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Treasury Proposes New Regulations to Restrict Valuation Discount Planning

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Prepare for a dramatic change in the scope of IRC Section 2704.

From 2010 to 2013, the Treasury attempted to convince Congress to amend Internal Revenue Code Section 2704 to restrict the use of partnerships and other entities to generate valuation discounts. Neither house of Congress showed the slightest interest in making these changes.

In 2013, the Treasury quit requesting these statutory changes, but it never gave up on its desire to tighten IRC Section 2704 to restrict valuation discount planning. On Aug. 4, 2016, the Treasury proposed regulations that, when finalized, may dramatically expand the scope of Section 2704 and restrict the availability of valuation discounts for many entities. If adopted as final, the proposed regs will curtail what's become a very common means of reducing a client's estate, gift and generation-skipping transfer (GST) tax obligations.

Brief Summary of Section 2704

Section 2704 was enacted in 1990. Section 2704(a) addresses issues raised by the Tax Court's decision in Estate of Harrison v. Commissioner, which involved the estate tax valuation of a majority interest in a family limited partnership (FLP). The general partners were given the right to compel the liquidation of the partnership at any time and thereby recoup their capital accounts. These rights were personal, nontransferable and terminated at death. The Internal Revenue Service contended that, because these rights gave value to the interests, they couldn't be ignored for estate tax valuation purposes, even though they didn't survive the partner's death.

The Tax Court disagreed, noting that the estate tax is imposed on only the value of property that can be transferred at death and that a power that lapses at death can't, therefore, be considered in valuing a business interest. Thus, the decedent's partnership interest was dramatically diminished in value for estate tax purposes, although it had significant value up until death. The legislative history of Section 2704 states that Harrison and "similar" cases typically involved a taxpayer successfully sustaining a relatively low value for an interest in a business by valuing it as a going concern, notwithstanding an effort by the IRS to value it as if liquidated.

Section 2704(a)(1) states that, "if there is a lapse of any voting or liquidation right in a corporation or partnership, and the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity," such lapse will be treated as a taxable transfer. The amount of the transfer is the difference between the fair market value (FMV) of all interests held by the individual immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing) and the FMV of such interests after the lapse. A transfer under Section 2704(a) takes the form of a taxable gift (if the lapse occurs during the holder's lifetime) or as an addition to the holder's gross estate (if the lapse occurs at the holder's death).

Section 2704(b), on the other hand, disregards an "applicable restriction" when valuing an interest in a corporation or partnership that's transferred to or for the benefit of a family member, if the transferor and his family control the entity immediately before transfer. There are important exceptions. First, if there's no provision calling for the restriction to lapse and neither

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the transferor nor the transferor’s family can remove the restriction, it isn’t an applicable restriction. Second, if the restriction is “imposed, or required to be imposed, by any Federal or State law,” it’s not an applicable restriction.6

Extension to New Types of Entities
The Treasury contended that the regs under Section 2704 needed to be updated to reflect various new types of entities that were created after 1990 to accomplish certain purposes. In particular, limited liability companies (LLCs) have become very popular, but the existing regs (and the IRC) still refer only to corporations and partnerships.

The proposed regs provide that Section 2704 applies to corporations, partnerships, LLCs and other domestic or foreign entities or arrangements that are business entities under Treasury Regulations Section 301.7701-2(a), regardless of how the entity or arrangement is classified for other federal tax purposes and whether the entity or arrangement is disregarded as an entity separate from its owner for other federal tax purposes.7

The proposed regs state that a “corporation,” for purposes of Section 2704, includes: (1) any business entity organized under a federal or state statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate or body politic; (2) any business entity organized under a state statute that describes or refers to the entity as a joint-stock company or joint-stock association; (3) an insurance company; (4) a state-chartered business entity conducting banking activities if any of its deposits are insured under the Federal Deposit Insurance Act or a similar federal statute; (5) a business entity wholly owned by a state or any political subdivision thereof; (6) a business entity wholly owned by a foreign government or any other entity described in Treas. Regs. Section 1.892-2T; (7) a business entity that’s taxable as a corporation under a provision of the IRC other than IRC Section 7701(a)(3); and (8) certain foreign entities. A “corporation” also will include an S corporation and a qualified subchapter S subsidiary, which subsidiary is treated as a corporation that’s separate from its parent for this purpose. The proposed regs expressly exclude from the definition of a “corporation” an unincorporated association that’s taxable as a corporation.8 Generally, the proposed regs state that a partnership is any business entity that’s not a corporation, regardless of how it’s classified for federal tax purposes. Therefore, a partnership includes an LLC that’s not an S corporation, whether or not it’s a disregarded entity for tax purposes.9

The proposed regs break from the statutory reference to just corporations and partnerships in two situations: for purposes of the tests to determine control of an entity and whether a restriction is imposed under state law. The form of a business entity or arrangement that isn’t a corporation will, for these purposes, be determined under local law, regardless of how it’s classified for federal tax purposes. In these cases, local law means the law of the domestic or foreign jurisdiction under which the entity or arrangement is created or organized. Consequently, in applying these two tests, there are three types of entities: corporations, partnerships (general and limited partnerships (LPs)) and other business entities (including LLCs that aren’t S corporations).10

The Section 2704 rules apply only to entities that the transferor’s family controls. Section 2704(c)(1) defines “control” using the definition found in IRC Section 2701(b)(2). The proposed regs clarify that control of an LLC or any other entity or arrangement that isn’t a corporation, partnership or LP means holding at least 50 percent of either the capital or profits interests of the entity or arrangement or holding any equity interest,
with the ability to cause the full or partial liquidation of the entity or arrangement. Thus, the determination of the type of entity establishes the precise tests for figuring out what interests are required to constitute control over the entity.

The explanation of how LLCs and other entities that aren't partnerships or corporations should be treated "repairs" a serious gap in the guidance that left practitioners trying to make sense of whether and, if so, how the partnership rules might apply to an LLC. Taxpayers and their advisors should welcome this part of the proposed regs as important clarifications of the rules. The rest of the proposed regs, perhaps, won't be as welcome.

Voting and Liquidation Rights
Section 2704(a) applies to voting and liquidation rights. The current regs define a "liquidation right" as the power (including one associated with aggregate voting power) to compel the entity to acquire all or part of the holder's equity interest, whether or not this would result in the complete liquidation of the entity. The current regs also state that a lapse of a liquidation right is the restriction or elimination of a presently exercisable liquidation right. Section 2704(a) doesn't, however, apply to a transfer that doesn't restrict or eliminate a liquidation or voting right with respect to the transferred interest. For example, a gift of a minority interest by the holder of a controlling interest sufficient to compel liquidation isn't itself a lapse under Section 2704(a), even though the transferor no longer has sufficient voting control to compel liquidation.

The proposed regs make several changes in the scope of Section 2704(a) to expand its application. First, the proposed regs confirm that the transfer of a partnership interest in a family controlled partnership to an assignee, who neither has nor may exercise the voting or liquidation rights of a partner, is a lapse of the voting and liquidation rights associated with the transferred interest. The Preamble to the proposed regs explains that this change merely confirms that a transfer that results in the restriction or elimination of a voting or liquidation right associated with the transferred interest is a lapse under Section 2704(a). It's not, however, clear whether this rule will apply when the transferee becomes a partner only on the vote of the remaining partners within a reasonable time after the transfer is made, so it may be preferable, if this proposal is adopted, to have the other partners approve the transferee as a new partner before the interest is transferred, to avoid an unintended lapse.

Second, the proposed regs narrow the exception to the definition of a lapse of a liquidation right to transfers occurring three years or more before the transferor's death that don't restrict or eliminate the rights associated with the ownership of the transferred interest. Therefore, a gift of a minority interest by a donor who had sufficient power, before the gift, to compel liquidation, would, if made within three years of the donor's death, be a taxable transfer under Section 2704(a), even though the minority interest never had a liquidation right. This gift would result in an additional inclusion in the gross estate equal to the difference between the value of the donor's total interest before the gift and the value of the donor's total interest after the gift, thereby eliminating the minority interest discount usually associated with such a gift.

In the Preamble, the Treasury explains that this change was appropriate to avoid deathbed tax planning. It cites Estate of Murphy v. Comm'r, which did in fact reject deathbed "attempts to avoid taxation of the control value of stock holdings through bifurcation of the blocks." The Preamble doesn't, however, cite a contrary holding under almost identical facts in Estate of Frank v. Comm'r. Nonetheless, the Treasury states that such deathbed transfers "generally have minimal economic effects, but result in a transfer tax value that is less than the value of the interest either in the hands of the decedent prior to death or in the hands of the decedent's family immediately after death." That statement may be difficult to refute. The Treasury also states that the 3-year "bright-line test" is desirable because it avoids "the fact-intensive inquiry underlying a determination of a donor's subjective motive which is administratively burdensome for both taxpayers and the IRS." The proposed regs modify Treas. Regs. Section 25.2704-1(f), Example 4, to illustrate the breadth and impact of this change. In the example, D, an individual, owns 84 percent of the stock in Corporation, whose bylaws require at least 70 percent of the vote to liquidate. D gives one-half of D's stock in equal shares to D's three children. D is deemed to have given up D's right to liquidate or control Corporation by making this gift, and if the gift transfers occurred within three years of D's death, they'll be treated as if the lapse of the liquidation right occurred at D's death. This result
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is the rough equivalent of including in D's gross estate an additional nondeductible asset equal to the minority and marketability discounts of the three gifts or, perhaps, increasing the value of what's included in the gross estate. This distinction may be important for purposes of determining the asset's basis pursuant to IRC Section 1014, as we discuss later.

Third, the proposed regs conform Section 2704(a) to certain changes made primarily with respect to 2704(b). Specifically, the proposed regs would:

1. Reiterate the existing provision for testing a family’s ability to liquidate an interest by taking into account state law, as modified by any provision in the organizing documents, but without regard to any restriction within the scope of Section 2704(b);

2. Clarify that the manner in which liquidation may be achieved is irrelevant; and

3. Conform the applicable restriction regs to the proposed provision for disregarding certain non-family member interests in testing the family’s ability to remove a restriction that may be a disregarded restriction.

Fourth, the proposed regs would adopt new attribution rules with respect to the determination of family control for purposes of Section 2704(a), which would deem an individual, his estate and members of his family to own, for this purpose, any interest held indirectly by him through a corporation, partnership, trust or other entity, under the rules contained in Treas. Regs. Section 25.2701-6. This appears to eliminate the previous limitation on attribution that permitted attribution only of interests that would be included in the individual’s gross estate if he died immediately before the lapse. This change could result in a much greater attribution of ownership and control for purposes of Section 2704(a), because it would attribute to an individual interests owned by a trust of which that individual is merely a beneficiary and over which the individual holds no general power of appointment.

Restrictions

The most dramatic changes under the proposed regs relate to the operation of Section 2704(b). In the Preamble, the Treasury explains that the effectiveness of Section 2704(b) has been limited because:

1. Practitioners have made a point of transferring a partnership interest to an assignee, rather than to a partner, which together with state legislation that restricts the rights of assignees, decreases the gift and estate tax value of a partnership interest transferred;

2. Courts have held that Section 2704(b) applies only to restrictions on the ability to liquidate an entire entity and not to restrictions on the ability to liquidate a transferred interest in that entity;

3. State LP (or similar) statutes have been revised to allow liquidation of the entity only on the unanimous vote of all owners (unless provided otherwise in the partnership agreement) and to eliminate the statutory default provision that had allowed a limited partner to liquidate his limited partner interest, so that a limited partner won’t ordinarily be able to withdraw from the partnership or have imposed other elective restrictions on liquidation; and

4. Taxpayers have avoided the application of Section 2704(b) by transferring a nominal partnership interest to a non-family member, such as a charity or an employee, to ensure that the family alone doesn’t have the power to remove a restriction.

The Treasury, therefore, proposes to impose stricter rules on determining what’s an applicable restriction under Section 2704(b) and to create an entirely new class of disregarded restrictions that aren’t applicable restrictions, but that will be disregarded in valuing transferred entity interests under Section 2704(b).

Applicable restrictions. The proposed regs make several significant changes in the treatment of applicable restrictions. First, the proposed regs confirm that an applicable restriction only includes a restriction on the holder’s ability to liquidate the entity (in whole or in part), but not a restriction on the holder’s ability to liquidate his own interest. (Restrictions on the holder’s
ability to liquidate his own interest is the subject of Prop. Treas. Regs. Section 25.2704-3.)

Second, the proposed regs clarify that the exception for restrictions "imposed, or required to be imposed, by any Federal or State law" includes only restrictions imposed by the United States, any state or the District of Columbia.28 This appears to exclude restrictions that are imposed by a locality, quasi-governmental body, foreign country or subdivision of a foreign country.

Third, the proposed regs state that a restriction is imposed or required to be imposed by federal or state law only if it can't be removed or overridden and is mandated by the applicable law, is required to be included in the governing documents or otherwise is made mandatory.29 This represents a dramatic change to the present rules, which treat default provisions of state laws that can be waived or varied by the governing instrument as exempt from the definition of applicable restrictions. Under the new rules, restrictions such as those on liquidation or transfer of a partnership interest under laws like the Revised Uniform Limited Partnership Act will now be classified as applicable restrictions and ignored for purposes of valuing interests in the entity for estate, gift and GST tax purposes.

The change in the exception from applicable restriction classification for restrictions that are mandatory under state or federal law, as opposed to those that are default rules, appears to eliminate most marketability and all minority discounts for family-owned entities. No state or federal law prohibits an entity from giving every one of its equity owners a right to compel liquidation of the entity at any time. Therefore, such a right would be imputed to every family-owned entity, for gift, estate and GST transfer tax purposes under Prop. Treas. Regs. Sections 25.2704-2(a) and 25.2704-2(b)(4)(ii).

Fourth, the proposed regs state that a restriction imposed by a state law that can't be removed or overridden is still an applicable restriction in two situations: (1) if the state law is limited in its application to certain narrow classes of entities, particularly family-controlled entities; and (2) if the law under which the entity was created also provides (either at the time the entity was organized or thereafter) an optional provision that doesn't include the restriction or that allows it to be removed or overridden or that provides a different statute for the creation and governance of that same type of entity that doesn't mandate the restriction, makes the restriction optional or permits the restriction to be superseded.30 This would preclude the avoidance of Section 2704(b) by having a state legislature create a new class of entity that includes mandatory limitations on liquidation and transfer, if there's another form of entity available that has no similar restrictions. Adopting the requirement that only mandatory restrictions are excluded from the operation of Section 2704(b) renders the state and federal statutory exception very nearly meaningless. Governments recognize that some flexibility is required in genuine business arrangements, and so none would strictly prohibit allowing a member, for example, to compel liquidation, as that may be necessary to entice certain investors in some business arrangements.

Prop. Treas. Regs. Section 25.2704-2(b)(4)(ii) states that this rule will apply to "particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704 . . . ." It's unclear whether "family-controlled entities," in this sentence, adopts the same definition of control otherwise applicable to Section 2704(b) or will be subject to a higher or lower standard of control. It seems likely that this determination will need to be made on a case-by-case basis.

The regs refer to the existence of a second statute for creating "that same type of entity." It's not clear what constitutes "that same type of entity" for this purpose. For example, an entity that, by law, must be subject to a mandatory restriction on liquidation or voting might arguably not be the "same type of entity" as one that, by law, has a choice whether to include such restrictions, if the two entities otherwise have significantly different features, such as duration and the number and identity of permissible members. We hope that the final regs will clarify this issue.

Fifth, the proposed regs state that an applicable restriction doesn't include a restriction if each holder of an interest in the entity has a put right that's enforceable under applicable local law, entitling each holder to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash and/or other property with a value that's at least equal to the "minimum value" of the interest determined as of the date of the liquidation or redemption.31 It seems likely that, if this provision remains part of the final regs, at least some, if not most, FLPs and LLCs will include such a put right, to avoid the application of Section 2704.
Sixth, the proposed regs state that, for purposes of Section 2704(b) only, if part of a decedent’s interest in an entity includible in his gross estate passes by reason of death to members of both the decedent’s family and persons who aren’t members of the decedent’s family, the part passing to the members of the decedent’s family is to be valued by disregard of an applicable restriction, and that part is treated as a single, separate property interest. In such cases, the part passing to one or more persons who aren’t members of the decedent’s family is also treated as a single, separate property interest. Consequently, the valuation discounts usually associated with the interest passing to the non-family members would seem to be preserved.

**Disregarded restrictions.** The most dramatic change in Section 2704(b) is the creation of a new category of “disregarded restrictions.” The purpose of this change is to ignore in valuing an interest in a family-controlled entity many of the restrictions that have been used in the past to reduce the value of such interests, but which, for various reasons, aren’t themselves “applicable restrictions.” The FMV of an interest in an entity is determined by assuming that all disregarded restrictions didn’t exist; the FMV of such entity is determined under generally accepted valuation principles, including any appropriate discounts or premiums.

Prop. Treas. Regs. Section 25.2704-3 states that any restriction in a family-controlled entity that limits an owner’s right to liquidate his interest in the entity will be disregarded if it will lapse at any time after the transfer or if the transferor or his family members, without regard to certain interests held by non-family members, can remove or override the restriction. A disregarded restriction includes one that: (1) limits the ability of the holder of the interest to liquidate the transferred interest; (2) limits the liquidation proceeds to an amount that’s less than a minimum value (discussed below); (3) defers the payment of the liquidation proceeds for more than six months; or (4) permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes. The proposed regs state that a disregarded restriction includes any limit on the time and manner of payment of the liquidation proceeds. Thus, a provision permitting deferral of full payment beyond six months or permitting payment in any manner other than in cash or property would be a disregarded restriction. For this purpose, “property” doesn’t include a note or other obligation issued directly or indirectly by the entity, other holders of an interest in the entity or persons related to either. Property does, however, include the note of an entity engaged in an active trade or business to the extent that: (1) the liquidation proceeds aren’t attributable to passive assets; and (2) the note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates and has an FMV (when discounted to present value) equal to the liquidation proceeds.

Exceptions that apply to applicable restrictions under the current and proposed regs also apply to disregarded restrictions, including: (1) commercially reasonable restrictions on liquidation imposed by an unrelated person providing capital to the entity; (2) requirements imposed by federal or state law; and (3) an option, right to use property or agreement that’s subject to IRC Section 2703.

Disregarded restrictions also wouldn’t include: (1) an enforceable put right held by each holder of an interest in the entity, entitling the holder to receive, on liquidation or redemption of the holder’s interest, cash or other property with a value that’s at least equal to the minimum value discussed above; (2) the full amount of such cash and other property that must be paid within six months after the holder gives notice to the entity of the holder’s intent to liquidate any part or all of the holder’s interest or withdraw from the entity; and (3) the other property that must be paid within six months that doesn’t include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity or by a person related either to the entity or to any holder of an interest in the entity. The proposed regs don’t provide any specific definition of “related” when that word is used in the discussion of put rights.

If an entity is engaged in an active trade or business at least 60 percent of whose value consists of the
non-passive assets of that trade or business, and to the extent that the liquidation proceeds aren't attributable to passive assets, the proceeds of such a put may include a note or other obligation if such note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates and has an FMV on the date of the liquidation or redemption equal to the liquidation proceeds.38

The proposed regs state that, for purposes of this put right, "local law" is the law of the domestic or foreign jurisdiction that governs liquidation or redemption rights with regard to interests in the entity and that "other property" doesn't include a note or other obligation issued directly or indirectly by the entity, one or more holders of interests in the entity or one or more persons related either to the entity or to any holder of an interest in the entity.40 "Other property" also doesn't include a note or other obligation if: (1) the entity is engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business and to the extent that the liquidation proceeds aren't attributable to passive assets (as defined in IRC Section 6166(b)(9)(B), relating to the option to pay estate tax attributable to certain closely held businesses for an extended period after death); and (2) the note or obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates and has an FMV on the date of liquidation or redemption equal to the liquidation proceeds.41

Prop. Treas. Regs. Section 25.2704-3(g), Example 1 illustrates the application of the new "put right" concept. In the example, Parent gives a 33 percent LP interest to Child A and an equal interest to Child B. Under applicable local law, a limited partner may withdraw from an LP at the time or on the occurrence of events specified in the partnership agreement. Under the partnership agreement: (1) liquidation will occur in 2066 unless all of the partners unanimously agree to an earlier liquidation; (2) no limited partner may withdraw from the partnership; and (3) the approval of all partners is required to amend the agreement. None of these provisions is mandated by local law.

The example states that the prohibition on withdrawal is a disregarded restriction because it imposes a restriction on the ability of the partner to compel a liquidation (redemption) of his interest, and it's not mandated by state or federal law. Family members could remove the restriction after the transfer, so the interest given to each child must be valued without taking into account the partnership agreement provision that prevents a limited partner from compelling a redemption of his interest. In Kerr v. Comm' r,42 the Tax Court concluded that a restriction on the right to force a redemption of a partnership interest, as opposed to the right to force a liquidation of the entire partnership, wasn't an applicable restriction. The restriction in Kerr would now be treated as a disregarded restriction under the proposed regs, as reflected in this example.

This deemed put right should have the effect of denying any minority discount and largely reducing or eliminating any discount for lack of marketability (DLOM). The IRS states that the DLOM reflects the fact that "a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock."44 Also, it's been noted that, "[i]n addition to being harder to sell, shares of closely held firms are far less suitable than their publicly traded counterparts for use as collateral for a loan."45 Because the proposed regs would essentially grant each transferee a deemed right to demand a proportionate value of the "minimum value," which is the value of the underlying net assets, there may be little or no DLOM for the interest transferred. Nonetheless, the underlying assets of the entity might be valued with a DLOM (for example, when the entity owns an interest in a closely held business). If the holder of an interest in the entity is deemed to have a right to compel the redemption of his interest, the value of that interest is less significantly affected by lack of marketability or lack of control. In appropriate circumstances, however, one could argue that the value of assets inside the entity should be reduced to reflect a DLOM for those assets.46

The result will be the same whether or not the partnership agreement expressly gives the partners a put right. Assuming that no mandatory provision in state or federal law precludes the partnership from granting a put right, and it's difficult to imagine such a provision under state or federal law, the proposed regs would disregard the failure to grant a put right and deem every owner of an interest in the entity to have a right to compel the liquidation of his interest. That is, the proposed regs read in to every entity's governing documents a put right, unless there's both a mandatory state or federal law precluding it and no alternative law under which such a right could be granted. Consequently, the proposed regs eliminate any minority discount and eliminate or
dramatically suppress DLOMs.

Example: Assume Parent, who owns all of the outstanding shares of Corporation, makes a lifetime gift to Daughter of one share. The gift is made more than three years before Parent’s death (thereby avoiding the new deathbed lapse rule under Prop. Treas. Regs. Section 25.2704-1(c)(1)). Under state law, as is typically the case, the holder of such a minority interest wouldn’t have the right to compel a liquidation. Under traditional valuation rules, the stock given to Daughter would be valued as a minority interest that can’t compel a redemption. That wouldn’t be the result under the proposed regs. The failure to confer in the governing documents a right on each shareholder to compel a liquidation of the entity would be disregarded under Prop. Treas. Regs. Section 25.2704-2. Put simply, even in this classic case of a gift of a minority interest, a minority discount wouldn’t be allowed absent a mandatory provision under state law prohibiting such a liquidation right.

One might, however, argue that the right of the minority owners to compel redemption of their own interests, which the agreements will prohibit but which prohibition must be ignored under the proposed regs, creates an additional contingent liability for the entity to fund such a redemption, thereby reducing the value of the going concern. Such a required reserve would tie up the company’s operating capital and could cripple its future earnings. This contingent liability should be considered under Section 2704(b), whether or not the put right is actually contained in the document. Section 2704(b) states that the value of the interest is determined without regard to any applicable restrictions. The proposed regs ignore any restriction on the right to liquidate the entity or one’s own interest, beyond a 6-month put right exercisable at the minimum value.

Nothing in the proposed regs suggests a different result would apply for an active business than for a holding company. The deemed right to compel liquidation treats the holder of the interest as if he were entitled to receive a proportionate share of “the fair market value . . . of the property held by the entity, reduced by the outstanding obligations of the entity.”46 With an active business, the assets would include not only the real property and tangible personal property, but also the intangible assets, such as goodwill, customer lists, patents, trademarks and going concern value. The net value of the individual’s interest would be the same whether the business is a holding company or a going concern.

In determining whether the transferor and/or the transferor’s family can remove a disregarded restriction, any interest in the entity held by an individual who isn’t a member of the transferor’s family is disregarded if, at the time of the transfer: (1) the interest has been held by such individual for less than three years; (2) the interest constitutes less than 10 percent of the value of all of the equity interests in a corporation or constitutes less than 10 percent of the capital and profits interests in a partnership, LLC or similar business entity described in Treas. Regs. Section 301.7701-2(a); (3) when combined with the interests of all other individuals who aren’t members of the transferor’s family, the interest constitutes less than 20 percent of the value of all of the equity interests in a corporation or constitutes less than 20 percent of the capital and profits interests in a business entity other than a corporation (for example, less than a 20 percent interest in the capital and profits of a partnership); or (4) any such individual, as the owner of an interest, has no enforceable right to receive in exchange for such interest, on no more than six months’ prior notice, the minimum value referred to in the definition of a disregarded restriction.47

The last of these requirements, that the non-family member have a put right, is noteworthy on several levels. First, it’s a severe and unnecessary requirement to impose if the goal is merely to avoid using nominal interests to avoid the requirements of Section 2704(b) with respect to disregarded restrictions. A 10 percent interest (with aggregate non-family interests of 20 percent) would appear to be sufficient to accomplish this task.

Second, this requirement will force practitioners to modify the governing instruments for entities that aren’t owned entirely by a family. These instruments will need to include an actual put right and can’t rely on the
imputation of a put right to assure that the non-family members’ interests are taken into account in determining whether the transferor and/or the transferor’s family can remove a disregarded restriction.

The determination of whether the family can remove the restriction in a disregarded interest is made by assuming that the remaining interests are the sole interests in the entity. Parenthetically, in Kerr, the U.S. Court of Appeals for the Fifth Circuit indicated that Section 2704(b)(2) doesn’t contemplate the possibility that the IRS could disregard a non-family member. Perhaps, that accounts for the IRS’ decision to include the non-family member concept only in Prop. Treas. Regs. Section 25.2704-3 and not in Prop. Treas. Regs. Section 25.2704-2. One could easily imagine the validity of the non-family member concept becoming the subject of litigation, given the Fifth Circuit’s conclusion.

Unintended Double Counting
The application of the transfer within three years of death rule and the disregarded restriction rules may result in an unintended double counting.

Example: Assume T owns 51 percent of the stock in Corporation, and T’s children own the remaining 49 percent. Corporation has a liquidation value of $100, and the 51 percent holding gives T the right to liquidate Corporation and receive 51 percent of Corporation’s liquidation, $51. T gives his children 2 percent of the stock, and T thereby loses the right to liquidate Corporation. The loss of the liquidation right reduces the value of the 51 percent T held prior to the gift interest to $40 or an $11 reduction in value, which will be treated as transferred at T’s death and be added to the value of T’s gross estate under the transfer within three years of death rule. When T dies, T’s remaining 49 percent—all other things being equal—will be valued with an assumed put right, meaning it will be worth $49. Of that, $11 will be included in T’s gross estate because of the transfer within three years of death rule, plus $49 for the 49 percent of the stock, for a total of $60. If T had retained the 51 percent of the stock until death, its value, all other things being equal, would be only $51.

Certainly, the Treasury’s proposals will have to be amended to prevent such a double counting of value effect. Perhaps, if these changes will be extensive, the Treasury should issue new proposed regs so the public may comment on them, rather than embed them into the final regs.

Coordination With Deductions
Section 2704(b) applies to intra-family transfers in family-controlled entities for all estate, gift and GST tax purposes. Where, and to the extent that, an interest in an entity qualifies for the gift or estate tax marital deduction and must be valued by taking into account the applicable restriction and disregarded restriction rules of Section 2704(b), the same value generally will apply in computing the marital deduction attributable to that interest. The value of the estate tax marital deduction may be further affected, however, by other factors justifying a different value, such as the application of a control premium.

Section 2704(b) doesn’t apply to transfers to non-family members and so doesn’t affect the value of an interest passing to charity or to an individual other than a family member. If part of an entity interest includible in the gross estate passes to family members and part of that interest passes to non-family members, and if (taking into account the proposed rules regarding the treatment of certain interests held by non-family members) the part passing to the decedent’s family members is valued under Section 2704(b), the proposed regs provide that the part passing to the family members is treated as a property interest separate from the part passing to non-family members. The FMV of the part passing to the family members is determined taking into account the special valuation assumptions of Section 2704(b), as well as any other relevant factors, such as those supporting a control premium. The FMV value of the part passing to the non-family members is determined without the special valuation assumptions of Section 2704(b). Hence, if the sole non-family member receiving an interest is a charity, the interest generally will have the same value for both estate tax inclusion and deduction purposes. If the interest passing to non-family members, however, is divided between charities and other non-family members, considerations other than Section 2704 may apply, resulting in a different value for charitable deduction purposes.

Effective Dates
The changes relating to the extension of Section 2701 (estate freezing recapitalizations) to entities other than corporations and partnerships would be effective on and after the date of publication of the final regs in the Federal Register.

The changes relating to the lapse of a voting or
liquidation right under Section 2704(a) will apply to the lapse of rights created after Oct. 8, 1990, to the extent that the lapse occurs on or after the date of publication of the final regs in the Federal Register.

The changes relating to applicable restrictions under Section 2704(b) would apply to transfers of property subject to restrictions created after Oct. 8, 1990, to the extent that the transfer occurs on or after the date of publication of the final regs in the Federal Register.

The new rules on disregarded restrictions will apply to transfers of property subject to restrictions created after Oct. 8, 1990, to the extent that the transfer occurs 30 or more days after the date of publication of the final regs in the Federal Register.

The proposed regs don't provide any rules for restrictions created before Oct. 9, 1990, which are amended after Oct. 8, 1990. One should anticipate that any substantial change in an effective date-protected restriction will be deemed to create a new restriction that falls under the proposed regs. It's less clear, however, whether a post-Oct. 8, 1990 change in a pre-Oct. 9, 1990 instrument that doesn't itself change the restriction will cause the proposed regs to apply. Generally, practitioners should be wary about any changes to a pre-Oct. 9, 1990 instrument that contains a restriction to which the proposed regs might otherwise apply.

Validity of the Proposed Regs
The Treasury took pains to explain how the IRC authorizes the proposed regs, possibly anticipating arguments that the proposed regs exceed the scope of the IRC itself. The Treasury noted that Section 2704(a)(3) authorizes it "by regulations [to] apply this subsection to rights similar to voting and liquidation rights."57 Also, Section 2704(b)(4) authorizes the Treasury:

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

Traditionally, the courts distinguished between a general authority and a specific authority regulation.52 This distinction, however, has been largely, if not entirely, erased by Mayo Foundation for Medical Education & Research v. United States and McDonald v. Comm'.53 Under Mayo, a regulation is valid unless: (1) Congress has directly spoken to the precise question at issue, and the regs are inconsistent with Congress' unambiguously expressed intent; or (2) the regulation "is arbitrary or capricious in substance, or manifestly contrary to the statute."54

Given the determinative role of Congressional intent under Mayo, the proposed regs raise the question whether Congress, in enacting Section 2704 and in conferring authority on the Treasury to issue regs that would deny effect to certain value suppressing restrictions, permitted the denial of practically all discounts for family-controlled entities.

Before the enactment of Section 2704, the IRS had argued vigorously in the courts against discounts when family was involved, essentially asking the courts to adopt a family-attribution principle.55 The IRS lost, ultimately conceding the issue in Revenue Ruling 93-12. Most significantly, the Conference Report issued in connection with the 1990 enactment of Section 2704 states: "[t]hese rules do not affect minority discounts or other discounts available under present law."56 Example 8 in the Conference Report also illustrates that a restriction on liquidation of a partnership is an applicable restriction that must be disregarded under Section 2704(b), but then adds that "any appropriate fragmentation discount" would nonetheless be permitted. Congress was presumably aware of the family-attribution litigation when the Conference Report was drafted, which is, perhaps, why the IRS conceded the issue a few years later.

This legislative history appears to contemplate continuing availability of some discounts in the family setting and not their complete elimination, as the proposed regs appear to attempt. As we suggest, the question is whether Congress definitively indicated its intent that such discounts would remain in place. In Chevron,57 which was extended to tax regulations by Mayo,58 the U.S. Supreme Court stated that traditional tools of statutory construction must be employed in determining if Congress has spoken to the issue. "If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect."59

In General Dynamics Corp. v. Cline,60 the Supreme...
Court applied the *Chevron* footnote, making explicit reference to legislative history, and concluded that Congress' intent was sufficiently unambiguous to displace an agency interpretation.64

The role of legislative history in *Chevron* and *Mayo* isn't entirely clear.62 Given Congress' apparent understanding that discounts wouldn't be affected by the enactment of Section 2704, it seems hard to sustain the proposed regs, to the extent that they eliminate these discounts by imputing into every interest in a family-controlled entity both a right to compel liquidation of the entity and a right to compel liquidation of the holder's own interest. The IRS may argue that the statute itself contemplates a modification of discount principles in calling for the disregard of certain restrictions and that the proposed regs won't affect entities that aren't family controlled. Still, the regs appear to ignore for estate and gift tax purposes the impact of restrictions on voting and liquidation, other than those that are mandatory under applicable state or federal law. Further, the proposed regs ignore the failure to include a right to compel liquidation of the entity or the holder's personal interest. Unless the final regs rein in these provisions significantly, their validity will presumably be the subject of litigation. Ultimately, the courts will need to decide whether Congress' statement of its intent is sufficiently clear to prevent the IRS from implementing its new approach.

Finally, for those who wonder about the ability of the Treasury to issue regs that take a new approach that's inconsistent with prior guidance or to overrule the outcome in a prior case, like *Kerr*, *Chevron* seems to provide a complete answer. Under *Chevron*, agency inconsistency isn't a basis for invalidating a new approach.63 *Chevron* also permits, as a general matter, agencies to overrule court decisions.64

**Planning**

There are several key issues to planning under the proposed regs. First, the effective date of the proposed regs invites taxpayers to create and make lifetime gifts or sales of interests in corporations, partnerships and LLCs, as they would have done before these regs, at least until the final regs are published in the Federal Register. There's no clear date when this will occur, but public hearings on these proposed regs aren't scheduled until Dec. 1, 2016, so even assuming that the IRS hears nothing at the hearings that convinces it to change any part of the regs, the final regs couldn't be published before the end of this year. As there are likely to be extensive comments provided, at least some of which will warrant direct response from the Treasury, it seems most likely that final regs won't be published until, at the earliest, the second quarter of 2017. It would be a welcome reprieve for practitioners if the final regs were delayed as long as those on the income taxation of private annuities, which were proposed 10 years ago (but are still in the latest Priority Guidance List) or those on IRC Section 2036(b), which were proposed in 1983. We shouldn't hold out much hope of such a long reprieve.

Before this time, clients can still create FLPs, LLCs or S corporations, taking advantage of the favorable state statutes and tax case law. Creating such entities will protect against the application of the proposed regs, however, only to the extent that the client gives or sells an interest in the entity before the final regs are promulgated. Thus, practitioners need to prompt those clients who are otherwise good candidates for creating such entities to do so now, rather than to continue to ponder their options. Tempus is fugiting.

One important issue is whether any discount in an interest transferred before the effective date will be recaptured if death occurs within three years of transfer. In any case, it seems that if there's no voting or liquidation right attributable to the transferred interest, there would be no recapture under the three year rule if given away before the effective date. For instance, if an entity has voting and non-voting interests and non-voting interests are given away (or sold) before the effective date, there would be no “lapse” to recapture if death occurs within three years of transfer. This result should be contrasted with a non-voting interest in a family-controlled entity transferred after the effective date. In that case, the transferred interest would be valued as though it included a put right to obtain the minimum value.

Second, if the final regs are issued in a form similar to the proposed regs, it will be virtually impossible to obtain a valuation discount for marketable assets merely by placing them in a family-controlled entity. The value of even active businesses almost certainly will be affected.

The regs shouldn't affect the DLOM associated with ownership of tangible real or personal property as a tenancy in common (TIC) or as community property. The courts have routinely found that such partial interests are entitled to significant valuation discounts, because
there’s a far smaller market for partial interests than for full ownership of an asset.65

Of course, one must be careful that a TIC not be a partnership for tax purposes. When the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created for tax purposes, without regard to state law.66 In Revenue Procedure 2002-22, the IRS provided guidelines on when it would rule that a TIC owning rental property wasn’t taxable as a partnership.

Rev. Proc. 2002-22 states that the IRS will issue a private letter ruling that an undivided fractional interest in taxable as a partnership. It would rule that a TIC owning rental property wasn’t a procedure. The IRS provided guidelines on when it would rule that a TIC owning rental property wasn’t taxable as a partnership.

Rev. Proc. 2002-22 states that the IRS will issue a private letter ruling that an undivided fractional interest in rental real property isn’t an interest in a business entity, under Treas. Regs. Section 301.7701-2(a), which applies for estate and gift tax, as well as income tax purposes.

The family holding company also remains useful for many non-tax reasons, including asset protection and consolidation of management of multiple assets. Families desiring such entities, after the final regs are published, should consider giving each owner a put right that complies with the requirements of the Section 2704(b) regs. This will avoid the application of Section 2704(b), though the actual put right will foreclose much, if any, valuation discount. Of course, a put isn’t always practical, because the entity may lack sufficient cash or borrowing power to satisfy an exercise of the put, and some of the owners can’t be relied on not to exercise their puts. In such cases, the practitioner can create the same entities he’s traditionally used, but the estate and gift tax valuation discounts will be largely, if not completely, unavailable under the new regime of Section 2704.

Also, the proposed regs may actually be beneficial for estates that will owe no estate tax because of the unified credit and marital deduction, even if valuation discounts aren’t available under Section 2704. The beneficiaries of such estates may find themselves with higher estate tax values, but with concomitantly higher income tax bases.67 If the higher estate tax value doesn’t generate additional tax, the higher income tax basis may significantly reduce federal and state income tax liabilities. Although the Section 2704 valuation rules, which may increase transfer tax values of interests in a family-controlled entity, apply for estate, gift and GST tax purposes, and the automatic change in basis for most assets transferred by or received from a decedent is an income tax provision, it seems unlikely the IRS will take the position that a taxpayer must pay estate tax on one value but the basis change will be limited to a lower value.

Alert Clients Now
These are just proposed regs, but if the final regs closely resemble the proposed regs, minority and marketability discounts will become largely unavailable for family-owned entities. Practitioners should alert their clients of the need to act before the final regs are published, if they wish to take advantage of most of the discount planning that has become a popular part of modern estate planning.

—Authors’ note: Questions have been raised about the effect of the proposed regulations. In particular, there’s uncertainty about the consequences of disregarding a restriction. As the authors read the proposed regulations, the effect is to imply that the transferred interest carries a right to unilaterally withdraw from the entity. Based on informal discussions with IRS and Treasury personnel, however, this may not reflect the government’s intent. Further clarification on this important point will hopefully be provided.

Endnotes
8. Ibid.
9. Ibid.


22. Ibid.


25. Kerr, ibid.

26. Ibid.


29. Ibid.

30. Ibid.


35. See IRC Section 6166(b)(9)(B).


39. Ibid.

40. Supra note 38.

41. Ibid.

42. Kerr, supra note 24.

43. Revenue Ruling 59-60, Section 4.02(g); see also Rev. Rul. 80-213, Section 4.08 (in valuing closely held stock with reference to prices of comparable stocks sold on open exchanges, “it is generally necessary to adjust the preliminary value in recognition that the shares of the comparative companies are publicly traded while the shares to be valued are not”).


50. See, e.g., Ahmanson Foundation v. United States, 664 F.2d 761 (9th Cir. 1981).

51. See Section 2704(a)(3); see also Preamble (quoting this section).

52. See Walton v. Comm’r, 115 T.C. 589, 598-599 (2000) (indicating that a general grant regulation is reviewed more deferentially than a specific grant regulation).

53. Mayo Foundation For Medical Education & Research v. United States, 562 U.S. 44 (2011); McDonald v. Comm’r, T.C. Memo. 2015-169 (indicating that both types of regulation are reviewed under the same Mayo standard).

54. Mayo, ibid., at p. 53.

55. See, e.g., Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981).


58. Mayo, supra note 53.

59. Chevron, supra note 57, at p. 843, fn. 9.


A Song in Her Heart
"Cleopatra," by Irene Clark, sold for $1,500 at Swann Auction Galleries’ African-American Fine Art sale in New York City on Oct. 6, 2016. Clark was both a painter and a designer; later in her career, she combined her two passions and painted her designs on wooden furniture for the Marshall Fields Company.
61. See also United States v. Home Concrete & Supply, LLC, 132 S.Ct. 1836 (2012) ("examination of legislative history ... [can lead to the conclusion that Congress had decided the question definitively], leaving no room for the agency to reach a contrary result.")

62. See Balestra v. United States 803 F.3d 1363 (Fed. Cir. 2015) ("Under the Chevron framework, we begin by using the ordinary tools of statutory construction to determine whether Congress's intent is clear regarding the precise question at issue... These tools include the statute's text, structure, canons of statutory construction, and legislative history"); Estate of Cervin v. Comm'n, T.C. Memo. 1994-550 (20 percent discount for undivided fractional interest in farm); Estate of Stevens v. Comm'n, T.C. Memo. 2000-53 (25 percent discount for undivided fractional interest in improved real estate); Williams v. Comm'n, T.C. Memo. 1998-59 (44 percent discount for undivided one-half interest in real estate); assessing attorney's fees against the Internal Revenue Service for continuing to assert that the discount is limited to cost of partitioning); Estate of Forbes v. Comm'n, T.C. Memo. 2001-72 (50 percent discount). With respect to a partial interest in artwork, see Estate of Elkins v. Comm'n, 757 F.3d 453 (5th Cir. 2014), aff'd in part, rev'd in part 140 T.C. 86 (2013) (44.75 percent discount for a 73.055 percent undivided partial interest in an art collection); Estate of Scull v. Comm'n, T.C. Memo. 1994-271 (5 percent discount for an undivided 65 percent interest in a pop art collection); and Stone v. United States, 2007 WL 1544786 (N.D. Cal. 2007), supplemented by 2007 WL 2389794 (N.D. Cal. 2007), aff'd, Stone ex rel. Stone Trust Agreement v. United States, 2009 WL 766497 (9th Cir. 2009) (5 percent discount for an undivided 50 percent interest in an art collection).

63. See Mayo, supra note 53, at p. 55.

64. See, e.g., National Cable & Telecommunications Ass'n v. Brand X Internet Services, 545 U.S. 967 (2005); United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836 (2012).


