

**THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL (ACTEC)
COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 2704
[REG-163113-02]**

SUMMARY

These comments of The American College of Trust and Estate Counsel (ACTEC) address the Proposed Regulations under section 2704 of the Internal Revenue Code relating to the treatment of the lapse of voting or liquidation rights and the effect of restrictions on the liquidation of a family controlled entity or of an interest in a family-controlled entity. These Comments emphasize ACTEC's recommendations to:

- Clarify the effect of disregarding the new proposed “disregarded restrictions,” as well as the current “applicable restrictions” (as modified by the Proposed Regulations), about which there has been considerable confusion and disagreement among commentators, including confusion and disagreement about a “deemed put right.” Specifically, ACTEC seeks clarification that the price that a third party, unrelated purchaser would be willing to pay for an interest continues to be the appropriate measure of fair market value for federal transfer tax purposes and that specific features such as illiquidity, fiduciary duty to other owners, and other causes of inability or reluctance to liquidate an interest will continue to be treated as legitimate factors that a third party purchaser would take into account in determining the price he or she is willing to pay;
- Limit the application of the new rules regarding “applicable restrictions” and “disregarded restriction” to persons who have created, or collaborated in the creation of, those restrictions, excluding from their application minority owners who never had control of the entities;
- Revise the “bright-line” criteria for identifying non-family members whose interests in an entity will be respected to make those criteria more realistic;
- Change the new “three-year rule” introduced to subject certain lifetime transfers to estate tax as lapses occurring upon death to a one-year rule, with a further exception when there is a low probability that death would occur within one year of the transfer (using standards similar to those used for purposes of section 7520), and limit the application of the rule to lifetime transfers that occur on or after the effective date of the Regulations; and
- Make all, not just some, of the Proposed Regulations effective 30 days after the Final Regulations are published in the Federal Register.

ACTEC also seeks clarification of other subjects, including the treatment of entities other than corporations and partnerships, transfers at death to multiple persons, the exceptions from the definitions of “disregarded restrictions” and “applicable restrictions,” requirements of federal or state law, rights described in section 2703, and entities in which all owners have put rights.

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ACTEC has no comment on provisions of the Proposed Regulations that are omitted from these Comments.	

COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 2701

1. Prop. Reg. §25.2701-2(b)(5). Controlled Entity: Clarification of “Control” in the Case of Entities or Arrangements That Are Not Corporations or Partnerships

Section 2701 provides special valuation rules for determining the amount of a gift in the case of certain transfers of equity interests in corporations or partnerships.¹ No mention is made in either section 2701 or the Regulations under section 2701 of limited liability companies or other arrangements. The omission of limited liability companies is not surprising because, at the time the section 2701 Regulations were promulgated in 1992, these companies were not commonly used. They did not achieve their current popularity until after 1997, when the “check-the-box” Regulations (Reg. §301.7701-3) became effective and clarified the income tax status of limited liability companies.

The Preamble to the Proposed Regulations states that the Proposed Regulations address “what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership, or limited liability company.” This issue is addressed in Prop. Reg. §§25.2701-2(b)(5)(i) & (iv).

Prop. Reg. §25.2701-2(b)(5)(i) provides as follows:

For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of § 301.7701-2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor’s spouse. The form of the entity determines the applicable test for control. For purposes of determining the form of the entity, any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B) is a corporation. For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. In the case of any business entity that is not a corporation under these provisions, the form of the entity is determined under local law, regardless of how the entity is classified for federal tax purposes or whether it is disregarded as an entity separate from its owner for federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under whose laws the entity is created or organized.

ACTEC recommends the following revisions to the Proposed Regulations to deal with the proposed expansion of the scope of the Treasury Regulations to limited liability companies and other entities and arrangements:

¹ References to “section ____” are to the relevant sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated. References to “Reg. §____” are to the relevant sections of the Treasury Regulations currently in place. References to “Prop. Reg. §____” are to the relevant sections of the Proposed Regulations.

a. The reference to Reg. §301.7701-2(a) to determine whether an arrangement is a business entity to which section 2701 should apply has caused confusion because this portion of the section 7701 Regulations does not tell us which arrangements will be treated as entities. That information is found in Reg. §301.7701-1, which provides that “a joint venture or other contractual arrangement may create a separate entity for federal estate tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.” To clarify this issue, consideration could be given to amending Prop. Reg. §25.2701-2(b)(5)(i) to provide as follows:

For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity that is a business entity within the meaning of § 301.7701-2(a) of this chapter, including a joint venture or other contractual arrangement treated as an entity under § 301.7701-1 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.

b. The use of Prop. Reg. §25.2701-2(b)(5)(i) to determine which form qualifies as a controlled entity when the entity is neither a corporation nor a partnership suggests that Treasury has concluded that transfers of interests in entities other than corporations and partnerships should be covered by section 2701. ACTEC agrees with this conclusion but recommends that it be clearly stated rather than only suggested. Consideration could be given to amending Reg. §25.2701-1(a)(1) to provide as follows:

Section 2701 provides special valuation rules to determine the amount of a gift when an individual transfers an equity interest in a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of § 301.7701-2(a) of this chapter, including a joint venture or other contractual arrangement treated as an entity under § 301.7701-1.

2. Prop. Reg. §25.2701-8. Effective Dates

See the discussion below of Prop. Reg. §25.2704-4.

COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 2704

3. Prop. Reg. §25.2704-1(a)(1). Lapse of Certain Rights: In General

This portion of the Proposed Regulations clarifies that the application of section 2704 is not limited to interests in corporations and partnerships; it is also intended to apply to limited liability companies, as well as other entities that are treated as business entities. For the reasons recommended in these Comments addressing the Proposed Regulations under section 2701, ACTEC recommends that the reference in Prop. Reg. §25.2704-1(a)(1) to “any other business entity within the meaning of §301.7701-2(e)” be changed to refer instead to “any other entity that is a business entity within the meaning of Reg. §301.7701-2(a), including a joint venture or other contractual arrangement treated as an entity under §301.7701-1.”

4. Prop. Reg. §25.2704-1(a)(2)(i). Control

a. Clarification of “Family”

Section 2704(c)(1) provides that for purposes of section 2704 the term “control” has the meaning given that term by section 2701(b)(2). Section 2701(b)(2) provides that the term “control” in the case of a corporation means the holding of at least 50 percent (by vote or value) of the stock of the corporation. It defines “control” in the case of a partnership to include the holding of at least 50 percent of the capital or profits interests in the partnership, or in the case of a limited partnership, the holding of any interest as a general partner. Section 2701(b)(2) does not, however, specify by whom the described interests must be held.

The meaning of “control” and the identification of those individuals who hold control is important to the application of both sections 2704(a) and 2704(b). Section 2704(a) applies to the lapse of an individual’s voting or liquidation rights only if the individual and “members of such individual’s family” hold control of the entity before and after the lapse. Section 2704(b)(1) disregards applicable restrictions when valuing a transferred interest in an entity only if “the transferor and members of the transferor’s family” hold control of the entity immediately before the transfer. Similarly, Prop. Reg. §25.2704-3(a) disregards disregarded restrictions when valuing a transferred interest only if “the transferor and/or members of the transferor’s family” control the entity immediately before the transfer.

Section 2704(c)(2) provides that the term “member of the family” means, with respect to any individual, (A) the individual’s spouse, (B) any ancestor or lineal descendant of the individual or the individual’s spouse, (C) any brother or sister of the individual, and (D) any spouse of any individual described in (B) or (C).

The reference in existing Reg. §25.2704-1(a)(2)(i) and in Prop. Reg. §§25.2704-2(c) & 25.2704-3(c) to Reg. §25.2701-2(b)(5) for a definition of “control” has caused confusion because that Regulation includes (in paragraph (b)(5)(i)) a definition of “controlled entity” for purposes of section 2701. Unlike section 2704, section 2701(b)(2)(C) and Reg. §25.2701-2(b)(5)(i) define a controlled entity by reference to “applicable family members,” which, for purposes of measuring control under section 2701, includes not only interests held by members of the family, but also interests held by any lineal descendant of any parent of the transferor or the transferor’s spouse.

Some commentators have concluded that the reference to Reg. §25.2701-2(b)(5) in the section 2704 Regulations suggests that Treasury intends to expand the definition of “family” for purposes of section 2704 beyond the scope of its definition in section 2704(c)(2). ACTEC assumes that this interpretation was not Treasury’s intention. If correct, ACTEC recommends that the reference to Reg. §25.2701-2(b)(5) be changed to refer specifically to clauses (ii), (iii), and (iv) of Reg. §25.2701-2(b)(5), the three provisions that actually address the meaning of “control.”

b. Clarification of Attribution

ACTEC is also troubled by the inclusion in Prop. Reg. §§25.2704-1(a)(2)(i), 25.2704-2(d) & 25.2704-3(d) of a direction to look to Reg. §25.2701-6 to determine whether an

individual will be treated as owning an interest in an entity that is owned by another entity or by a trust or estate in which the individual has an interest. Reg. §25.2701-6 contains a set of very broad attribution rules that attribute the ownership of interests in entities owned by trusts and estates to individuals whose actual interests are attenuated. Examples include: (1) the grantor of a grantor trust who is treated as owning all of the entity interests owned by the trust regardless of whether the grantor has any beneficial interest in the trust or any right to control the voting interests of the entity; (2) the 95-year-old income beneficiary of a trust who has no interest in the principal who is deemed to hold all the interests held by the trust in any entity; and (3) each of 10 cousins who are discretionary beneficiaries of an educational trust established for them by their grandfather who are deemed to own all of the interests held by the trust in any entity.

The attribution rules of Reg. §25.2701-6 also result in the attribution of the same interests in an entity to multiple persons. For example, the interests deemed held by the grantor of a grantor trust will also be attributed to the beneficiaries of the trust. The interests held by the income beneficiary of a trust will also be attributed to its remainder beneficiaries, and all of the interests of the beneficiaries of a discretionary trust will be separately attributed to each of the discretionary beneficiaries.

Reg. §25.2701-6 does contain a set of rules designed to alleviate the multiple attribution problem, but these rules do not work appropriately in the context of section 2704 because section 2704 does not use the same concept of applicable family member that is used in section 2701 and because the operation of section 2704 does not depend on the identification of a transferee.

ACTEC recommends that the Proposed Regulations contain their own set of trust and estate attribution rules. The Regulations under section 2704 should not attribute ownership to the grantor of a trust who is not also a trust beneficiary. The treatment of the grantor of a trust as the owner of its assets is an income tax concept that should have no relevance to the operation of those portions of the transfer tax system that depend on actual ownership. In addition, the Regulations under section 2704 should clearly prevent attribution of the same interest to multiple individuals.

Consideration could be given to the following language:

Indirect holding of interests in estates and trusts — (a) *In general.*—A person is considered to hold an interest in an entity held by an estate or trust if, under the terms of the governing instrument of the estate or trust, that person will receive that interest. An individual will not be considered to hold an interest in an entity held by an estate or trust if that interest, under the terms of the governing instrument, will pass to another person. If an estate or trust holds an interest in an entity that is not directed to pass to a particular person, that interest will be deemed to be owned by each of the persons to whom it could pass, ignoring any powers of appointment that have not been irrevocably exercised.

(b) *Multiple attribution.*—If this section attributes an interest in an entity to more than one person, the interest shall be attributed in the following manner:

(1) In the case of an estate or trust whose governing instrument requires payments to its beneficiaries in fixed proportions, the entity interests owned by the estate or trust shall be deemed to be owned by the beneficiaries in those proportions.

(2) In the case of an estate or trust whose governing instrument divides payments to its beneficiaries on a temporal basis, the entity interests owned by the estate or trust shall be deemed to be owned by the beneficiaries in proportion to the actuarial interest of each, determined using the principles set forth in Reg. §1.7520-1.

(3) In the case of a trust whose governing instrument permits distributions to beneficiaries on a discretionary basis, the entity interests owned by the trust shall be deemed to be owned at any particular time in those proportions that each beneficiary would receive if the trustee were then to distribute the assets of the trust among the beneficiaries who are descendants of the grantor of the trust on a per stirpital basis or, if none of the beneficiaries are descendants of the grantor of the trust, among the beneficiaries of the trust who are descendants of the nearest ancestor of the grantor of the trust who has descendants who are beneficiaries of the trust.

(4) In the case of an estate or trust not described above, in a manner that is reasonable taking into account all of the facts and circumstances.

(c) Examples.—The following examples illustrate the provisions of this section:

Example 1.—An irrevocable trust holds a 40 percent interest in a corporation. One-half of the trust income is to be distributed to O Charity. The other one-half is to be distributed among the issue of the grantor (G) in such proportions as the trustees in their sole discretion determine. The trust is a perpetual trust. At the time that a determination of ownership in the corporation is to be made for purposes of this section, G's issue consist of G's child C, C's children GC-1, GC-2 and GC-3, and the two children of a deceased child of G, GC-4 and GC-5. O is treated as holding a 20 percent interest in the corporation. C is treated as holding a 10 percent interest in the corporation. Each of GC-4 and GC-5 is treated as owning a 5 percent interest in the corporation. C's three children (GC-1, GC-2, GC-3) are not treated as owning any portion of the corporation because, if one-half of the trust property were to be distributed to G's issue on a per stirpital basis, no portion of the trust property would be distributed to them.

Example 2.—The facts are the same as in *Example 1*, except that O's income interest terminates in 10 years, and at the end of 10 years the terms of the trust permit distribution of principal as well as income to G's issue on a discretionary basis. The actuarial value of a 10-year, 50 percent income interest is 10 percent of the value of the trust. O is treated as owning a 2 percent interest in the corporation; C is treated as owning a 19 percent interest; and each of GC-4 and GC-5 is treated as owning a 9.5 percent interest.

5. Prop. Reg. §25.2704-1(a)(5). Assignee Interests

The Proposed Regulations provide that a transfer of a partnership interest to an assignee who neither has nor may exercise the voting or liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest. *See* Prop. Reg. §25.2704-1(a)(5). The Preamble explains that this change merely confirms that a transfer that results in the restriction or elimination of a voting or liquidation right associated with the transferred interest is a lapse under section 2704(a). 81 Fed. Reg. at 51420.

In ACTEC's experience, it is very common that a partner may transfer only an assignee interest to a transferee who cannot become a partner without the consent of the other partners. In many cases, however, it *is* intended that the transferee become a partner with no intention otherwise. In fact, it is not unusual for the same document to both assign the transferred interest and provide the consent needed to admit the transferee as a partner. When such a transfer (even involving more than one document) is effectuated, it seems arbitrary that the application of section 2704(a) might depend, for example, on the order in which the parties sign.

ACTEC recommends that the Final Regulations clarify the application of the assignee rule to provide that the transfer of a partnership interest to an assignee who becomes a partner as part of an integrated transaction will not be treated as causing a lapse of the rights associated with the transferred partnership interest.

6. Prop. Reg. §25.2704-1(c)(1). Lapse of Liquidation Right: In General

a. Recommended Change of the "Three-Year Rule" to a One-Year Rule

Section 2704(a) treats the lapse of a voting or liquidation right in a family-controlled entity as a transfer (or additional transfer) by the individual holding the right immediately before its lapse. Reg. §25.2704-1(c)(1) exempts a transfer of an interest in a family-controlled-entity that results in the lapse of the transferor's control if the rights with respect to the transferred interest are not restricted or eliminated. The Proposed Regulations amend that regulation to deny the exemption for transfers occurring within three years before the transferor's death. Reg. §25.2704-1(f), Example (4), would be modified to illustrate this provision. The Preamble introduces this amendment by stating that "[t]he Treasury Department and the IRS . . . believe that this exception should not apply when the inter vivos transfer that results in the loss of the power to liquidate occurs on the decedent's deathbed." 81 Fed. Reg. at 51414.

Lifetime gifts of interests in family-owned entities can be gifts of minority interests carved out of a controlling interest and can leave the donor with only a minority interest at death, all discounted for transfer tax valuation purposes. But these gifts have consequences to the donor, including the loss of actual control that might hinder the donor from taking actions considered desirable or preventing actions considered undesirable. On the other hand, if the donor's death is imminent, such a gift might achieve the same minority-interest benefits for tax purposes without significant downside costs and risks to the donor. It might be said that the downside costs and risks – the real effect of the transfer on the donor – are essentially the same in that case as in the case of an actual testamentary transfer or similar transfer that does not take effect until the moment of death.

ACTEC understands Treasury's concern with deathbed transfers and understands why Treasury is interested in treating them essentially as transfers occurring at the moment of death. The Preamble to the Proposed Regulations similarly explains this concern with reference to the downside cost and risk of a transfer to the transferor:

The Treasury Department and the IRS have concluded that the regulatory exception created in §25.2704-1(c)(1) should apply only to transfers occurring more than three years before death, where the loss of control over liquidation is likely to have a more substantive effect.

81 Fed. Reg. at 51414.

Case law regarding deathbed transfers has been uneven. An IRS challenge was successful in *Estate of Murphy v. Commissioner*, T.C. Memo. 1990-472 (cited in the Preamble to the Proposed Regulations), in which the Tax Court found that "the facts in this case are extreme" and concluded that 49.65 percent of the stock of a family-controlled corporation remaining after two transfers, each of 0.88 percent of the stock, 18 days before the transferor's death should be valued without a minority discount to be "consistent with the established principle that transactions with no purpose or effect other than to reduce taxes are disregarded for Federal tax purposes."

But a similar IRS challenge was unsuccessful in *Estate of Frank v. Commissioner*, T.C. Memo. 1995-132, in which the Tax Court refused to include in the decedent's gross estate (a slightly different formulation of the issue than the *Murphy* court had used) the value of 12.18 percent of the stock of a close-held corporation that had been transferred only two days before the decedent's death, reducing the donor's stockholdings from 50.30 percent to 38.12 percent. The *Frank* court valued the remaining 38.12 percent of the stock as a minority interest.

These contrasting results illustrate the subjectivity, and the unpredictability, of identifying and proving the existence and effect of a deathbed transfer. Therefore, ACTEC also understands the interest expressed in the Preamble in establishing a bright-line test for these kinds of transfers.

ACTEC is concerned, however, that a period of three years before death (aside from not self-evidently mirroring the 18-day period ruled upon by the court in *Murphy*) does not correspond to any period that an estate planning professional would typically treat as a transferor's last days for planning purposes. In ACTEC's experience, while estate planning is always sensitive to the mortality of all clients, many (if not most) transfers that turn out to have occurred within three years before the transferor's death are not made with a deathbed motivation. Specifically, those transfers are typically not made on the premise that the transferor's sacrifice of enjoyment, income, control, or other benefits of the transferred property will be nominal or inconsequential. The Service's life expectancy tables tell us that individuals who are 95 years of age or younger all have life expectancies in excess of three years. A requirement to survive three years to qualify for the exception in Reg. §25.2704-1(c)(1) would "catch" many transfers that have no deathbed motivation at all, including cases, frequently seen by estate planning professionals, in which a perfectly healthy transferor dies unexpectedly from an accident or other similar cause.

Although the Preamble to the Proposed Regulations cites section 2035(a) as “a bright-line, three-year test,” it cites nothing – and ACTEC knows of nothing – to suggest that Congress originally chose a three-year period with the intention of emulating a deathbed outlook. Moreover, ACTEC questions whether Treasury would be *prudent*, or perhaps even *authorized*, to select a period originally prescribed *by Congress*, as the model for a period to be prescribed *by regulations* for the stated purpose of emulating a deathbed outlook.

ACTEC believes that the search for appropriate models should be guided by the precedent of other regulations in which the imminence of death has been explicitly considered. What comes most readily to mind are the regulations under section 7520, which itself is cited by Congress in the legislative history of chapter 14. Those regulations are obliged by section 7520(c)(2) “to take into account the most recent mortality experience available.” While the regulations are indeed premised on “mortality data most recently available from the United States census” (Reg. §§1.7520-1(b)(2), 20.7520-1(b)(2) & 25.7520-1(b)(2)) – that is, data reflecting the population in general – they provide the following “bright-line” exception:

The mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life dies or is terminally ill at the time the gift is completed. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year. However, if the individual survives for eighteen months or longer after the date the gift is completed, that individual shall be presumed to have not been terminally ill at the date the gift was completed unless the contrary is established by clear and convincing evidence.

Reg. §25.7520-3(b)(3). Reg. §§1.7520-3(b)(3) and 20.7520-3(b)(3)(i) are similar.

Following that precedent, ACTEC recommends that the required period of survival in Prop. Reg. §25.2704-1(c)(1) be changed from three years to one year. A period of one year would align much more closely with a period in which the concern for an imminent death might inform gift-giving and similar transactions. Of course, during a one-year period, or even a one-month period, it is still likely that some healthy transferors will die. Although that risk is unavoidable when any bright-line test replaces a facts-and-circumstances test, ACTEC believes that a period of one year would more closely approximate the period during which transferors are likely to engage in “deathbed” planning. We also recommend that the regulations provide that the lapse rule not apply if the death of the transferor was not expected to occur during the one-year period after the transfer, using the same factors applied for purposes of section 7520.

ACTEC believes that these modifications would be consistent – more so than the Proposed Regulations as drafted – with the stated motivation of the rule in the concern for the case where “the inter vivos transfer that results in the loss of the power to liquidate occurs on the decedent’s deathbed.” 81 Fed. Reg. at 51414.

b. Clarification of the Rule's Prospective Application Only

Prop. Reg. §25.2704-4(b)(1) provides that the changes to be made by Prop. Reg. §25.2704-1 apply to lapses of rights created after October 8, 1990, “occurring on or after the date these Proposed Regulations are published as the Final Regulations in the Federal Register.” Prop. Reg. §25.2704-1, however, provides that the lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor’s death is “treated as a lapse occurring” on the transferor’s date of death. A strict reading of these two provisions, including the use of the word “occurring” in both provisions, suggests that the Proposed Regulations are intended to apply to any transfer that results in a lapse of a voting or liquidation right, regardless of when the transfer is actually made (even if made before the Proposed Regulations were published) if the transferor dies (i) within three years of the transfer and (ii) death occurs after the Proposed Regulations are published as final in the Federal Register.

ACTEC is reluctant to assume that Treasury intended the Proposed Regulations to apply to transfers made before the Proposed Regulations are published in final form. If this was not Treasury’s intention, ACTEC recommends that Prop. Reg. §25.2704-4 should be modified to confirm that the proposed change to Reg. §25.2704-(1)(c) applies only to transfers that actually occur on or after the effective date of the Final Regulations.

7. Prop. Reg. §25.2704-1(c)(2). Exceptions

Reg. §25.2704-1(c)(2)(i)(A) provides that section 2704(a) does not apply to the lapse of a liquidation right to the extent that the holder (or the holder’s estate) and members of the holder’s family cannot immediately after the lapse liquidate an interest that the holder held directly or indirectly and could have liquidated prior to the lapse. Prop. Reg. §25.2704-1(c)(2)(i)(B) provides that, for purposes of making this determination, an interest held by a person other than a member of the holder’s family (a non-family-member interest) may be disregarded. Whether a non-family-member interest is disregarded would be determined under Prop. Reg. §25.2704-3(b)(4), applying that section as if, by its terms, it also applies to the question of whether the holder (or the holder’s estate) and members of the holder’s family may liquidate an interest immediately after the lapse.

Prop. Reg. §25.2704-3(b)(4) provides that non-family-member interests would be generally ignored unless (A) the interest has been held by the non-family member for at least three years immediately before the transfer; (B) the interest constitutes at least 10 percent of the value of all of the equity interests in the corporation, or at least a 10-percent interest in the business entity (for example, a 10-percent interest in the capital and profits of a partnership) for a business entity other than a corporation; (C) the total of the equity interests in the entity held by non-family members constitutes at least 20 percent of the value of all of the equity interests in the corporation, or at least 20 percent of all of the interests in the non-corporate entity; and (D) each non-family member has a put right as described in Prop. Reg. §25.2704-3(b)(6).

Under the Proposed Regulations, if a transferor who has the ability to liquidate an interest in the entity makes a transfer within three years of death, and if as a result of the transfer, the transferor’s ability to liquidate the interest lapses, the lapse is treated as a transfer if the transferor (or the transferor’s estate) and members of the transferor’s family actually have the

power to liquidate the transferred interest immediately after the lapse or, would have had the ability to liquidate the entity if the interests of non-family members who fail to meet the requirements of Prop. Reg. §25.2704-3(b)(4) are ignored.

ACTEC addresses concerns about the new disregarded non-family interest rule later in these Comments. However, ACTEC recommends here that the proposed disregarded non-family interest rule is particularly inappropriate when combined with the lapse rule under Prop. Reg. §25.2704-1(a)(1). Suppose, for example, that the holder of a 50 percent interest in a limited liability company whose governing instrument requires the consent of 50 percent of its members to liquidate a membership interest sells a 25 percent interest to an unrelated person within three years of death. The other 50 percent of the membership interests in the company are held by the individual's children. After the sale, the company remains an entity controlled by the transferor and the transferor's children but they cannot liquidate the transferred interest because it is not owned by any member of the family. Yet, the disregarded non-family-member interest rule does not permit taking this fact into account because the unrelated purchaser has not held the interest for three years and does not have a put right.

8. Prop. Reg. §25.2704-1(d). Amount of the Transfer

Section 2704(a)(2) provides that, when section 2704(a) applies to cause a lapse of a voting or liquidation right to be treated as a transfer, the amount of the transfer equals the excess (if any) of the "value" of all interests in the entity held by the transferor immediately before the lapse (determined as if the lapsed rights were non-lapsing) over the "value" of such interests immediately after the lapse.

Reg. §25.2704-1(d) provides:

Amount of transfer. The amount of the transfer is the excess, if any, of—

- (1) The value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right was nonlapsing); over
- (2) The value of the interests described in the preceding paragraph immediately after the lapse (determined as if all such interests were held by one individual).

It is unclear, for two reasons, how this valuation rule applies to a transfer within three years of the death of the transferor. The first source of uncertainty is lack of clarity as to when the values are to be determined. One application would result in values determined on the date of the actual transfer that caused the lapse. Another would result in values determined on the date of death, which is the date that the lapse is deemed to have occurred under the three-year rule. If the values are determined on the date of the transferor's death, post-transfer changes in the market value of the retained and transferred interest would have to be taken into account. Because the purpose of the rule is to capture the loss of value attributable to the lapse, rather than post-transfer changes in value, ACTEC recommends that Reg. §25.2704-1(d) be modified to clarify that the value of the transfer should be determined as of the date of the actual transfer.

These recommendations with respect to Reg. §25.2704-1(d) could be implemented, for example, by adding the following at the end of Reg. §25.2704-1(d):

In the case of the lapse of a voting or liquidation right that actually occurs prior to the date of the transferor's death but that is deemed under Reg. §25.2704-1(c)(1) to occur on the date of the transferor's death, the amount of the transfer shall be determined as of the date of the actual transfer and shall be determined after giving effect to the valuation rules described in Reg. §25.2704-2 and §25.2704-3.

The second source of uncertainty is the method for determining the amount to be included in a transferor's taxable gifts as a result of a transfer within 3 years of his or her death. Section 2704(a)(2) provides that the amount to be included is the excess of the value of all interests in the entity owned by the individual before the lapse over the value of those interests after the lapse. Reg. §25.2704-1(d) provides that the post-lapse value of the interests held by the individual immediately before the lapse are to be valued "as if all such interests were held by one individual." A literal application of this provision seems to result in no decrease in value.

Suppose, for example, that the transferor T owns 100 percent of a limited liability company, X. X owns investment assets worth \$1 million. T's 100% ownership gives T the power to liquidate X. If T liquidated X, T would receive assets worth \$1 million. For transfer tax purposes, T's interest in X is worth \$1 million. T gives a 25% interest in X to each of his 4 children. Each of the 25% interests, after applying appropriate discounts for lack of marketability and lack of control, is worth only \$200,000. T dies 2 weeks after making the gifts. All of T's interests in X before the transfer are worth \$1 million. All of the interests in X, previously owned by T, immediately after the transfer "determined as if all such interests were held by one individual" would also be \$1 million. The amount to be included, therefore, seems to be zero.

ACTEC recommends that the Regulations be clarified to explain how the decrease in value attributable to the lapse is to be calculated.

These comments discuss below the possibility that the manner in which the Proposed Regulations deal with applicable and disregarded restrictions could result in the elimination of minority and lack of marketability discounts. If the Final Regulations take this position, the new three-year rule will have little effect, because the transferred interest and any interest retained by the transferor would have a value equal to the liquidation value of the interests. If this is so, ACTEC recommends that the three-year rule be eliminated. If the Final Regulations dealing with applicable and disregarded restrictions do not result in the elimination of minority and lack of marketability discounts, the three-year rule should clarify that the loss of value that occurs as a result of a transfer within the three-year period will be determined after taking into account the applicable and disregarded restrictions rules, thus avoiding the possibility of double taxation.

Suppose, for example, that T owns 70% of the membership interests in L, a limited liability company. Applicable state law gives a 70% member of a limited liability company the power to compel liquidation of the company. It also provides that the limited liability company agreement of a limited liability company may permit any member to compel liquidation. L owns \$10 million worth of real estate. If T exercised the right to compel liquidation, T would receive

assets worth \$7 million. At a time when T has a life expectancy of 6 months, T gives a 25 percent membership interest in L to T's child C. T dies one week after the transfer. T's transfer of a 25 percent interest causes the lapse of T's right to liquidate L and results in a loss of value. Assume that under current valuation principles, the amount of the loss would be \$2.1 million, 30 percent of \$7 million. After the transfer, the 45% interest retained by T and the 25% interest given to C had an aggregate value of \$4.9 million. Suppose that the effect of disregarding the restrictions on T's and C's right to liquidate results in a post-transfer value of the 70 percent interest of \$5.25 million rather than \$4.9 million. As a result, the loss in value subject to tax under section 2704(a) should be only \$1.7 million rather than \$2.1 million.

9. Prop. Reg. §25.2704-2(a). Transfers Subject to Applicable Restrictions: In General

See discussion above related to Prop. Reg. 25.2701-2(b)(5).

10. Prop. Reg. §25.2704-2(b)(1). Applicable Restriction Defined: In General

Prop. Reg. §25.2704-2(a) provides that when an individual transfers an interest in an entity that is controlled by that individual and members of that individual's family to or for the benefit of a member of that individual's family, any applicable restriction is disregarded in valuing the transferred interest. Prop. Reg. §25.2704-2(b) defines an applicable restriction as any limitation imposed on the ability to liquidate the entity if, after the transfer, the limitation either lapses or may be removed by any combination of the transferor or members of the transferor's family.

This portion of the Proposed Regulations raises two concerns. First, it does not specify the identity of the person whose ability to liquidate the entity is limited. Generally applicable principles of valuation give equal weight to concerns of both a willing buyer and a willing seller. Nevertheless, when considering the impact of a post-transfer restriction on the ability to liquidate the entity, that issue would be of greater concern to the transferee. A third party purchaser who has the ability to require a liquidation of an entity after purchase of an interest in that entity would very likely be willing to pay a different price than if there were no ability to require the liquidation of the entity. The purchaser would not be particularly interested in whether any other person has the ability to require a liquidation of the entity.

Second, Prop. Reg. § 25.2704-2(b) does not specify the time within which the limitation on the ability to liquidate the entity must lapse in order for the limitation to be treated as an applicable restriction. ACTEC assumes that the intention is to reach lapses of restrictions that will occur either immediately after the transfer, or lapses that may occur within a short period of time after the transfer. It is unrealistic to conclude that a limitation on the ability to liquidate the entity that will not occur, for example, for 99 years after the transfer should be disregarded in determining the value of the transferred interest.

To resolve these concerns, ACTEC recommends that Prop. Reg. §25.2704-2(b) be modified to read as follows:

The term applicable restriction means a limitation on the transferee's ability to liquidate the entity, in whole or in part (as opposed to the transferee's interest in the entity), if, within a period of [six] months or fewer, the restriction either lapses

or may be removed by the transferor, the transferor's estate, or members of the transferor's family, either alone or collectively. See § 25.2704-3 for restrictions on the ability to liquidate a particular holder's interest in the entity.

11. Prop. Reg. §25.2704-2(b)(2). Source of Limitation

Prop. Reg. §25.2704-2(b)(2) provides that the source of the applicable restriction is irrelevant. This language seems to be premised on an underlying assumption that, unless one of the exceptions described in Prop. Reg. §25.2704-2(b)(4) applies, a person who acquires an interest in a family-controlled entity is deemed to have the ability to liquidate the entity, but that the presence of family members may somehow prevent that person from exercising that ability.

For example, a typical state law authorizing the creation of corporations provides that the liquidation of a corporation, in the absence of the approval of the board of directors, requires the unanimous consent of all shareholders. See, for example, Delaware General Corporation Law §275(c). If all of the shareholders were family members, family members would have the power to remove the restriction either by amending the corporation's governing instrument to permit individual shareholders to require that the corporation be liquidated or by liquidating the corporation. It is unclear, however, whether this typical provision would constitute an applicable restriction on a transferee's ability to require the liquidation of the corporation.

12. Prop. Reg. §25.2704-2(b)(4)(i) and Prop. Reg. §25.2704-3(b)(5)(ii). Commercially Reasonable Restrictions

Both the applicable and disregarded restriction provisions of the Proposed Regulations provide exceptions for commercially reasonable restrictions imposed by certain persons who provide financing to the family controlled entity. This exception is based on section 2704(b)(3)(A), which provides that an applicable restriction shall not include "any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either. . . ."

The Proposed Regulations, which are substantially similar to the existing Treasury Regulations, depart from the text of section 2704(b)(3)(A) in three important ways. First, they make it clear that the "financing" referred to in 2704(b)(3)(A) includes equity as well as debt financing. This clarification is welcome.

Second, the Proposed Regulations provide that only financings that provide capital for an entity's trade or business operations will qualify for the exception. This construction is difficult to rationalize. Nothing in section 2704 suggests that greater respect should be given to financing used to advance an entity's business purposes than to financings undertaken for any other legitimate purpose.

ACTEC recommends that the text of the first sentence of Prop. Reg. §25.2704-2(b)(4)(i) be changed to provide as follows:

An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity,

whether in the form of debt or equity, for the entity's trade or business or investment purposes.

Similarly, ACTEC recommends that the text of the first sentence of Prop. Reg. §25.2704-3(b)(5)(ii) be changed to provide as follows:

A disregarded restriction does not include a commercially reasonable restriction on redemption imposed by an unrelated person providing capital to the entity, whether in the form of debt or equity, for the entity's trade or business or investment purposes.

Third, the Proposed Regulations expand the number of persons whose commercially reasonable restrictions imposed on financings will be treated as applicable or disregarded restrictions. Section 2704(b)(3)(A) includes within the prohibited class of financiers only (a) the transferor and transferee, (b) persons related to either of the transferor and transferee and (c) members of the family of the transferor and transferee. The Code section treats persons who are related to individual members of the family of the transferor but not related to either the transferor or transferee as permitted financiers.

The Proposed Regulations refer to section 267(b) as the source for testing whether one person is related to another and excludes persons who are related to members of the family of either the transferor or transferee as well as to those related directly to the transferor or transferee.

Suppose, for example, that T has made a transfer of shares in a family controlled corporation to her child C. T's uncle, U, (the brother of T's father F) had previously made a loan to the corporation in order to enable it to purchase inventory. The terms of the loan prohibit the corporation from redeeming shares while the loan is outstanding. Assume this prohibition is commercially reasonable under the circumstances. Section 2704(b)(3)(A) would respect the restrictions because U is not related, within the meaning of section 267(b), to either T or C. The Proposed Regulations would not, because U is related, within the meaning of section 267(b), to F and F is a member of T's and C's family.

ACTEC recommends that this portion of the Proposed Regulations be modified so that it is consistent with section 2704(b)(3)(A). Consideration could be given to the following suggested language:

An unrelated person is any person who is not a member of the family of either the transferor or the transferee and whose relationship to the transferor or the transferee is not described in section 267(b), provided that for purposes of this section the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

13. Prop. Reg. §25.2704-2(b)(4)(ii) and Prop. Reg. §25.2704-3(b)(5)(iii). Requirement of Federal or State Law

Both the applicable and disregarded restriction terms of the Proposed Regulations provide certain exceptions, including one for restrictions imposed or required to be imposed by federal or state law. *See* Prop. Reg. §§25.2704-2(b)(4)(ii) & 25.2704-3(b)(5)(iii).

Securities laws, banking regulations, and other laws may impose restrictions. ACTEC assumes that this exception would respect restrictions in governing documents designed to comply with those laws and would appreciate a nonexclusive example confirming this assumption.

ACTEC is unaware of any federal or state law generally governing relationships among owners or between entities and owners that imposes a restriction that might otherwise be an applicable or a disregarded restriction, without allowing for an override in the governing documents of the entity. The Preamble to the Proposed Regulations notes that the Tax Court in *Kerr* described the current Regulations as a regulatory expansion of the statutory exception. Yet it is difficult to the point of impossible to give meaning to the statutory language as limited in the Proposed Regulations in the context of laws generally governing relationships among owners or between entities and owners.

It is a cardinal rule of statutory construction that statutory words “cannot be meaningless, else they would not have been used.” *See, e.g., United States v. Butler*, 297 U.S. 1, 65 (1936). ACTEC understands that Treasury might have included this absolute form of exception, or interpreted the statute to do so, merely to ensure that states, or Congress, would be free to impose absolutely mandatory requirements as they saw fit. If so, ACTEC believes that an acknowledgment to that effect in the Preamble to the Final Regulations would be desirable. If ACTEC misunderstands the intent of this exception, the Final Regulations should clarify the scope of the exception.

14. Prop. Reg. §25.2704-2(b)(4)(iii). Certain Rights Under Section 2703

The Preamble to the Proposed Regulations states:

Note that, although it may appear that sections 2703 and 2704(b) overlap, they do not. While section 2703 and the corresponding regulations currently address restrictions on the sale or use of individual interests in family-controlled entities, the proposed regulations would address restrictions on the liquidation or redemption of such interests. 81 Fed. Reg. at 51417.

Prop. Reg. §§25.2704-2(b)(4)(iii) & 25.2704-3(b)(5)(iv) state that an option, right to use property, or agreement that is subject to section 2703 is not a disregarded or applicable restriction. However, Prop. Regs. §§25.2704-2(b)(2) & 25.2704-3(b)(2) state that the source of a limitation could include agreements that are typically subject to section 2703, including buy-sell and redemption agreements. These provisions seem inconsistent, and it is not clear when section 2703 would apply and when section 2704 would apply.

Section 2703(a) provides that, for transfer tax purposes, the value of property is determined without regard to any option, agreement, or other right to acquire or use the property at a price less than its fair market value (without regard to the option, agreement, or right), or any restriction on the right to sell or use the property. Common examples of such a restriction are arrangements commonly referred to as “buy-sell agreements” and “redemption agreements.” Section 2703(b) provides a statutory exception to the application of section 2703, when the following three criteria are met: the agreement (1) is a bona fide business arrangement; (2) is not a device to transfer property to family members for less than full and adequate consideration; and (3) contains terms that are comparable to those found in similar arm’s-length transactions.

It is unclear what “subject to” section 2703 means in the context of the Proposed Regulations. Readers could interpret that phrase to mean “compliant with” section 2703 when meeting the exceptions outlined in section 2703(b). An equally plausible reading could be that if an agreement constitutes an option, agreement, or other right to acquire or use the property at a price less than its fair market value (without regard to the option, agreement, or right), or any restriction on the right to sell or use the property as described in section 2703(a), but *does not meet* the exception in section 2703(b), so that it is disregarded in valuing the subject property under section 2703, it would nevertheless be “subject to” section 2703. ACTEC requests that the Regulations clarify what it means to be “subject to” section 2703.

A buy-sell agreement can take many forms, with many provisions. A buy-sell agreement generally restricts transfers to third parties and gives other owners or the entity the option to purchase the interest upon terms and for the price stated in the agreement. The price set out in the agreement would be the highest price at which the owner could reasonably expect to sell the interest. A buy-sell agreement likely also would restrict the liquidation or redemption of an interest in the entity in that no *right* of liquidation or redemption is given, and any *right* that might be given under state law is negated. Sometimes, a buy-sell agreement would include a right of redemption, but at the same price and terms. These provisions are often overlapping and intertwined. ACTEC is concerned that Prop. Reg. §§25.2704-2(b)(4)(iii) & 25.2704-2(b)(5)(iv) could be read to bifurcate a buy-sell agreement into separate parts, with one part addressing the price ceiling and setting that value for transfer tax purposes if the exception under section 2703 is met, and the other part addressing restrictions on liquidation or redemption of an interest in an entity then subject to section 2704. On the other hand, those same provisions could mean that if a buy-sell agreement meets the exception under section 2703, then no provisions in that agreement will be considered disregarded or applicable restrictions under section 2704.

The latter approach appears to more closely comply with historical Treasury policy. If a buy-sell agreement for a family-controlled entity meets the three requirements of the exception in section 2703(b), including specifically the “comparable to similar arm’s-length transactions” prong, a transferor of an interest in that entity should not be penalized with a higher value for transfer tax purposes than would an interest in a comparable non-family-controlled entity. In addition, the latter approach allows consistency in the valuation of the interest so that only one transfer tax valuation applies to interests in that entity.

If the “do not overlap” provision is intended as described in the preceding two paragraphs of these Comments, ACTEC recommends that the Proposed Regulations clarify that a buy-sell agreement or any other option, agreement, or right to use property at a price less than fair market

value that is described in section 2703 and meets the exception in section 2703(b) will not, in turn, be considered a disregarded or applicable restriction under section 2704.

ACTEC suggests that the text of this exception be changed to read as follows:

An option, right to use property, or agreement that is described in §2703(b) is not an applicable restriction.

15. Prop. Reg. §25.2704-2(e) and §25.2704-3(f). Effect of Disregarding an Applicable Restriction and a Disregarded Restriction

Prop. Reg. §25.2704-2(e) states, “[i]f an applicable restriction is disregarded, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction (whether in the governing documents, applicable law, or both) does not exist.” Similarly, Prop. Reg. §25.2704-3(f) provides, “[i]f a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized.”

Prop. Reg. §25.2704-2(b)(1) provides that the term “applicable restriction” applies only to a limitation that either lapses or may be removed by the transferor, the transferor’s estate, and/or any member of the transferor’s family, either alone or collectively. Prop. Reg. §25.2704-3(b)(3) likewise provides that a restriction is a disregarded restriction only to the extent that the restriction either will lapse by its terms at any time after the transfer or may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor’s estate, and members of the transferor’s family. Prop. Reg. §§25.2704-2(b)(3) & 25.2704-3(b)(3) both provide that the manner in which the restriction may be removed is irrelevant, describing methods of removal that include, for example, revising governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents or terminating the entity.

Many commentators have interpreted the broad language in Prop. Reg. §25.2704-2 that describes the manner in which restrictions might be removed to suggest that all entities to which Prop. Reg. §25.2704-2 applies must be treated as though the owners have the ability to liquidate the entity. Commentators have interpreted similarly the language of Prop. Reg. §25.2704-3 to provide that all interests to which Prop. Reg. §25.2704-3 applies must in effect be regarded as though holders of interests have a right to “put” their interests in the entity at minimum value according to the terms outlined in Prop. Reg. §25.2704-3(b)(1).

This interpretation is likely based on the theory that any one or more of the transferor and members of the transferor’s family might revise governing documents to provide liquidation rights to all owners or to override prescribed restrictions that preclude liquidation rights or rights to obtain minimum value by explicitly granting those rights to owners. Some commentators have interpreted Prop. Reg. §§25.2704-2(b)(3) & 25.2704-3(b)(3) to mean that a failure by the transferor and/or members of the transferor’s family to adopt such rights might itself be treated as a disregarded restriction.

State laws that permit the creation of an entity typically also provide mechanisms for terminating the entity. As noted in the discussion of Prop. Reg. §25.2704-2(b)(4)(ii) above, ACTEC is unaware of any federal or state law governing relationships among owners or between entities and owners that imposes restrictions that might otherwise be applicable or disregarded restrictions, without allowing for an override in the governing documents of the entity. Commentators question whether a state law that grants entities continuity of life (which generally applies to entities other than general partnerships) constitutes a provision restricting the liquidation of the entity or the holder's interest in the entity. It is unclear whether the Proposed Regulations are meant to treat state law procedures for terminating an entity, which require various thresholds of consent, as constituting provisions restricting the liquidation of the entity. If applicable law permits (or does not forbid) the creation of a class of equity that can be liquidated at will but places barriers to granting these liquidation rights, it is equally unclear whether any provisions creating the barriers constitute applicable restrictions.

Clause (ii) of Example 1 in Prop. Reg. §25.2704-3(g) illustrates the effect of disregarding restrictions and does not specifically suggest that the owner of a business interest is deemed to hold any new right. After describing a scenario involving a disregarded restriction, it concludes:

Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest determined under generally applicable valuation principles taking into account all relevant factors affecting value including the rights determined under the governing documents and local law and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise.

However, this example does not address the applicability of default state laws that might impact the termination or liquidation of the entity or the liquidation of the holder's interest in the entity.

Clause (ii) in Examples 4 and 5 in Prop. Reg. §25.2704-3(g) contain similar language. None of the examples provides that the effect of disregarding the disregarded restriction is to deem the holder of the interest to have a right to put the interest to the entity for minimum value upon the terms outlined in Prop. Reg. §25.2704-3(b)(1). None of the examples in Prop. Reg. §25.2704-2(f) specifically suggests that the effect of treating an applicable restriction as though it does not exist is to deem holders of interests in the entity to hold the right to liquidate the entity. *The level of confusion and disagreement on this point throughout the estate planning community, however, is deeply troubling and calls for a need for clarity in the Final Regulations.*

Prop. Reg. §§25.2704-2(e) & 25.2704-3(f), along with Examples 1, 4, and 5 in Prop. Reg. §25.2704-3(g), provide that if an applicable or disregarded restriction is found, and if no other exception applies, the restriction is treated as though it does not exist. The Proposed Regulations do not explicitly purport to substitute any other provisions in place of the ignored restrictions. Neither do the Proposed Regulations or examples treat the failure by the transferor or the members of the transferor's family to grant liquidation rights or "put" rights at minimum value as an applicable or disregarded restriction. Again, however, these examples do not address the applicability of default state laws that might impact the termination or liquidation of the entity or the liquidation of the holder's interest in the entity, applicability that could be "removed" by the holder's family by simply overriding the default state law. The use of the word "otherwise" (as

an apparent addition to “governing documents” and “local law”) in Prop. Reg. §25.2704-3(f), repeated in Examples 1(ii), 4(ii), and 5(ii) of Prop. Reg. §25.2704-3(g), fuels these concerns. As discussed below, some commentators have understandably interpreted the use of the term “minimum value” as purporting to define the actual “minimum value” for transfer tax purposes.

ACTEC recommends that the provisions of the Proposed Regulations clarify whether the effect of ignoring restrictions requires all equity interests to be valued at net liquidation value, *i.e.*, as if each member of the family had the right to force a liquidation of the entity or to force a liquidation of his or her interest in the entity for its minimum value (a hypothetical “put right”), and, if not, how interests are to be valued when restrictions are ignored. Prop. Reg. §§25.2704-2 & 25.2704-3 only require that valuations be made ignoring applicable or disregarded restrictions and thereafter require only that the fair market value of the transferred interest be determined under generally applicable valuation principles as if the disregarded restriction did not exist in the governing documents or in mandatory local law.

Section 2704(b)(1) directs that applicable restrictions be disregarded. Section 2704(b)(4) gives Treasury the authority only to disregard a provision of a governing document, or a state law restriction (and then only if that governing document provision, or state law restriction, does not ultimately reduce the value of such transferred interest to the transferee). Neither section confers upon Treasury the authority to impute or deem into existence hypothetical liquidation, “put,” or other state law property rights or assumptions in substitution for the disregarded restrictions. ACTEC is concerned that, without clarification, the Proposed Regulations’ disregard of default entity termination provisions under state law and default rules regarding liquidation of entities or interests in entities could be held by a court to have the equivalent effect of treating holders as though they have puts or other similar rights.

Because the language in the Proposed Regulations has generated significant confusion, ACTEC requests that the language in Prop. Reg. §25.2704-2(e) and in Prop. Reg. §25.2704-3(f) regarding the effect of ignored restrictions be supplemented. The proposed supplemental language would clarify the Proposed Regulations by stating how interests are to be valued when restrictions are ignored, first by clarifying whether the provisions outlined in Prop. Reg. §25.2704-2(b)(1) create a liquidation right in entities controlled by the transferor and members of the transferor’s family and whether the rights described in Prop. Reg. §25.2704-3(b)(1) are to be treated as having been granted with regard to interests in entities controlled by the transferor and members of the transferor’s family and, even more importantly, by explaining what impact disregarding an applicable restriction or a disregarded restriction is intended to have on the valuation of a non-controlling interest in an entity. Specifically, the supplemental language would clarify that (i) nothing in the Proposed Regulations is intended to create specific substantive rights with regard to the entity or interest in question; (ii) nothing in the Proposed Regulations is intended to require the valuation of such interests as if they carried such substantive rights; and (iii) the failure of the transferor or members of the transferor’s family to grant specific substantive rights (including liquidation rights) not otherwise required by state law will not be considered an applicable or disregarded restriction.

In addition, if the Proposed Regulations are clarified in the manner suggested in the preceding paragraphs, it is equally important that the Proposed Regulations describe what impact disregarding an applicable restriction or a disregarded restriction is intended to have on the

valuation of a non-controlling interest in an entity. Without this clarification appraisers will lack sufficient guidance to determine what, if any, difference there is between (a) the value of a non-controlling interest in an entity if the entity's governing instrument provides that no holder can require the entity to redeem his or her interest and (b) the value of that interest if the holder's inability to require a redemption is to be disregarded but there is no requirement that any particular redemption price be paid.

Suppose, for example, that local law provides that no member of a limited liability company may require the company to redeem the member's interest but does permit a limited liability company's operating agreement to give members the right to require the redemption of their interests at a price set forth in the agreement. All of the membership interests in L, a limited liability company, are owned by T and members of T's family. L's limited liability agreement permits any member to require L to redeem that member's interest at a price equal to its fair market value, defined as what an unrelated person would be willing to pay for it. T transfers a 10 percent interest in L to T's child C. If the restriction on C's ability to redeem C's interest in L is to be ignored, and, at the same time, C is not to be treated as having the right to put the interest to L for its minimum value, it is not clear what, if any, effect ignoring the restriction on the right to redeem can have on valuation.

ACTEC recommends that the Final Regulations include clarifying examples on this and similar subjects.

16. Prop. Reg. §25.2704-2(f). Certain Transfers at Death to Multiple Persons

Each of Prop. Reg. §§25.2704-2(f) & 25.2704-3(e) provides that, solely for purposes of section 2704(b), if: (1) part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family; (2) part of that includible interest passes to one or more persons who are not members of the decedent's family; and (3) if the part passing to members of the decedent's family is to be valued so that either an applicable restriction or a disregarded restriction is treated as though the restriction does not exist, then the part passing to members of the decedent's family is to be treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also to be treated as a single, separate property interest. Prop. Reg. §25.2704-3(g), Example 4, provides that in the case of a decedent who holds a 98 percent limited partnership interest that passes 53 percent to the decedent's surviving spouse, 25 percent to an unrelated individual, and 20 percent to charity, then the 53 percent interest is valued without regard to any disregarded restriction, and the 25 percent and 20 percent interests are valued taking all restrictions into account. This circumstance would have the effect of increasing the marital deduction to comport with the value of the interest for purposes of inclusion in the gross estate and reducing the charitable deduction, as all restrictions would be taken into account for purposes of establishing the value of the interest both for inclusion and deduction purposes.

Although this bifurcated valuation approach creates an apparent fairness and symmetry, it also causes certain technical difficulties. In many cases, how property will be allocated to different shares of an estate is not known at the time of death or at the time the estate tax return is filed. An executor of an estate may have significant discretion to allocate property among shares

established by a decedent's estate plan. (This result is, in some ways, similar to the issues ACTEC has raised in its comments about the basis consistency rules of sections 1014(f) and 6035 (REG-127923-15), where assets could be used to satisfy interests passing from a decedent to several different persons.) As a general matter, a share qualifying for a deduction is valued for estate tax purposes at the lowest potential value that the share could have.

For example, suppose that a decedent's estate consists of a 98 percent limited partnership interest and \$100,000 in cash. Suppose the 98 percent limited partnership interest would worth \$75,000 if it passed exclusively to an unrelated person or charity, but worth \$100,000 if it passed to the decedent's surviving spouse. Suppose the residuary estate must pass 50 percent to the spouse and 50 percent to charity. It is unclear what the value of the gross estate is. On the one hand, the value of the gross estate could be \$200,000, if the partnership interest is used to satisfy the marital bequest. On the other hand, the value of the gross estate could be \$175,000, if the business interest funds the charitable bequest. Arguably, the value of the gross estate could be \$200,000, with the charitable deduction limited to \$75,000. See *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981); *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987). This valuation problem would be more acute if there were multiple family shares, some taxable and some not, if such a disposition were combined with interests in the estate not subject to section 2704(b).

Further, suppose the 50 percent interest in the previous example is divided between the surviving spouse and children, 25 percent passes to the surviving spouse, and 25 percent passes to children. It seems possible that a 25 percent interest could be valued differently than a 50 percent interest, even if certain restrictions are disregarded. It is unclear whether the marital deduction must be reduced in that case and whether that reduction would reduce the value of the gross estate. Perhaps the marital deduction would be limited to the value of a 25 percent interest in the partnership, but the value of the decedent's interest in the partnership would continue to be \$100,000 for purposes of determining the value of the gross estate.

The valuation of interests in family controlled entities may determine whether a United States Estate (and Generation-Skipping Transfer) Tax Return must be filed. It is therefore important for the Final Regulations to clarify how Code provisions based on the size of the gross estate or a component of it are to be applied where the special valuation rules under section 2704 may apply.

17. Prop. Reg. §25.2704-3. Transfers Subject to Disregarded Restrictions

Section 2704(b)(4) authorizes Treasury to issue regulations to "provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if the 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."

Prop. Reg. §25.2704-3 creates a new set of rules under which certain restrictions will be disregarded in valuing property for transfer tax purposes and sets forth the consequences of disregarding the restrictions.

Prop. Reg. §25.2704-3(a) provides, in part:

If an interest in a corporation or a partnership (an entity)...is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any restriction described in paragraph (b) of this section is disregarded, and the transferred interest is valued as provided in paragraph (f) of this section.

A disregarded restriction is defined in Prop. Reg. §25.2704-3(b)(1), in general, as “a limitation on the ability to redeem or liquidate an interest in an 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....” Prop. Reg. §25.2704-3(f) provides, in part, that “[i]f 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.”

Prop. Reg. §25.2704-3 must be interpreted in light of the regulatory authority granted under section 2704(b)(4). The application of Prop. Reg. §25.2704-3 must be premised upon two findings: first, that the restriction in question has the effect of reducing the value of the transferred interest; and second, that the restriction in question does not ultimately reduce the value of the interest to the transferee.

Prop. Reg. §25.2703-3(b)(3) provides that a restriction is a disregarded restriction only to the extent that the restriction either will lapse by its terms at any time after the transfer or may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family. The Proposed Regulations appear to presume that any restriction that lapses or that may be removed by the transferor, the transferor's estate, and members of the transferor's family will have the effect of reducing the value of the transferred interest. This presumption is unjustified in many situations. For example, the right to liquidate an interest might reduce the value of the entire entity and, in turn, reduce the value of the interest transferred – certainly the case with many an operating business. This matter is discussed in more detail in the part of these Comments on the meaning of “minimum value.” Treasury should provide rules that establish when the limitation on the ability to liquidate an interest will reduce the value of the interest transferred to the transferee.

In many instances, the premise that appears to underlie the Proposed Regulations is false. As a result, ACTEC recommends that Prop. Reg. §25.2704-3 provide an exception for those times when a taxpayer is able to demonstrate that the restriction will not be removed or that the likelihood of its removal is very remote (such as where there is disharmony in the family or where the family believes it is not in its best interests to liquidate interests). Alternatively, the Final Regulations could simply make explicit that the application of “generally applicable valuation principles” contemplated by Prop. Reg. §§25.2704-2(e) and 25.2704-3(f) if a restriction is disregarded would ordinarily include the appraiser's assessment of such family dynamics in evaluating the likelihood of a redemption on favorable terms or the likelihood of any redemption at all. Without these modifications, concerns will persist that the statutory

standard for ignoring a disregarded restriction that “does not ultimately reduce the value of such interest to the transferee question” has not been met.

18. Prop. Reg. §25.2704-3(a). In General

Whatever impact the Proposed Regulations are intended to have on the valuation of interests in family controlled entities, the impact will fall equally on those individuals whose actions contributed to the creation of the restrictions and those who played no role in their creation.

When an individual who has the power to dispose of an asset for its full fair market value voluntarily takes steps to relinquish that power by placing the asset in an entity over which the transferor lacks control or by disposing of that portion of the asset that conferred the power to dispose of the entire asset for fair market value, a regulation that prevents that individual from claiming valuation discounts resulting from those actions is understandable. On the other hand, it may not be appropriate to treat those individuals who played no role in creating the restrictions in the same manner. Those individuals may never have had any access to the underlying wealth of the entity. Subjecting them to transfer tax on a value determined without regard to any applicable or disregarded restrictions is arguably inconsistent with the purpose of a tax imposed on the transfer of an individual’s wealth.

Consider the following example: G dies owning 10 percent of the membership interests in a family-controlled limited liability company that owns a portfolio of marketable securities worth \$10 million. G received the 10 percent interest as a distribution from a trust that terminated several years ago when G’s mother died. The other 90 percent of the company is owned by G’s father and G’s siblings. G has no right to require the company to redeem G’s interest. If no person would be willing to purchase G’s 10 percent interest for more than \$650,000, it is difficult to justify treating G’s membership interest at any value higher than \$650,000.

ACTEC recommends that the application of the proposed disregarded restriction rules be limited to those individuals who at one time had the power to remove the restrictions and lost that power as a result of their own transfers of interests in the family-controlled entity.

As in the example, such an exception is likely to benefit transferees in younger generations when they themselves make transfers to still younger generations. ACTEC believes that if there is a prime “target” of the Proposed Regulations, it is likely to be the restriction that is temporary – that is in effect only long enough to provide a transfer tax benefit to those family members who created the structure – not the restriction that lasts a generation, as in the example. The limitation ACTEC proposes would not prevent the Proposed Regulations from applying to their likely target.

19. Prop. Reg. §25.2704-3(b)(1). Disregarded Restrictions Defined: In General

In identifying “disregarded restrictions,” Prop. Reg. §25.2704-3(b)(1)(ii) employs the term “minimum value,” with respect to an interest in an entity. Any provision that limits or permits the limitation of the amount that may be received by the holder of an interest to an amount that is less than its minimum value is a disregarded restriction. The term “minimum

value” is defined as the interest’s share of the net value of the entity determined on the date of liquidation or redemption of the interest. The “net value” of the entity is the fair market value, as determined under section 2031 or section 2512 and the regulations thereunder, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for the purpose of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations were claims against a decedent’s estate. The minimum value of the interest is the net value of the interest multiplied by the interest’s share of the entity. The interest’s share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity. The minimum value rule provides a look-through rule in the event the entity holds an interest in another entity that, if the transferor held the interest directly, would be subject to section 2704(b).

Prop. Reg. §25.2704-3(b)(1)(ii) provides, in the case of a testamentary transfer, that if the entity holds an operating business, Reg. §20.2031-2(f)(2) (relating to estate tax value of shares of stock when actual sale prices and bona fide bid-and-asked prices are lacking) or Reg. §20.2031-3 (relating to estate tax valuation of businesses in testamentary transfers) applies. It further provides, in the case of an inter vivos transfer, that Reg. §25.2512-2(f)(2) (relating to gift tax value of shares of stock when actual sale prices and bona fide bid-and-asked prices are lacking) or Reg. §25.2512-3 (relating to gift tax valuation of businesses in inter vivos transfers) applies. However, even in the case of an operating business, Prop. Reg. §25.2704-3(b)(1)(ii) provides that the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations were claims against a decedent’s estate. “Minimum value” seems to be a novel invention of these Proposed Regulations, never before encountered in the Internal Revenue Code, the Regulations, or in actual practice. The Proposed Regulations nevertheless use this new concept of minimum value as a litmus test for measuring whether restrictions or interests are to be disregarded.

The minimum value rule is applicable for purposes of determining whether an interest has a sufficient put right such that it will not be deemed subject to a disregarded restriction. As discussed above, the minimum value rule is also to be applied to determine whether a non-family-member interest is disregarded by reason of an insufficient put right – that is, one that does not comply with Prop. Reg. §25.2704-3(b)(6), which requires that the holder be entitled to receive cash and/or property with a value at least equal to minimum value as of the date of liquidation or redemption of the holder’s interest.

Further, the minimum value rule is relevant for purposes of defining an applicable restriction under section 2704(b). Under Prop. Reg. §§25.2704-2(b)(4)(iv) & 25.2704-3(b)(5)(v), a restriction is not an applicable restriction for purposes of section 2704(b) if each holder of an interest in the entity has a put right at minimum value, as described in Prop. Reg. §25.2704-3(b)(6).

Under section 2704(a), the lapse of a voting or liquidation right in an entity is treated as a transfer for transfer tax purposes if the entity is controlled by the holder and/or members of the holder’s family immediately before and after the lapse. The Regulations currently provide, in effect, that section 2704(a) does not apply to the lapse of a liquidation right to the extent that the holder (or the holder’s estate) and members of the holder’s family cannot immediately after the

lapse liquidate an interest that the holder held directly or indirectly and could have liquidated prior to the lapse. Under Prop. Reg. §25.2704-1(a)(2)(i)(B), whether an interest can be liquidated immediately after the lapse is determined without regard to a disregarded non-family-member interest, which would include one that fails to hold a put right at minimum value.

Prop. Reg. §25.2704-3(b) defines a disregarded restriction as a limitation on the ability to redeem or liquidate an interest in an entity described therein 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 (disregarding certain non-family-member interests), either alone or collectively. Under Prop. Reg. §25.2704-3(b)(1)(ii), a provision that limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of an interest in the entity to an amount that is less than "minimum value" is a disregarded restriction if it can be removed by the transferor or any member of the transferor's family or is deemed to be capable of being so removed because the interests of non-family-members are disregarded.

Prop. Reg. §25.2704-3(b)(1) does not include the transferor's estate among those who must have the power to remove a restriction in order for it to be considered a "disregarded restriction," although a corresponding definitional provision in Prop. Reg. §25.2704-2(b)(1) does include the transferor's estate. It is not clear whether the omission is intentional or, if it is intentional, what prompted it.

The Preamble to the Proposed Regulations states that if a restriction is disregarded under Prop. Reg. §25.2704-3, the fair market value of the interest in the entity is determined assuming that the disregarded restriction did not exist, either in the governing instrument or in applicable state law. The Preamble goes on to state, "[f]air market value is determined under generally accepted accounting principles, including any appropriate discounts or premiums, subject to the assumptions described in this paragraph," resulting in the non-existence (for transfer tax purposes) of the disregarded restriction. This concept is reflected in Prop. Reg. §25.2704-3(f), which provides that if a restriction is disregarded, the fair market value of the transferred interest is determined under generally accepted valuation principles as if the disregarded restriction did not exist in the governing documents, local law, or otherwise. Prop. Reg. §25.2704-3(b)(5)(v) states that any restriction that would otherwise constitute a disregarded restriction will not be considered a disregarded restriction if each holder of an interest in the entity has a put right described in Prop. Reg. §25.2704-3(b)(6).

As in the case of the effect of disregarding an applicable restriction discussed above, these provisions, read together, have given some commentators the impression that if a transferor transfers an interest in a family controlled entity to or for the benefit of a family member, except in rare circumstances, the interest will be valued as if it included a put right at minimum value because any restriction on the right of withdrawal under the governing instrument, local law, or otherwise would be disregarded, including, perhaps, one that derives purely from the fact that a minority owner has insufficient authority to demand a withdrawal or redemption of a minority interest in the entity. If a disregarded restriction causes a put right to be read into governing instrument, the interest would be valued as if it required a payment of the full amount of the liquidation or redemption proceeds within six months in cash or other property (other than a

note). Only in the case of an active trade of business at least 60 percent of whose value consisted of non-passive assets of that trade of business could the liquidation or redemption proceeds be satisfied with a note.

ACTEC understands that the foregoing “deemed put” interpretation of the Proposed Regulations may not be what Treasury intended. In that case, clarification is needed to distinguish a restriction on the ability of a minority owner to liquidate or redeem a minority interest resulting from express provisions under the governing documents, local law, or otherwise, from the inability to liquidate or redeem the interest that derives purely from the fact that a minority owner lacks sufficient control to demand a liquidation or redemption of the interest or that the assets of the entity are illiquid or encumbered so that a liquidation or redemption of the interest is not practically feasible. ACTEC requests clarification as to whether the willing buyer/willing seller test continues to apply to establish the fair market value of the transferred interest.

The minimum value of an interest is determined by reference to the net value of the entity, which in turn is defined to mean the transfer tax value of the “property” held by the entity, reduced by certain obligations. ACTEC requests clarification as to whether the minimum value rule contemplates that the value of the entity would be established by valuing each property held by the entity separately. For example: where an entity owns a series of rental properties, minimum value of the entity could be established by multiplying the percentage interest held by the aggregate fair market value of each property valued separately, without regard to the relationship among them. Or, minimum value of the entity could be established by the additional value potentially represented by the group of properties owned. ACTEC requests clarification as to the method contemplated by Treasury in this regard.

In addition, ACTEC requests guidance as to how the minimum value rule would be applied in the case of a service business with few assets, and whether such a business would be treated as an “operating business,” as discussed below.

Prop. Reg. §25.2704-3(b)(1)(ii) provides, “if the entity holds an operating business, the rules of §20.2031-2(f)(2) or §20.2031-3 of this chapter apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or §25.2512-3 apply in the case of an inter vivos transfer.” ACTEC requests clarification on the meaning of the phrase “if the entity holds an operating business.” One interpretation is that the rules are intended to apply if the entity itself is an operating business. The net value approach would appear to require that even the value of an operating business would be established by separately valuing inventory, accounts receivable, goodwill, equipment, etc. A contrasting interpretation is that an interest in an entity that is an operating business would require valuation as a going concern. In that case, it is unclear whether the Proposed Regulations are intended to mean that the entity is to be valued under standard transfer tax valuation principles for a closely held entity, so that an income approach and a market approach should be considered, if appropriate, as well as a net asset value approach. ACTEC requests clarification as to whether the valuation principles of Rev. Rul. 59-60, 1959-1 C.B. 237, would apply to establish the value of such an operating business. In that case, the requirement in the Proposed Regulations that appears to fix minimum value by ignoring obligations other than those that would be immediately deductible under section 2053 appears to be arbitrary and unwarranted.

The rules of section 2053 are designed to be applied in the context of the actual administration of a decedent's estate, taking into account the composition and character of the estate as a whole, the harmony or discord within the family, the threat of litigation from outside the family, and all other relevant factors, all as actually affected by the decedent's death itself. Reliably applying those rules in the abstract for purposes of determining the effect of Prop. Reg. §25.2704-3(b)(1)(ii), especially for *inter vivos* transfers when no one has died, could be difficult or impossible.

20. Prop. Reg. §25.2704-3(b)(1)(iv). Treatment of Active Trades and Businesses

Prop. Reg. §25.2704-3(b)(1)(iv) characterizes a provision that permits liquidation or redemption proceeds to be satisfied with anything other than cash or other property as a disregarded restriction. For this purpose, Prop. Reg. §25.2704-3(b)(1)(iv) provides that the "cash or property" proceeds of such a buyout may not include intra-family debt – that is, a note issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related to either the entity or any holder of an interest in the entity. Prop. Reg. §25.2704-3(b)(1)(iv) goes on to state that:

in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include a note or other obligation if such note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of the liquidation or redemption equal to the liquidation proceeds.

Although section 2704 does not distinguish between family controlled entities that operate businesses and other family controlled entities, the special treatment given by the Proposed Regulations to debt issued by an entity engaged in a trade or business, as well as several other sections of the Proposed Regulations, suggest that the IRS and Treasury seek to provide favorable treatment under the Proposed Regulations to family controlled entities engaged in active trades and businesses. The relief offered to active trades and businesses by these exceptions in the Proposed Regulations is too little to be meaningful if the distinction is intended but is confusing if no distinction is warranted.

Providing that the ability of an entity to issue debt in payment of a redemption price is not a disregarded restriction is not particularly helpful when the Proposed Regulations provide that (1) a provision permitting the holder of an entity interest to be bought out at a price less than the minimum value of that interest and (2) a provision permitting deferral of payment of that minimum value for more than 6 months after notice of an intent to be redeemed are also disregarded restrictions. It is unlikely that many interest holders in operating businesses will ever have the right to be bought out on six months' notice at a value equal to minimum value.

As a practical matter, an entity operating an active trade or business would seldom give an owner the right to liquidate or redeem an interest at any time. Business realities frequently compel the owners of a family business to include restrictions on liquidation or redemption, and constrain them from removing these restrictions. A set of rules in which restrictions driven by

business necessity are disregarded in valuing the interests in the business would be hard to justify. In fact, the value of an active trade or business that gave its owners the right to be redeemed at any time at minimum value would likely be severely compromised.

Moreover, the valuation of an active trade or business is complicated. A net asset value method of valuation, which “courts are overwhelmingly inclined to use ... for holding companies whose assets are marketable securities” (*Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26) is rarely as useful for valuing an interest in an active trade or business, and, even when it is used, is normally attended by many adjustments to the otherwise unhelpful concept of “book value.” Business valuation entails judgments in or about: selecting and weighting valuation approaches; selecting and weighting comparable businesses; making adjustments to financial statements; the economic context and outlook; specific opportunities and risks of the business in question; relevant rates of return and similar data to be used; and other judgments that trained and experienced appraisers must make. These judgments include more than how various discounts are to be applied after the appropriate base of value has been determined. Rather, they are inseparable from the unique overall process of business valuation. ACTEC believes that applying any mechanical constraints on that last part of a unified process would be imprudent and unworkable.

If the IRS and Treasury intend to give meaningful relief to family businesses, including family farms and real estate businesses ACTEC recommends exempting them. A suspicion or misperception that the Proposed Regulations *target* family businesses seems to have contributed to significant public and political fury over the Proposed Regulations, including furnishing the motivation and stated rationale for bills introduced in Congress (H.R. 6042, H.R. 6100, and S. 3436) to block the Proposed Regulations. If this was not the intention, ACTEC believes that exempting active trades and businesses from the reach of the Proposed Regulations would cost little in terms of needed regulatory coverage, while gaining much in terms of public acceptance.

21. Prop. Reg. §25.2704-3(b)(2). Source of Limitation

See the discussion above related to Prop. Reg. §25.2704-2(b)(2).

22. Prop. Reg. §25.2704-3(b)(4)(i). Interests Held by Non-Family Members: In General

Prop. Reg. §25.2704-3(b)(4)(i) provides that in the case of a transfer to or for the benefit of a member of the transferor’s family, for purposes of determining whether the transferor (or the transferor’s estate) or any member of the transferor’s family, either alone or collectively, may remove a restriction, only certain non-family member interests are to be taken into account. Interests held by anyone other than non-family members who meet specified criteria are disregarded. Prop. Reg. §25.2704-3(b)(4)(ii) provides that if a non-family member interest is disregarded, Prop. Reg. §25.2704-3 is applied as if all interests other than disregarded non-family-member interests constitute all of the interests in the entity.

Specifically, Prop. Reg. §25.2704-3(b)(4)(i) provides that the only non-family member interests that are to be taken into account are interests in the entity that on the date of the transfer:

- (A) have been held for at least three years immediately before the transfer;

- (B) constitute at least 10 percent of the value of the entity, being at least 10 percent of all of the equity interests if the entity is a corporation, or at least a 10-percent interest in any other business entity (such as at least a 10-percent interest in the capital *and* profits of a partnership);
- (C) when combined with interests held by all other non-family members constitute at least 20 percent of the value of all of the equity interests if the entity is a corporation, or at least 20 percent of all the interests in any other business entity (such as at least a 20-percent interest in the capital and profits of a partnership); and
- (D) have a put right.

A put right is defined in Prop. Reg. §25.2704-3(b)(6) as an enforceable right of an interest holder on liquidation or redemption of the holder's interest to receive within, six months after the date the holder gives notice of the holder's intent to withdraw, cash, property or a qualified note from the entity or from one or more other interest holders, with a value that is at least equal to the minimum value of the interest as of the liquidation or redemption date.

The Preamble to the Proposed Regulations outlines the reasons for effectively changing the definition of the term "member of the family" for this purpose:

Finally, taxpayers have avoided the application of section 2704(b) through the transfer of a nominal partnership interest to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a restriction. Kerr [*Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002)], 292 F.3d at 494...

Further, the Treasury Department and the IRS have concluded that the grant of an insubstantial interest in the entity to a nonfamily member should not preclude the application of section 2704(b) because, in reality, such nonfamily member interest generally does not constrain the family's ability to remove a restriction on the liquidation of an individual interest. . . . The interest of such nonfamily members does not affect the family's control of the entity, but rather, when combined with a requirement that all holders approve liquidation, is designed to reduce the transfer tax value of the family-held interests while not ultimately reducing the value of those interests to the family member transferees. . . . The Treasury Department and the IRS have concluded that the presence of a nonfamily-member interest should be recognized only where the interest is an economically substantial and longstanding one that is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of whether the interest of the nonfamily member effectively constrains the family's ability to liquidate the entity. Accordingly, the proposed regulations disregard the interest held by a nonfamily member that has been held less than three years before the date of the transfer, that constitutes less than 10 percent of the value of all of the equity interests, that when combined with the interests of other nonfamily members constitutes less than 20 percent of the value of all of the

equity interests, or that lacks a right to put the interest to the entity and receive a minimum value. . . .

ACTEC appreciates the desirability of “bright-line” tests, which often can provide significant help in both compliance by taxpayers and enforcement by the IRS. ACTEC also appreciates that in this context, the four requirements of the Proposed Regulations appear to describe a non-family owner whose investment is both substantial (represented by the 10 percent and 20 percent rules) and in a sense voluntary or committed (represented by at least three years of involvement despite the ability to withdraw by exercising a put right). The problem with these requirements is that, in ACTEC’s experience, they simply are not observed in the real world in this combination. They are unrealistic. The effect of these rules is to give the appearance of drawing a “bright line,” while in reality effectively ignoring *all* non-family owners that are encountered in real life, either in otherwise family-controlled entities or in the marketplace of businesses in general.

In particular, first, it would be impractical for any closely held entity to give a non-family member a put right that meets the criteria of Prop. Reg. §25.2704-3(b)(4)(i)(D), especially if that right included the right to sell an interest at a price not less than the new standard of “minimum value.” There are numerous investment control, creditor protection, business planning, operational planning, and balanced portfolio reasons why a closely held entity would never maintain the cash level necessary to satisfy the potential of the described “put” right being exercised. Furthermore, if a non-family member meets all of the criteria of Prop. Reg. §25.2704-3(b)(4) other than the put requirement, that non-family member certainly has a substantial interest and the family owners must seek that non-family owner’s cooperation to amend the restriction.

Second, Prop. Reg. §25.2704-3(b)(4)(A) requires a three-year waiting period for a non-family member’s ownership to be respected for purposes of determining if the family acting alone can remove a restriction. ACTEC believes that this bright-line test would extend the application of the Proposed Regulations by seeking to ignore restrictions that have the effect of reducing the value of the transferred interest for transfer tax purposes *and reducing* the value of the interest to the transferee. ACTEC believes that such an application would be viewed, with justification, as beyond the regulatory authority granted in section 2704(b)(4).

If state law or the governing documents were to prevent the non-family member from exercising a right to block the removal of a restriction for three years or some other period of time, it would be reasonable to ignore the interest held by that non-family member for as long as the non-family owner could not act. ACTEC believes, however, that if there is no waiting period for the non-family member to actually exercise the right to block an amendment or other action, then the arbitrary three-year requirement is unnecessarily restrictive. A hypothetical willing buyer, who is assumed under the generally applicable valuation principles outlined in the Regulations issued under sections 2512 and 2031 not to be related to the transferor or the transferor’s family, would reasonably assume that the consent of other owners, including non-family owners, would be required to remove a restriction, without regard to how long that interest has been held by the other non-family owners. That assumption will be reflected in the hypothetical buyer’s offer, whether the other non-family member has owned an interest three

days, three years, or thirty years. Furthermore, ACTEC believes that the three-year “bright line” test seems to be particularly unfair in valuing interests in start-up businesses.

Nevertheless, the detail of these rules, and of the four requirements, suggests that the drafters must have intended them to be meaningful. ACTEC recommends that the target of these rules needs to be more explicitly defined and that new rules aimed at that target need to be developed. Perhaps consideration should be given to applying a longevity-of-voluntary-commitment test (three years with a put right) only to relatively small interests, particular interests received gratuitously, like the non-family interest in *Kerr*. In other words, perhaps consideration could be given to developing a test of *either* substantiality (10 percent, 20 percent) *or* commitment (a period of time and an exit opportunity). Substantiality criteria would identify serious sacrifice by the family in the sharing of any income, appreciation, and future acquisition opportunities, while commitment criteria would identify serious sacrifice by the non-family owner in staying with the family investment rather than cashing out. For example, a “cashing out” option would ordinarily be particularly attractive to a charity with a small interest as in *Kerr*, making the decision to remain invested in the entity particularly meaningful. ACTEC assumes that rules could be included to prevent circumvention of the commitment through techniques like side agreements, which is a potential issue no matter what the underlying rules are.

23. Prop. Reg. §25.2704-3(b)(5)(iii). Requirement of Federal or State Law

See the discussion above related to Prop. Reg. §25.2704-2(b)(4)(ii).

24. Prop. Reg. §25.2704-3(b)(5)(iv). Certain Rights Described in Section 2703

See the discussion above related to Prop. Reg. §25.2704-2(b)(2).

25. Prop. Reg. §25.2704-3(b)(5)(v). Right To Put Interest to Entity

Both the applicable restriction provisions of Prop. Reg. § 25.2704-2(b)(4)(iv) and the disregarded restriction provisions of Prop. Reg. § 25.2704-2(b)(5)(v) provide exceptions if each holder of an interest in the entity has a put right as is described in Prop. Reg. §25.2704-3(b)(6). As discussed above, there has been much debate over whether or not the proposed regulations provide for an imputed or deemed put right at minimum value or at fair market value of the transferred interest determined under generally applicable evaluation principles as if the restriction does not exist. Aside from that debate, ACTEC points out the anomaly of the potential existence of a deemed put right by reason of there being an applicable or disregarded restriction and those rules not applying at all if the holder of the interest has an actual explicit put right. In other words, if one does not have a put right, one will be deemed to exist, but if one does have a put right the applicable and disregarded restriction rules will not apply at all. In any event, ACTEC believes it would be desirable for specific language to put the question to rest.

26. Prop. Reg. §25.2704-3(e). Certain Transfers at Death to Multiple Persons

See the discussion above related to Prop. Reg. §25.2704-2(f).

27. Prop. Reg. §25.2704-4. Effective Date

Although the effective date of some of the Proposed Regulations is described in the familiar way as the date that Final Regulations are published in the Federal Register, the new “disregarded restriction” rules of Prop. Reg. §25.2704-3 will not take effect until 30 days later. ACTEC appreciates that this structure reflects the general rule in the Administrative Procedure Act (5 U.S.C. §553(d)) for what are considered “substantive” regulations. But ACTEC believes that dual effective dates for the changes made by these Proposed Regulations will have the potential to create significant additional complexity and frustration, which can easily be avoided by making all of the Final Regulations effective 30 days after publication.

It is human nature to make or plan to make transfers during the 30-day period before a proposed regulation becomes effective. Treasury and the Service should, and probably do, expect such transfers to occur. The possibility that such transfers might be “caught” by other new rules in the Proposed Regulations – such as the assignee rule in Prop. Reg. §25.2704-1(a)(5) or the removal from the exception in Reg. §25.2704-1(c)(1) of transfers within three years of death – that would have been in place for less than a month could appear to be a trap that would ill-serve the public acceptance of these already controversial rules.

Finalizing the Proposed Regulations will necessarily create a new set of rules not only for determining the transfer tax values of transferred interests in the future but also for determining the continuing tax effects of those transfers, such as the estate tax consequences under section 2036 or even under section 2704 itself. Dual effective dates might mean that there would be *two* new sets of rules for determining those estate tax consequences, one applicable only to transfers made during the intervening 30-day period. That outcome could be a source of confusion, uncertainty, and risk of error both for taxpayers and their advisors trying to comply with the rules, as well as for Service personnel charged with enforcing these rules.

In the long term, it is inevitable that a body of law will develop about the scope and meaning of these Proposed Regulations and their application to particular fact patterns. One of the issues regarding the application of the Proposed Regulations is likely to be the potential overlap of various provisions. For example, could a taxable lapse under the Prop. Reg. §25.2704-1(a)(5) or Prop. Reg. §25.2704-1(c)(1) also, or more properly, be subject to the special valuation rules of Prop. Reg. §25.2704-3? But such a developed body of law could still leave unclear the treatment of those transfers that occurred during the 30-day period when only some and not all of the Proposed Regulations were in effect.

Moreover, a unified effective date would eliminate any burden on the drafters to make judgments about what is “substantive” within the meaning of the Administrative Procedure Act and would avoid an expenditure of resources to judicially resolve any disputes about those judgments down the road.

ACTEC realizes that 30 days is a short time, and that this matter might seem trivial. But that argument works both ways. Permitting transfers for another 30 days to escape these

Regulations that have been contemplated and in preparation for at least 13 years seems to be a small sacrifice, justified by the avoidance of the complications outlined above. In any event, it appears that the 30-day effective date delay for the entirely new set of rules in Prop. Reg. §25.2704-3 will already be applicable to a substantial majority of new situations covered, and the application of that 30-day delay to the other changes in the Regulations will apply to a correspondingly small number of situations.

Accordingly, ACTEC recommends that Prop. Reg. §25.2704-4(b)(1) be modified to indicate that all changes made by the Proposed Regulations apply only to lapses of rights created after October 8, 1990, and to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date the Regulations are published as final in the Federal Register.

ANCILLARY CONSIDERATIONS: BASIS, EFFECT ON OTHER CODE PROVISIONS

28. Implications of Proposed Regulations for Income Tax Basis

Section 1014(a) provides that the basis of property acquired from a decedent is “the fair market value of the property at the date of the decedent’s death” or the alternate valuation date if applicable, with special rules for “qualified use” property under section 2032A and qualified conservation easements under section 2031(c). Section 1014(f)(1) adds that the basis of certain property acquired from a decedent “shall not exceed” the value of the property determined for federal estate tax purposes. There is no similar rule stating that the basis of property acquired from a decedent shall not be less than the value of the property determined for federal estate tax purposes. The omission of a rule dealing with values less than estate tax value suggests that there will be occasions when the fair market value and the basis of an asset will be *less* than the estate tax value. This would occur, for example, if the executor of an estate that is not subject to estate tax because for example the estate’s assets pass to the decedent’s spouse overvalues the estate’s assets on the estate tax return.

A similar issue arises under section 1015, dealing with the basis of a donee in gifted property. Section 1015 provides that the donee’s basis is generally equal to the donor’s basis in the gifted property at the time of the gift but may not exceed its then fair market value.

The Proposed Regulations under section 2704 present the question of whether that “fair market value” for purposes of sections 1014 and 1015 is the higher value resulting from the application of the rules in sections 2703 and 2704, which apply by their terms “[f]or purposes of this [the transfer tax] subtitle.”

When section 2704 was added to the Code in 1990, Congress made no corresponding change to section 1014 or 1015 to reflect the fact that section 2704 might cause the actual fair market value of an asset to be *less* than its estate tax value. In contrast, Congress had added section 1014(a)(3) to the Code to make it clear that if the special use valuation provisions of section 2032A were elected to determine the estate tax value the actual “fair market value of the property at the date of the decedent’s death” could not be invoked to justify a basis *greater* than estate tax value. From that rule it could be inferred, albeit tentatively, that Congress has been concerned that special rules not be exploited to produce a basis *greater* than estate tax value, but

not as insistent that special rules, if they apply, produce a basis *less* than estate tax value. When Congress enacted section 1014(f) in 2015, there is no reason to believe Congress considered these questions at all. The temporary and proposed regulations under section 1014(f) (REG-127923-15) include cross-references to sections 2701 and 2704 for definitions of control and family, but do not mention the potential mismatch between the estate tax value that might be determined under section 2704 and the “fair market value of the property at the date of the decedent’s death” that might be determined under section 1014(a) without regard to section 2704.

ACTEC believes that it is intrinsically unfair to require the income tax basis of property acquired from a decedent but subject to section 2704 to be *lower* than the value upon which estate tax is imposed. In any event – that is, even if such a mismatch is intended, or cannot be avoided – ACTEC requests that the Final Regulations under either section 2704 or section 1014(f) clarify and explain the intended outcome under these provisions.

Similarly, ACTEC believes that the regulations under section 1014(f) should explain how the rule regarding certain transfers within three years of death in Prop. Reg. §25.2704-1(f) will affect the basis of property the transfer of which cause that rule to apply.

29. Impact of the Proposed Regulations on Other Code Provisions

a. Valuation of Estate Interests

The Proposed Regulations create special valuation rules in the event an interest in a family controlled entity is transferred to a member of the transferor’s family unless the entity has a nonfamily-member whose interest is not disregarded under the Proposed Regulations. The Proposed Regulations also treat lapses of certain rights as a transfer. If the transfer occurs by reason of the transferor’s death, or is deemed to occur at death as the result of a transfer made within three years of death, additional value is included in the transferor’s estate. These rules create the question as to how the special valuation rules will affect the application of other provisions applicable to computing the estate tax due upon the death of a decedent, such as the marital or charitable deduction, and the estate tax deferral provisions of section 6166. As a general matter, ACTEC believes that consistency in valuation is most fair to taxpayers and will improve the administration of the estate tax. ACTEC appreciates that perhaps the special valuation provisions of section 2704 may apply only to a transfer of an interest in a family-controlled entity to members of the transferor’s family. This limitation creates certain special problems.

b. Application to Section 6166

Section 6166 permits a taxpayer to defer the payment of estate taxes if the estate holds an interest in a closely held business provided it is an active trade or business. One of the tests for qualification under section 6166 is whether more than 35 percent of the adjusted gross estate of the decedent is composed of interests in the active closely held business. Another test is whether the business is a sole proprietorship or has 45 or fewer shareholders or partners, if the decedent’s gross estate includes 20 percent or more of the value of the voting stock if the business is a

corporation or 20 percent of more of the capital interest if the business is a partnership. The question is how the 2704(b) special valuation rules apply for purposes of meeting these tests.

As a general matter, it does not appear that the funding of a marital bequest with the closely held business affects the allowance of the section 6166 election. See, for example, PLR 200518047 (not precedent). Accordingly, if the qualification thresholds are met, then under existing law an election under section 6166 is permitted with respect to the estate tax due in respect of the taxable bequests under a decedent's estate plan. However, because section 2704(b) appears to alter the value of the gross estate depending of the identity of the beneficiary of an interest in a family controlled business, qualification for tax deferral under section 6166 becomes uncertain. This uncertainty will arise if bequests to unrelated persons or charity are permitted to be funded with an interest in the business in whole or in part. In that case, the value of the portion of the business that funds those interests may be reduced. Guidance is needed as to the manner in which the gross estate will be valued in that case, in light of the examples given above, because the value of the gross estate will determine whether the decedent's estate can qualify for deferral.

If the business is allocated to members of the decedent's family, section 2704(b) would increase the value of the decedent's interest, enhancing the likelihood that the decedent's estate would qualify to make an election. This outcome appears to be fair given that estate tax is in fact due on the increased value.

A second valuation issue arises under section 6166(g), relating to acceleration of payment of the estate tax. Section 6166(g) provides that the extension of time to pay ceases to apply if any portion of the interest in a closely held business that qualified for deferral under section 6166 is distributed, sold, exchanged or otherwise disposed of and the aggregate of such distributions, withdrawals, exchanges or other dispositions equals or exceeds 50 percent of the value of such interest. If the interest was initially valued applying the valuation principles of section 2704(b), clarification is needed as to whether those principles continue to apply to determine the value of the interest in the business for purposes of section 6166(g). ACTEC believes that principles of fairness dictate that the same method of valuation should be used in all cases to which section 2704 is applied and requests that final regulations clarify this issue.

Similar issues arise under section 303, relating to a corporate redemption to pay death taxes, which ACTEC also recommends be addressed in the Final Regulations. In particular, ACTEC is concerned that a corporation will not be able to redeem shares at "inflated" values without violating fiduciary duties owed to the other shareholders, and if shares are redeemed at fair market value taking into account all restrictions, including those disregarded under section 2704 will subject other shareholders to gift tax. In effect, the Proposed Regulations have the potential of preventing redemptions to pay estate tax.

c. Application of Section 6324(a)(2)

Section 6324(a)(2) imposes personal liability for a decedent's estate tax on persons, including the trustees of funded revocable trusts, who are in possession of property included in a decedent's gross estate under sections 2034 to 2042 to the extent of the value of the property on the date of death. If the property in the person's possession consists of property whose value is

to be determined without regard to restrictions on an owner's ability to liquidate it, will the scope of the person's personal liability be measured by the value dictated by section 2704 or will it be limited to the actual fair market value of the property?

d. Adjusting the Inclusion Ratio of a Trust Under Section 2642(d)

Section 2642(d) requires an adjustment to the inclusion ratio of a trust if a transfer of property to the trust is made at a time when the trust has an inclusion ratio of other than one. Presumably, if a transferor sells an interest in an entity controlled by the transferor and the transferor's family to a zero inclusion ratio trust for the benefit of family members at fair market value rather than at the value determined without regard to applicable and disregarded restrictions, that sale will require the recomputation of the trust's inclusion ratio. Suppose, however, the sale is not made by an individual but is made by the trustees of another trust that has an inclusion ratio of one? Will the sale require a recomputation of the inclusion ratio of the purchasing trust?

CONCLUSION

ACTEC appreciates consideration of these Comments on REG-163113-02 and would be pleased to answer any questions and to work with the drafters in developing solutions to the issues raised in these Comments and other issues raised in the public consideration of the Notice of Proposed Rulemaking and the drafters' continued work on the Regulations.