Family Values: An Evaluation of Internal Revenue Code Sections 2703 and 2704(b)

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Introduction

Valuation for transfer tax purposes can be an exceedingly difficult endeavor. When a robust market exists for a given asset, the calculus becomes simpler.[1] For closely-held business interests, however, markets often provide little guidance. Particularly when family-owned, these assets are distinctive by nature. These distinctive characteristics—including contracted restrictions and arrangements among owners—can be a reasonable basis for discounting assessed value. Restrictions can be imposed for good-faith business purposes. Under the traditional "willing

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[1] *See, e.g.*, Treas. Reg. § 20.2031-2(b)-(d) (as amended 2006); Treas. Reg. § 25.2512-2(b)-(d) (as amended 1976) (explaining that in such cases, the chief issue is establishing the relationship between the timing and weight of market valuations and the time of death or transfer).

buyer/willing seller" test of value,[2] restrictions often materially decrease the present value of business interests. It is also true that, in addition to such warranted discounts, owners have a natural incentive to self-impose artificial, value-depressing business entity restrictions in order to minimize their transfer tax liability.[3] As such, ideal valuation rules strike a balance between respecting legitimate discounts and disregarding the chaff of artificial, tax-driven business arrangements. Rules that disallow legitimate discounts effectively create an additional tax on closely-held (as opposed to marketable) interests, while overly permissive rules create the inverse tax. Both outcomes are inefficient.

Sections[4] 2703[5] and 2704(b)[6] contend with this problem, specifically as applied to discount-generating restrictions on family-owned prop-

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2 Treas. Reg. § 20.2031-1(b) (as amended 1965) ("[F]air market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.").

3 *But see* Richard Schmalbeck & Jay A. Soled, *Estate Tax Relief and the Erosion of Capital Gains Tax Revenues*, 133 TAX NOTES 733, 733-35 (2011) (noting that a higher exemption coupled with basis step-up incentivizes high valuations for taxpayers below the exemption amount). This high-valuation incentive is pertinent for lower-wealth taxpayers, but such taxpayers are presumably less likely to own substantial interests subject to Chapter 14. Higher-wealth taxpayers often remain incentivized to depress value as long as the applicable transfer tax exceeds the applicable capital gains tax, assuming the interest will be sold, taking into account both rates and basis. *See id.*

4 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

5 Section 2703 reads as follows:

> § 2703. *Certain rights and restrictions disregarded*
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> (a) *General rule*. For purposes of this subtitle, the value of any property shall be determined without regard to: (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property.
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> (b) *Exceptions*. Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements: (1) It is a bona fide business arrangement, (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth, [and] (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

6 Section 2704(b) reads as follows:

> (b) *Certain restrictions on liquidation disregarded*.
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> (1) *In general*. For purposes of this subtitle, if: (A) there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and (B) the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any applicable restriction shall be disregarded in determining the value of the transferred interest.

erty.[7] Section 2703 gives the IRS, when valuing such property, broad authority to disregard "any option, agreement, or other right to acquire or use" the property, as well as "any restriction on the right to sell or use such property."[8] The IRS must respect those agreements and restrictions only if they qualify for a safe harbor.[9] The safe harbor attempts to delineate (and respect) legitimate agreements and restrictions. Section 2704(b) follows, in form, a similar scheme.[10]

When Congress enacted §§ 2703 and 2704(b) as part of Chapter 14's special transfer tax valuation rules,[11] the issue of balance was front and center. Congress had failed to achieve balance in § 2036(c), the overly-aggressive predecessor to Chapter 14.[12] As the Senate voted to replace § 2036(c) with Chapter 14, the Senate Finance Committee noted that the "complexity, breadth, and vagueness" of § 2036(c) posed "an unreasonable impediment" to family businesses.[13] However, Congress

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> (2) *Applicable restriction*. For purposes of this subsection, the term "applicable restriction" means any restriction: (A) which effectively limits the ability of the corporation or partnership to liquidate, and (B) with respect to which either of the following applies: (i) The restriction lapses, in whole or in part, after the transfer referred to in paragraph (1), [or] (ii) The transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.
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> (3) *Exceptions*. The term "applicable restriction" shall not include: (A) 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, or (B) any restriction imposed, or required to be imposed, by any Federal or State law.
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> (4) *Other restrictions*. The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

7 *See id.* § 2704(b)(1)(B) (stating § 2704 is only applicable when transferor and/or family "hold . . . control of the entity"); Treas. Reg. § 25.2703-1(b)(3) (stating § 2703 is inapplicable when non-family members own "more than 50 percent . . . of the property").

8 I.R.C. § 2703(a)(1)-(2).

9 *See* I.R.C. § 2703(b).

10 *See infra* Part III. As will be discussed, while similar in form, these sections have diverged in substantive efficacy.

11 Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388, 1498-99 (1990) (codified as amended at I.R.C. §§ 2703, 2704(b)).

12 *See* Richard L. Dees, *Section 2036(c)*: *The Monster That Ate Estate Planning and Installment Sales, Buy-Sells, Options, Employment Contracts and Leases*, 68 TAXES 876 (1988).

13 136 CONG. REC. 30, 538 (1990). Practitioners were franker in their assessments. A representative of the American College of Trust and Estate Counsel deemed § 2036(c) a "disaster." *'Discussion Draft' Relating to Estate Valuation Freezes*: *Hearing Before the H. Comm. on Ways and Means*, 101st Cong. 92 (1990) [hereinafter *Hearing*] (statement of E.

did not want to repeal § 2036(c) without a replacement. The Committee remained "concerned about potential estate and gift tax valuation abuses"[14]— hence the "targeted rules" of Chapter 14.[15] In particular, Congress noted a concern for even-handed application with § 2703.[16]

Nearly a quarter of a century after Chapter 14's enactment, it is worth considering whether §§ 2703 and 2704(b) have, in practice, achieved their congressionally-intended balance. Now is also an ideal time to take stock of these Code sections given hints of potential new IRS rulemaking pursuant to § 2704.[17] These two sections offer an enlightening study in contrasts. In Part I, this Article argues that, at least as interpreted through case law, § 2703 has come to strike that congressionally-mandated balance successfully. However, Part II discusses two chief problems that remain in the provision's application. First, as illustrated through the dissenting opinion in *Holman v. Commissioner*,[18] drafting ambiguities have engendered unnecessary (though non-fatal) complexities regarding the provision's interrelation with earlier case law and regulations. Second, issues have arisen with valuation. Once restrictions are deemed ineligible for the § 2703(b) safe harbor, courts have taken a muddled approach to the quantitative valuation impact.[19] Also on that valuation front, courts have accorded improper § 2703 treatment to certain insurance proceeds.[20] Part III then turns to § 2704(b). Reviewing the history and implementation of the statute, this Article argues that § 2704(b) has been an unmitigated failure. The poor drafting of § 2704(b) has rendered it too easy to circumvent. In Part IV, this Article considers the interrelation between §§ 2703 and 2704(b), as well as potential fixes to § 2704(b). While reparative legislation is necessary to fix § 2704(b), a partial remedy is possible through a simple amendment to the provision's companion regulations. Also, if and when a leg-

James Gamble, Chairman, Estate and Gift Tax Committee of the American College Of Trust and Estate Counsel). Another practitioner called it "Frankenstein's monster." Dees, *supra* note 12, at 876.

14 136 CONG. REC. 30, 538.

15 *Id.*

16 *See id.* at 539 (remarking on the need to balance legitimate reasons for buy-sell agreements and other similar restrictions with the potential for abuse).

17 *See* Steve R. Akers, *Speculation About Upcoming Section 2704 Proposed Regulation*, BESSEMER TR. (June 2015), http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Section%202704%20Regulation%20Speculation_June%202015.pdf. At writing, these potential revisions are too speculative for in-depth consideration, but this Article will certainly help inform any discussion of these revisions once they are made public.

18 Holman v. Comm'r, 601 F.3d 763, 776-84 (8th Cir. 2010) (Beam, J., dissenting).

19 *E.g.*, *Id.* at 773-76.

20 *E.g.*, Estate of Blount v. Comm'r, 428 F.3d 1338 (11th Cir. 2005).

islative fix becomes feasible, this comparison with § 2703 points toward an approach that is more efficient than current proposals.

I. Section 2703: Legislative History and Post-Enactment Interpretation

A. Legislative History

In assessing § 2703, legislative history provides an important lens through which to consider certain interpretive issues with the statute.

As can be charted through successive drafts of § 2703, the statute evolved from one primarily built on new tax law concepts to one that borrowed heavily from existing standards and regulations. In the initial "discussion draft" of Chapter 14, the § 2703-equivalent was quite different from its enacted form.[21] The section had the same basic structure as the enacted § 2703. The first part required a general disregard of discount-generating restrictions on closely-held business interests, and the second part provided a safe harbor against that default disregard.[22] However, while the form is similar, the substance diverges. In its first section, the discussion draft covered a narrower set of restrictions—only buy-sell options, rights of first refusal and leases.[23] That contrasts with the far more capacious § 2703(a), which covers "any option, agreement, or other right to acquire or use" the property in question,[24] along with "any restriction on the right to sell or use" the property.[25]

The discussion draft's safe harbor was also dramatically different from the one codified in § 2703(b). As a threshold issue, only buy-sell agreements were eligible for the safe harbor, so ROFRs and restrictive leases could not qualify.[26] Also, the safe harbor itself involved burdensome, bright-line requirements. To qualify, for instance, the buy-sell agreement had to be exercised (rather than just allowing property subject to the agreement to pass via gift or bequest),[27] and the buy-sell price had to be "reviewed" within the past three years.[28] These aspects of the safe harbor did little to delineate legitimate buy-sell restrictions from artificial ones. The exercise requirement, for example, does nothing to get at the fairness of the price. If the buy-sell price is artificially

21 *See Hearing*, *supra* note 13, at 20-21. In this draft, the § 2703-equivalent was numbered as § 2702.

22 *Id.*

23 *Id.*

24 I.R.C. § 2703(a)(1).

25 *Id.* § 2703(a)(2). This broader formulation of § 2703(a), as contrasted with the discussion draft, is of particular interpretive importance. *See infra* Part II.B.1.

26 *Hearing*, *supra* note 13, at 20-21.

27 *Id.*

28 *Id.*

low, then family can fulfill that requirement by exercising at that bargain price. Overall, the safe harbor largely omitted existing valuation principles to instead create "a new set of rules" to govern the transfer tax valuation effects of the covered restrictions.[29] The next legislative draft of § 2703, again originating in the House, generally built on the discussion draft.[30] However, this House approach was jettisoned. The § 2703-equivalent in a subsequent Senate bill largely contained the language used in the enacted version of the statute,[31] and the House acquiesced to the Senate approach.[32]

In contrast to those early House drafts, the Senate formulation pulled standards from existing case law and regulations. The first two requirements of the Senate's three-pronged safe harbor—that the restriction be a "bona fide business arrangement" and also "not a device to transfer such property" at below FMV[33]—both came from existing Treasury Regulations and established case law.[34] The third prong—that the restriction "be comparable to similar arrangements entered into by persons in an arms' [sic] length transaction"[35]—was not an independent test in existing regulations.[36] However, even this allegedly novel "arm's-length" requirement was found in prior case law.[37]

There are a few interpretive lessons in this legislative progression from "a new set of rules" to established standards.[38] First, because of this shift, the statute allows for precedential continuity. When explicating § 2703, courts can—and do—reason from pre-section 2703 cases and

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29 *Hearing*, *supra* note 13, at 98.

30 *See generally* H.R. 5425, 101st Cong. § 2703 (1990).

31 S. 3113, 101st Cong. § 3(e) (1990).

32 Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388, 1498 (1990) (codified at I.R.C. § 2703).

33 I.R.C. §§ 2703(b)(1)-(2); S. 3113 § 3(e).

34 Treas. Reg. § 20.2031-2(h) (as amended 1992); Treas. Reg. § 20.2031-3(c) (as amended 1992); *e.g.*, St. Louis Cnty. Bank v. United States, 674 F.2d 1207, 1210 (8th Cir. 1982); Estate of Bischoff v. Comm'r, 69 T.C. 32, 39 (1977); *see also* Rev. Rul. 59–60, 1959–1 C.B. 237. Pre-section 2703, there was some question as to whether these two requirements were separate tests or if fulfillment of one necessarily entailed fulfillment of the other. *See* Estate of Gloeckner v. Comm'r, 152 F.3d 208, 213 (2d Cir. 1998); Roth v. United States, 511 F. Supp. 653, 654-55 (E.D. Mo. 1981), *rev'd sub nom*. St. Louis Cnty. Bank v. United States, 674 F.2d 1207 (8th Cir. 1982). However, § 2703 codified these requirements as independent.

35 I.R.C. § 2703(b)(3); S. 3113 § 3(e).

36 136 CONG. REC. 30,541 (1990) ("[T]he bill adds a third requirement, not found in present law.").

37 Estate of True v. Comm'r, T.C. Memo. 2001-176, 82 T.C.M. (CCH) 27, 48 (2001) ("[T]he arm's-length requirement has always been a factor used . . . to decide whether a buy-sell agreement's price was determinative of value."), *aff'd*, 390 F.3d 1210 (10th Cir. 2004).

38 *Hearing*, *supra* note 13, at 98.

regulations.[39] Absent some reason to the contrary, these established portions of § 2703 should be interpreted in accordance with their pre-enactment meaning.[40] Congress considered (and rejected) a "new rules" approach, one that would have required *de novo* interpretation.

However, precedential continuity is only part of the story. A complementary consideration is that proper interpretation should pay close attention to the ways in which the statute departed from established law. For instance, pre-section 2703 case law and regulations are chiefly targeted at buy-sell agreements.[41] Congress enacted a statute with far greater breadth. As the legislative history shows, Congress considered a statute that retained a targeted approach to covered restrictions,[42] but that approach lost out.

Lastly, while § 2703 codified existing standards, the statute was only a partial codification, one "meant to supplement, not replace, prior case law."[43] As the Senate Finance Committee stipulated, § 2703 was not intended to "alter the requirements for giving weight to a buy-sell agreement" or other covered restrictions.[44] As such, if the statute does not overrule a standard in prior case law or regulation, such a standard should be assumed to remain applicable.

B. Post-Enactment Interpretation

With those interpretive lessons in mind, it is possible to turn to subsequent judicial interpretation of the statute and its companion regulations to determine whether § 2703 has achieved, in practice, its intended

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39 *E.g.*, Estate of Amlie v. Comm'r, T.C. Memo. 2006-76, 91 T.C.M. (CCH) 1017, 1026-27 (2006); *see also* John A. Bogdanski, Federal Tax Valuation, § 604(2)(a) n.241 (2014) (noting § 2703's heavy borrowing "from prior law").

40 Practitioners have long recognized this continuity. *E.g.*, Jerold I. Horn, *Buy-Sell Agreements Under Chapter 14, Including Amendment/Modification of Grandfathered Agreements, and Drafting New Agreements*, 21 ACTEC Notes 37, 38 (1995) ("Code section 2703 purports to codify the law.").

41 The relevant regulations refer to "an option or a contract to purchase securities owned by a decedent" and not other types of restrictions. *See* Treas. Reg. § 20.2031-2(h) (as amended 1992); Treas. Reg. § 20.2031-3(c) (as amended 1992); *see also* Estate of Gloeckner v. Comm'r, 152 F.3d 208, 213 (2d Cir. 1998); Roth v. United States, 511 F. Supp. 653, 654-55 (E.D. Mo. 1981), *rev'd sub nom*. St. Louis Cnty. Bank v. United States, 674 F.2d 1207 (8th Cir. 1982).

42 *See* H.R. 5425, 101st Cong. § 2703(a)(1)-(3) (1990).

43 *Estate of Amlie*, T.C. Memo 2006-27, 91 T.C. M. (CCH) 1017, 1024 (2006).

44 136 Cong. Rec. 30,541 (1990). The legislative record tends to refer to buy-sell agreements synecdochically as shorthand for all of § 2703's covered restrictions, so this quote can be read to refer to all such restrictions. *See* H.R. Rep. No. 101-964, at 1137 (1990) (Conf. Rep.) (title of "Buy-sell agreements and options" used for section discussing all of § 2703's covered restrictions).

balance. In this analysis, it is most efficient to work through the statute piece-by-piece.

On its face, § 2703 sweeps broadly. Its first section—§ 2703(a)—seemingly covers any property "restriction" or "option."[45] If any "restriction" or "option" fails to qualify for the subsequent safe harbor in § 2703(b),[46] then transfer tax valuations must be calculated "without regard to" that "restriction or "option."[47] One can see the potentially pervasive reach of that broad language. Absent any other limits, all property restrictions and options would have to jump through the hoops required to qualify for the three-pronged § 2703(b) safe harbor. However, in the spirit of Congress's intention for "targeted rules" in Chapter 14,[48] regulations and related case law add effective, bright-line standards that delimit § 2703(a)'s reach. These bright-line standards efficiently cull out most legitimate restrictions and options without permitting abuse.

The most impactful bright-line test is found in the companion regulations. Any restriction or option is deemed to fulfill the safe harbor automatically "if more than 50 percent of the value of the property subject to the right or restriction is owned. . .by individuals who are not members of the transferor's family."[49] In other words, if a businesses or property is not family-controlled, then it is deemed to comply with the safe harbor. This deemed compliance is only effective, however, if the third-party owners are subject to the right or restriction "to the same extent" as the transferor.[50]

This deemed compliance provision is an elegant solution to potential overbroad application of § 2703. As will become evident in case-law analysis of § 2703(b), the three prongs of the safe harbor require a laborious, fact-intensive inquiry to determine whether a given option or restriction qualifies.[51] It takes considerable effort and creates planning

45 I.R.C. §2703(a). It is true that, per § 2703(a)(2), the provision only covers restrictions on "the right to sell or use" property. *Id.* However, this phrase does little (if anything) to limit the scope of § 2703. If "use" is defined with sufficient breadth, it is hard to conceive of a property restriction that would be a restriction on something other than sale or use. In other words, in this valuation context, virtually any restriction on property will be a restriction on sale or use, unless "use" is given a narrow interpretation. In case law, the Tax Court has confidently applied such a broad definition of use. *See* Estate of Elkins v. Comm'r, 140 T.C. 86 (2013) (applying broad definition of "sale or use" in the § 2703 context), *aff'd on this issue, rev'd in part on other grounds*, 767 F.3d 443 (5th Cir. 2014). Thus, it is extremely unlikely that § 2703 will ever fail to apply because the restriction at issue is not considered to be a restriction on sale or use.

46 I.R.C. § 2703.

47 *Id.*

48 136 CONG. REC. 30,538.

49 Treas. Reg. § 25.2703-1(b)(3).

50 *Id.*

51 For further discussion, see *infra* text accompanying notes 69-148.

uncertainty to require actual compliance with the full safe harbor. As such, § 2703(b) should only come into play in difficult, borderline situations where such effort is warranted. At the same time, the safe harbor, for all that difficulty, is trying to answer one core question: is the restriction or option something that arm's-length economic actors would rationally accept as a business matter? This deemed compliance regulation circumvents § 2703(b) when the nuances of the safe harbor are unnecessary to answer that question. Families and likely beneficiaries may be able to collusively self-impose value-destructive restrictions or options, but unrelated third parties are loath to destroy the long-term value of their property for the short-term transfer tax gain of minority owners.[52] Importantly, "family" is broadly defined here to include any "natural objects of the transferor's bounty,"[53] so the third-party owners must be strictly disinterested when it comes to gifts or bequests from the transferor. Moreover, even when this deemed compliance is available, the option or restriction is still subject to other valuation requirements.[54] For instance, if a buy-sell option is only binding at death (and parties are otherwise "free to dispose of [the property]. . .at any price"),[55] that option will be disregarded in transfer tax valuation notwithstanding the deemed compliance.[56] As such, third parties must be truly locked in to restrictions or options for them to retain effect under the deemed compliance regulation. In such circumstances, it is not necessary to postulate what self-interested third-party negotiators would do—their actions will speak for themselves.

The other bright-line standards could be described as deemed *non*-compliance rules. As noted above, § 2703 is only a partial codification of the relevant standards. To be respected, restrictions and options need to fulfill other requirements. Just as § 25.2703-1(b)(3) provides an effective heuristic to deem compliance without intensive § 2703(b) review, these other requirements can be applied as a threshold matter to disregard restrictions or options. The first set of requirements grow out of the "Wilson-Lomb test."[57] Any restriction or option must "be enforceable

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52 For value-destroying restrictions or options, third parties will lose value dollar-for-dollar, while the transferor only gains its portion of the destroyed value multiplied by the transfer tax rate (assuming the exemption has been exhausted). Since the transferor must be a minority owner for deemed compliance, the third-party losses will always exceed the transferor's tax savings.

53 Treas. Reg. § 25.2703-1(b)(3).

54 *E.g.*, Treas. Reg. § 20.2031-2(h) (as amended 1992); Treas. Reg. § 20.2031-3(c) (as amended 1992).

55 Treas. Reg. § 20.2031-2(h).

56 *Id.*

57 Estate of True v. Comm'r, T.C. Memo. 2001-176, 82 T.C.M. (CCH) 27, 48 (2001) (quoting Lomb v. Sugden*,* 82 F.2d 166, 167 (2d Cir. 1936); Wilson v. Bowers*,* 57 F.2d 682, 683 (2d Cir. 1932); Estate of Salt v. Comm'r*,* 17 T.C. 92, 99-100 (1951)), *aff'd*, 390 F.3d

against the parties" and "bind transferors both during life and at death."[58] In other words, the restrictions or options must be real and legally enforceable, and the transferor cannot retain the unilateral ability to circumvent or revoke them. The most common taxpayer issue here arises when the transferor has unilateral authority to remove or void the option or restriction.[59] In practice, these Wilson-Lomb components have been used to avoid the intensive § 2703(b) analysis.[60] The other avenue for "deemed noncompliance" is when, as a matter of business entity law, a transferor fails to respect the entity to which a restriction or option relates.[61] In the same vein, courts can also apply the step transaction doctrine to disregard imposed restrictions or options, although courts have employed that tactic sparingly.[62]

In sum, case law and regulations smartly limit § 2703. The broad language of § 2703(a) would otherwise pull far too many taxpayers into the exhaustive § 2703(b) analysis. The heuristics for deemed compliance and deemed noncompliance address estate freeze concerns efficiently, leaving only the hard cases for analysis under the safe harbor. However, that is not to say all circumscription of § 2703(a)'s broad language is good. The bright-line heuristics here only work because, unlike the arbitrary bright-line rules in the House predecessor to § 2703,[63] they accurately separate legitimate options and restrictions from artificial, tax-driven ones. An early 5th Circuit case illustrated how narrowing of § 2703(a) can be improper. In *Church v. United States*,[64] the court con-

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1210 (10th Cir. 2004). These requirements have evolved specifically in the context of buy-sell agreements, but insofar as they are possible to apply to other § 2703-covered restrictions or options, it seems reasonable to assume they should be applied. It would be a losing argument, for example, to argue that a discount-generating transfer restriction must be respected even if the transferor can unilaterally revoke it.

58 *Estate of True*, 82 T.C.M. (CCH) at 48. The Wilson-Lomb test also includes the "ascertainable price" requirement, but per the preceding footnote, that requirement falls into the category of requirements that do not make sense when applied outside of buy-sell agreements.

59 *E.g.*, Bommer Revocable Trust v. Comm'r, T.C. Memo. 1997-380, 74 T.C.M. (CCH) 346, 353 (1997).

60 *E.g.*, Estate of Blount v. Comm'r, T.C. Memo. 2004-116, 87 T.C.M. (CCH) 1303, 1312 (2004), *aff'd on this issue*, 428 F.3d 1338 (11th Cir. 2005); Smith v. United States, No. 02-264 ERIE., 2005 WL 3021918, at *6 (W.D. Pa. July 22, 2005).

61 *E.g.*, Estate of Jorgensen v. Comm'r, T.C. Memo. 2009-66, 97 T.C.M. (CCH) 1328, 1336 (2009) ("Ms. Jorgensen and her children often failed to treat the partnerships as separate entities."), *aff'd*, 431 F. App'x 544 (9th Cir. 2011). This case did not concern § 2703, but it illustrates the principle. *See also* Steven M. Fast et al., *Context Matters: Rules for Reducing Taxable Value*, 120 YALE L.J. ONLINE 141, 143, 150 n.15 (2010).

62 Fast et al., *supra* note 61, at 145-46.

63 *E.g.*, H.R. 5425, 101st Cong. § 2703(b)(1)(C) (1990).

64 Church v. United States, No. SA-97-CA-0774-OG, 2000 WL 206374 (W.D. Tex. Jan. 18, 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001).

tended that, based on the legislative history, § 2703(a) was only intended to cover buy-sell agreements (and not other restrictions like transfer limits).[65] It is hard to see what aspect of the legislative history supports that conclusion. To the contrary, earlier versions of § 2703 specifically enumerated the types of covered restrictions,[66] but Congress rejected that approach for the capacious language of the enacted § 2703(a). If that congressional choice means anything, it means that the *Church* court is wrong. Thankfully, while a later court gestured toward the *Church* view,[67] it seems to have disappeared in subsequent case law.[68]

While precedent and regulations efficiently winnow the cases that require a § 2703(b) analysis, it must be determined whether, among the remaining cases, courts have employed the three prongs of § 2703(b) to discern accurately between legitimate and purely tax-driven restrictions and options. Two cases—*Holman* and *Estate of Amlie*[69]—illustrate where recent jurisprudence has drawn that line.

The first prong asks whether a restriction or option is "a bona fide business arrangement."[70] Precedent offers ample guidance for what qualifies as such an arrangement. A restriction or option can qualify, for instance, if the arrangement furthers "maintenance of family ownership and control" of a business.[71] For § 2703, that "family control" rationale is vitally important, since true § 2703(b) analyses are generally (though not always) targeted at family-controlled entities.[72] This family control rationale is not just valid as a matter of precedent, but also as a matter of economic reason. It makes intuitive economic sense that a value-maximizing family business could be motivated to contractually mandate sustained family control. A business often functions most efficiently

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65 *Id.* at *8.

66 H.R. 5425, 101st Cong. § 2703(a)(1)-(3). In its read of the regulations, the *Church* court also seemingly ignores Treas. Reg. § 25.2703-1(a)(3). *See also* Rev. Rul. 2008-35, 2008-29 I.R.B. 116.

67 Smith v. United States, No. C.A. 02-264 ERIE, 2004 WL 1879212, at *4 (W.D. Pa. June 30, 2004), *report and recommendation adopted*, No. C.A. 02-264 ERIE, 2004 WL 2051218 (W.D. Pa. July 23, 2004).

68 The *Holman* courts did not even mention the *Church* view. Holman v. Comm'r, 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).

69 *Id.*; Estate of Amlie v. Comm'r, T.C. Memo. 2006-76, 91 T.C.M. (CCH) 1017 (2006).

70 I.R.C. § 2703(b)(1).

71 Estate of Bischoff v. Comm'r, 69 T.C. 32, 39 (1977); *see also* St. Louis Cnty. Bank v. United States, 674 F.2d 1207, 1210 (8th Cir. 1982).

72 Treas. Reg. § 25.2703-1(b)(3).

when its owners share homogeneous goals and interests.[73] Family control can provide precisely such homogeneity. That familial cohesion is perhaps the primary organizational advantage that a family business can have. Accordingly, rational family shareholders may be willing to decrease the immediate value of their holdings—through restrictions and buy-sell options—to cement family control. That control can, at least theoretically, drive the long-term value of the business. Such arrangements can be legitimate as a theoretical business matter, so § 2703(b)(1) should (and does) respect them.

However, this rationale loses its validity when the restrictions or options have no relation to the management of an actual business. The *Holman* court recognized as much.[74] In *Holman*, the taxpayers moved their public Dell stock—an immaterial amount relative to Dell's market capitalization—into a restrictive partnership and then gifted partnership interests to their children.[75] On their gift tax returns for the relevant years, the taxpayers claimed steep discounts on the gifts' values relative to the market price of the Dell equity.[76] In this context, the family control rationale has no relevance.[77] The partnership restrictions did nothing to further efficient family management of an enterprise, since there was no enterprise.[78] The restricted entity was "a mere asset container."[79] The *Holman* court rightly denied the "family management/control" rationale as viable in this context for § 2703(b)(1).[80]

That is not to say that investment entities cannot qualify under § 2703(b)(1). On the investment front, the *Holman* court noted that the "strongest cases" for the taxpayers were a cluster of three decisions where a legitimate business purpose was found for "investment entities

73 *See* HENRY B. HANSMANN, THE OWNERSHIP OF ENTERPRISE 39-44 (1996); Henry B. Hansmann, *Ownership of the Firm*, 4 J. L., ECON. & ORG. 267, 302 (1988). That homogeneity helps to decrease the costs and difficulty of collective decision-making.

74 Holman v. Comm'r, 601 F.3d 763, 770 (8th Cir. 2010) ("We. . .have held. . .family ownership and control of [a] business may be a bona fide business purpose. . .We have not so held. . .in the absence of a business."(citations omitted) (internal quotation marks omitted)).

75 *Id.* at 765.

76 *Id.* at 766-67. The taxpayers attempted to claim an over 49% discount to the shares' market price.

77 *Id.* at 770 ("In answering the question of whether a restriction constitutes a bona fide business arrangement, context matters.").

78 *Id.* at 771. The only business at issue was Dell, and of course, these restrictions and options did nothing to affect Dell's management or operations.

79 *Id.* at 772 (quoting Estate of Erickson v. Comm'r, T.C. Memo. 2007-107, 93 T.C.M. (CCH) 1175, 1181 (2007)).

80 Louis A. Mezzullo, *Holman Sheds Light on the Reach of § 2703*, 35 EST., GIFTS & TR. J. 249, 252 (2010) ("[I]f the word 'business' in [§ 2703(b)(1)]. . .has any meaning, the Tax Court and the 8th Circuit got it right [in *Holman*].").

with restrictions imposed to ensure perpetuation of an investment model or strategy."[81] These cited cases all dealt with the "bona-fide sale" exception to § 2036(a).[82] Of the three cases, two are immediately distinguishable from the *Holman* facts.[83] In these cases—*Black* and *Murphy*—the taxpayers' families owned, through investment entities, sizable minority and/or majority stakes in companies and other investment assets.[84] The consolidated investment entities were a means to exercise meaningful managerial control over the operations of the underlying assets. As such, the family management and control rationale was as valid as it would be for a pure operating (as opposed to investing) business. The difficult case to distinguish is *Estate of Schutt*.[85] In that case, much as with the Dell stock in *Holman*, the investment entities held stakes in two massive public companies, Exxon and DuPont.[86] The stock was valuable as a monetary matter, but given the size of the companies, the holdings were irrelevant from a shareholder influence perspective.[87] The *Holman* court differentiated *Schutt* on the basis that the *Schutt* taxpayer, unlike those in *Holman*, was effectuating "a specific buy-and-hold investment strategy."[88] It is generous to describe the *Schutt* investment regime as a "strategy."[89] The taxpayer was merely, through decades, holding two blue-chip stocks.[90] If the *Holman* taxpayers had stipulated that they had a "specific. . .investment strategy"[91] of perpetually retaining Dell equity, their situation would be indistinguishable from *Schutt*. It is too easy and formalistic to allow cases to turn on such a nominal "investment strategy." Reading between the lines, it thus seems like *Schutt* is distinguished for other reasons. As one commentator noted, the judgment may be "that the bona fide business arrangement test is more difficult to satisfy than the bona fide sale exception to § 2036(a)."[92] In other words, to support the family control rationale

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81 *Holman*, 601 F.3d at 771.

82 To qualify for this § 2036(a) exception, transfers need a "legitimate business purpose[ ]." *Id.* The Holman court found this § 2036(a) issue analogous to § 2703(b)(1), or at least analogous enough to consider these § 2036(a) cases.

83 Estate of Murphy v. United States, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009); Estate of Black v. Comm'r, 133 T.C. 340 (2009). The Holman opinion did not state how distinguishable these two cases are, but that judgment is implicit in the opinion's greater focus on *Schutt*. *Holman*, 601 F.3d at 771.

84 *Estate of Murphy*, 2009 WL 3366099, at *9; *Estate of Black*, 133 T.C. at 363.

85 Estate of Schutt v. Comm'r, T.C. Memo. 2005-126, 89 T.C.M. (CCH) 1353 (2005).

86 *Id* at 1361.

87 *Id.*

88 *Holman*, 601 F.3d at 771.

89 *Id*.

90 *Estate of Schutt*, 89 T.C.M. at 1354.

91 *Holman*, 601 F.3d at 771.

92 Mezzullo, *supra* note 80, at 252.

under § 2703(b)(1) for an investment entity (as opposed to an operating business), the court was really looking for a fact pattern more like those in *Black* and *Murphy*, where the investment entities facilitated real operational involvement with (and influence on) the underlying assets. This read of *Holman* rightly limits the family control rationale for a business arrangement to where it can make long-term economic sense.[93]

This interpretation was borne out in the subsequent *Fisher* case, where the taxpayers presented the type of nominal investment strategy that would have aligned the *Holman* fact pattern with *Schutt*.[94] In substance, the restricted LLC in *Fisher* was "a mere asset container" for personal-use lakefront property.[95] Instead of accepting the *Schutt*-style buy-and-hold strategy on its face, the *Fisher* court looked for substantive evidence of active commercial management. It found none and declared § 2703(b)(1) inapplicable on summary judgment.[96]

As the other leading § 2703(b)(1) case—*Estate of Amlie*[97]—illustrates, however, family control is not the only possible rationale to support a "bona fide business arrangement."[98] Certain passive interests can qualify as well. In *Amlie*, the taxpayer held a substantial minority interest in a privately-held bank.[99] The stake was entirely passive.[100] That bank merged into FABG, another bank.[101] At this point, the taxpayer's conservator deemed it prudent—and perhaps even required as a fiduciary matter—to secure a fixed-price stock repurchase guarantee from FABG.[102] This at-death reciprocal put/call option (with related transfer restrictions) between the taxpayer and FABG provided "a hedge against the risk. . .in holding a minority interest in a closely held bank."[103] Due to bitter litigation among prospective beneficiaries, the put/call option

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93 Brent B. Nicholson, Holman v. Commissioner*: A Death Knell for the Tax Value of Transfer Restrictions in Family Limited Partnerships?*, 2 WM. & MARY BUS. L. REV. 291, 319-20 (2011) ("The majority in *Holman* got it right . . . . The arrangement was certainly not designed for a business purpose.").

94 Fisher v. United States, No. 1:08-CV-0908-LJM-TAB, 2010 WL 3522952, at *1 (S.D. Ind. Sept. 1, 2010) (The LLC operating agreement "provides that the Fishers formed . . . [the LLC] . . .to engage in the business of investing in and holding for investment real property.").

95 *Holman,* 601 F.3d at 772 (quoting Estate of Erickson v. Comm'r, T.C. Memo. 2007-107, 93 T.C.M. (CCH) 1175, 1181 (2007)).

96 *Fisher*, 2010 WL 3522952, at *4-5.

97 Estate of Amlie v. Comm'r, T.C. Memo. 2006-76, 91 T.C.M. (CCH) 1017 (2006).

98 I.R.C. § 2703(b)(1).

99 *Estate of Amlie*, 91 T.C.M. (CCH) at 1019. Since the underlying business was not family-controlled, it may seem like Treas. Reg. § 25.2703-1(b)(3) should handle this case. It does not because the buy-sell agreement did not apply to other shareholders. *Id.*

100 *Id.* at 1026.

101 *Id.* at 1020.

102 *Id*.

103 *Id.*

was instituted between the taxpayer and one of the beneficiaries, her son Rod Amlie, rather than the taxpayer and the bank.[104] However, the hedging function remained the same. A couple of years later, Rod Amlie negotiated a substantially higher price with FABG for the repurchase of its shares from him once they passed to him through his mother's estate.[105]

Amlie presents the wrinkle of the second agreement with the beneficiary Rod Amlie, but for purposes of § 2703(b)(1), the important fact is that a passive minority shareholder in a closely-held business entered into a buy-sell agreement to hedge her minority-status risk. The *Amlie* court found that to be a legitimate rationale for a business arrangement to qualify under § 2703(b)(1).[106] That determination was the right one. Minority ownership in a closely-held business is particularly risky,[107] and absent tax considerations, arm's-length parties will negotiate to hedge or otherwise mitigate that risk. As such, even when a transferor owns a purely passive interest, restrictions and options can still qualify for § 2703(b)(1). The key is that the underlying business must be closely-held, such that minority ownership presents real risks beyond the typical vicissitudes of the market, and the option (along with any related restrictions) must mitigate that heightened risk.

While nuanced, a § 2703(b)(1) analysis can at least be decided on the presence (or absence) of specific business contexts.[108] It is an objective question whether those circumstances exist. Section 2703(b)(2) asks whether the option or restriction at issue is "a device to transfer such property" for below-market value.[109] This prong threatens to turn into a messy, subjective question of testamentary intent. Mercifully, "[C]ourts applying the device test often look to objective evidence in determining the parties' 'intent' or 'purpose.'"[110] This approach assures objective, systematized analysis. Precedential continuity is vitally important here, providing the specific types of "objective evidence" that are commonly

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104 *Id.* at 1021-22.

105 *Id.* at 1022

106 *Id.* at 1026-27.

107 Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 699 (1993) ("[C]entralized control and majority rule, when combined with the lack of a public market for shares in a close corporation, leave a minority shareholder vulnerable in a way. . .distinct from the risk faced by investors in public corporations.").

108 Family control and minority risk are not the only justifications for a business arrangement. They are just the most relevant here. Business arrangements can also be bona fide when used "to retain key employees, to provide management incentives, or to provide shareholder/key-employees with continued employment." Anthony J. Testa Jr., *Buy-Sell Agreements and the Web of Federal Estate and Gift Tax Exposure*, 27 DEL. J. CORP. L. 181, 198 (2002).

109 I.R.C. §2703(b)(2).

110 BOGDANSKI, *supra* note 39, § 6.04(2)(c)(ii).

considered.[111] In *Estate of True*, the court summed up the list of factors, as forged in pre-section 2703 precedent:

> (1) the decedent's ill health when entering into the agreement, (2) lack of negotiations between the parties before executing the agreement, (3) lack of (or inconsistent) enforcement of buy-sell agreements, (4) failure to obtain comparables or appraisals to determine the buy-sell agreement's formula price, (5) failure to seek professional advice in selecting the formula price, (6) lack of provision in buy-sell requiring periodic review of a stated fixed price, (7) exclusion of significant assets from the formula price, and (8) acceptance of below-market payment terms for purchase of decedent's interest.[112]

The *True* court was discussing these factors in the context of an at-death buy-sell agreement, but most apply to any other § 2703 restrictions or options.[113] These factors are "judged at the time the agreement is entered" rather than with adjudicatory hindsight,[114] which is especially important for the eighth factor. As illustrated in *Holman* and *Amlie*, these factors can be weighed and considered based on the particulars of the situation. In *Amlie*, factors two through eight weighed in favor of the taxpayer.[115] The buy-sell price was formulated through a professional appraisal based on comparable holdings, and the price adjusted upward over time.[116] Moreover, the price was aggressively negotiated among adversarial parties.[117] The transferor's health was deteriorating,[118] but that meant little in the circumstances, since the conservator was the self-initiating negotiator. The taxpayer deserved to qualify under § 2703(b)(2).[119]

In *Holman*, ill-health had no relevance to the *inter vivos* transfer, but the family members entered the ostensibly value-destroying partnership without negotiation, even though some Dell shares were trans-

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111 *Id.*

112 Estate of True v. Comm'r, T.C. Memo. 2001-167, 82 T.C.M. (CCH) 27, 51 (2001), *aff'd,* 390 F.3d 1210 (10th Cir. 2004) (citations omitted).

113 *Id.* In terms of application to restrictions or options aside from buy-sell agreements, the treatment should be the same as with the Wilson-Lomb test. *See supra* text accompanying note 57.

114 Estate of Amlie v. Comm'r, T.C. Memo. 2006-76, 91 T.C.M. (CCH) 1017, 1026 (2006).

115 *Id.* at 1026-27.

116 *Id.*

117 *Id.*

118 *Id.* at 1019, 1022.

119 *Id.* at 1026-27.

ferred into the partnership from the children's custodial accounts.[120] The *Holman* Tax Court found that the partnership restrictions failed to qualify for § 2703(b)(2) primarily based on a version of the eighth factor.[121] The issue was the partnership's partner buyout provision for impermissible (i.e., any) transfers. In essence, the parental general partners could force the purchase of partnership interests from children trying to sell interests.[122] This partnership-interest purchase price would be well below the value of the underlying Dell equity attributable to that interest.[123] The benefit of that value discrepancy would accrue to the other children in the partnership.[124] The court thus found that the partnership restrictions constituted a vehicle for below-market transfer to the natural objects of the parents' bounty.[125]

This approach to the § 2703(b)(2) analysis—weighing all or some of the *True* court's list of objective factors—is the optimal one. A subjective test of intent would more directly address the question that §2703(b)(2) is meant to answer, but evidentiary issues make a subjective approach impracticable.[126] However, on the opposite end of the spectrum, an inflexible objective test where a taxpayer had to satisfy all the relevant factors would be inequitable. Consider, for instance, the ill-health criterion. It is often a helpful tool in the testamentary device determination.[127] However, were ill-health always required to find against the taxpayer, it would invert the results in *Amlie* and *Holman*, cases that were both rightly decided. Accordingly, this middle-ground—a menu of possibly relevant objective factors considered based on which are pertinent to the particular case—is the best approach available. Multi-factor legal tests can become "redundant, incomplete and unclear,"[128] but that risk is most acute where, unlike here, the test involves imponderable

120 Holman v. Comm'r, 130 T.C. 170, 179 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010). One would expect a rational custodian to negotiate some consideration for the exchange of liquid Dell shares for illiquid, constrictive partnership interests, at least where that partnership merely holds those same shares.

121 *Id.* at 195-97. The circuit court declined to review the lower court's § 2703(b)(2) analysis. The issue was moot once it affirmed on § 2703(b)(1).

122 *Id.* at 196.

123 *Id.*

124 *Id.*

125 *Id.* The lack of negotiation with respect to the custodial account transfer was perhaps a clearer reason to find § 2703(b)(2) unsatisfied, but the court did not focus on that aspect of the transaction.

126 *Cf.* Pevsner v. Comm'r, 628 F.2d 467, 470 (5th Cir. Unit A 1980) (choosing an objective over a subjective test for similar administrability reasons in another tax context).

127 *See, e.g.*, Estate of Lauder v. Comm'r, T.C. Memo. 1990-530, 60 T.C.M. (CCH) 977, 978 (1990); Slocum v. United States, 256 F. Supp. 753, 755 (S.D.N.Y. 1966).

128 Palmer v. City of Chicago, 806 F.2d 1316, 1318 (7th Cir. 1986).

moral (or otherwise incalculable) variables.[129] With § 2703(b)(2), these objective factors are either present or not, and the factors that should be considered pertinent, as in the ill-health example, are generally self-evident based on the context.

The final prong of the § 2703(b) safe harbor is the requirement that the terms of the option or restriction "are comparable to similar arrangements entered into by persons in an arms' [sic] length transaction."[130] This comparability requirement is final in the sense that it comes last sequentially in the statute, but more than that, this prong should be the final one considered because it presents the most difficulty. At first blush, § 2703(b)(3) seems to invite a straightforward application: compare the terms of other actual business arrangements in the same industry. However, "[A]vailable data on arrangements entered into among private parties can be sparse, if any exist,"[131] and moreover, "[I]n the same line of business, data will be scarcer still; an entity seems less likely to share financial data with a competitor than with virtually anyone else."[132] To combat this problem, one group of lawyers made a valiant attempt to compile publicly-filed partnership agreements to use for § 2703(b)(3) comparisons.[133] However, as they conceded, "[I]t may be impractical to identify arm's length partnership agreements that are in the same or similar business to that of the partnership under examination."[134] Public resources seemingly do not provide the right data.

Given this evidentiary issue, courts have moved, understandably, toward accepting expert testimony and—specifically for quantitative restrictions like a buy-sell option price—appraisals based on comparable market sales. In earlier dicta in *Estate of Blount*, the Tax Court strongly indicated that it wanted actual evidence of other, real-world business arrangements.[135] However, by the time of *Amlie*, the Tax Court was largely satisfied with an appraisal methodologically similar to the one dismissed as insufficient in *Blount*.[136] In *Holman*, while neither the Tax

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129 *E.g.*, Mathews v. Eldridge, 424 U.S. 319, 339-49 (1976).

130 I.R.C. § 2703(b)(3).

131 Bogdanski, *supra* note 39, § 6.04(2)(c)(iii).

132 *Id.*

133 Francis X. Burns et al., *Valuing Limited Partnership Interests*, 149 Tr. & Est., Oct. 2010, at 33.

134 *Id.* at 38. The authors go on to argue that certain financial terms should be comparable across entities in entirely different lines of business, so their methodology should thus still be usable to satisfy § 2703(b)(3). *Id.* at 38-39. That argument is debatable as a normative matter, much less as a legal one under the statute. Moreover, their application of that premise produced taxpayer-unfriendly results. *Id.* at 40.

135 Estate of Blount v. Comm'r, T.C. Memo. 2004-116, 87 T.C.M. (CCH) 1303, 1315 (2004), *aff'd on this issue*, 428 F.3d 1338 (11th Cir. 2005).

136 Estate of Amlie v. Comm'r, T.C. Memo. 2006-76, 91 T.C.M. (CCH) 1017, 1027 (2006).

Court nor the Eighth Circuit reached the § 2703(b)(3) issue, commentators were heartened by "the willingness of the court to accept testimony concerning the comparability requirement" as opposed to requiring other actual agreements.[137] Looking to the legislative history of § 2703, Congress expressed concern that § 2703(b)(3) should not be made too high a hurdle for taxpayers,[138] and acceptance of expert testimony and appraisals is consonant with that concern. Moreover, as a matter of precedential continuity, pre-section 2703 arm's-length analyses did not require other business agreements be entered into evidence.[139]

However, it is still advisable, as both *Holman* courts did, to consider § 2703(b)(3) only if an option or restriction satisfies all the other safe-harbor requirements (and cannot otherwise be deemed compliant or noncompliant). Unlike § 2703(b)(2), where the fact and form of professional input and appraisal are important, § 2703(b)(3) is about the substance of those professional judgments. The judge needs to choose between each side's impeccably-credentialed appraisal experts, who will each give resolute defense to the market validity (or invalidity) of an appraisal or restriction.[140] The judge is unenviably stuck deciding what qualifies as reasonable market practice. The courtroom is an ill-suited forum for such business judgments.[141] Accordingly, the *Amlie* court exemplified the best approach to § 2703(b)(3)—a measure of deference and an aversion to hindsight bias. In that vein, the *Amlie* court probed the relevant appraisal, though not too aggressively.[142] Although the equity at issue was priced at an over 84% markup to the buy-sell price within two years, the court noted the *ex post* factors that may have con-

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137 Mezzullo, *supra* note 80, at 250. It is still conjectural how either *Holman* court would have ruled on this issue.

138 H.R. Rep. No. 101-964, at 1137 (1990) (Conf. Rep.) ("The conferees do not intend . . . to disregard such an agreement merely because its terms differ from those used by another similarly situated company . . . [G]eneral business practice may recognize more than one valuation methodology . . . [O]ne of several generally accepted methodologies may satisfy the standard."); *see also* Treas. Reg. § 25.2703-1(b)(4)(ii).

139 *E.g.*, Dorn v. United States, 828 F.2d 177, 182 (3d Cir. 1987); Estate of Carpenter v. Comm'r, T.C. Memo. 1992-653, 64 T.C.M. (CCH) 1274, 1280 (1992); *see also supra* note 37 and accompanying text (explaining precedential origins of arm's-length test).

140 *E.g.*, Holman v. Comm'r, 130 T.C. 170, 198-99 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010). In its opinion, the *Holman* Tax Court excerpted testimony from such opposed, adamant experts. Since the court ultimately declined to address the issue, one imagines that the court included the excerpts to illustrate the difficulty of § 2703(b)(3).

141 *Cf.* Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838 (7th Cir. 1999) (observing, analogously, that judges are ill-suited to determine a market-rate salary); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 810-11 (Sup. Ct. 1976) ("The directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions.").

142 *See* Estate of Amlie v. Comm'r, T.C. Memo. 2006-76, 91 T.C.M. (CCH) 1017, 1027-28 (2006).

tributed to the higher price.[143] Functionally, the *Amlie* court employed § 2703(b)(3) as a sanity check on the buy-sell agreement, rather than an invasive analysis. This approach is the right one, and not only due to the limits of judicial business expertise. As noted above,[144] it is important to consider the ways in which § 2703 departed from established law. The independent § 2703(b)(3) requirement was one such departure.[145] As such, it must add something to the analysis. However, that imperative must be balanced against congressional concern with applying § 2703(b)(3) too aggressively.[146] The *Amlie* court's sanity check approach, with an allowance for expert testimony, balances these two countervailing imperatives.

This Part thus concludes that courts and regulations have been balanced in their overall application of § 2703. Regulations and case law provide a helpful winnowing function to decide cases without resorting to § 2703(b). Where a real § 2703(b) safe-harbor analysis is necessary, the first two prongs of the safe harbor are decided based on fair, objective factors, with the final prong as a somewhat deferential sanity check on the arrangement's substance. Post-enactment regulations and case law have thus addressed concerns about "highly subjective" application of the statute.[147] Certain commentators find § 2703, both in theory and in practice, far too friendly to either the IRS or taxpayers.[148] However, judged against its congressionally-mandated aims, § 2703 has been, as a general matter, soundly implemented.

II. Remaining Interpretive Issues

This review of § 2703's legislative history and post-enactment interpretation does not only serve to evaluate the statute's implementation. It also provides the tools and background necessary to resolve outstanding interpretive issues with the statute. Specifically, this Part address two sets of issues: (a) unanswered questions about the applicability of § 2703(b)(2) to certain transactions and (b) problems of valuation that often occur once a restriction or option is deemed not to qualify for the § 2703(b) safe harbor.

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143 *See Id.*

144 *See supra* Part I.A.

145 *See supra* text accompanying notes 35-37.

146 *See supra* note 138 and accompanying text.

147 Testa, *supra* note 108, at 205.

148 Calvin H. Johnson & Joseph M. Dodge, *Passing Estate Tax Values Through the Eye of the Needle*, 132 Tax Notes 939, 941-42 (2011) (finding §§ 2703-04 too weak); Mark R. Siegel, *The Internal Revenue Code's Assault on Buy-Sell Agreements*, 54 La. L. Rev. 149, 168 (1993) (deeming § 2703 an overly-aggressive "legislative intrusion").

A. Section 2703(b)(2) and *Inter Vivos* Transfers: A Response to Judge Beam

In his dissent to the majority opinion in *Holman*, Judge C. Arlen Beam makes a compelling argument that § 2703(b)(2)—the second prong of the safe harbor—is only applicable for estate-related (and not gift or, presumably, *inter vivos* Generation Skipping Transfer ("GST")) tax purposes.[149] In other words, for purposes of *inter vivos* transfers, restrictions or options are only required to satisfy the first and third prongs of the safe harbor to avoid application of § 2703(a). Judge Beam reaches this conclusion because § 2703(b)(2) asks whether the option or restriction at issue is "a device to transfer . . . to members of the *decedent's* family."[150] Judge Beam notes—and it is, of course, hard to argue with him—that the term decedent unambiguously refers to a "dead person."[151] As such, by virtue of its plain language, § 2703(b)(2) only operates when there is a "dead person" at issue,[152] i.e. in the estate tax or postmortem GST context. In Judge Beam's view, the companion regulation impermissibly expands the reach of § 2703(b)(2) by referencing "the transferor[ ]"[153] where the statute is perfectly clear in its reference to a "decedent[ ]."[154] Thus, insofar as the regulation is a back-door attempt to cover *inter vivos* transfers, the regulation is invalid.[155] Similarly, § 2703(b)(2) only covers "device[s]" to transfer to the decedent's "*family*."[156] Again, in Judge Beam's view, the regulation makes an end-run around the statute's unambiguous language. In its second *ultra vires* turn of phrase, the regulation expands § 2703(b)(2) to cover transfers to the broader "natural objects of. . .bounty."[157]

The majority did not find it necessary to address § 2703(b)(2),[158] so Judge Beam's analysis goes unanswered in the majority opinion. The IRS, however, argued the issue in its brief. The Service makes a two-step argument. First, as a matter of statutory interpretation, the *inter vivos* applicability of § 2703(b)(2) is ambiguous. Section 2703 is supposed to apply, by the statute's own terms, "[f]or purposes of this subtitle."[159] As the IRS notes, "this subtitle" is "Subtitle B of the Code,

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149 Holman v. Comm'r, 601 F.3d 763, 780-81 (8th Cir. 2010) (Beam, J., dissenting).
150 I.R.C. § 2703(b)(2) (emphasis added).
151 *Holman*, 601 F.3d at 781.
152 *Id.*
153 Treas. Reg. § 25.2703-1(b)(1)(ii).
154 I.R.C. § 2703(b)(2).
155 *Holman*, 601 F.3d at 781.
156 *Id.*; I.R.C. § 2703(b)(2) (emphasis added).
157 Treas. Reg. § 25.2703-1(b)(1)(ii).
158 Their affirmation on § 2703(b)(1) was enough to find the safe harbor inapplicable.
159 I.R.C. § 2703(a).

which includes the estate tax (Chapter 11), the gift tax (Chapter 12), and the tax on generation-skipping transfers (Chapter 13)."[160] These conflicting aspects of § 2703—the narrower reference to "decedent[ ]"[161]and the broader reference to the entire "subtitle"[162]—engender ambiguity through their tension. This ambiguity moves the analysis to the deferential territory of the *Chevron* doctrine.[163] Under *Chevron*, if a statute is ambiguous, courts must respect an administrative agency's interpretation of that statute if that interpretation is, in a broad sense, "reasonable."[164] The IRS thus asserted that *Chevron* required the court to defer to its interpretation of § 2703(b)(2) as embodied in Treas. Reg. § 25.2703-1(b)(1)(ii).[165] Moreover, the IRS argued that its interpretation fulfilled another norm of statutory construction: holistic reading. As the Supreme Court has explained, "Statutory construction is a holistic endeavor, and. . .must account for a statute's full text, language as well as punctuation, structure, *and subject matter*."[166] In the IRS's telling, given these interpretive norms, § 2702(b)(2) must be applied as the IRS reads it, to cover all transfer tax contexts (and to cover all natural objects of bounty). Some commentators have reiterated strands of the IRS's argument.[167]

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160 Brief for Appellee at 38, Holman v, Comm'r, 601 F.3d 763 (8th Cir. 2010) (No. 08-3774), 2009 WL 789127.

161 I.R.C. § 2703(b)(2).

162 *Id.* § 2703(a).

163 *See* Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 844 (1984) (explaining that if a statute is ambiguous, administrative regulations on points of ambiguity "are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute"); Brief for Appellee, *supra* note 160, at 35-37.

164 *Chevron*, 467 U.S. at 844; *see also* Thomas W. Merrill & Kristin E. Hickman, *Chevron's Domain*, 89 GEO. L.J. 833, 833 (2001) ("*Chevron* expanded . . . mandatory deference through one simple shift . . . It posited that courts have a duty to defer to reasonable agency interpretations not only when Congress expressly delegates interpretative authority . . . but also when Congress is silent or leaves ambiguity in a statute. . . .").

165 Brief for Appellee, *supra* note 160, at 34-39.

166 U.S. Nat'l Bank of Or. v. Indep. Ins. Agents of Am., Inc., 508 U.S. 439, 455 (1993) (emphasis added) (citations omitted) (internal quotation marks omitted); *see also* Brief for Appellee, *supra* note 160, at 37.

167 *See, e.g.*, JOSEPH M. DODGE, WENDY C. GERZOG & BRIDGET J. CRAWFORD, FEDERAL TAXES ON GRATUITOUS TRANSFERS: LAW AND PLANNING 193-94 (2011). Dodge, Gerzog, and Crawford also put forward the argument that Judge Beam inverts the issue. They argue that, if Judge Beam is correct, an *inter vivos* transfer can never qualify for § 2703(b)(2) since "it is the exception that cannot (literally) apply" to *inter vivos* contexts. *Id.* at 193. However, that counterargument (rather than Beam's view) is the inversion. Section 2703(b)(2) is phrased in the negative—requiring that a restriction or option "is *not* a device." I.R.C. § 2703(b)(2) (emphasis added). As such, assuming the validity of Judge Beam's literal read of "decedent," any *inter vivos* situation, by definition, "is not" a decedent's device. *Id.*

While the Service offers a colorable argument, their position feels inadequate relative to Judge Beam's plain-language obviousness. After all, *Chevron* deference does not apply if the statute is clear,[168] and in Judge Beam's telling, the statutory language could not be clearer. However, the interpretive lessons from Part I demonstrate that Judge Beam's appealing § 2703(b)(2) argument is ultimately incorrect.

On this *inter vivos* issue, the key is to remember that § 2703 was a partial (and not a full) codification of existing law in this area.[169] Prior to § 2703, established law and regulation granted the IRS power to disregard buy-sell agreements or other § 2703-applicable restrictions for certain reasons other than those listed in the § 2703(b) safe harbor.[170] As Congress stipulated,[171] § 2703 was enacted to "supplement, not replace, prior case law."[172] Accordingly, those pre-existing reasons to disregard applicable restrictions remain valid. Congress provided the example that § 2703 "leaves intact present law rules requiring that an agreement have lifetime restrictions in order to be binding on death."[173]

Prior to § 2703, it was a well-established principle "that restrictive agreements, such as the buy-sell agreements. . .*generally do not control value for [f]ederal gift tax purposes*."[174] In the gift context, the IRS has long had tremendous leeway to disregard § 2703-type restrictions on gifts, much more so than in the estate tax context.[175] Several considera-

168 *See Chevron*, 467 U.S. at 842-43 (1984) ("If the intent of Congress is clear . . . the court . . . must give effect to the unambiguously expressed intent of Congress.").

169 *See supra* notes 43-44 and accompanying text.

170 *E.g.*, Treas. Reg. § 20.2031-2(h) (as amended 2006); *see also* Jerold I. Horn, *Buy-Sell Agreements Under Chapter 14, Including Amendment/Modification of Grandfathered Agreements, and Drafting New Agreements*, 21 ACTEC NOTES 37-38 (1995) (remarking on these pre-existing standards still in effect).

171 136 CONG. REC. 30,541 (1990) ("The bill does not otherwise alter the requirements for giving weight to a buy-sell agreement."). This avowal would be meaningless if the text of the statute contradicted it. However, the text does not do so. If § 2703(b) is applicable, it simply means that § 2703(a) "shall not apply." I.R.C. § 2703(b). Section 2703(b) *does not* state that, in addition to avoiding § 2703(a), compliance with § 2703(b) guarantees that no other restriction-disregarding facet of the Code—as expounded through regulations or case law—will apply, either. To contend otherwise leads to absurd results. The congressional example given in this portion of the record illustrates this point, for it cannot be seriously contended that a buy-sell option only binding at death should control for valuation purposes.

172 Estate of Amlie v. Comm'r, T.C. Memo. 2006-76, 91 T.C.M. (CCH) 1017, 1024 (2006).

173 136 CONG. REC. 30,541.

174 Estate of True v. Comm'r, T.C. Memo. 2001-167, 82 T.C.M. (CCH) 27, 71 (2001) (emphasis added) (citing copious pre-section 2703 cases holding that such restrictions do not control for gift tax purposes), *aff'd*, 390 F.3d 1210 (10th Cir. 2004).

175 Rev. Rul. 59-60, 1959-1 C.B. 237 ("[T]he option price *is not* determinative of fair market value for gift tax purposes . . . such agreement *may or may not*, depending upon

tions motivate this more aggressive gift treatment. The most salient for buy-sell options specifically is that, in the estate context, "the critical event (death) that subjects the stock to the purchase right has occurred, and. . .the seller-estate can receive no more than the formula price."[176] In contrast, gifts are voluntary. If a gift triggers an unwanted buy-sell obligation, the donor can choose not to give the gift. Where the donor can make the gift without tripping the buy-sell obligation (but where the transferred property remains subject to such obligation, which remains contingent on future events like the donor's death), the obligation is at most a potential "factor to be considered" in appraisal.[177] The present value of the interest may be affected, but not controlled, by the formula price at which it may eventually need to be sold.[178]

As such, it is irrelevant that the plain language of § 2703(b)(2) only refers to a "decedent[ ]."[179] If anything, given that regulatory background, § 2703(b) serves as a floor (and not a ceiling) for what the IRS can require to honor restrictions in the gift context. Insofar as the IRS has, for gifts, required no more than the satisfaction of § 2703(b)'s criteria, then that is the gift standard for taxpayers. Alternatively, at the least, this background law on gift treatment—when considered as part of interpreting § 2703(b)(2)—engenders the ambiguity necessary to trigger *Chevron* deference to the regulation.[180] And in either case, this gift background must be considered through the lens of another interpretive norm. As the Supreme Court has determined, "The federal estate tax and the federal gift tax. . .are construed *in pari materia*, since the purpose of the gift tax is to complement the estate tax by preventing tax-free depletion of the transferor's estate during his lifetime."[181] The IRS's interpretation best actualizes that imperative. Accordingly, § 2703(b)(2) can apply equally in both the estate and gift contexts. For what it is worth, after the enactment of Chapter 14, many practitioners seemed to assume that § 2703 (including the second safe-harbor prong) would be so read.[182]

With that established, it is possible to resolve a few final considerations on this issue. First, on the issue of natural bounty as opposed to

the circumstances of each case, fix the value for estate tax purposes." (emphasis added)); Rev. Rul. 189, 1953-2 C.B. 294.

176 *Estate of True*, 82 T.C.M. (CCH) at 72.

177 Spitzer v. Comm'r, 153 F.2d 967, 971 (8th Cir. 1946).

178 *See id.*

179 I.R.C. § 2703(b)(2).

180 Treas. Reg. §25.2703-1(b)(1)(ii).

181 Harris v. Comm'r, 340 U.S. 106, 107 (1950) (citations omitted).

182 E. James Gamble, *Buy-Sell Agreements, Section 2703, and the Final Regulations*, 18 ACTEC NOTES 16, 17 (1992) ("Section 2703 also applies for gift tax valuation purposes.").

family, the argument is much the same. Pre-section 2703 standards like Treas. Reg. § 20.2031-2(h) used the "natural bounty" standard for the test that would become § 2703(b)(2). Moreover, the term "family" is not defined in § 2703, as in other Chapter 14 sections,[183] so that statutory silence grants the IRS leeway in its gloss of the term. In this vein, the other regulations blur the distinction between family and natural objects of bounty,[184] so this slippage between the concepts is not novel to § 2703(b)(2).

Second, one could argue that that this discussion only settles the § 2703(b)(2) issue for estate and gift taxes, but not the GST tax. The argument is that the above-cited pre-existing law related specifically to gift (and not GST) tax. That position is unsustainable. Even under Judge Beam's interpretation, § 2703(b)(2) covers GST transactions that occur at or after a transferor's death since a "decedent[ ]" is present.[185] That leaves *inter vivos* GST transactions. As a statutory matter, when GST exemption is allocated on a timely-filed gift tax return, the valuation for GST purposes statutorily must match the gift valuation.[186] Thus, for someone trying to argue this GST point, they are left asserting that § 2703(b)(2) should not apply only to *inter vivos* GST transfers where no GST exemption is allocated on a gift tax return. At this point, the imperative to construe transfer taxes "*in pari materia*" washes away what little is left of this GST argument.[187]

Lastly, to support his argument, Judge Beam notes that Congress failed in attempts to pass a technical correction to "substitut[e] the legislative phrase 'members of the decedent's family' with the Commissioner's phrase 'natural objects of the transferor's bounty.'"[188] According to Judge Beam, the fact that those subsequent bills failed supports his reading of the statute.[189] Insofar as, per the above, the IRS at least deserves *Chevron* deference for its interpretation, this issue is moot. Subsequent unpassed laws do not alter existing laws by negative implication. To contend otherwise undermines the democratic process, since it gives weight to legislation that did not have majority support. Moreover, Congress could have just as plausibly dropped the technical correction because it decided the issue was already settled.

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183 I.R.C. §§ 2701(e), 2702(e), 2704(c)(2).

184 Treas. Reg. § 25.2703-1(b)(3).

185 I.R.C. § 2703(b)(2)

186 *Id.* § 2642(b)(1).

187 Harris v. Comm'r, 340 U.S. 106, 107 (1950) (citations omitted). While *Harris* was decided long before the advent of the GST tax, *Harris*'s rule of construction undoubtedly applies to GST, since GST polices the borders of the estate tax just as the gift tax does.

188 Holman v. Comm'r, 601 F.3d 763, 781 (8th Cir. 2010); *see also* Horn, *supra* note 170, at 40.

189 *Holman*, 601 F.3d at 781.

The analysis required to respond to Judge Beam is far from simple, and so this Part II.A illustrates the hazards in partial codification of an already rich area of law. A comprehensive version of § 2703 that fully codified all existing law would perhaps be clearer. Regardless, the general applicability of § 2703(b)(2) retains a solid interpretive foundation.

B. Valuation When § 2703(a) Applies

1. *Post-*Holman *Confusion about Valuation under § 2703(a)*

When the IRS and a taxpayer wrestle over § 2703, the safe-harbor determination is only half the battle. If the taxpayer loses that question of law, the fight moves to the particulars of the resulting valuation. It is unclear from case law what, if any, weight should be given to § 2703-applicable restrictions that fail to meet the § 2703(b) safe harbor. The answer may seem self-evident. Section 2703(a) stipulates that value must be determined "without regard to" such restrictions,[190] and so such restrictions should be given no weight whatsoever. That answer is mostly right (with one caveat to be discussed later[191]), but the result in *Holman* has confused that plain meaning.

As has been discussed at length, the *Holman* court adjudged the examined partnership restrictions to be outside the § 2703(b) safe harbor.[192] After affirming the Tax Court on this point, the majority opinion moved on to valuation, and it is here that the IRS's victory became somewhat pyrrhic.[193] Even though the taxpayers lost on the law, they ultimately received discounts of 22.4%, 25% and 16.5% on their three respective gifts.[194] A portion of those discounts was due to the unregistered nature of the underlying Dell shares,[195] but that only generated part of the discounts.

The court found that no examined restriction in the partnership agreement qualified under § 2703(b); specifically, sections 9.1 through 9.3 of the partnership agreement—restrictions on the sale or assignment LP units—were deemed subject to § 2703(a).[196] So how did taxpayers still manage such steep discounts? They succeeded because the IRS did

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190 I.R.C. § 2703(a).

191 *See infra* Part IV.

192 *See Holman*, 601 F.3d at 765.

193 As one commentator noted, "The case overall is still a taxpayer victory." Steve R. Akers, Commentary, *Musings on Current Events:* Holman v. Commissioner, ACTEC .ORG (Mar. 11, 2015, 9:37pm), http://www.actec.org/public/AkersHolman8thCircuit.asp.

194 *See* Holman v. Comm'r, 130 T.C. 170, 216 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).

195 Holman v. Comm'r, 601 F.3d 763, 773-75. A discount for the unregistered nature of the Dell shares was unquestionably warranted. The IRS only contested the magnitude of that discount.

196 *Holman*, 601 F.3d at 767-68.

not challenge all the entity-level restrictions that it could have.[197] In particular, the partnership also had limits on partner withdrawal in section 8.4.[198] There is no reason to think that section 8.4 would have survived the § 2703(b) analysis that the other partnership sections failed. If the IRS had also won on section 8.4, the willing buyer/willing seller test would produce no (or only a nominal) discount, aside from the discount for the unregistered nature of the underlying shares. Where withdrawal rights are unfettered, a rational willing buyer would buy the partnership interest for a price at (or close) to the market value of the proportional underlying Dell shares. Subsequent to purchase, the buyer would be able to redeem its interest for that underlying value[199]—thereby justifying that price for the partnership interest. Note that in this § 2703(a) hypothetical where section 8.4 is excised from the agreement, more restrictive default state law restrictions that apply when partnership agreements are silent on withdrawal would also be disregarded.[200] Unlike other simultaneously-enacted provisions,[201] § 2703 makes no distinction between restrictions that are contracted or that apply as a matter of law.

Perhaps because the IRS was not as aggressive as it could have been in *Holman*, § 2703(a)'s ultimate valuation effects have been questioned.[202] In light of this uncertainty, it is important to recognize that, for § 2703(a) valuation purposes, entities must treated as if § 2703(a)-subject restrictions do not exist. That is the imperative inherent in § 2703's "without regard to" language.[203] That complete disregard is an important law change enacted through the statute. As noted above, § 2703 largely codified existing precedent and regulation, but the statute was not a mere restatement. It also "supplement[ed]" the regulatory framework.[204] Prior regulation contemplated the relative weight to give

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197 Assuming its strategic goal in *Holman* was to establish friendly § 2703 case law, the IRS may have solely targeted sections 9.1 through 9.3 to keep the litigation focused. However, this motivation is pure conjecture.

198 *See Holman*, 130 T.C. at 176.

199 *See* J. William Callison & Maureen A. Sullivan, Partnership Law & Practice: General and Limited Partnerships § 21:6 (2014).

200 *Holman*, 130 T.C. at 175 (stating that Minnesota law governed the *Holman* partnership); *see also* Minn. Stat. § 322.16 (2014) (illustrating that in *Holman*, Minnesota default law on limited partner withdrawal would apply).

201 I.R.C. § 2704(b).

202 *E.g.*, Deborah M. Beers, Commentary, Fisher v. U.S.*: District Court Ignores Transfer Restrictions in LLC Operating Agreement for Valuation Under § 2703*, 35 Est., Gifts & Tr. J. 288, 288-90 (2010) (noting uncertainly on *Fisher* valuation given *Holman* result); *see also* Alden Koste, Note, *The IRS Fished Its Wish: The Ability of Section 2703 to Minimize Valuation Discounts Afforded to Family Limited Partnership Interests in* Holman v. Commissioner, 59 Cath. U. L. Rev. 289, 311-14 (2009).

203 I.R.C. § 2703(a).

204 Estate of Amlie v. Comm'r, T.C. Memo. 2006-76, 91 T.C.M. (CCH) 1017, 1024 (2006).

buy-sell agreements and other restrictions.[205] By its own terms, § 2703(a) is not concerned with relative weight—it is an absolute directive to ignore covered restrictions unless § 2703(b) is applicable. To employ a relative weight analysis is to ignore a core innovation of the statute.

It is important to note a settled point of law that may seem in tension with this argument. Section 2703 is not a look-through provision. Whether or not entity-level restrictions are subject to § 2703(a), the "property" at issue is interests in that entity, not that entity's underlying assets. The IRS tried to employ § 2703 as a look-through provision.[206] It argued that that an entity itself can constitute a "restriction" that the statute disregards.[207] However, the Tax Court definitively quashed that argument in *Estate of Strangi*.[208] The *Strangi* court was right on this issue. Nothing in the statute's language indicates that § 2703 should operate as a look-through provision, nor does the existing case law or regulations provide for that view. If anything, § 2703's companion regulations point to the opposite. As the regulations explain, § 2703 is not an all-or-nothing question. If property "is subject to more than one right or restriction. . .the failure of a right or restriction to satisfy [§ 2703(b)] does not cause any other right or restriction to fail to satisfy those requirements."[209] In light of this independent analysis of each right and restriction, consider two taxpayers. Taxpayer *A* owns an interest in Partnership *A*, which has two restrictions in its partnership agreement, and only one of those restrictions qualifies for the § 2703(b) safe harbor. Partnership *A* only owns Asset *A*. Taxpayer *B* owns an interest in Partnership *B*, which has only one restriction in its partnership agreement, and that sole restriction does not meet the safe harbor. Partnership *B* only owns Asset *B*. It would be incongruous as a matter of legal form if

205 Treas. Reg. § 20.2031-2(h) (as amended 1992); *see* also Estate of True v. Comm'r, 390 F.3d 1210, 1241 (10th Cir. 2004).

206 *See* S. Stacy Eastland & John W. Porter, *Defending the Family Limited Partnership*—Estate of White v. Commissioner *in the United States Tax Court Docket No. 14412-97*, 23 ACTEC NOTES 278, 278 (1997) (The IRS "took the position that IRC § 2703 allowed it to disregard completely the existence of the applicable entity, whether or not that entity was validly created and existing.").

207 Eastland & Porter, *supra* note 206, at 304-05, Ex. 4.

208 Estate of Strangi v. Comm'r, 115 T.C. 478, 488-89 (2000) ("Treating the partnership assets, rather than decedent's interest in the partnership, as the 'property' to which section 2703(a) applies in this case would raise anew the difficulties that Congress sought to avoid by repealing section 2036(c) and replacing it with chapter 14. . . . Congress did not intend . . . to treat partnership assets as if they were assets of the estate where the legal interest owned by the decedent at the time of death was a limited partnership or corporate interest."), *aff'd on this issue and rev'd in part on other grounds*, 293 F.3d 279 (5th Cir. 2002).

209 Treas. Reg. § 25.2703-1(b)(5).

the § 2703 property for Taxpayer *A* were its interest in Partnership *A*, while the property for Taxpayer *B* were Asset *B*.

The tension arises, as in the above *Holman* hypothetical with section 8.4, where the valuation of the entity interest equals the value of the underlying assets. While, in form, that hypothetical differed from a look-through analysis, both approaches produced, in substance, equivalent valuations.[210] However, this equivalency only arises when the entity has no restrictions that qualify under § 2703(b). In such situations, this equivalency is proper. Such an entity is restriction-free for § 2703 valuation purposes, so it should be frictionless in relation to the underlying assets. Where any restrictive aspect of an entity or entity-related agreement is respected under § 2703(b), the entity-level and look-through valuations will diverge.

2. *Entity-Owned Insurance to Fund a Disregarded Buy-Sell Agreement*

An interesting challenge to the valuation scheme of § 2703 arose in *Estate of Blount*.[211] However, the ultimate valuation in *Blount* runs counter to the proper valuation method under § 2703. This aspect of *Blount* represents a rare recent case where a court has misapplied § 2703.

In *Blount*, the decedent passed away with a controlling-ownership stake in BCC, an active construction company.[212] The deceased owner had a buy-sell agreement between himself and the corporation.[213] A buy-sell agreement is also known as a "redemption agreement" when it is implemented, as here, between a shareholder and the company.[214] The redemption agreement failed to qualify for the § 2703(b) safe harbor (and was therefore entirely irrelevant for valuation purposes).[215] However, the company-counterparty to the buy-sell agreement had taken out a roughly three-million dollar insurance policy—payable upon the taxpayer's death—to finance its contractually-mandated share re-

210 *See* Holman v. Comm'r, 601 F.3d 763, 775 (8th Cir. 2010). In a look-through analysis, the value would be the value of the underlying assets.

211 Estate of Blount v. Comm'r, T.C. Memo. 2004-116, 87 T.C.M. (CCH) 1303 (2004), *aff'd in part and rev'd in part*, 428 F.3d 1338 (11th Cir. 2005).

212 *Id.* at 1305.

213 *Id*. at 1305-07.

214 Siegel, *supra* note 148, at 149.

215 *See* Estate of Blount v. Comm'r, 428 F.3d 1338, 1344-45 (11th Cir. 2005). The agreement was invalid because the transferor could unilaterally revoke it during life. Reasoning in the alternative, even if the agreement fulfilled that requirement, it was still judged to fail the § 2703(b)(3) comparability requirement. The taxpayer's appraisal essentially ignored nearly two million dollars in liquid assets, so even a sanity check application of § 2703(b)(3) would lead to that finding.

purchase.[216] The Tax Court included those insurance proceeds in the value of the company without an offset for the buy-sell repurchase obligation.[217] The Tax Court did so for two reasons. First, they read the "without regard to" language of § 2703(a) to require complete disregard of the buy-sell obligation in the valuation.[218] Second, even if the buy-sell obligation were valid, the Tax Court argued that "the redemption obligation should not be treated as a value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued."[219] While affirming on the disregard for the buy-sell agreement, the 11th Circuit reversed on this insurance issue and excluded the insurance proceeds from the valuation.[220]

The 11th Circuit elaborated minimally in its reversal.[221] It cited a prior case where, for corporate valuation purposes, insurance proceeds to a corporation used for shareholder redemption were offset against that redemption requirement.[222] However, aside from offering bare precedent for the offset, the case was not examined so as to demonstrate why the offset was proper. The 11th Circuit also cited Treasury Regulation § 20.2031-2(f)(2), which states in the relevant part that, for business entity valuation, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, *to the extent that such nonoperating assets have not been taken into account in the determination of net worth*."[223] The appellate panel viewed the use of the proceeds to pay off the redemption obligation as "tak[ing] into account" the life insurance policies (thereby excluding it from the regulatory imperative to "consider[ ]" the insurance proceeds in valuation).[224]

In essence, the court claimed that it saw no reason to treat the shareholder redemption obligation any differently than a liability to a third party.[225] However, that cannot fully explain its insurance exclusion. The insurance paid most, but not all, of the buy-sell obligation.[226] The 11th Circuit allowed the estate, in its valuation, to offset the buy-sell redemption requirement against the insurance proceeds, but it did *not*

216 *Estate of Blount*, 87 T.C.M. (CCH) at 1306.
217 *Id*. at 1319.
218 *Id*.
219 *Id*.
220 Estate of Blount v. Comm'r, 428 F.3d 1338, 1345 (11th Cir. 2005).
221 *Id.* at 1345-46.
222 Estate of Cartwright v. Comm'r, 183 F.3d 1034, 1038 (9th Cir. 1999).
223 Treas. Reg. § 20.2031-2(f)(2) (as amended 2006) (emphasis added).
224 *Id.*; *Estate of Blount*, 428 F.3d at 1345.
225 *See Estate of Blount*, 428 F.3d at 1346.
226 Estate of Blount v. Comm'r, T.C. Memo. 2004-116, 87 T.C.M. (CCH) 1303, 1319 (2004), *aff'd in part and rev'd in part*, 428 F.3d 1338 (11th Cir. 2005).

allow the estate to offset the remainder of the redemption obligation against other company assets.[227] If the redemption obligation were truly the same as a third-party liability—like four million dollars in accounts payable, for instance—the estate would receive a full offset in its valuation. With those hypothetical accounts payable, if the insurance went toward paying them, the accounts payable would offset the insurance payment. The excess accounts payable would then net out against other assets.

Beyond this discrepancy, the 11th Circuit's reasoning falls apart in simple application. To see how, one needs to consider the transfer tax valuation contexts in which this issue is relevant. This insurance issue is irrelevant where the redemption is subject to a valid buy-sell agreement that is respected for purposes of § 2703. In that context, the valuation is already set. As such, the insurance issue only matters where no valid agreement exists to set the entity interest value for transfer tax purposes—either because the buy-sell agreement is disregarded under § 2703 or no agreement exists. In this context, imagine Corporation *A* with two shareholders, Owner *1* and Owner *2*.[228] Each owner has a 50% interest in Corporation *A*. The owners have a redemption agreement with Corporation *A* that states, for whichever owner dies first, Corporation *A* will redeem that owner's interest at fair market value. Corporation *A* has no liabilities or obligations other than that redemption agreement. Owner *1* dies first, and at his death, the sole asset of Corporation *A* is eight million dollars in cash. Of course, Corporation *A* would fulfill the redemption obligation by paying Owner *1*'s estate four million dollars. There is no reason to believe that the 11th Circuit would disagree with that common-sense result. Now imagine the same set of facts with one change—Corporation *A* also owns an insurance policy that pays four million dollars upon the death of the first owner to die. The insurance policy is specifically for funding this redemption obligation. In this second scenario, how much would Corporation *A* pay Owner *1*'s estate? Under the 11th Circuit's reasoning, Corporation *A* would still only pay four million dollars, since the at-death insurance proceeds would be offset against the redemption obligation. In other words, Corporation *A* in the second scenario, which has twelve million dollars, is given the same valuation as Corporation *A* in the first scenario, which has eight million. The Corporation with four million more dollars and no additional obligations is given the same fair market value. It is untenable that Corporation *A* would pay the same amount in both situations,

227 Estate of Blount v. Comm'r, 428 F.3d 1338, 1345-46 (11th Cir. 2005).

228 For an additional array of hypotheticals demonstrating problems with the 11th Circuit's approach, see Adam S. Chodorow, *Valuing Corporations for Estate Tax Purposes: A* Blount *Reappraisal*, 3 HASTINGS BUS. L.J. 1, 20-29 (2006).

since "[c]learly, the company with the insurance is in much better shape than the company that had none."[229] However, that is what the 11th Circuit's reasoning requires.

There are two potential cures to this problem. To be consistent, the redemption obligation must be either treated as an offsetting liability against all assets (and not just insurance) or never treated as an offsetting liability. That first cure, however, is impossible in its circularity. In the first scenario, if the redemption obligation of four million is a liability, it reduces the overall FMV of Corporation *A* to four million. But then, based on that lower valuation, the redemption obligation falls to two million dollars, thereby again changing Corporation *A*'s overall FMV to six million. And so on. Thus, the only real solution is to *not* treat the redemption obligation as an offsetting liability in either scenario. That is the logic that the reversed Tax Court applied to *Blount*. Under this regime, Corporation *A* pays four million in the first scenario and six million in the second.[230] This logic should hold in any situation without a buy-sell agreement respected under § 2703. If, as in *Blount*, there is a redemption agreement (but it fails to qualify under § 2703(b)), the analysis is the same. Per Part II.B.1, once the restriction or agreement is deemed subject to § 2703(a), the valuation proceeds as if that restriction or agreement did not exist.[231]

The 11th Circuit's appeal to Treasury Regulations does nothing to salvage its position. As has been noted, "The legislative history of Treasury Regulations §§ 20.2042-1 and 20.2031-2(f) makes clear that insurance proceeds are to be treated no differently from other types of non-operating assets when valuing a corporation."[232] In other words, this special offset of redemption obligations only against insurance (and not other assets) finds no warrant in the Code. While creating this special preference for insurance proceeds used to fulfill redemption obligations—a preference that finds no statutory support—judges also fail to provide "any justification for creating a preference for life insurance-funded redemptions."[233] A *Blount* proponent could argue that the preference is justified because it will otherwise be too tax-adverse for shareholders to fund buy-sell agreements through insurance. As a preliminary matter, that argument is insufficient since the Code requires the oppo-

229 John A. Bogdanski, *Stock Buyouts Funded by Life Insurance: The Blount Conundrum*, EST. PLAN., June 2006, at 40, 42.

230 However, this does not mean insurance proceeds will increase every valuation dollar-for-dollar. As with the proper valuation method for any complicated business, it depends on the particulars of the valuation. *See* Estate of Huntsman v. Comm'r, 66 T.C. 861, 874 (1976); *see also* Chodorow, *supra* note 228, at 17.

231 *See* Bogdanski, *supra* note 229, at 41.

232 Chodorow, *supra* note 228, at 12.

233 *Id.* at 32.

site. However, that aside, shareholders can also avoid this valuation issue through cross-purchase agreements, where each shareholder individually purchases an insurance policy on all the other shareholders.[234] Under a cross-purchase agreement, the insurance proceeds accrue to surviving shareholders rather than the corporation, so no valuation issue arises at the corporate level. While redemption and cross-purchase agreements can have other distinct tax and business considerations,[235] cross-purchase agreements have the added benefits of avoiding potential AMT implications for insurance payments to C Corporations and increasing basis (relative to redemption agreements) for purchasing shareholders.[236] As such, insurance-funded buy-sell agreements are far from foreclosed if *Blount* is reversed, even if shareholders are subsequently averse to redemption agreements. The "without regard to" valuation rule of § 2703 should thus be applied the same way to corporate-owned life insurance as anything else.[237]

III. Section 2704(b): Legislative History and Post-Enactment Interpretation

There is, however, one material exception to § 2703's absolute disregard for restrictions that fail to qualify for § 2703(b). This exception is for certain restrictions on entity liquidation, and it arises because of the interaction between § 2703 and § 2704(b). To understand the scope of this exception, it is first necessary to review the history and prevailing interpretation of § 2704(b). As this review demonstrates, § 2704(b) has been, in application, an unmitigated failure.

In form, § 2704(b) operates similarly to § 2703. The statute stipulates that whenever (i) someone transfers "an interest in a corporation or partnership"[238] to family and (ii) "the transferor and members of the transferor's family hold. . .control of the entity,"[239] any "applicable restriction" is "disregarded" in the transfer tax valuation of that interest.[240] An applicable restriction is any restriction that "effectively limits the ability of the corporation or partnership to liquidate,"[241] if the restriction either (i) lapses post-transfer or (ii) is removable by the "transferor or any member of the transferor's family, either alone or

234 *See* David Joy et al., *Structuring Corporate Buy-Sell Agreements*, The CPA Journal, June 2004, at 37.
235 *See id.* at 37-38; Siegel, *supra* note 148, at 150-59.
236 David Joy et al., *supra* note 234, at 37.
237 I.R.C. § 2703(a); *see* Bogdanski, *supra* note 229, at 41-42.
238 I.R.C. § 2704(b)(1)(A).
239 *Id.* § 2704(b)(1)(B).
240 *Id.* § 2704(b)(1)(A).
241 *Id.* § 2704(b)(2)(A).

collectively."[242] In essence, if a family controls a partnership or corporation and self-imposes a liquidation restriction on the entity, that restriction will not be respected for transfer-tax valuation purposes.

However, as with § 2703, the statute has a safe-harbor provision for certain restrictions. Even if covered under § 2704(b)(1), a liquidation restriction will be respected if it is either (i) a "commercially reasonable restriction"[243] related to third-party financing arrangements or (ii) "imposed, or required to be imposed, by any Federal or State law."[244] The first safe-harbor option is analogous in purpose to the § 2703(b) safe harbor. In essence, as with § 2703(b), this financing safe harbor is attempting to sort out the types of "commercially reasonable" liquidation restrictions that arm's-length parties would accept.[245] The more relevant safe harbor—and crux of § 2704(b)'s problems—is the second one. As interpreted in the regulations, this second safe harbor covers liquidation restrictions "that would apply under the State law generally applicable to the entity in the absence of" any contracted liquidation restrictions in the corporate documents or partnership agreement.[246] Put more plainly, the safe harbor protects any liquidation restrictions that are less restrictive than (or equally restrictive as) state law defaults. The implications of this approach are best considered through example. Imagine Family *A*, members of which wholly-own Partnership *A*. Partnership *A*'s partnership agreement requires at least 60% of partners to approve a liquidation. But for the safe harbor, that liquidation restriction would be an applicable restriction subject to § 2704(b)(1). It would thus be ignored in transfer-tax valuation of interests in Partnership *A*. However, Partnership *A* is subject to the laws of State *A*. Under State *A* law, the default is that 75% of partners must assent to liquidation. Since the 60% requirement is less restrictive than state law, it will qualify for the safe harbor. To fully flesh out the safe harbor, it is helpful to consider three additional permutations of this fact pattern. The facts are the same as above, except: (i) the partnership agreement requires 75% of partners to vote for liquidation, (ii) the partnership agreement requires 90% of partners to vote for liquidation or (iii) the partnership agreement is silent on liquidation. All three scenarios result in the same treatment under § 2704(b). In scenario (i), the partnership agreement still qualifies for the safe harbor, since it is no more restrictive than the state-law default.[247] In (ii), the liquidation restriction does not qualify since it is

242 *Id.* § 2704(b)(2)(B)(i)-(ii).
243 *Id.* § 2704(b)(3)(A).
244 *Id.* § 2704(b)(3)(B).
245 *Id.* § 2704(b)(3)(A).
246 Treas. Reg. § 25.2704-2(b).
247 *Id.*

more restrictive than state law.[248] However, the restriction is not disregarded entirely—§ 2704(b) would instead value Partnership A as if it had a restriction no more restrictive than the state law default.[249] Partnership A would thus receive the same valuation treatment under (ii) as under (i). Lastly, in (iii), state law defaults that actually apply to an entity are respected just as if, per (i), a partnership agreement expressly incorporated the default standard.[250]

Put bluntly, this interaction with state law defaults is a mess. Even absent tax planning, the reference to the default workings of state entity law renders the statute confusing. It is not simple to determine what qualifies as the default. If a fixed-term partnership is established in a state that follows the original or revised Uniform Limited Partnership Act, then the state law default will generally be that no partner has a liquidation right.[251] Is that the default, or should the statute involve a "blank page" approach, which considers what the default would be without any other partnership terms in the agreement? One practitioner articulated the answer while explaining the fundamental problem with the § 2704 safe harbor:

> The confusion. . .stems directly from the confusion inherent in the statute [§ 2704(b)]. A statute drafted. . .with a reference. . .to another body of law generally, is known. . .as a 'referential statute'. . .few legislative drafting devices are more rife with ambiguity. . .
>
> . . . .
>
> In truth, there is nothing in I.R.C. § 2704(b) or in the regulations thereunder which compels either view [on contextual or "blank page" defaults] . . . . There is no way to determine in a vacuum what limitations are imposed under state law generally applicable. *Law is a formula, not a result*.[252]

If that "inherent" ambiguity were not enough,[253] the default law safe harbor has come to swallow the whole rule due to subsequent state lawmaking. Numerous states have enacted more restrictive default entity

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248 *Id.*

249 *Id.*

250 *Id.*

251 *See* Kenneth P. Brier, *Family Limited Partnerships and Chapter 14: Some Estate Planning Perspectives*, 21 ACTEC NOTES 297, 300 (1996).

252 *Id.* (citations omitted).

253 *Id.*

liquidation rules to qualify under the § 2704(b)(3)(B) state-law safe harbor.[254] It is now easy to avoid application of § 2704(b)(1).

Given the statute's weakness, it is unsurprising that §2704(b) was "hurriedly drafted."[255] Unlike § 2703, which was refined through numerous bills and expert input,[256] § 2704(b) was not added until the Conference Committee's reconciled bill.[257] It is impossible to know exactly what happened in that Committee, but the best guess is that the Committee considered § 2704 in isolation (and not in relation to other sections of Chapter 14). The motivation for § 2704(b) was this concern that taxpayers could avoid § 2704(a)—which deals with liquidation rights that lapse at death—by never granting liquidation rights in the first place.[258] It may be that no one stopped to think that § 2703 could already cover ongoing restrictions. One can perhaps attribute this oversight to the legislative conditions at the time of passage. The broader budget bill that included Chapter 14 was a hard-fought, politically explosive battle.[259] The massive bill's eventual passage took place under a compressed timeline.[260] It is easy to imagine, during the harried conference, a sleep-deprived congressional staffer pushing § 2704(b) without fully considering its potential flaws.

Notwithstanding those flaws inherent in the statute, the IRS undertook a sustained effort to employ § 2704(b) aggressively. This effort ended in failure. In late-nineties TAMs, the IRS took the position that it could look to default state-law provisions for individual partner or shareholder withdrawal to define the scope of state law default liquidation rights for purposes of § 2704(b)(3)(B).[261] This position was a variation on the above-mentioned "blank page" method for determining

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254 U.S. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals 79 (Feb. 2012); Dodge, Gerzog & Crawford, *supra* note 167, at 509; *e.g.*, S. 350, 75th Sess. § 25-27 (Nev. 2009).

255 Richard L. Dees, *The Slaying of Frankenstein's Monster: The Repeal and Replacement of Section 2036(c)*, 69 Taxes 151, 166 (1991).

256 *Id.* at 153.

257 H.R. Rep. No. 101-964, at 1138 (1990) (Conf. Rep.). The prior Senate bill did have a provision to disregard "any restriction other than a restriction which by its terms will never lapse." S. 3209, 101st Cong. § 7210(a) (1990). However, that provision is so different from the eventual § 2704(b) as to be distinct.

258 Brier, *supra* note 251, at 300; Dees, *supra* note 255, at 165.

259 *See* William Eaton, *Congress Passes $490-Billion Cut in Deficit; Bush to Sign Bill*, L.A. Times, Oct. 28, 1990, at A1; *see also Countdown to Crisis: Reaching a 1991 Budget Agreement*, N.Y. Times, Oct. 9, 1990, at A20.

260 136 Cong. Rec. 30,730 (1990) ("We're now trying to do in 3 weeks and just before an election what we normally do in 9 months," stated Senator Grassley); Eaton, *supra* note 259, at A1.

261 I.R.S. Tech. Adv. Mem. 97-30-004 (July 25, 1997); I.R.S. Tech. Adv. Mem. 97-25-002 (June 20, 1997); I.R.S. Tech. Adv. Mem. 97-23-009 (June 6, 1997).

state law defaults.[262] The IRS claimed support for its reference to default withdrawal rights based on § 2704(b)'s companion regulations. The regulations refer to an ability to liquidate an entity "in whole or *in part*."[263] The IRS viewed withdrawal as a form of partial liquidation.[264] Under common state law, each partner in a "blank page" partnership has a unilateral withdrawal right upon sufficient notice.[265] As such, by conflating withdrawal with partial liquidation, the IRS established a narrow view of most state-law defaults for purposes of the § 2704(b)(3)(B) safe harbor. Moreover, the IRS also took an aggressive position on the types of liquidation restrictions that could be subject to § 2704(b) in the first instance. As noted above, to be an "applicable restriction" under § 2704(b), the transferor or his or her family members must have the ability to (or in fact) remove the liquidation restriction post-transfer.[266] One could thus circumvent § 2704(b) by (i) requiring the consent of all partners or shareholders to liquidate and (ii) giving a portion of equity to a cooperative third party. In that case, the family would not technically be able to liquidate the partnership on its own. The IRS took the quite aggressive position that it could disregard such third-party owners if it deemed them to be straw men.[267]

In *Kerr v. Commissioner*,[268] the Tax Court rejected the IRS's stance. In *Kerr*, the partnership agreement stipulated that the partnership would liquidate "upon the earlier of December 31, 2043, or by agreement of all the partners."[269] The entity was Texas law governed, and the Texas law default for partnership liquidation was equally (or arguably more) restrictive than the partnership agreement.[270] However, the IRS pointed to Texas's default partner withdrawal rule, which allowed unilateral withdrawal upon six months' notice.[271] The Tax Court flatly rejected the Service's conflation between withdrawal and liquidation, noting the Service's position was inconsistent with examples provided in the regulations.[272] The court found that the liquidation restriction qualified for the safe harbor.[273]

262 Brier, *supra* note 251, at 300.

263 Treas. Reg. § 25.2704-2(b) (emphasis added).

264 *See* sources cited *supra* note 261.

265 *See* Callison & Sullivan, *supra* note 199, § 21:6.

266 I.R.C. § 2704(b)(2)(B)(ii). The liquidation restriction could also lapse by its terms post-transfer. *See also Id.* § 2704(b)(2)(B)(i).

267 *E.g.*, I.R.S. Tech. Adv. Mem. 97-23-009 (June 6, 1997).

268 Kerr v. Comm'r, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002).

269 *Id.* at 471.

270 *Id.* at 472.

271 *Id.* at 473.

272 *Id.* at 473-74; *see* Treas. Reg. § 25.2704-2(d).

273 I.R.C. § 2704(b)(3)(B).

At the appellate level, the 5th Circuit affirmed on other grounds.[274] However, the 5th Circuit did not dismiss the lower court's reasoning. Instead, the 5th Circuit rejected the IRS's other main § 2704(b) argument by finding that the liquidation restriction was not even an "applicable restriction" in the first instance.[275] The partnership had one nonfamily partner—the University of Texas (UT), which had received interests as a charitable gift.[276] In terms of testing the Service's "straw man" argument, UT was the ideal candidate. The IRS and the taxpayer both agreed that "UT would convert its interests into cash as soon as possible,"[277] so it could be assumed that UT would always vote for a pro rata liquidation. However, the IRS still lost. As the 5th Circuit found, "The Code provides no exception allowing us to disregard nonfamily partners who have stipulated their probable consent to a removal of the restriction."[278] In other words, the IRS's "straw man" argument was invalid, even under the most IRS-friendly circumstances.

Kerr was a staggering loss for the IRS. Like Charlie Brown trying to kick Lucy's football, the IRS made several more fruitless attempts to push the same § 2704(b) arguments in court. It lost each time, with the Tax Court curtly referring the Service back to *Kerr*.[279] The courts were right to reject the IRS's arguments. Nothing in the statute or the regulations indicates that withdrawal should constitute partial liquidation, and that argument is contrary to common sense. If a large partnership redeems and retires a small partner's interest in the ordinary course, it would be improper to describe that partnership as in partial liquidation. Rather, one would say a partner had withdrawn. The two concepts are distinct. Similarly, nothing in the statute provides for the "straw man' rule. From a revenue-raising perspective, it would certainly be helpful if the statute included that rule, but it would be improper for courts to legislate that concept into the statute by judicial fiat. The simple fact is that, given the ease of avoidance, § 2704(b) was dead letter on arrival. For neither the first nor the last time, Congress wrote a bad law.

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274 *Id.* § 2704(b)(2)-(3); Kerr v. Comm'r, 292 F.3d 490, 491 (5th Cir. 2002).

275 *Kerr*, 292 F.3d at 494.

276 Kerr v. Comm'r, 113 T.C. 449, 456 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002).

277 *Kerr*, 292 F.3d at 494.

278 *Id.*

279 *See* Estate of Jones v. Comm'r, 116 T.C. 121, 130 (2001); Knight v. Comm'r, 115 T.C. 506, 520 (2000); Estate of Harper v. Comm'r, T.C. Memo. 2000-202, 79 T.C.M. (CCH) 2232, 2234 (2000).

IV. The Weakness of § 2704(b): § 2703 Impact and Potential Policy Responses

Section § 2704(b)'s weakness creates interesting problems, from the interpretive impact on § 2703 to possible policy responses. This Part considers the ability (or inability) of § 2703 to apply where § 2704(b) is potentially applicable. It also reviews regulation revisions that the IRS could implement to strengthen § 2704(b). Lastly, this Part considers proposed legislative changes to § 2704(b) and offers a different approach to that reparative legislation.

When considered in relation to § 2703, § 2704(b) is effectively a limit on the IRS's § 2703 power rather than an additional grant of authority to disregard liquidation restrictions. It is doubtful that is what Congress intended, but it is hard to read the statutes together any other way. Absent § 2704(b), § 2703 would cover liquidation restrictions, since they are certainly, just as *Holman*-style limits on transfer,[280] value-depressing restrictions on sale and use.[281] Under § 2703(a), it makes no difference that a restriction results from inaction—a failure to elect more liberal liquidation rules than the default—as opposed to action. It also should not matter if an entity-level restriction is required by law for that entity.[282] The only question is whether the restriction qualifies for the § 2703(b) safe harbor.

However, proper statutory interpretation precludes reading § 2703(a) to cover liquidation restrictions. If § 2703(a) is read that way, it renders § 2704(b) meaningless.[283] That violates the interpretive norm that statutes "should be read to avoid rendering superfluous any parts thereof."[284] If § 2703 were enacted after § 2704, one could argue that § 2703 implicitly superseded § 2704. However, even that argument would be difficult since "repeals by implication are not favored. . .and will not be found unless an intent to repeal is clear and manifest."[285] In any case, since these sections were enacted simultaneously in the same

280 *See supra* Part II.B.1

281 I.R.C. § 2703(a).

282 *See supra* Part II.B.1; *see also* Johnson & Dodge, *supra* note 148, at 941 n.20 ("[I]f one knowingly transfers assets to an entity subject to [a restriction] . . . the restriction is indeed self-imposed.").

283 One could counter that § 2704(b) is already meaningless since it is so easily avoidable, but that is a different (and here irrelevant) species of meaninglessness. The distinction is between a statute that is ineffective in practice because of taxpayers' responses and one that is meaningless from the get-go as a matter of statutory interpretation. *See* I.R.C. § 2704(b).

284 Astoria Fed. Sav. & Loan Ass'n v. Solimino, 501 U.S. 104, 112 (1991); *see also* Marbury v. Madison, 5 U.S. (1 Cranch) 137, 174 (1803) (interpreting so as to avoid "mere surplusage").

285 Rodriguez v. United States, 480 U.S. 522, 524 (1987) (citations omitted).

legislative package, the heavy presumption is to construe them both to be meaningful. Since § 2703 can be reasonably read not to encroach on § 2704(b)—by excluding liquidation restrictions from § 2703's reach—it must be read that way. The companion regulations buttress this view. They state, "An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction" under § 2704(b).[286] Rephrased in the logical inverse, an applicable restriction under § 2704(b) cannot also be subject to § 2703.

A last-gasp interpretive attempt to apply § 2703 would argue that § 2703 can apply to liquidation restrictions that are not applicable restrictions under § 2704(b). As the *Kerr* case demonstrated,[287] plenty of suspect liquidation restrictions can escape § 2704(b) by avoiding the "applicable restriction" label. If, by its terms, § 2704(b) is unconcerned with these restrictions, why should § 2703 be precluded from covering them? The answer is twofold. First, the title of §2704(b)—"*Certain* Restrictions on Liquidation Disregarded"[288]—counsels against that interpretation. That only "[c]ertain" restrictions are disregarded implies that the section is not just meant to define a group of disregarded restrictions, but also a group that is *not* disregarded.[289] If § 2703(a) covers all liquidation restrictions that are not applicable restrictions, then § 2704(b) loses its implied role as the delineator between "[c]ertain" disregarded and regarded liquidation restrictions.[290] Second, an interpretation that allows § 2703 to cover liquidation restrictions that are not applicable restrictions leads to a perverse result. In this construction, § 2704(b) essentially becomes a safe harbor against § 2703. Since § 2704(b) is so much weaker than § 2703, a tax-conscious taxpayer would want a liquidation restriction to be an applicable restriction rather than face § 2703. That interpretation is uncomfortable, to say the least. The best holistic interpretation remains that § 2704(b) covers all liquidation restrictions while § 2703 covers everything else.

Moving from statutory interpretation to regulatory authority, another compelling question is whether the IRS has any rulemaking power to strengthen § 2704(b). There are two paths the IRS could follow. The first is a dead end. The second, while not a full fix, would stiffen § 2704(b) somewhat (and would better harmonize the text of § 2704(b) with the regulations).

In terms of the dead end, the IRS could argue that it has authority pursuant to § 2704(b)(4) to issue regulations strengthening § 2704(b) by,

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286 Treas. Reg. § 25.2704-2(b).
287 Kerr v. Comm'r, 292 F.3d 490, 494 (5th Cir. 2002).
288 I.R.C. § 2704(b) (emphasis added).
289 *Id.*
290 *Id.*

for instance, circumscribing the state-law safe harbor under § 2704(b)(3)(B). Under § 2704(b)(4), the IRS can issue regulations to "provide that other restrictions shall be disregarded. . .if such restriction has the effect of reducing the value of the transferred interest" artificially.[291] The *Kerr* Tax Court noted this provision was a grant of "broad regulatory authority."[292] Arguably, the IRS could take the position that it can use this provision to pass regulations allowing it disregard *any* restrictions, including liquidation restrictions that are not disregarded under the rest of §2704(b). However, that position is untenable. The reference to "other" restrictions most naturally reads to mean restrictions other than liquidation restrictions.[293] If that were not the case, then the marginal regulatory discretion in § 2704(b)(4) would be able to re-write the other express terms of the statute. If Congress intended § 2704(b)(4) to be that broad, it would not have bothered to include the rest of § 2704(b). Even for restrictions "other" than liquidation restrictions,[294] this regulation-writing grant cannot be used especially broadly. In its context, section § 2704(b)(4) is most naturally read to mean that the IRS can subject restrictions (other than restrictions on liquidation) to the terms of § 2704(b).[295] To contend otherwise makes § 2704(b)(4) impossibly powerful. If §2704(b)(4) allows the IRS to disregard restrictions in any manner (rather than just subjecting them to §2704(b)), the IRS could issue regulations stating, for example, that all restrictions on transfer are disregarded. It could apply that rule to entities whether or not family-owned and whether or not safe-harbored under § 2703(b). That cannot be so, and contextual interpretation counsels against such a broad reading.[296]

However, the IRS is not bereft of regulatory tools to strengthen § 2704(b). The *Kerr* court alluded to another regulatory change the IRS could make. When the *Kerr* court compared the required-by-law safe harbor of § 2704(b)(3)(B) with the companion regulations, it noted the regulations were "an expansion of the [statutory safe harbor] exception."[297] The Tax Court provided no explanation for this comment.

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291 *Id*. § 2704(b)(4).

292 Kerr v. Comm'r, 113 T.C. 449, 474 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002).

293 I.R.C. § 2704(b)(4).

294 *Id.*

295 The IRS likely finds this power unappealing, given § 2704(b)'s weakness.

296 Interestingly, this logic may bode ill for future IRS rulemaking under § 2704(b)(4). The IRS recently hinted that it plans to employ its § 2704(b)(4) rulemaking authority to enact § 2704 revisions similar to the unpassed legislative proposals from the Treasury Greenbook. I.R.C. § 2704(b)(4); Akers, *supra* note 17, at 3; U.S. Dep't of the Treasury, *supra* note 254, at 79. It is doubtful that the IRS has sufficient rulemaking authority pursuant to § 2704(b)(4) for such a move. I.R.C. § 2704(b)(4).

297 *Kerr*, 113 T.C. at 472.

However, the court had seemingly recognized that the statute itself only references restrictions "imposed, or required to be imposed" by law.[298] The statute does not reference defaults. It is the regulations that introduce the default concept.[299] Per the *Kerr* court's observation, the statutory safe harbor is most sensibly read to refer, not to default rules, but *required* rules that cannot be contracted away. Only the latter are truly "imposed."[300] The legislative history supports this reading.[301] To be true to the statute, the regulations should be amended so that the § 2704(b)(3)(B) safe harbor only covers required (and not default) restrictions.[302] This revision has the added benefit of making § 2704(b) somewhat more effective. It is relatively easy to make classes of entities that have exceedingly restrictive default liquidation rules, since owners can contract out of those rules. The default is set at the maximum level of restriction, and owners modify as needed. That easy contractual control disappears for entities that include required, unalterable restrictive liquidation provisions. Thus, § 2704(b) will become harder to avoid. However, this change, while ameliorative, will not fix the statute. In response, states will undoubtedly create menus of entity types with an array of required restrictive liquidation terms. These entities will be separate from standard partnerships, LLCs, corporations, etc., and only the transfer-tax conscious will opt to create them.[303] Taxpayers will no longer be able to custom-tailor their own entities, so states will respond by offering more tailored entity options up front. Even so, maneuvering required rules is inevitably less user-friendly than default ones, so the rule change will make § 2704(b) mildly harder to avoid. This strengthening of § 2704(b) is material but still marginal.

After defining the limits of regulatory change, the natural next question is what could be done through legislation. Notwithstanding the rule change proposed above, § 2704(b) requires reparative legislation. Aside from the issues already discussed, the statute remains otherwise flawed and easily avoidable due to, for instance, its narrow definition of family and the related straw-man problem.[304] As with most any issue in the current political climate—much less one related to the transfer tax

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298 I.R.C. § 2704(b)(3)(B).

299 Treas. Reg. § 25.2704-2(b).

300 I.R.C. § 2704(b)(3)(B).

301 H.R. Rep. No. 101-964, at 1138 (1990) (Conf. Rep.) (§ 2704(b) "does not apply to . . . a restriction *required* under State or Federal law." (emphasis added)).

302 For examples of required liquidation restrictions, see, for example, Del. Code Ann. tit. 8, § 275 (2015); N.Y. Bus. Corp. Law §§ 1002-03 (McKinney 2015); and Model Bus. Corp. Act § 14.02 (2010).

303 Nevada has already taken this entity-type approach. S. 350, 75th Sess. § 25-27 (Nev. 2009).

304 *See* Brier, *supra* note 251, at 299-300.

system—federal legislative action appears unlikely. However, it is worth noting that this twin consideration of § 2703 and § 2704(b) shows the best approach to take if and when reparative legislation becomes viable.

Current reform proposals are quite complicated. The Treasury Department has put forward a plan to, in essence, undo *Kerr*.[305] Under the Treasury proposal, rather than allude to other state and federal law for the § 2704(b)(3)(B) safe harbor, liquidation restrictions would be disregarded if they are "more restrictive than a standard to be identified in regulations."[306] To fix the straw man problem, "certain interests. . .held by charities or others who are not family members of the transferor would be deemed to be held by the family."[307] Section 2704(b) would also be expanded to cover "an additional category of restrictions" including transfer restrictions.[308] To help taxpayers cope with this expanded § 2704(b), the IRS would be given the authority to create safe harbors "so as to avoid the application of section 2704 if certain standards are met."[309]

This proposal is too complex. It just drives more cars into the pileup that is § 2704(b). Specific safe-harbor standards hardwired into the statute will either be too general or so specific as to require volumes of explanation. What should be the minimum acceptable liquidation restriction for an Oregon partnership that holds a family's plumbing supply business? How about a single-member Delaware LLC that holds marketable securities and a fractional interest in actively-cultivated farmland? The statute could not possibly be long enough to satisfactorily cover every such business context. The same problem arises in delineating who is or is not a straw man for purposes of the deemed-control analysis. Moreover, that new safe-harbor power would turn into a succession of whack-a-mole regulatory revisions as the IRS tries to curb the avoidance that blossoms with each new safe harbor.

There is an easier way, one that will shorten and streamline the Code rather than expand it. Section 2704(b) should be repealed, with a stipulation that § 2703 covers liquidation restrictions. Section 2703 is a balanced, battled-tested method for evaluating valuation discounts. It makes sense for that provision to occupy the field. While Treasury's proposed § 2704(b) revisions would require pages upon pages of complex new regulations, this § 2703 approach piggybacks on existing law and standards. Since § 2703 builds on decades of regulations and case law, its general concepts have been well fleshed out in their application.

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305 U.S. DEP'T OF THE TREASURY, *supra* note 254, at 79.
306 *Id.*
307 *Id.*
308 *Id.*
309 *Id.*

Through that precedent, practitioners have learned what to expect from § 2703, so the transition out of § 2704(b) would be a smooth one. The ABA has already gestured toward this idea, proposing that a § 2703-style arm's-length standard should be imported into § 2704(b).[310] It is just a few steps further from that proposal to entirely replacing § 2704(b) with § 2703.

Conclusion

This analysis has painted a tale of two statutes—§ 2703, which has been largely successful in implementation, and § 2704(b), which has largely failed. These divergent statutory fates demonstrate the importance of thoughtful, iterative drafting with the benefit of expert input. Indeed, the final form of § 2703 can be traced to practitioner comments.[311] While § 2703 also demonstrates the benefits of building on existing standards, it shows the potential for confusion and complexity in partial codification of a larger body of tax law.

This analysis concluded with legislative and regulatory proposals to improve the interrelated operation of these statutes, but these object lessons are generalizable beyond these two Code sections. However difficult transfer tax valuation may be, § 2703 shows the benefit of incorporating prior experience into current rules.

310 Am. B. Assoc. Section of Taxation, Options for Tax Reform and Simplification with Respect to Federal Estate, Gift and GST Taxes 3 (Apr. 2012).
311 *Hearing*, *supra* note 13, at 97-98.