



Section of Taxation

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August 9, 2017

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2017-38)
Room 5205
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20224

Re: Comments on Notice 2017-38 (Proposed Regulations Under Section 2704)

Dear Ladies and Gentlemen:

Enclosed please find comments on Notice 2017-38 regarding proposed regulations under section 2704 ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Sincerely,

A handwritten signature in blue ink that reads "William H. Caudill".

William H. Caudill
Chair, Section of Taxation

Enclosure

cc: Hon. Steven T. Mnuchin, Secretary, Department of the Treasury
Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Hon. John A. Koskinen, Commissioner, Internal Revenue Service
Dana L. Trier, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Thomas West, Tax Legislative Counsel, Department of the Treasury
William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service

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**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

**COMMENTS ON NOTICE 2017-38 REGARDING
PROPOSED REGULATIONS UNDER SECTION 2704**

These comments (the “Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Benjamin G. Carter, Chair of the Section’s Committee on Estate and Gift Taxes (the “Committee”). Substantive contributions were made by Hannah W. Mensch and George D. Karibjanian. The Comments were reviewed by Julian Y. Kim, the Section’s Vice Chair (Government Relations).

Although the members of the Committee who participated in preparing these Comments have clients that might be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Benjamin G. Carter
ben.carter@texascapitalbank.com
(214) 210-3068

Date: August 9, 2017

**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

**COMMENTS ON NOTICE 2017-38 REGARDING
PROPOSED REGULATIONS UNDER SECTION 2704**

On April 21, 2017, President Trump (the “President”) issued Executive Order 13789 (the “Executive Order”). The Executive Order directed the Secretary of the Treasury to review all significant tax regulations issued by the Treasury Department (“Treasury”) on or after January 1, 2016 (the “2016 Regulations”) and to issue an interim report to the President that identifies those 2016 Regulations that (1) impose an undue financial burden on U.S. taxpayers; (2) add undue complexity to the Federal tax laws; or (3) exceed the statutory authority of the Internal Revenue Service (the “Service”).

In response to the Executive Order, the Service issued Notice 2017-38 (the “Notice”), in which Treasury identified eight 2016 Regulations (the “Selected Regulations”) that Treasury concluded impose an undue financial burden on U.S. taxpayers or add undue complexity to the Federal tax laws. Notably, the Selected Regulations included proposed regulations under section 2704¹ issued on September 6, 2016 (noting that the proposed regulations also impacted section 2701, hereinafter the “Proposed Regulations”).²

On November 2, 2016, the American Bar Association’s Section of Taxation (the “Tax Section”) submitted detailed comments on the Proposed Regulations, a copy of which is attached hereto (the “Tax Section Comments”).³ The Tax Section Comments addressed a variety of ways that the Proposed Regulations, once finalized, could be improved to provide additional clarity, efficiency, and fairness. Moreover, thousands of other organizations and individuals provided substantive comments to the Proposed Regulations.⁴ The level of attention and scrutiny given to the Proposed Regulations, both by the written comments and by the testimony at the full day public hearing on December 1, 2016, can be described as “unprecedented.”

The Tax Section Comments are in agreement with Treasury’s conclusion in the Notice that, absent changes, the Proposed Regulations could impose an undue financial

¹ Unless otherwise specifically stated, all references herein to a “section” or the “Code” shall be references to the Internal Revenue Code of 1986, as amended; and all references to the “Regulations” shall be references to the Treasury Regulations promulgated under the Code.

² Internal Revenue Bulletin 2016-36 (REG-163113-02). Note that the Notice refers to the Proposed Regulations by only referencing regulations under section 2704 although the citation in the Notice to REG-163113-02 covers regulations issued under both sections 2701 and 2704.

³ American Bar Association, Section of Taxation, *Comments Concerning Proposed Regulations Under Section 2701 and 2704* (November 2, 2016), available at <https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/110216comments.authcheckdam.pdf>.

⁴ On January 9, 2017, as part of the Current Developments Panel at the 51st Annual University of Miami Philip E. Heckerling Institute on Estate Planning in Orlando, Florida, Catherine V. Hughes, Esq., the Estate and Gift Tax Attorney Advisor for Office of Tax Policy at the Department of Treasury, stated that during the 90-day comment period, in excess of 10,000 comments were submitted.

burden on U.S. taxpayers and add undue complexity to the Federal tax laws. Unlike many of the comments provided to Treasury by other organizations which concluded that the Proposed Regulations should be withdrawn, the Tax Section Comments instead focused on specific changes to the Proposed Regulations that could improve the overall regulatory structure. Some of the recommendations are as follows:⁵

- Clarifying that the Proposed Regulations do not impose a “Deemed Put Right” for all entity Interests that would otherwise be subject to section 2704;⁶
- Addressing the impact of the regime created by the Proposed Regulations on the income tax basis adjustment at death for those Entity Interests that are not subject to the income tax basis consistency requirements under section 1014(f);⁷
- Practical issues associated with the Proposed Regulation’s treatment of Nonfamily Member Interests;⁸ and
- Issues surrounding the valuation methodology in the case of estate tax inclusion under the three-year rule of section 2704(a).⁹

The Tax Section reaffirms all of its recommendations to Treasury contained in the Tax Section Comments. Should Treasury elect to revise the Proposed Regulations in an effort to issue final regulations as to the subject material, the Tax Section respectfully suggests its recommendations be considered in such final regulations.

In the interest of time, the Tax Section now submits these comments regarding the Proposed Regulations. The Tax Section may submit comments on others of the Selected Regulations in a later submission.

⁵ The capitalized terms in the bullet pointed items herein are defined within the Tax Section Comments.

⁶ Section IV.A of the Tax Section Comments.

⁷ Section IV.B of the Tax Section Comments.

⁸ Section IV.D of the Tax Section Comments.

⁹ Section IV.G of the Tax Section Comments.



Section of Taxation
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November 2, 2016

The Honorable John Koskinen
 Commissioner
 Internal Revenue Service
 1111 Constitution Avenue, NW
 Washington, DC 20024

The Honorable Mark Mazur
 Assistant Secretary (Tax Policy)
 Department of the Treasury
 1500 Pennsylvania Avenue, NW
 Washington, DC 20220

Re: Comments on Proposed Regulations under Sections 2701 and 2704

Dear Messrs. Koskinen and Mazur:

Enclosed please find comments on proposed regulations under sections 2701 and 2704 ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,



William H. Caudill
 Chair, Section of Taxation

Enclosure

cc: Hon. William J. Wilkins, Chief Counsel, Internal Revenue Service
 William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service
 Curtis G. Wilson, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
 John D. MacEachen, Attorney, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
 Karen M. Schiller, Commissioner (Small Business/Self-Employed Div.), Internal Revenue Service
 Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
 Thomas C. West, Tax Legislative Counsel, Department of the Treasury
 Catherine V. Hughes, Attorney-Advisor (Estate & Gift Tax), Department of the Treasury

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ABA SECTION OF TAXATION
COMMENTS CONCERNING PROPOSED REGULATIONS UNDER
CODE SECTIONS 2701 AND 2704

[REG-163113-02]

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by representatives from the Section’s Estate and Gift Committee (“EGT”), Fiduciary Income Tax Committee (“FIT”) and Closely-Held Business Committee (“CHB”), namely Benjamin G. Carter, George Karibjanian, Jeffrey Chadwick, Hannah Mensch, Scott Sambur, Stacey Delich-Gould, Carly McKeeman, Bruce Pinegar, Erica Howard-Potter, and Allison Clayton. The Comments were reviewed by Benjamin G. Carter, Chair of EGT, David A. Berek, Chair of FIT, and Shelby Wilson, Chair of CHB. The Comments were further reviewed by John F. Bergner, Council Director for EGT and FIT, by T. Randolph Harris (former Chair of FIT) and Barbara A. Sloan (former Chair of EGT), on behalf of the Committee on Government Submissions, by Julian Y. Kim, Vice-Chair of Government Relations, and by William H. Caudill, Chair of the Section.

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: November 2, 2016

I. Executive Summary

Sections 2701 and 2704¹ are two of the four transfer tax valuation sections added in 1990 as part of Chapter 14 of the Code. The rules contained in Chapter 14 are aimed at preventing the undervaluation of certain intra-family gifts and bequests. Section 2701 contains special rules for determining the amount of a gift when an individual transfers only a portion of his or her equity interest in a corporation or partnership (which, under section 7701(a)(2), includes a limited liability company (an “LLC”)).² Section 2704, in general, applies special valuation rules to the transfer of Entity Interests in a family-controlled Entity if the Entity Interest being transferred is subject to a lapsing voting or liquidation right or a restriction on liquidation.

Specifically, under section 2704(a), if a lapse of a voting or liquidation right occurs with respect to an Entity Interest (presumably as a result of a transfer of the Entity Interest), and if the individual whose right lapsed and his or her family members control the entity both before and after the lapse, the lapse itself is treated as a transfer.

Under section 2704(b)(1), if an individual transfers an Entity Interest to a member of his or her family, and, both before and after the transfer, the transferor and members of his or her family (which may include family members other than the transferee), control the Entity, certain “Applicable Restrictions” with respect to the Entity will be “disregarded” in valuing the transferred Entity Interest. Section 2704(b)(2) defines an “Applicable Restriction” as (a) any restriction that effectively limits the ability of the Entity to liquidate, and (b) either, (1) lapses (entirely or partially) after the transfer, or (2) can be removed, either entirely or partially, by the transferor or a member of the transferor’s family (referred to herein as an “Applicable Restriction”).

Under section 2704(b)(3), there are two important exceptions to the definition of an Applicable Restriction. First, an Applicable Restriction does not include a commercially reasonable restriction which arises as part of financing by the Entity with a person who is not related to the transferor, the transferee, or any member of the family of either. Second, an Applicable Restriction does not include any restriction imposed, or required to be imposed, by any federal or state law.

Within two years after the enactment of Chapter 14, Treasury issued Treasury Regulation sections 25.2704-1, 25.2704-2 and 25.2704-3 to expand the analysis of section 2704(b). Treasury Regulation section 25.2704-2(b) provides, in part, that an “applicable restriction” is a particular limitation on the ability to liquidate the Entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law governing the Entity if such particular limitation did not exist. For example, suppose that an Entity is formed under the laws of State X. Under State X law, a vote of the members or partners owning at least a combined 51% of all Entity Interests is needed to liquidate the Entity. If the Entity’s governing documents required that a vote of the members or partners owning at least a combined 66 2/3% of all Entity

¹ Unless otherwise specifically stated, all references herein to a “section” or the “Code” shall be references to the Internal Revenue Code of 1986, as amended; and all references to the “Regulations” shall be references to the Treasury Regulations promulgated under the Code.

² For all purposes of this submission, any such corporation or partnership is referred to herein as an “Entity,” and an interest in such Entity is referred to herein as an “Entity Interest.”

Interests is needed to liquidate the Entity, this particular limitation (*i.e.*, the “66 2/3% vote” limitation) would be an Applicable Restriction under Treasury Regulation section 25.2704-2(b) because it is more restrictive (*i.e.*, a greater total of Entity Interests is required to liquidate) than that provided under the laws of State X (where a lesser total of Entity Interests is required to liquidate). For valuation purposes, this Applicable Restriction would be disregarded under section 2704.

Section 2704(b)(4) provides that the Secretary may issue regulations identifying other restrictions that shall be disregarded in determining the value of any Entity Interest transferred to a member of the transferor's family, if the restriction identified in such regulations has the effect of reducing the value of such transferred interest for transfer tax purposes but does not ultimately reduce the value of such transferred interest to the transferee.

Relying, in part, on the enabling authority of section 2704(b)(4), on August 2, 2016 Treasury issued proposed regulations under sections 2704 and 2701 (hereinafter, the “Proposed Regulations”).³ In the “Background” section of the Preamble to the Proposed Regulations (hereinafter, the “Preamble”), Treasury posited its view that the current Treasury Regulations under section 2704 “have been rendered substantially ineffective in implementing the purpose and the intent of the statute” as a result of changes in state law and other subsequent developments, emphasizing the case of *Kerr v. Commissioner*.⁴ The *Kerr* case, in particular, interpreted the term “applicable restriction” as a restriction on the ability to liquidate the entire entity and not as a restriction on the ability to liquidate solely the transferred Entity Interest, which is a concept that Treasury believes is not the true intent behind the meaning of Applicable Restriction. Further, most states changed their Entity laws to make certain elements extremely restrictive so that any restriction contained in an Entity agreement could not be more restrictive than applicable state law, thereby rendering as relatively moot a significant element of section 2704(b).

Treasury solicited public comments on all aspects of the Proposed Regulations and scheduled a public hearing on the Proposed Regulations for December 1, 2016.

The Section acknowledges that a variety of questions and concerns about the Proposed Regulations have been raised by practitioners across the country. With these Comments, the Section has not attempted to list each and every potential issue, recognizing that other organizations will also provide comments on various issues. Nevertheless, the Section has focused on selected issues that the Section deems particularly worthy of Treasury’s consideration. With that in mind, the Section respectfully requests further guidance and/or clarification on the following seven items contained in or referenced by the Proposed Regulations:

- A. Clarification that the Proposed Regulations do not impose a “deemed put right” for all Entity Interests that would otherwise be subject to section 2704;

³ 81 Fed. Reg. 51413 (Reg. 163113-02) (<http://federalregister.gov/a/2016-18370>) August 4, 2016. The notice of proposed rulemaking was modified on October 3, 2016, to correct an error regarding effective date language.

⁴ 113 T.C. 449 (1999), *aff’d*, 292 F.3d 490 (5th Cir. 2002).

- B. Clarification as to the impact of the Proposed Regulations on income tax basis, including the income tax basis adjustment at death for Entity Interests not subject to the consistent basis requirements under section 1014(f);
- C. Clarification as to the interaction between sections 2703 and 2704 in light of the statement in the Proposed Regulations that rights subject to section 2703 are not subject to section 2704;
- D. Consideration of practical issues associated with the approach of the Proposed Regulations to Nonfamily Member Interests (as herein defined);
- E. Clarification as to the meaning of “market” interest rates;
- F. Clarification as to the definition of a “controlled entity”; and
- G. Clarification as to the valuation methodology in case of inclusion under section 2704(a)’s “three year rule” and consideration to reducing the look-back period from three years to one year.

II. Background and Introduction

A. General Rule: Fair Market Value.

With respect to a transfer of property, the application of federal transfer taxes typically depends on the “fair market value” of property transferred. “Fair market value” means the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (referred to as the “General Valuation Rule”).⁵

The fair market value of certain assets, such as publicly traded stock,⁶ can be ascertained through simple objective measures. In other cases, such as ownership interests in a privately owned business, the determination of fair market value requires a more sophisticated analysis.⁷ If an interest in a privately owned business cannot be sold on the open market or does not represent a controlling interest in the business, the determination of fair market value will often result in the application of valuation discounts from the pro-rata share of the full fair market value of the business.

⁵ Regs. §§ 20.2031-1(b) (estate tax) and 25.2512-1 (gift tax).

⁶ Reg. § 20.2031-2(b)(1) (valuing corporate stock publicly traded on a stock exchange by taking the mean of the high and low selling prices on the valuation date).

⁷ See, e.g., Reg. § 20.2031-3.

B. Section 2704.

Section 2704 was added to the Code in 1990⁸ and sets forth exceptions to the General Valuation Rule for certain intra-family transfers of Entity Interests subject to lapsing voting or liquidation rights and restrictions on liquidation.

To restate the concepts discussed in the Executive Summary, section 2704(a) generally states that if there is a lapse of any voting or liquidation right in an Entity, and the individual holding such right immediately before the lapse and members of his or her family⁹ possess, both before and after the lapse, control¹⁰ of the Entity, such lapse is deemed to be either (1) a transfer by such individual by gift, or (2) a transfer which is includible in such individual's gross estate for federal estate tax purposes under section 2031 (the "Gross Estate"), whichever is applicable.¹¹ The amount of such deemed transfer equals the excess, if any, of the value of all Entity Interests in the Entity held by the individual immediately before the lapse (determined as if the voting and liquidation rights were non-lapsing), over the value of such Entity Interests immediately after the lapse.¹² Section 2704(a)(3) grants Treasury the authority, through the issuance of Regulations, to apply section 2704(a) to rights similar to voting and liquidation rights.¹³

Section 2704(b) provides that if there is a transfer of an Entity Interest to, or for the benefit of, a member of the transferor's family (referred to as a "Family Member") and the transferor and Family Members possess, immediately before the transfer, control of the Entity,

⁸ The legislative history of Chapter 14, which is primarily contained in a 1990 Conference Report, suggests that Congress intended Chapter 14 to be quite narrow. 136 Cong. Rec. 15679, 15681 (October 18, 1990). Specifically, the enactment of Chapter 14 was not intended to "affect minority discounts or other discounts available under [present] law."

The 1990 Senate Finance Committee Report provided:

The value of property transferred by gift or includable in the decedent's gross estate generally is its fair market value at the time of the gift or death. 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 sell and both having reasonable knowledge of the relevant facts (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer. Accordingly, courts generally have refused to consider familial relationships among co-owners in valuing property. [footnotes omitted] For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.

....

[T]he bill does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally in all items of income, deduction, loss and gain in the same proportion (*i.e.*, straight-up allocations).

⁹ I.R.C. § 2704(c)(2) (defining member of the family for purposes of section 2704).

¹⁰ I.R.C. § 2704(c)(1) (defining "control" as having the same meaning of such term given under section 2701(b)(2)).

¹¹ I.R.C. § 2704(a)(1).

¹² I.R.C. § 2704(a)(2).

¹³ I.R.C. § 2704(a)(3).

any Applicable Restriction shall be disregarded in determining the value of the transferred Entity Interest for transfer tax purposes.¹⁴

Finally, an Applicable Restriction is defined as a restriction that effectively limits the ability of the Entity to liquidate, and either, (1) the restriction lapses, in whole or in part, after the transfer, or (2) the transferor or any member of the transferor's family, either alone or collectively, has the right after the transfer to remove the restriction, either in whole or in part.¹⁵ However, an Applicable Restriction excludes (1) any commercially reasonable restriction imposed as part of a financing by the Entity with a person who is not related to the transferor, transferee or family member of either, and (2) any restriction imposed, or required to be imposed by federal or state law.

Section 2704(b)(4) authorizes Treasury, through the issuance of Regulations, to identify other restrictions that will be disregarded in determining the value of the transfer of any Entity Interest to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for transfer tax purposes (*i.e.*, generate a valuation discount) but does not ultimately reduce the value of such interest to the transferee (presumably, the full liquidation value).¹⁶

III. Proposed Regulations

The Proposed Regulations implement the following important modifications of, and additions to, the existing regulatory scheme for section 2704:

A. Assignee.

Citing a transfer of a partnership interest to an assignee as an example, the Proposed Regulations provide that a transfer of an Entity Interest that results in the restriction or elimination of the transferee's ability to exercise voting or liquidation rights that were associated with such interest when held by the transferor, is a lapse of those rights.¹⁷ Consider, for example, an individual who owns 75% of the Entity Interests in an Entity. The individual transfers a 10% Entity Interest to her child when such child previously did not own any Entity Interests in the Entity and, under the governing documents and applicable state law, the child is a mere assignee. Because the child is a mere assignee, the voting and liquidation rights associated with the transferred interest in the transferor's hands did not pass to child. The Proposed Regulations would treat this as a lapse.

B. Section 2704(a) Three Year Rule Exception.

The current Treasury Regulations provide that a transfer of an Entity Interest that results in a lapse of a liquidation right is not subject to section 2704(a) if the rights with respect to such transferred interest are not restricted or eliminated.¹⁸ For example, suppose that Individual owns

¹⁴ I.R.C. § 2704(b)(1).

¹⁵ I.R.C. § 2704(b)(2).

¹⁶ I.R.C. § 2704(b)(4).

¹⁷ Prop. Reg. § 25.2704-1(a)(5).

¹⁸ Reg. § 25.2704-1(c)(1).

66% of the Entity Interests of an Entity under which the governing instrument provides that the holders of at least 51% of the Entity Interests can liquidate the Entity. Individual gifts one-half of his Entity Interests equally to his three children, so that, after the transfer, each child has 11% of the Entity Interests in the Entity. As a result of the transfer, Individual no longer has the unilateral ability to liquidate the Entity. Despite the loss of the liquidation right, section 2704(a) does not apply to Individual's loss of his liquidation ability because none of the voting or liquidation rights with respect to the Entity are restricted or eliminated by reason of the transfer.¹⁹

The Proposed Regulations modify this exception by excluding such transfers made within three years of the transferor's death (the "Three Year Rule"). Under the Three Year Rule, the transfer will be treated as a lapse occurring on the transferor's date of death, and the lapse will be includible in the transferor's Gross Estate under section 2704(a).²⁰

C. Definition of Applicable Restrictions.

The Proposed Regulations provide that an Applicable Restriction can be imposed as part of the governing entity documents, contractual arrangements, or pursuant to local law (even if the restriction can be overridden under the governing documents or otherwise).²¹

Under the current Regulations, an Applicable Restriction includes any limitation on the ability to liquidate an entity "that is more restrictive than the limitations that would apply under State law generally applicable to the entity in the absence of the restriction."²² As explained above, subsequent to the release of the Regulations, most states changed their entity laws to impose extremely strict restrictions such that governing instruments would rarely impose restrictions more strict than those under state law.

The Proposed Regulations eliminate this standard. In lieu thereof, the Proposed Regulations merely restate the statutory language that an Applicable Restriction excludes a restriction imposed, or required to be imposed, by federal or state law (the "Imposed By Law Exclusion"). The Proposed Regulations state that the following types of federal or state laws will not satisfy the Imposed By Law Exclusion:

- A law that applies only in the absence of a contrary provision in the governing documents or if such law may be superseded by the shareholders, partners, members and/or managers of the entity or otherwise;
- A law that is limited to a narrow class of entities, particularly those likely to be subject to section 2704; and

¹⁹ See generally Reg. § 25.2704-1(f) Example 4.

²⁰ Prop. Reg. § 25.2704-1(c)(1).

²¹ Prop. Reg. § 25.2704-2(b)(2).

²² Reg. § 25.2704-2(b).

- A law that provides for an optional provision (or different statutory scheme for formation and governance) that does not mandate the restriction or allows it to be overridden.²³

The Proposed Regulations also exclude from the definition of Applicable Restriction an option, a right to use property, or an agreement subject to section 2703,²⁴ as well as any “Qualified Put Right” (as discussed in section III.D., below).²⁵

Finally, the Proposed Regulations conclude that if an Applicable Restriction is disregarded under section 2704, the fair market value of the transferred Entity Interest is determined under generally applicable valuation principles as if the restriction does not exist.²⁶

D. Creation of Disregarded Restrictions.

The Proposed Regulations establish a new class of restrictions that would be disregarded under section 2704(b) (referred to as “Disregarded Restrictions”). Unlike Applicable Restrictions, which apply to restrictions on the ability to liquidate the entire Entity, Disregarded Restrictions apply to the ability to liquidate *an Entity Interest* in an applicable Entity.

A Disregarded Restriction consists of one of four specific limitations on the ability to redeem or liquidate an Entity Interest in an applicable Entity, 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, either alone or collectively.²⁷

First, a Disregarded Restriction includes a provision that limits, or permits the limitation of, the ability of the holder of the Entity Interest to compel liquidation or redemption of such Entity Interest.²⁸

Second, a Disregarded Restriction includes a provision that limits, or permits the limitation of, the amount that may be received by the holder of the Entity Interest on the liquidation or redemption of such Entity Interest to an amount that is less than a “Minimum Value.” “Minimum Value” means the Entity Interest's pro-rata share of the net value of the Entity determined on the date of liquidation or redemption.²⁹

Third, a Disregarded Restriction includes a provision that defers, or permits the deferral of, the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date that the holder gives notice to the Entity of the holder's intent to have the holder's Entity Interest liquidated or redeemed.³⁰

²³ Prop. Reg. § 25.2704-2(b)(4)(ii).

²⁴ Prop. Reg. § 25.2704-2(b)(4)(iii).

²⁵ Prop. Reg. § 25.2704-2(b)(4)(iv), *referencing* Prop. Reg. § 25.2704-3(b)(6).

²⁶ Prop. Reg. § 25.2704-2(e).

²⁷ Prop. Reg. § 25.2704-3(b)(1).

²⁸ Prop. Reg. § 25.2704-3(b)(1)(i).

²⁹ Prop. Reg. § 25.2704-3(b)(1)(ii).

³⁰ Prop. Reg. § 25.2704-3(b)(1)(iii).

Fourth, a Disregarded Restriction includes a provision that authorizes, or permits the payment of, any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property. “Property,” in this context, generally excludes a promissory note. However, an exception is made for certain promissory notes issued in the redemption of Entity Interests in certain Entities that are engaged in an active trade or business. In those cases, the promissory note must be adequately secured, require periodic payments on a non-deferred basis, bear interest at a “market interest rate” (discussed below), and have a fair market value on the date of liquidation or redemption equal to the liquidation proceeds.³¹

As with Applicable Restrictions, the source of a Disregarded Restriction can flow from governing documents for the Entity (*i.e.*, the partnership agreement or limited liability company operating agreement), contractual arrangements, or pursuant to local law (even if the restriction can be overridden under the governing documents or otherwise).³² The Imposed By Law Exclusion that applies for Applicable Restrictions also applies for Disregarded Restrictions.³³

Finally, in determining whether the transferor (or his or her estate) or any member of his or her family, either alone or in conjunction with other family members, may remove what would otherwise be a Disregarded Restriction, the Proposed Regulations exclude those Entity Interests held by a person other than a member of the transferor’s family (a “Nonfamily Member,” and the Entity Interest owned by the Nonfamily Member shall be referred to as a “Nonfamily Member Interest”) unless:

- Three Year Holding Period – The Nonfamily Member Interest is held for at least three years immediately before the transfer;³⁴
- Ten Percent Rule – The Nonfamily Member Interest represents at least ten percent of the Entity’s equity (for corporation) or capital and profits (for other Entities);³⁵
- Twenty Percent Rule – All Nonfamily Member Interests, collectively, represent at least twenty percent of the Entity’s equity (for corporation) or capital and profits (for other Entities);³⁶ and
- Qualified Put Right – Each Nonfamily Member Interest has a “Qualified Put Right.”³⁷

A “Qualified Put Right” means the power to receive cash or other property from the Entity or its owners equal to the Minimum Value of the interest, payable within six months of giving notice of the exercise of such put right. Generally, other property does not include a

³¹ Prop. Reg. § 25.2704-3(b)(1)(iv).

³² Prop. Reg. § 25.2704-3(b)(2).

³³ Prop. Reg. § 25.2704-3(b)(5)(iii).

³⁴ Prop. Reg. § 25.2704-3(b)(4)(i)(A).

³⁵ Prop. Reg. § 25.2704-3(b)(4)(i)(B).

³⁶ Prop. Reg. § 25.2704-3(b)(4)(i)(C).

³⁷ Prop. Reg. § 25.2704-3(b)(4)(i)(D).

promissory note, except in the case of certain interests in an active trade or business, as set forth in the general exceptions to what constitutes a Disregarded Restriction.³⁸

E. Transfers at Death to Multiple Persons.

The Proposed Regulations address the transfers of Entity Interests at death to multiple persons, where some, but not all, of the transfers trigger valuation issues under section 2704(b). Specifically, suppose that the holder of Entity Interests dies and the Entity Interests are includible in her Gross Estate. Pursuant to the decedent's testamentary documents, a portion of such Entity Interests passes to one or more Family Members and the other portion passes to one or more Nonfamily Members. If the portion passing to the Family Members is to be valued by disregarding Applicable Restrictions or Disregarded Restrictions, then that portion is treated as a single, separate property interest. In that case, the portion passing to the Nonfamily Member or Members is also treated as a single, separate property interest.³⁹

F. Applicable Entity Issues.

Chapter 14 was adopted prior to the explosion in popularity of LLCs. To that end, even though, as stated above, an LLC is considered under federal tax law to be a partnership, the Proposed Regulations seek to provide some clarity in the application of section 2704 to different types of business arrangements besides corporations and partnerships, such as LLCs. Section 2704(c)(1) states that the term "control" has the meaning given to it by section 2701(b)(2). The Proposed Regulations amend Regulation section 25.2701-2 to clarify the meaning of control for an entity other than a corporation or partnership to mean holding at least fifty percent of the capital or profits interest in the entity.⁴⁰

G. Attribution Rules.

The Proposed Regulations provide that, for purposes of section 2704, an individual, the individual's estate, and Family Members are treated as also holding any interest held indirectly by such person through a corporation, partnership, trust or other entity under the rules contained in Treasury Regulation section 25.2701-6.⁴¹

H. Effective Dates.

Changes to Treasury Regulation sections 25.2704-1 and 25.2704-2, as implemented by the Proposed Regulations, will apply to lapses of rights created after October 8, 1990 that occur on or after the date that the Proposed Regulations are published as final regulations.⁴²

Proposed Regulation section 25.2704-3 will apply to transfers of property subject to restrictions created after October 8, 1990 that occur 30 or more days after the date that the Proposed Regulations are published as final Regulations.⁴³

³⁸ Prop. Reg. § 25.2704-3(b)(6).

³⁹ Prop. Reg. §§ 25.2704-2(f), 25.2704-3(e).

⁴⁰ Prop. Reg. § 25.2701-2(b)(5)(iv).

⁴¹ Prop. Reg. §§ 25.2704-2(d), 25.2704-3(d).

⁴² Prop. Reg. § 25.2704-4(b)(1).

IV. Requests for Further Guidance and/or Clarification

The Section respectfully requests additional guidance from Treasury on the following areas within the Proposed Regulations.

A. Clarification that the Proposed Regulations do not impose a “Deemed Put Right” for all Entity Interests that would otherwise be subject to section 2704.

While the Proposed Regulations are very specific as to the effect of Disregarded Restrictions, many practitioners have noted that the Proposed Regulations do not address the result that would occur if the particular governing instrument is silent on the ability of an owner of an Entity Interest to withdraw or demand a liquidation. Many practitioners have interpreted the Proposed Regulations to mean that, for transfer tax valuation purposes, the Proposed Regulations’ silence evidences an intent by Treasury to deem each holder of an Entity Interest to have the right to “put” (*i.e.*, demand a sale of) such Entity Interest to the Entity and, within six months thereof, receive, in exchange for such Entity Interest, cash or other property equal to a minimum value (referred to as a "Deemed Put Right").⁴⁴ The lone exception would be if state law prohibited an Entity's governing documents from granting a Deemed Put Right.

At the recent American Bar Association Joint Meeting of the Tax Section and the Real Property Trust & Estates Section, which was held in Boston, Massachusetts from September 29 – October 1, 2016, Treasury representatives stated that Treasury did not intend for Proposed Regulation section 25.2704-3(b) to create a Deemed Put Right. While the Section acknowledges these statements, there is still significant confusion and disagreement among practitioners as to whether a Deemed Put Right exists.

Consequently, despite oral statements by Treasury representatives to the contrary, Treasury should clarify and expressly provide, either in Proposed Regulation section 25.2704-3, or in the Preamble to the final Regulations, that no Deemed Put Right exists.

B. Clarification as to the impact of the Proposed Regulations on income tax basis, including the income tax basis adjustment at death for Entity Interests not subject to the consistent basis requirements under section 1014(f).

1. Background.

The basis of property received from a decedent is generally its fair market value at the decedent’s date of death.⁴⁵ Although the same valuation principles are generally applied for income tax and estate tax purposes, there can be a discrepancy between what values are used for each. For example, suppose that an Entity Interest is included in a decedent’s Gross Estate and the estate valued such interest with a 35% discount. Such interest is then distributed to the decedent’s son. Ordinarily, under section 1014, the decedent’s son will be assigned a cost basis in the Entity Interest equal to the value of the Entity Interest in the decedent’s Gross Estate. If,

⁴³ Prop. Reg. § 25.2704-4(b)(3).

⁴⁴ See, e.g., Stephen A. Akers, *Section 2704 Proposed Regulations Impose Far-Reaching Limitations on Valuation Discounts for Transfers of Interests in Family-Controlled Entities*, BESSEMER TRUST, October 2016 at pp. 9-14.

⁴⁵ Section 1014(a)(1).

however, the decedent's son has a reasonable belief that the value of the Entity Interest was not accurately determined by the decedent's executor, *i.e.*, that the value was too low, the decedent's son could assign a different value to such Entity Interest and use that value as his basis in the Entity Interest.

The Obama administration saw this discrepancy as a loophole and, beginning with Fiscal Year 2010 and continuing through Fiscal Year 2015, proposed the creation of rules mandating "consistency in value" for transfer tax and income tax purposes.⁴⁶ For example, most recently, the President's Fiscal Year 2016 revenue proposal (the "Greenbook") contained the following provision:

The proposal would impose both a consistency and a reporting requirement. The basis of property received by reason of death under section 1014 must equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor must equal the donor's basis determined under section 1015. The basis of property acquired from a decedent to whose estate section 1022 is applicable is the basis of that property, including any additional basis allocated by the executor, as reported on the Form 8939 that the executor filed.

The proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments). A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary valuation and basis information to both the recipient and the Internal Revenue Service.

A grant of regulatory authority would be included to provide details about the implementation and administration of these requirements, including rules for situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503, for situations in which the surviving joint tenant or other recipient may have better information than the executor, and for the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return. The proposal would be effective for transfers after the year of enactment.⁴⁷

On July 31, 2015, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, which added new Code sections 1014(f) and 6035, was enacted into law. These new Code sections impose new basis consistency and reporting requirements applicable to property received from a decedent.

Section 1014(f) provides that the basis of certain property acquired from a decedent may not exceed the value of that property as "finally determined" for federal estate tax purposes.

⁴⁶ General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, Department of the Treasury, February 2010, p.122; General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, Department of the Treasury, February 2011, p.125; General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, Department of the Treasury, February 2012, p.77; General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, Department of the Treasury, April 2013, p.140; General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals, Department of the Treasury, March 2014, p.160; and General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals, Department of the Treasury, February 2015, p.195.

⁴⁷ 2016 Greenbook at p.195.

Pursuant to section 1014(f)(2), however, the general basis rule of section 1014(f) only applies to any property whose inclusion in the decedent's Gross Estate increased the estate tax liability (reduced by credits allowable against such tax) on such estate. Further, under Proposed Regulation section 1.1014-10(b)(2), property that qualifies for an estate tax charitable or marital deduction under section 2055, 2056, or 2056A, respectively, does not generate a tax liability under chapter 11 and therefore is excluded from the property subject to the consistency requirement under section 1014(f).

2. Applicability of Proposed Regulations to Section 1014.

The first sentence of Proposed Regulation section 25.2704-1(a)(1) limits the regulation's applicability to all "purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes)." Such phraseology is used throughout various sections of the Proposed Regulations.⁴⁸ Section 1014, which is an income tax provision, is found within subtitle A of the Code. Accordingly, it is clear that the Proposed Regulations are intended to apply in the context of the estate, gift and generation-skipping transfer tax regimes. On its face, it would appear that, by limiting the applicability of Proposed Regulation section 25.2704-1(a)(1) to subtitle B, that the concepts of Proposed Regulation section 25.2704-1(a)(1) would not apply to subtitle A (relating to income tax concepts).

Applying Proposed Regulation section 25.2704-1(a)(1) to the analysis of section 1014(f), it would appear that Proposed Regulation section 25.2704-1(a)(1) should apply to any asset that is subject to section 1014(f), which would make sense because section 1014(f) is dependent on the value as reported on a federal estate tax return. The value reported on a federal estate tax return would be the transfer tax value, which, for Entity Interests, is determined under the Proposed Regulations. What remains unclear is the effect, if any, that the Proposed Regulations may have on the income tax basis of an asset that is included in a decedent's Gross Estate but which is not subject to section 1014(f).

Pursuant to Proposed Regulation section 25.2704-3(f), the fair market value of the transferred Entity Interest is determined under generally applicable valuation principles as if the Disregarded Restriction does not exist in the governing documents, local law, or otherwise. In other words, the effect of a restriction being disregarded under the Proposed Regulations could be the reduction of discounts typically applied for lack of marketability and lack of control.

If the Proposed Regulations apply to a transferred Entity Interest, there is nothing in the Proposed Regulations or the Preamble specifying whether the value as determined under the Proposed Regulations translates to an equivalent basis adjustment to the recipient of the transferred Entity Interest. This analysis would fall within the scope of section 1014(f). If the transferred Entity Interest is not subject to the provisions of section 1014(f) because it either does not add to the estate tax liability or qualifies for a deduction under sections 2055, 2056 or 2056A, the recipient of such interest is not required to adopt, as his or her basis, the value of the property as finally determined for federal estate tax purposes. Thus, if the particular Entity Interest is not subject to section 1014(f), the recipient appears unbound, for tax basis purposes, by the value of the Entity Interest as determined under the Proposed Regulations.

⁴⁸ See, e.g., Prop. Reg. §§ 25.2704-2(a) and 25.2704-3.

For example, suppose that a 40% Entity Interest in M LLC, a limited liability company, is included in D's Gross Estate. D's estate tax liability is calculated to be \$2,000,000. Pursuant to D's testamentary documents, D's Entity Interest in M LLC passes as part of the residuary clause and into separate trusts for D's descendants. Further suppose that the value of D's Entity Interest in M LLC is determined pursuant to the Proposed Regulations. Because, D's Entity Interest in M LLC adds to D's estate tax liability, and such interest does not pass to a beneficiary that would qualify for a deduction in D's estate pursuant to sections 2055, 2056 or 2056A, section 1014(f) applies and each of D's children must assign a basis to his or her respective share of D's Entity Interest in M LLC equal to the value of such interest in D's Gross Estate. If, however, D's estate is not subject to federal estate tax liability or if D's residuary clause passes the balance of D's estate to charity, then D's Entity Interest in M LLC is not subject to section 1014. Therefore, even if the value of D's Entity Interest in M LLC is determined pursuant to the Proposed Regulations, section 1014(f) would not apply and therefore, the recipients are not required to take a cost basis in M LLC based on the value as included in D's Gross Estate.

While ordinarily the lack of a discount would be beneficial to the recipient because this would lead to a higher basis, the beneficiary is not necessarily bound to accept the full value as determined by the decedent's executors. Suppose in the above example, that F, a Nonfamily Member, receives interests in M LLC from D's estate (the "Inherited Interests") that were valued in D's estate at \$3,000,000. If the Inherited Interests are not subject to section 1014(f), and if F has a reasonable belief that the fair market value at the time of D's death of the Inherited Interests was actually \$4,000,000, it would appear as if F could assign that basis to her Inherited Interests.

Given Treasury's recent focus and proposed rules regarding basis consistency, this does not seem like the intended result of these provisions.

As a result of this potential issue, an executor may be required to obtain several appraisals for different beneficiaries with respect to the same Entity Interest. For instance, if an Entity Interest is bequeathed to a Family Member, a Nonfamily Member and a charity, an executor would have to obtain multiple appraisals in connection with filing the federal estate tax return.⁴⁹ As a result, different values and, possibly, different bases, will be attributable to different beneficiaries with respect to the same asset (*i.e.*, the same type of Entity Interest). Not only do these requirements present complexity and impose a burden on the executor, they also result in inequitable treatment of estate beneficiaries.

To address these issues, we respectfully request that Treasury clarify the effect, if any, that the Proposed Regulations have on the income tax basis of an asset that is included in a decedent's Gross Estate and to which the Proposed Regulations apply but is not subject to the consistent basis requirements of section 1014(f).

⁴⁹ See Example 4 of Prop. Reg. § 25.2704-3(g), clearly identifying that, in facts similar to the above, the decedent's gross estate "will be deemed to include two separate assets."

- C. Clarification as to the interaction between sections 2703 and 2704 in light of the statement in the Proposed Regulations that rights subject to section 2703 are not subject to section 2704.

Section 2703(a) provides that, for purposes of the estate and gift tax rules, the value of any property shall be determined without regard to, (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property.

Section 2703(b) provides that section 2703(a) does not apply to any option, agreement, right, or restriction that, (1) is a bona fide business arrangement, (2) is not a device to transfer such property to a Family Member for less than full and adequate consideration in money or money's worth and (3) is comparable to similar arrangements entered into by persons in an arms' length transaction.

The Preamble states that,

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

Proposed Regulation section 25.2704-2(b)(4)(iii) provides that an option, right to use property, or agreement that is subject to section 2703, is not an applicable restriction. Similarly, Proposed Regulation section 25.2704-3(b)(5)(iv) provides that an option, right to use property, or agreement that is subject to section 2703, is not a restriction for purposes of Proposed Regulation section 25.2704-3(b) (regarding transfers subject to Disregarded Restrictions).

Despite the statement in the Preamble that sections 2703 and 2704(b) do not overlap, it seems plausible that some restrictions may, in fact, implicate both sections if the Proposed Regulations are enacted as drafted. The new category of Disregarded Restrictions created by the Proposed Regulations covers restrictions having a particular effect, rather than restrictions of a particular type. Such a broad category of restrictions could very well include restrictions that would also address the sale or use of interests in a family-controlled entity under section 2703. Given the potential for overlap between the two sections, the Section has several questions regarding the provisions in the Proposed Regulations that relate to section 2703.

1. Is an option, agreement, right or restriction to which section 2703(a) does not apply pursuant to the provisions of section 2703(b) treated as "subject to section 2703" under the Proposed Regulations?

It is unclear what the phrase "subject to section 2703" means for purposes of the Proposed Regulations. Such language likely refers, at a minimum, to options, rights and agreements that do not satisfy the safe harbor provisions of section 2703(b) and therefore are disregarded under section 2703(a). However, what if an option, agreement, right or restriction (each, a "Right or Restriction") that is potentially subject to scrutiny under section 2703(a), satisfies the safe harbor provisions of section 2703(b)? According to section 2703(b), section

2703(a) does not apply to any such Right or Restriction. If section 2703(a) does not apply to such Right or Restriction, does that mean such Right or Restriction is not “subject to section 2703” for purposes of the Proposed Regulations and that, accordingly, such Right or Restriction will be scrutinized under the Proposed Regulations? The more reasonable interpretation, and what appears to have been Treasury’s intention, is that a Right or Restriction that falls within the ambit of section 2703(a), regardless of whether it satisfies the provisions of section 2703(b), will not be subject to additional scrutiny under the Proposed Regulations.

We respectfully request that Treasury modify Proposed Regulation sections 25.2704-2(b)(4)(iii) and 25.2704-3(b)(5)(iv) to clarify that an option, right to use property or agreement that is “subject to section 2703,” refers to any such option, right or agreement referred to in section 2703(a), regardless of whether such option, right or agreement satisfies the requirements of section 2703(b).

2. May restrictions on the right to sell or use property under section 2703(a)(2) be treated as Applicable Restrictions or Disregarded Restrictions under the Proposed Regulations?

As noted above, Proposed Regulation sections 25.2704-2(b)(4)(iii) and 25.2704-3(b)(5)(iv) state that an option, right to use property, or agreement that is subject to 2703, will not be treated as an Applicable Restriction or a Disregarded Restriction under the Proposed Regulations. The words “option, right to use property, or agreement” appear to reflect the provisions of section 2703(a)(1). However, such sections of the Proposed Regulations do not mention a “restriction on the right to sell or use” property, which appears in section 2703(a)(2). Does Treasury intend that such restrictions may be treated as Applicable Restrictions or Disregarded Restrictions under the Proposed Regulations? The most reasonable interpretation of these provisions is that the omission of such restrictions was an oversight, and that Treasury intends to exclude any such restriction on the right to sell or use property from the provisions of Proposed Regulation sections 25.2704-2(b)(4)(iii) and 25.2704-3(b)(5)(iv).

We respectfully request that Treasury modify Proposed Regulation sections 25.2704-2(b)(4)(iii) and 25.2704-3(b)(5)(iv) to clarify that a restriction on the right to sell or use property that is subject to section 2703 (with the clarifications to the meaning of the phrase “subject to section 2703” requested above) will not be treated as an Applicable Restriction or a Disregarded Restriction under the Proposed Regulations.

3. How do the effective date provisions applicable to section 2703 interact with the effective date provisions of the Proposed Regulations?

Section 2703 applies to agreements, options, rights, or restrictions entered into or granted after October 8, 1990, and agreements, options, rights, or restrictions which are substantially modified after October 8, 1990. Similarly, Proposed Regulation section 25.2703-1 applies to any right or restriction created *or* substantially modified after October 8, 1990.⁵⁰

As provided above, Proposed Regulation section 25.2704-4(b)(2) states, in relevant part, that Proposed Regulation section 25.2704-2(b) would apply to transfers of property subject to

⁵⁰ P. L. 101-508, section 11602(e)(1)(A)(ii)(I)(II).

restrictions created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register. Proposed Regulation section 25.2704-4(b)(3) provides that Proposed Regulation section 25.2704-3 would 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.

The effective date provisions of the Proposed Regulations do not contain the “substantially modified” language of the effective date provisions applicable to section 2703. In some cases, this difference may not matter. If, for example, an agreement among members of a family-controlled entity is created before October 8, 1990 and no modification whatsoever is made to the agreement after such date, neither section 2703 nor the Proposed Regulations would apply to the agreement pursuant to the respective effective date provisions of such statute and the Proposed Regulations. However, what if the agreement is modified after October 8, 1990 in a way that does not constitute a “substantial modification” as defined in Proposed Regulation section 25.2703-1(c)?

For example, what if a Family Member, who is assigned to a generation no lower than the lowest generation occupied by all individuals who are already parties to a particular restriction, becomes a party to such restriction after October 8, 1990 when she receives an interest in the family Entity subject to the restriction? Pursuant to Proposed Regulation section 25.2703-1(c)(1), the addition of the Family Member as a party to the restriction would not constitute a substantial modification of such restriction, so section 2703 would not apply to the restriction. If the Family Member subsequently transferred a portion of her interest in the entity to another Family Member, would such restriction be deemed to have been created after October 8, 1990 for purposes of the Proposed Regulations?

The Proposed Regulations offer no guidance regarding the circumstances under which a Right or Restriction created on or before October 8, 1990 but modified thereafter will be treated as having been created after October 8, 1990. We believe the most reasonable interpretation of the effective date rules, as they pertain to the interaction between section 2703 and the Proposed Regulations, is that a Right or Restriction to which section 2703 does not apply because of the effective date provisions applicable to such statute is deemed to have been created on or before October 8, 1990 for purposes of the Proposed Regulations. We respectfully request that Treasury clarify the effective date provisions of the Proposed Regulations accordingly.

D. Practical issues associated with the approach of the Proposed Regulations to Nonfamily Member Interests.

In evaluating whether a restriction constitutes a Disregarded Restriction, the Proposed Regulations exclude all Nonfamily Member Interests unless all of the following criteria are met:

- The Nonfamily Member Interest is held for at least three years immediately before the transfer (the “Three Year Holding Period”),⁵¹
- The Nonfamily Member Interest represents at least ten percent of the Entity’s equity (for corporation) or capital and profits (for other entities) (the “Ten Percent Rule”),⁵²

⁵¹ Prop. Reg. § 25.2704-3(b)(4)(i)(A).

- All Nonfamily Member Interests, collectively, represent at least twenty percent of the Entity’s equity (for corporation) or capital and profits (for other entities) (the “Twenty Percent Rule”),⁵³ and
- Each Nonfamily Member Interest has a Qualified Put Right.⁵⁴

Taken together, these criteria could have the effect of disregarding nearly all Nonfamily Member Interests.

1. Issues Associated with Three Year Holding Period.

The Three Year Holding Period raises some confusion and, arguably, some potential unfairness.

First, all Nonfamily Member Interests would be excluded for transfers that occur within the first three years of a business’s existence, regardless of the percentage ownership or the number of nonfamily members. Such a limitation reduces the ability of Family Members to efficiently implement estate planning even if, as frequently occurs, the Nonfamily Member Interests at the outset of the formation of the entity were included for legitimate business reasons.

Second, it is unclear under the Proposed Regulations how the Three Year Holding Period applies once a transfer of an interest to a Family Member occurs. As to subsequent transfers, does the Three Year Holding Period for Nonfamily Member Interests start over?

Based on the above, the Section suggests that Treasury consider revising Proposed Regulation section 25.2704-3(b)(4)(i) as follows:

- Exclude from the application of the Three Year Holding Period those Nonfamily Member Interests that were in existence upon formation of the Entity, provided that they otherwise meet the designated percentage limitations, and
- Clarify how the Three Year Holding Period applies after an initial transfer of an interest to a Family Member.

2. Issues Associated with Percentage Requirements.

The Section believes that the Ten Percent Rule and Twenty Percent Rule for Nonfamily Member Interests exceed the levels necessary to address the desire of Treasury to ensure that a Nonfamily Member Interest represents a meaningful portion of the overall ownership of an applicable Entity.

⁵² Prop. Reg. § 25.2704-3(b)(4)(i)(B).

⁵³ Prop. Reg. § 25.2704-3(b)(4)(i)(C).

⁵⁴ Prop. Reg. § 25.2704-3(b)(4)(i)(D).

For example, the Nonfamily Member Interests would be disregarded if four Nonfamily Members each own 5% Entity Interests, which satisfies the Twenty Percent Rule but not the Ten Percent Rule. Such a result seems unreasonable, as the 20% total Entity Interests is certainly meaningful even if it is spread out in 5% portions.

Consider further the example whereby an LLC, owned 70% by Member A and 30% by Member B (a non-Family Member as to Member A), requires consent of 90% of the Entity Interests to liquidate a member's Entity Interest. Assume that both members own their Entity Interests for at least three years. Member B decides to transfer a 24% Entity Interest, in equal 8% shares, to each of her three children. Following those transfers, if Member A wishes to implement estate planning with his 70% Entity Interest, all Entity Interests held by Member B and B's children (who, as to Member A, are Nonfamily Members) will be disregarded because their combined 30% Entity Interest (which satisfies the Twenty Percent Rule) does not satisfy the Ten Percent Rule (as no single Nonfamily Member holds at least a 10% Entity Interest).

In response to the two examples above, it can be argued that, in those examples, each Nonfamily Member Interest below 10% may lack sufficient economic impact, standing alone, to materially affect the behavior of the other non-Family Members and the separate non-Family Members may have no reason to act together. Yet, given that the intent of the percentage requirements is to address the use of Nonfamily Member Interests for the primary purpose of avoiding section 2704 valuation adjustments, the Section believes that a focus on total Nonfamily Member Interests (as opposed to a minimum size for each Nonfamily Member Interest) should be the overriding concern.

Also, for larger Entities, an Entity Interest representing less than 10% of the equity in the Entity should still be viewed, in a general business sense, as meaningful. Imagine, for example, a company worth \$1 billion. A 3% Entity Interest in such company, measured on an undiscounted net asset value basis, represents \$30 million of value before application of any applicable discounts. From an economic standpoint, this 3% would likely be viewed as meaningful, but it is not so under the Proposed Regulations.

In an effort to address Treasury's concerns about illusory Nonfamily Member Interests while reflecting common business entity realities, the Section recommends that Treasury consider revising Proposed Regulation section 25.2704-3(b)(4)(i) as follows:

- Reduce the Ten Percent Rule and Twenty Percent Rule; and/or
- Allow a Nonfamily Member Interest to satisfy the exception if either test is met (*i.e.*, the minimum percentage for a single interest or combined percentage for all Nonfamily Member Interests).

3. Issues Associated with Mandatory Put Right Requirements.

The Section believes that the requirement of a Mandatory Put Right for all Nonfamily Member Interests effectively results in disregarding virtually all Nonfamily Member Interests. A typical privately-held entity does not want to allow its investors to liquidate their investments at a minimum value. Such a right would put at risk the company's ability to successfully operate its business and potentially diminish the ability of such company to raise and maintain capital.

In fact, the consensus of Section members involved in these Comments is that such a put right is not seen in actual practices.

The Section urges Treasury and the Service to consider the following changes to Proposed Regulation section 25.2704-3(b)(4)(i):

- remove the Mandatory Put Right for a Nonfamily Member Interest as a requirement for the recognition of a Nonfamily Member Interest; or
- provide that a Nonfamily Member Interest will not be disregarded if such interest, (a) contains a Mandatory Put Right or (b) satisfies the other remaining requirements (percentage limitations and holding period).

E. Clarification as to the meaning of “market” interest rates.

The Proposed Regulations contain two references to “market” interest rates but do not expressly define how to calculate such an interest rate.

First, the definition of Disregarded Restriction excludes a provision authorizing payment with a promissory note of liquidation proceeds for Entity Interests in certain Entities engaged in active trade or business, provided that such promissory note must, among other criteria, be issued at “market” interest rates.⁵⁵

Second, the definition of a Qualified Put Right also contains a similar description of payment with a promissory note for Entity Interests in certain Entities engaged in active trade or business if such promissory note is issued at a “market” interest rate.⁵⁶

The Section requests guidance from Treasury and the Service as to how to calculate a “market” interest rate under the Proposed Regulations.

F. Clarification as to the definition of a “controlled entity.”

Proposed Regulation sections 25.2704-2(c) and 25.2704-3(c) both cross-reference Regulation section 25.2701-2(b)(5) for the definition of the term “controlled entity.”

There are two references to “family-controlled entities” in each of Proposed Regulation sections 25.2704-2(b)(4)(ii) and 25.2704-3(b)(5)(iii), but there is no reference to the term “controlled entity.”

Proposed Regulation sections 25.2704-2(a) and 25.2704-3(a) apply in situations in which the transferor and/or members of the transferor’s family control the Entity. “Members of the transferor’s family” is defined in Regulation section 25.2702-2(a)(1) and means the transferor’s spouse, any ancestor or lineal descendant of the transferor or the transferor’s spouse, any brother or sister of the transferor, and any spouse of the foregoing.

⁵⁵ Prop. Reg. § 25.2704-3(b)(1)(iv).

⁵⁶ Prop. Reg. § 25.2704-3(b)(6).

However, “controlled entity” is defined in Regulation section 25.2701-2(b)(5) to mean any corporation or partnership controlled, immediately before the transfer, by the transferor, the transferor’s spouse, an ancestor of the transferor or the transferor’s spouse, the spouse of any such ancestor, and any lineal descendants of the parents of the transferor or the transferor’s spouse.

Therefore, a “controlled entity” and an Entity controlled by the transferor and/or Family Members are not the same thing, and the existence of the term “controlled entity” in the Proposed Regulations with a reference to Regulation section 25.2701-2(b)(5) creates an ambiguity in the Proposed Regulations regarding the Family Members that would be included in any determination of control. The Section requests that Treasury clarify this discrepancy.

G. Clarification as to the valuation methodology in case of inclusion under section 2704(a)’s “three year rule.”

The Three Year Rule described in section III.B raises a number of issues about which the Section requests guidance.

1. Interest Disposed of by Transferee.

Proposed Regulation section 25.2704-1(c)(1) provides that a lapse described in such section occurring 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). However, the Proposed Regulations do not provide guidance as to how the transferor’s executor is supposed to value the lapse.

As a threshold matter, the Proposed Regulation leaves ambiguous the relevant date of revaluation in the event that the three year rule is triggered. Specifically, must the valuation look to the values on the date of the transfer that started the running of the three year rule or, instead, to the date of death values? Given the purpose of the three year rule, the Section suggests that the Proposed Regulations should be clarified to look to the values on the date of the initial transfer, thereby excluding changes in value following that transfer from potential estate inclusion.

But, consider, other complexities potentially in play as a result of the structure of the three year rule. For example, if an Entity Interest is still held by the same transferee at the death of the transferor, the executor could, (1) have said interest appraised both with and without a lack of control discount to determine the appropriate percentage discount, (2) determine the value of said interest (with and without the previously determined lack of control discount) based on the percentage of the Entity that was transferred, and (3) treat the difference between the two valuations in step 2 as the value of the lapse.

What happens, though, if the Entity Interest is no longer held by the transferor at his death? For example, during the intervening years, the transferee may have sold or otherwise disposed of the Entity Interest (or the entire Entity) or the Entity may have been dissolved. In addition, even if the transferee still possesses the Entity Interest, the transferee is not compelled to cooperate with the executor, so it is possible that the executor may not be able to appraise the Entity because the transferee may not produce the requisite information needed for such an appraisal. It is possible that such information could instead be provided to the executor by the

manager or an officer of the Entity; however, such individual may very well refuse to produce the information without the transferee's consent. The Section requests guidance from Treasury as to how to value the lapse under these scenarios.

2. Income Tax Basis.

If the Three Year Rule applies, the value of the lapsed right is included in the decedent's Gross Estate. However, there does not appear to be any corresponding basis increase with respect to the transferred interest or any other asset. The Section questions whether it was Treasury's intention to create the Gross Estate inclusion of a "phantom" asset without any corresponding income tax basis adjustment, or should the Gross Estate inclusion of the lapse amount increase the basis of the transferred Entity Interest in the hands of the transferee? If the latter, then the Section requests that Treasury consider developing alternative basis adjustment concepts for the transferee if, at the time of the death of the transferor, the Entity is no longer in existence.

3. Consider Reducing Look-Back Period to One Year.

Finally, the Section requests that Treasury consider reducing the look-back period described in Proposed Regulation section 25.2704-1(c)(1) from three years to one year. Such a reduced timeframe would still capture most of the types of "deathbed" style transfers with which Treasury appears most concerned. A shorter timeframe for the look-back period would minimize the complexities in the application of the rule under Proposed Regulation section 25.2704-1(c)(1). Additionally, the one year time period would also coincide with the one year rule in Section 1014(e), which is also designed to prevent deathbed tax planning (in that case, related to gifts of appreciated property acquired by a decedent within one year of death).

4. Effective Date for Transfers Before Regulations Finalized But Transferor Dies After Regulations Finalized.

Proposed Regulation section 25.2704-1(c)(1) would apply to the lapse of rights created after October 8, 1990, occurring on or after the date that the regulations are published as final regulations.⁵⁷

The Proposed Regulations provide that a transfer implicated by Proposed Regulation section 25.2704-1(c)(1) made within three years of the transferor's death will be treated as a lapse *occurring on the transferor's date of death*, includible in the transferor's gross estate under section 2704(a).

This regime could be interpreted to apply the provisions of Proposed Regulation section 25.2704-1(c)(1) to a transfer made by an individual before the Proposed Regulations become final but who dies less than three years after the transfer (which time is *after* the Proposed Regulations become final), because the lapse is deemed to occur at the transferor's date of death. Such a result seems inconsistent with the intent of the effective date provisions of the Proposed Regulations.

⁵⁷ Prop. Reg. § 25.2704-4(b)(1).

The Section requests that the Proposed Regulations be modified so that the Three Year Rule would not apply to transfers made prior to the effective date of the Regulations, even if the transferor dies after the effective date of the Regulations.