PROPOSED SECTION 2704 REGULATIONS WORK TO MINIMIZE VALUATION DISCOUNTS

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New proposed regulations are intended to affect certain transferors of interests in corporations and partnerships to prevent the under valuation of such interests.

No recent issuance of proposed regulations has generated more commentary and discussion than those released on 8/2/16, and published in the Federal Register on 8/4/16,[1] concerning the valuation of interests in corporations and partnerships for estate, gift, and generation-skipping transfer (GST) tax purposes. Specifically, the proposed regulations concern the treatment of certain lapsing rights and restrictions on liquidation in determining the value of transferred equity interests. The regulations, as proposed, are intended to affect certain transferors of interests in corporations and partnerships, and are deemed necessary by the IRS to prevent the undervaluation of such transferred interests.

In effect, the new rules, as proposed, can be summed up as providing a limitation or elimination of the use of discounts for lack of control and lack of marketability in valuing equity interests transferred in intergenerational family planning. The release of the proposed regulations is the most-recent battle in a 35-year war between the IRS and taxpayers over the use of valuation discounts in estate and gift tax planning and family attribution.

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The new rules represent a camouflaged means of imposing a significant tax increase without direct congressional authorization. In this case, that tax increase will directly affect those taxpayers with sufficient business ownership interest value (pre-discount) to invoke the reach of the gift, estate, and generation-skipping tax. If finalized and adopted as proposed, that reach will be much more imposing than ever before and will make it considerably harder to transfer family farms and businesses from one generation to the next without incurring greater tax liabilities.

Historical application of discounts in family businesses

Valuation discounts associated with intra-family transfers of privately held business interests, no matter how appropriate, have long been viewed with disdain by the IRS. Viewed as an artificial means of defeating the gift, estate, and generation-skipping tax rules, the IRS has argued for its position dating back to at least 1981, when it issued Rev. Rul. 81-253.[2] In this ruling, the IRS determined that "ordinarily, no minority share-

[1] REG-163113-02.
[2] 1981-2 CB 187.

holder discount is allowed with respect to the transfers of shares of stock between family members if, based upon a composite of the family members' interests at the time of the transfer, control (either majority voting control or de facto control through family relationships) exists in the family unit."

In the years following the release of Rev. Rul. 81-253, several courts have taken up the matter of applying discounts,[3] each time with a similar finding. The courts held that when a corporation had: (1) only a single class of stock issued and outstanding, and (2) an ownership group both before and after the transfers that comprised a familial unit among the transferor, the transferee(s), and the remaining shareholders, the stock owned by common family members was not to be aggregated with the transferred shares to determine if the transferred shares should be valued as part of a controlling interest. The consistency of these cases' results ultimately forced the IRS to reconsider its position on family attribution and aggregation for purposes of determining the validity of applying discounts for lack of control.

That reconsideration resulted in the release of Rev. Rul. 93-12,[4] in which the IRS held that a sole stockholder of a corporation who gave a 20% equity interest to each of his five children would not be denied a minority discount in valuing those shares solely due to the factor of corporate control in the family. The Ruling represented a total "about face" and retreat from the IRS's previous position, and presented a significant opportunity for small and privately-held business owners seeking to pass their businesses or interests in their businesses to their designated junior generation successors, while minimizing the burdensome transfer tax consequences.

With the release of Rev. Rul. 93-12, a controlling shareholder who chose to give away minority equity interests in a company was able to claim that all equity interests together totaled much less than the value of the control block for transfer tax purposes. It is important to note that the overall guidance in the ruling does not provide for the use of a valuation discount for lack of control. The ruling simply provides that if the economics of the taxpayer's fact pattern merits a discount, it will not be disallowed simply by virtue of the control within the family ownership group.

Also as a result of the ruling, the estate of a shareholder who died owning a minority interest was able to get a minority discount for that interest, notwithstanding the fact that the decedent's estate and the surviving family members together may ultimately own a controlling interest in that entity.

Rev. Rul. 93-12 provided welcome relief to family-owned businesses, affording those business owners greater flexibility in transferring equity interests at a more-efficient tax cost. However, both taxpayers and planners were quick to identify family limited partnerships (FLPs) as a means to leverage lifetime property transfers through the use of sophisticated partnership structures and to maximize allowable discounts for lack of control by incorporating various limitations and restrictions into the governing documents. Use of these structures, especially those that fell outside the parameters of being reasonable, caused great angst within Treasury and the IRS. After numerous challenges on several technical fronts with limited success, Chapter 14 (comprising Sections 2701-2704) was enacted by Congress in 1990. Section 2704 was intended to prevent certain abuses that taxpayers were perceived to have been taking advantage of in transferring equity interests in family-owned businesses.

A brief Chapter 14 primer

Sections 2701, 2703, 2704 and, perhaps to a lesser degree, Section 2702, were enacted to set forth specific rules for estate, gift, and generation-skipping tax compliance purposes in the context of valuation of transferred equity interests in corporations and partnerships to a member of the transferor equity interest holder's family.

The centerpiece for applying Chapter 14 rests with the concept of "applicable restrictions." The general thrust of the concept is that certain restrictions set forth in the governing legal documents (buy/sell agreements, partnership agreements, etc.) will be respected when considered in conjunction with the application of a discount for lack of control, while other restrictions, defined within the statutes as "applicable restrictions," will be disregarded and effectively dismissed in the determination of value of the transferred equity interest and the

[3] *Estate of Bright*, 658 F.2d 999, 48 AFTR2d 81-6292 (CA-5, 1981); *Propstra*, 680 F.2d 1248, 50 AFTR2d 82-6153 (CA-9, 1982); *Estate of Andrews*, 79 TC 938 (1982); *Estate of Lee*, 69 TC 860 (1978).

[4] 1993-1 CB 202.

[5] REG-163113-02.

discounts associated with those determinations.

The Chapter 14 sections can be summarized as follows:

- Section 2701 provides guidance to determine whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift.
- Section 2702 provides that, solely for purposes of determining whether a transfer of an interest in trust (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member shall be valued in consideration of the retained interest.
- Section 2703 states that the fair market value (FMV) of property shall be determined without regard to any agreement to acquire or use the property or any restriction on the right to sale or use of the property.
- Section 2704(a) provides that if there is a lapse of voting or liquidation rights in an entity controlled by a family before and after the lapse, the lapse shall be disregarded and the interest transferred shall be treated as if there had been no lapse.
- Section 2704(b) addresses applicable restrictions. An applicable restriction is any restriction that limits the transferee's ability to liquidate, which then lapses (or can be removed by the family) after a transfer of an equity interest has been made.

A great deal of the IRS's historical emphasis has been on the use of valuation discounts in FLPs. Specifically, Sections 2701, 2703, and 2704 apply to these entity structures and have some applicability to these vehicles. It is noteworthy, however, that while FLPs have been the focal point of the IRS attacks for some time, Chapter 14 and each of the four statutes extend to intra-family transfers of equity interests in operating companies as well.

Treasury and IRS concerns with the current regulations

The proposed regulations summarily note that the proposed rules concern:

> …the valuation of interests in corporations and partnerships for estate, gift and generation-skipping transfer (GST) tax purposes. Specifically, these proposed regulations concern the treatment of certain lapsing rights and restrictions on liquidation in determining the value of the transferred interests. These proposed regulations affect certain transferors of interests in corporations and partnerships and are necessary to prevent the undervaluation of such transferred interests.[5]

Of the four sections in Chapter 14, the currently-proposed Treasury regulations focus most heavily on Section 2704(b) and work to expand the definition of "applicable restriction" and add numerous other changes, as will be discussed below.

Pursuant to the current Reg. 25.2704-2(b), an "applicable restriction" is a restriction that limits the ability of the partnership to liquidate. Such restriction lapses after a transfer, or the transferor and members of his or her family, alone or collectively, have the right to remove the restriction. Under the regulation, a restriction is not an "applicable restriction" if it is not more restrictive than the limitations imposed under state law.

Section 2704 was intended to prevent certain abuses that taxpayers were perceived to have been taking advantage of in transferring equity interests in family-owned businesses.

The rules further provide that a restriction imposed on the corporation or partnership as part of financing or equity participation with an unrelated party is not an "applicable restriction" for purposes of Section 2704. Currently, Section 2704(b) fails to address certain "applicable restrictions" on liquidation, which, under normal conditions and common valuation practice, would support the use and level of discounts for lack of control and lack of marketability in valuing equity interest transfers in a family-controlled business.

Section 2703(b) is integral to the correct application of Section 2704(b). This section provides that Section 2703(a) will not apply to any option, agreement, right, or restriction that:

1. Is a bona fide business arrangement.
2. Is not a device to transfer the property for less than full and adequate value to family members.
3. Has terms comparable to similar arrangements entered into by persons in arm's-length transactions.

The practical implication of this statutory provision is that if a restriction placed within the governing documents meets the requirements of Section 2703(b), that same restriction should be considered in the determination of the value of the transferred equity interest. The proposed regulations take direct aim at the valuation of intra-family transfers of equity interests in corporations and partnerships when the transferred equity interests are subject to lapsing voting or liquidation rights and restrictions on liquidation.

The proposed rules explain that,

> Lapses of voting or liquidation rights are treated as a transfer of the excess of the fair market value of all interests held by the transferor, determined as if the voting or liquidation rights were nonlapsing, over the fair market value of such interests after the lapse.[6]

Interestingly, the proposed regulations purport that the legislative history of Section 2704 states that the provision is intended, in part, to prevent results similar to those in *Estate of Harrison*.[7]

In *Harrison*, the decedent held a 1% general partner interest and a 77.8% limited partner interest in a Texas limited partnership (Harrison Interests, Ltd.) at the time of his death. The decedent's sons held the balance of all ownership in the partnership. The partnership was essentially a holding company that held a variety of assets, including oil and gas interests. As a general partner, the decedent had the right to dissolve the partnership by provision of the partnership agreement, which lapsed at the moment of the decedent's passing. Neither limited partners nor successor general partners had such a right.

The IRS found that the value of the general partner interest was in agreement with the value set by the estate. However, there was a dispute over the value of the limited partner interest held by the decedent. The value, as determined by the IRS was $59,555,020. The estate took the position that the value was $33,000,000. The difference between the two values was attributable entirely to the right the decedent had as a general partner, up until his death, to force the partnership's liquidation. The parties agreed that under the partnership agreement and Texas law, this right did not pass to the estate. Thus, it "lapsed" at the decedent's death.

In *Harrison*, the IRS argued that when the decedent's right to dissolve the partnership terminated at the time of his death, something of value passed to his two sons. The court disagreed, noting that the IRS's argument was contrary to its stipulation that the value of the interest of the sons was the same at the moment before decedent's death, at the moment of the decedent's death, and at the moment after the decedent's death.

Thus, *Harrison* set a precedent, in that lapsing rights could be considered in determining the FMV of a decedent's limited partnership interest transferred at death. This decision would be of little value in the future if the proposed regulations are finalized as currently released.

Section 2704

To better understand the mechanics of the proposed regulations, it is necessary to understand the specific statutory construct of Section 2704. As noted earlier, Section 2704(a) provides that if there is a lapse of voting or liquidation right(s) in an entity controlled by a family before and after the lapse, the lapse shall be disregarded and the interest transferred shall be treated as if there had been no lapse. The key element for application of this provision is family control both before and after the lapse of the restriction. In such cases, Section 2704(a) treats certain lapses of voting or liquidation rights as "deemed" transfers for value.

Section 2704(b) provides that certain restrictions on a corporation or partnership regarding its ability to liquidate will be disregarded in valuing transferred equity interests. In concert, these two provisions work to limit the ability to use valuation discounts in intrafamily consideration of these "applicable restrictions."

IRS concerns

In drafting the proposed regulations, the Treasury and the IRS made four consequential arguments based on their identification of four specific instances in which the current statute and regulations do not work to honor the spirit of Section 2704(b). Each of these perceived shortcomings under current rules serves as a block in the foundation on which the proposed regulations were built.

Lack of overall effectiveness. The first argument is that the current regulations' lack overall effectiveness. The language in the proposed regulations notes that the Treasury Department and

6 *Id.*

7 TCM 1987-8.

8 113 TC 449 (1999), *aff'd* 292 F3d 490, 89 AFTR2d 2002-2838 (CA-5, 2002).

the IRS have determined that the current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws and by other subsequent developments. Examples of this ineffectiveness cited in the proposed regulations include the court's finding in *Kerr*.[8]

In *Kerr*, the court concluded that Section 2704(b) applied to only restrictions on the ability to liquidate an *entire* entity, and did not apply to liquidating a transferred *interest* in that entity. Such a finding leads to the conclusion that an applicable restriction under Section 2704(b) does not apply to individual equity interests in an entity, and further, allows for the ability to reduce value for the inherent investment risks associated with the restrictions. Usually, these reductions in value were quantitatively applied via discounts for both lack of control and lack of marketability.

Restrictions under state law. A second perceived issue fueling the argument by the Treasury and the IRS for new regulations is the current exceptions in the statute that bar from the definition of "applicable restriction" any restriction that is less restrictive than that permitted under state law. The argument in this matter is that many states have modified their statutes affecting FLPs to allow liquidation of the entity on only the unanimous vote of the owners, and to eliminate the statutory default provision that had previously allowed a limited partner to liquidate his or her limited partner interest. As a result, those restrictions generally included in a partnership agreement are less restrictive than state law, as it currently exists, and, as such, do not constitute applicable restrictions under the current regulations. The Treasury and the IRS view these state laws as defeating the Congressional intent with respect to Section 2704(b).

Transferring equity interest. A third argument by the Treasury and the IRS for issuing the proposed regulations is that taxpayers have attempted to avoid the reach of Section 2704(b) by transferring the equity interest to an assignee rather than to a partner. According to the Treasury and the IRS, an assignee is allocated all income, gain, loss, etc. of the partnership but does not have the rights or powers of a partnership. Taxpayers then argue that the inability to liquidate is no more restrictive than state statutes, and as such, is not an applicable restriction subject to Section 2704(b).

Section 2704(b)'s mandate and intent. The Treasury and IRS's final argument for the issuance and adoption of the proposed regulations is that taxpayers have successfully avoided Section 2704(b)'s mandates and intent by transferring a nominal equity interest in the partnership to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have sole authority to remove a restriction. The argument is that the transfer of a nominal interest has served as a catalyst for defeating certain restrictions on liquidation when a unanimous vote was required by the governing documents to accomplish the liquidation.

The proposed regulations

As noted, the general focus of the proposed regulations is on addressing these four specific issues identified by the Treasury and the IRS. However, in the course of developing the proposed regulations, additional elements were added as a matter of regulatory efficiency. One of these additions was the expansion of Section 2704(b)'s applicability to entities organized as LLCs. The statute, as originally crafted, applied to only corporations and partnerships.

The proposed regulations expand the reach of Section 2704(b) to include transfers of equity interest in corporations, partnerships, and LLCs, as well as any other entity structure or arrangement that is found to be a business entity within the meaning of Reg. 301.7701-2(a), regardless of whether the entity or arrangement is domestic or foreign; how the entity is classified for other federal tax purposes; and whether the entity is disregarded as an entity separate and apart from its owner for other federal tax purposes.

The primary purpose of expanding Section 2704(b)'s statutory scope beyond two entity categories (corporation and partnership) is to allow the proposed regulations to address two specific factual situations: (1) the instance when it is necessary to determine control of an entity, and (2) the instance when it is necessary to determine whether a restriction is imposed under state law. In these instances, the proposed regulations note that consideration should be given to the differences accorded various types of entities under the local law of the organizing jurisdiction.

Understanding these differences plays an important part in both the determination of control and of the presence of a restriction.

The proposed regulations provide that in the case of any business entity or arrangement that is not a corporation, the form of that entity or arrangement will be determined under the local jurisdictional law. This determination is not influenced by how the entity is classified for federal income tax purposes, even if it is disregarded as an entity apart from its owner.

The proposed regulations, then, set out three types of entities to be considered in the application of these two tests: corporations, partnerships (including limited partnerships), and other business entities, which include LLCs that are not S corporations.

Determination of control

The next issue tackled by the proposed regulations is the matter of control. The proposed regulations would expand the historical definition of control to include indirect interest held by LLCs or other arrangements not constituting a corporation, partnership, or limited partnership. In this expanded definition, control is defined as holding at least 50% of either the capital or the profits interest of the entity or arrangement. In addition, the rules, as proposed, include as an alternative means to determining control, the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement.

Finally, the proposed regulations note that any indirect interest in an entity held through a corporation, partnership, trust, or other entity will be attributed to an individual, his estate, or members of his family in determining control. This attribution is essentially the same as that currently under Reg. 25.2701-6.

Lapses of restrictions and rights and deathbed transfers

The proposed regulations would amend Reg. 25.2704-1(a) to provide that the definition of a "lapse," as set out in Section 2704(a) includes any transfer that results in the restriction or elimination of any rights or powers associated with the transferred interest.

The proposed rules also amend Reg. 25.2704-1(c)(1) by substantially limiting the liquidation right exception in the definition of a lapse. The current exception is proposed to be applicable only when the transfers to which the lapse attaches occurred three or more years before the transferor's death, and do not restrict or eliminate the rights associated with the transferred interest.

Lastly, the proposed regulations align the current test of a family unit's ability to liquidate an equity interest with the proposed rule of eliminating comparisons to local law. The proposed regulations indicate that, in effect, the idea behind the change is to clarify that the manner in which a liquidation may be undertaken is irrelevant. The proposed rule change is also intended to conform to another proposed provision, which would disregard "nonfamily" equity interest ownership in testing whether that family continues to maintain an ability to remove a restriction.

Expansion of applicable restrictions

At the core of Section 2704 is the term "applicable restrictions." Qualification as an "applicable restriction" invokes the statutory provision and essentially disregards that restriction in valuing the transferred equity interest. The proposed regulations work to significantly expand the definition of "applicable restriction," which essentially broadens the tax base on which the estate and gift tax is assessed.

In a fundamental change in the application of Section 2704(b), the regulations propose to remove the exception provided in Reg. 25.2704(b) that, heretofore, has limited "applicable restriction" to limitations that are more restrictive than the limitations that would otherwise apply under the local law to which the entity is subject in the absence of the restriction.

The perception by Treasury and the IRS in proposing this change is that, under the current regulations, the transferor and the family members have the power to avoid any statutory rule.

The proposed regulations further revise the current regulation to provide that an "applicable restriction" does not include a restriction that is imposed under the terms of the governing document, as well as under a local law, regardless of whether that restriction may be superseded by, or pursuant to, the governing documents or otherwise. In effect, the rule, as proposed, intends to ensure that a restriction that is not imposed or required to be imposed by a federal or state law is disregarded without regard to its source.

In a proposed change of lesser reach, the terms "federal" and "state" are noted as referring to only the U.S. and the District of Columbia and do not include any other jurisdiction. Although of lesser general applicability, there is still a question as to why such a limitation is proper because limitations or restrictions imposed by a governmental authority outside of the borders of the U.S. would still present an investment risk to the holder of any equity interest and, accordingly, be reflected in the consideration of value.

The proposed regulations note that a restriction "is imposed or required to be imposed by law" if the restriction cannot be removed or overridden in the course of drafting the governing documents, is mandated by the applicable law, and is required to be included in the governing documents, or is otherwise mandatory.

The proposed rules set out two specific instances when such restriction imposed by state law will still constitute an applicable restriction. The first is when state law is limited in its application to certain narrow classes of entities, especially those most likely to be subject to Section 2704 (i.e., family-controlled entities). The second situation arises when the applicable state law required, at one point in time, the mandatory restriction, and that state's law also provides an optional provision or alternative statute for governance of the same type of entity without the imposition of the mandatory restriction.

The effect of disregarding any restriction is that the FMV of the transferred equity interest is determined under generally applicable valuation principles as if the restriction did not exist. Thus, there is assumed to be no such restrictions on liquidation of the entity.

A new class of disregarded restrictions

Disregarded restrictions represent an entirely new concept in the application of Chapter 14 and Section 2704. This class of restrictions, as set forth in the proposed regulations, intends to address restrictions on the liquidation or redemption of entity interests.

Pursuant to Reg. 25.2704-3, in the case of a family-controlled entity, any restriction on an equity interest holder's right to liquidate his or her personal equity interest will be disregarded if the restriction will lapse at any time after the transfer. In addition, any powers to remove or override the restriction held by the transferor, or the transferor's family members (without regard to any equity interest held by non family members) will be disregarded.

The proposed rules segregate disregarded restrictions into four separate categories. These include restrictions that:

1. Limit the ability of the holder of the equity interest to liquidate that interest.
2. Limit the liquidation proceeds to an amount that is less than "minimum" value.
3. Defer the payment of the liquidation proceeds for more than six months.
4. Permit the payment of liquidation proceeds in any manner other than cash or other property, other than certain notes.

The proposed rules define "minimum value" as the [transferred] equity interest's share of the "net value" of the entity on the date of liquidation or redemption. In other words, the minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. The equity interest's share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity. The net value of the entity is defined as the FMV of the property held by the entity, reduced by the outstanding obligations of the entity. The definitional provisions go on to note that the only outstanding obligations of the entity that may be taken into account in the determination of net value are those that would be allowable (if paid) as deductions under Section 2053, if those obligations instead were claims against the estate.

The proposed regulations take direct aim at the valuation of intra-family transfers of equity interests in corporations and partnerships when the transferred equity interests are subject to lapsing voting or liquidation rights and restrictions on liquidation.

The proposed regulations provide that exceptions that apply to "applicable restrictions" under the current and proposed regulations also apply to the new class of disregarded restrictions The proposed regulations cite one example of the exceptions applicable to the disregarded restrictions. These rules note that an exception applies if:

> (a) each holder of an interest in the entity has an enforceable "put" right to receive, on liquidation or redemption of the holder's interest, cash and/or other property with a val-

ue that is at least equal to the minimum value previously described,

(b) the full amount of such cash and other property must be paid within six months after the holder gives notice to the entity of the holder's intent to liquidate any part or all of the holder's interest and/or withdraw from the entity, and

(c) such other property does not include a note or other obligation issued directly, or indirectly, by the entity, by one or more holders of interests in the entity, or by a person related either to the entity or to any holder of an interest in the entity.

Note that exceptions apply to certain entities engaged in operating activities where at least 60% of the entity's value is comprised of nonpassive assets of an active trade or business. In this case, as long as the note is attributable to the nonpassive asset value on liquidation, the proceeds can include a note or other obligation, if the note is structured on an arm's-length basis—meaning that the transaction includes adequate securitization, periodic payments on a nondeferred basis, market interest rates, and FMV on the date of liquidation or redemption equal to the liquidation proceeds.

It is clear from this specific provision of the proposed regulations that the Treasury and the IRS are excepting transfers from the applicable restriction when the transfers are based on market considerations and reflect economic norms with respect to value and payment terms.

Outside equity ownership

To mitigate taxpayer arguments that nonfamily member equity owners are in place to reduce the family members' ability to remove a restriction included in the new class of disregarded restrictions, the proposed regulations introduce a provision limiting consideration of the outside equity owners. Under these proposed rules, any equity interest held by a person who is not a member of the transferor's family is disregarded if, at the time of the transfer, the equity interest:

(a) Has been held by such person for less than three years;

(b) constitutes less than 10 percent of the value of all of the equity interests in a corporation, or less than 10 percent of the capital and profits interests in a business entity described in § 301.7701-2(a) other than corporations…;

(c) when combined with the interests of all other persons who are not members of the transferor's family, constitutes less than 20 percent of the value of all of the equity interests in a corporation, or constitutes less than 20 percent of the capital and profits interests in a business entity other than a corporation; or

(d) any such person, as the owner of an interest, does not have an enforceable right to receive in exchange for such interest, on no more than six months' prior notice, the minimum value referred to in the definition of a disregarded restriction.

Once the outside equity interest ownership is disregarded, the determination of whether the family has the ability to remove the restriction will be made, assuming that the remaining interests are the sole equity interest holders in the entity. As is the case with all disregarded restrictions, once disregarded, the value of the transferred equity interest is determined as if the restriction did not exist, either in the governing documents or applicable law.

Coordination with the marital deduction and charitable deductions

The final technical elements of the proposed regulations address the rule's relationship to the marital deduction in computing estate, gift, and generation-skipping transfer taxes. Simply put, the computation of a marital deduction applicable to any transferred equity interest subject to Section 2704(b) must consider the same rules for a marital deduction attributable to that equity interest.

With respect to charitable deductions, it is noted within the proposed regulations that the special valuation assumptions of Section 2704(b) apply to only family members and, as such, have no application in valuing an equity interest passing to a charity or other nonfamily member. Logically, as with the marital deduction, in consideration of the nonapplicability of Section 2704(b), the equity interest passing to charity will generally have the same value for both estate and charitable deduction purposes.

Treasury and IRS authority

The drafting and proposal of comprehensive regulations with the breadth and impact of the proposed regulations under Section 2704(b) has led many commentators to question the Treasury and the IRS's authority to issue such rules. Clearly, the scope of the proposed rules extends well beyond the process of providing an interpretation as to Congressional intent with respect to statutory law. This reach is viewed by many as the unauthorized creation of new law without the consideration of Congress and, as such, the Treasury and the IRS have gone far beyond those powers granted them under the Constitution.

To validate their authority, the Treasury and the IRS have adopted the position that they have been granted just such authority by virtue of Section 2704(b)(4), which provides,

> (4) Other restrictions.
>
> 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.

The Treasury and the IRS noted that Congress granted this broad power so that they could identify additional restrictions not covered by Section 2704(b), which met the parameters of the statutory provision and, as a result, should be disregarded. It is clear from the proposed regulations that the Treasury and IRS believe that Congress passed the law "abdicating" its authority with respect to law changes in this area.

The outgrowth of this interpretation by the Treasury and the IRS is the determination that those "other" restrictions that shall be disregarded by virtue of Section 2704(b)(4) include:

> (a) A restriction on the ability to liquidate the transferred interest; and
>
> (b) any restrictions attendant upon the nature and extent of the property to be received in exchange for the liquidated interest, or the timing of the payment of that property.

These two restrictions form the foundational basis for the proposed regulations. Should the Treasury and the IRS be found to have overstepped their authority, it is expected that the rules will be withdrawn.

Synopsis

The proposed regulations take several steps that serve to modify the standard of value generally required in valuations of equity interests for estate, gift, and generation-skipping tax. FMV and its use in such valuations is a long-standing tradition, steeped in both statutory and regulatory guidance, as well as numerous IRS rulings[9] and judicial decisions. The Treasury's and the IRS's current attempt to require the determination of an "artificial" FMV is somewhat alarming.

Consider Prop. Reg. 25.2704-3(f),

> If a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise.

Clearly, the regulations as proposed are intended to dismiss inherent investment risks associated with the restrictions imposed by the governing documents, local law, or otherwise. The basis for this modification in the definition of FMV is predicated on the expansion of the attribution rules as proposed and the underlying premise that the transferred equity interest is to be valued in light of the holder and his or her relationship to the transferor.

In *Estate of Bright*,[10] the court cited Reg. 20.2031-1(b) and the following rule, noting its universal application in the courts:

> 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.

The Fifth Circuit saw this language from the regulation as indicating that the "willing seller" is a hypothetical seller rather than the particular estate. Thus, the willing seller should not be identified with the decedent, and the decedent's stock should not be included as part of a family unit for valuation purposes. Nor was it proper, according to the Fifth Circuit, to place any weight on the identity of the parties who actually received the stock after distribution from the estate. For purposes of valuation, one should construct a hypothetical sale from a hypothetical willing seller to a similarly-hypothetical willing buyer.

The proposed regulations interfere with this seminal finding in that the dismissal of an entity's governing document or local law provisions due to the identification of the "holder" of the interest as being familial to the transferor pierces the fundamental premise that an equity interest is to be valued of its own accord and not with respect to the holder of that interest.

Further, the presence of restrictions, such as those proposed to be disregarded in the context of valuation by the proposed regulations, unequivocally represents significant investment risks and would clearly be considered in conjunction with a hypothetical sale between a willing buyer and the willing seller. To dismiss these risks is to fundamentally revise generally-accepted business valuation practices and to run afoul of those professional standards by which most valuators conduct their practices.

The findings in *Estate of Bright* were followed in the Ninth Circuit in *Propstra*,[11] as well as *Estate of Andrews,*[12] in which the Tax Court noted that,

[9] Rev. Rul. 59-60, 1959-1 CB 237.

[10] Note 3, *supra*.

[11] 680 F.2d. 1248, 50 AFTR2d 82-6153 (CA-9, 1982).

[12] 79 TC 938 (1982).

in following the Fifth Circuit's "well-reasoned and thoroughly researched opinion,"

> Respondent's [IRS] approach would have us [the court] tailor "hypothetical" so that the willing seller and the willing buyer were seen as particular persons who would most likely undertake the transaction. However, the case law and regulations require a truly hypothetical willing seller and willing buyer. We must assume these hypothetical parties exist even though the reality of the situation may be that the stock will most probably be sold to a particular party or type of person.

Given the historical application of FMV; the case and statutory history; and regulatory acceptance over a period reaching back more than half a century, the attempt to modify that term and present an artificial definition of FMV so as to broaden the reach of the current estate, gift, and generation-skipping tax may be inappropriate.

A second avenue of change incorporated into the proposed regulations, and a cause for concern, is the aggregation of ownership interest or voting rights of a family if the family unit controls an entity. The proposed aggregation rules expand the historical attribution rules set forth in Section 2701. Under Prop. Reg. 25.2701-2(b)(5)(i),

> For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of § 307.7701-2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse.

Under the proposed rules, the threshold for control is decreased to a collective holding among the family unit of at least 50% of either the capital or profits interest of the entity, or the holding of any equity interest with the power to cause full or partial liquidation of the entity.

The third critical element of the proposed rules is the expansion of the term, "applicable restrictions" and the new category of restrictions labeled disregarded restrictions. Both classes of restrictions are not to be considered in conjunction with the determination of value of a transferred interest. It is unclear as to whether the expansion of the Section 2704(b) language to include these extended limitations is interpreted as a new law or whether they are simply expansions allowed under the regulatory authority granted in the statute in 1990.

Finally, the proposed rules assume that all holders of an equity interest in a family partnership have a "put" right to liquidate their interest in those entities. The rules note that no restriction will constitute a disregarded restriction if each holder of an interest in that entity has a put right as described in paragraph (b)(6) of this section.[13]

Prop. Reg. 25.2704-3(b)(6) provides the definition of the put as follows:

> The term put right means a right, enforceable under applicable local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption…For purposes of this paragraph (b)(6), the term other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or any holder of an interest in the entity.

In effect, this proposed rule addressing put rights appears to be an attempt by the Treasury and the IRS to provide a means for taxpayers to avoid the dismissal of the applicable and disregarded restrictions in valuing the transferred interests. The cost of providing every equity owner a put, however, is dear, with the likely outcome of eliminating most, if not all, discounts.

Conclusion

The proposed regulations are subject to a comment period that ended on 11/2/16, and the interest that has been generated by the release of the rules produced a substantial amount of commentary. The process turned to a public hearing on 12/1/16.

If the rules are finalized as proposed, it is reasonable to believe that the effective date could be close to year end. As such, those family business owners contemplating the transfer of business interests to junior generation transferees may wish to consider making the transfers in calendar year 2016 and complete the gifts, if possible, before the effective date of the new regulations.

If deemed final as proposed, the new regulations are virtually certain to be challenged in the courts. Therefore, family business owners reporting transfers of equity interests without consideration of applicable restrictions and discounts under the proposed regulations may want to file protective claims for refunds in the event that the proposed rules are eventually overturned in court.

[13] Prop. Reg. 25.2704-3(b)(5)(v).