2704-1(a)(5) also addresses the issue of "assignee interests," and states that "[a] transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights." The Proposed Regulations give the example of a transfer of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights associated with the transferred interest.

Significantly, the Proposed Regulations will cause certain transfers of entity interests within three years of death to trigger this expanded new rule. Prop. Treas. Reg. § 25.2704-

1(c)(1) states that "[e]xcept 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." However, "[t]he 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)." (Prop. Treas. Reg. § 25.2704-1(c)(1).) The Proposed Regulations give two examples to illustrate this point, which are set forth in Part B of this section of the memorandum.

The effective date provisions of Prop. Treas. Reg. § 25.2704-4(b)(1) state that Prop. Treas. Reg. § 25.2704-1 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. However, Prop. Treas. Reg. § 25.2704-1(c)(1), in turn, states that "[t]he 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)." The Proposed Regulation would seem to indicate that transactions entered into three years prior to the date of death of a decedent who dies subsequent to the finalization of these regulations may be subject to this addback --- even though the transfers may have occurred prior to the publication of any final regulations.

B. Comments

1. Deemed Lapses as a Result of Transactions Occurring More than Three Years Before Death – Prop. Treas. Reg. § 25.2704-1(c)(1), -1(f), Examples 4 and 7

As discussed above, the Proposed Regulations will cause certain transfers within three years of death to trigger the inclusion of an amount in the transferor's gross estate under section 2704(a) that is attributable to the deemed lapsed voting or liquidation right. Prop. Treas. Reg. § 25.2704-1(c)(1) states that "[e]xcept 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." However, "[t]he 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)." (Prop. Treas. Reg. § 25.2704-1(c)(1)) The Proposed Regulations provide the following examples to illustrate this point:

> Example 4. * * * More than three years before D's death, D [who had held an 84% interest in an entity known as "Y," the by-laws of which require a 70% vote by interest to liquidate] transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(b) 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.** (Prop. Treas. Reg. § 25.2704-1(f), Example 4) (emphasis added)
>
> 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.** (Prop. Treas. Reg. § 25.2704-1(f), Example 7) (emphasis added)

This possible retroactive result is fundamentally unfair as it relates to transactions entered into before the Proposed Regulations become effective, and we question whether this retroactive consequence was in fact specifically intended by Treasury.

The City Bar accordingly requests that Treasury revise the effective date provisions of Prop. Treas. Reg. § 25.2704-4(b)(1) to provide that, notwithstanding any other provision to the contrary, Prop. Treas. Reg. § 25.2704-1 shall not apply to any transactions that are entered into prior to the date that the Proposed Regulations are effective.

2. Computation of Amount of Lapse Deemed to Occur at Death

Clarification is also needed concerning the computation of the lapse that is treated as occurring at the decedent's death. Among other things, Treasury should clarify that the lapse is based on values for estate tax purposes as of the date of decedent's death (or as of the alternative valuation date under section 2032, to the extent applicable), rather than the date of the transaction prior to death that is deemed to occur as of the decedent's death as a result of Prop. Treas. Reg. § 25.2704-1(c)(1).

3. Computation of Amount of Lapse Deemed to Occur at Death Where Section 2704(b) Also Applies

In addition, clarification is needed to confirm that the same transfer will not effectively be taxed twice where both section 2704(a) and section 2704(b) apply to the transferred interest. For example, if a gift is valued with a reduction in discounts under the new proposed valuation rules of section 2704(b), then the amount of any deemed lapse at death should also be computed without any such reduction in discount, and not by using the traditional willing buyer – willing seller test of Treas. Reg. § 20.2031-1(b). Presumably, there should not be any lapse for section 2704(a) purposes under these circumstances.

4. Grandfathering for Lapses of Rights Created on or before October 8, 1990

The rules of Prop. Treas. Reg. § 25.2704-1 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." (Prop. Treas. Reg. § 25.2704-4(b)(1).) It is unclear how these rules could potentially apply to lapses of rights created *on or before October 8, 1990*, and more specifically, under what circumstances, if any, a post-October 8, 1990 modification to an entity or other agreement, or to applicable state law, could be deemed to implicate these proposed rules with respect to an otherwise grandfathered lapse. Accordingly, clarification of the grandfathering provisions is warranted.

Committee on Estate and Gift Taxation
Evelyn M. Capassakis, Chair
evelyn.capassakis@pwc.com

Subcommittee on Section 2704 Proposed Regulations:
Kevin Matz, Subcommittee Chair and Principal Drafter, Parts One and Three
Jeffrey N. Schwartz, Principal Drafter, Part Two
Jessica Galligan Goldsmith, Substantial Contributor, Parts One, Two and Three
Lois Tilton, Substantial Contributor, Parts One and Three
Andrea L. Sanft, Contributing Member

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