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# Navigating the New Section 2704 Discount Valuation and Transfer Regulations: What Estate Planners Must Do Now

TUESDAY, OCTOBER 11, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 25

[REG-163113-02]

RIN 1545-BB71

Estate, Gift, and Generation-skipping Transfer Taxes; Restrictions on Liquidation of an Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

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

DATES: Written and electronic comments must be received by [**INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**]. Outlines of topics to be discussed at the public hearing scheduled for December 1, 2016, must be received by [**INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**].

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-163113-02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand delivered Monday through Friday between the hours of

8 a.m. and 5 p.m. to: CC:PA:LPD:PR (REG-163113-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking portal at www.regulations.gov (IRS REG-163113-02). The public hearing will be held in the Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John D. MacEachen, (202) 317-6859; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Background**

Section 2704 of the Internal Revenue Code provides special valuation rules for purposes of subtitle B (relating to estate, gift, and GST taxes) for valuing intra-family transfers of interests in corporations and partnerships subject to lapsing voting or liquidation rights and restrictions on liquidation. Lapses of voting or liquidation rights are treated as a transfer of the excess of the fair market value of all interests held by the transferor, determined as if the voting or liquidation rights were nonlapsing, over the fair market value of such interests after the lapse. Certain restrictions on liquidation are disregarded in determining the fair market value of the transferred interest. The legislative history of section 2704 states that the provision is intended, in part, to prevent results similar to that in Estate of Harrison v. Commissioner, T.C. Memo. 1987-8. Informal S. Rep. on S. 3209, 136 Cong. Rec. S15629-4 (October 18, 1990); H.R. Conf. Rep. No. 101-964, 2374, 2842 (October 27, 1990).

In Harrison, the decedent and two of his children each held a general partner interest in a partnership immediately before the decedent's death. The decedent also held all of the limited partner interests in the partnership. Because any general partner could liquidate the partnership during life, each general partner could cause all partners to obtain the full value of such partner's partnership interests. A general partner's right to liquidate the partnership lapsed on the death of that partner. In determining the estate tax value of the decedent's limited partner interest, the court concluded that the right of the decedent to liquidate the partnership (and thus readily obtain the full value of the limited partner interest) could not be taken into account because that right lapsed at death. As a result, the Court determined the value for transfer tax purposes of the limited partner interest to be less than its value either in the hands of the decedent immediately before death or in the hands of his family (the other general partners) immediately after death.

Section 2704(a)(1) provides generally that, if there is a lapse of any voting or liquidation right in a corporation or a 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 shall be treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate, whichever is applicable. The amount of the transfer is the fair market value of all interests held by the individual immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing) over the fair market value of such interests after the lapse.

Section 25.2704-1(a)(2)(v) of the current Gift Tax Regulations defines a liquidation right as the right or ability, including by reason of aggregate voting power, to

compel the entity to acquire all or a portion of the holder's equity interest in the entity, whether or not its exercise would result in the complete liquidation of the entity.

Section 25.2704-1(c)(1) provides a rule that a lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. However, under §25.2704-1(c)(1), a transfer of an interest that results in the lapse of a liquidation right generally is not subject to this rule if the rights with respect to the transferred interest are not restricted or eliminated. The effect of this exception is that the inter vivos transfer of a minority interest by the holder of an interest with the aggregate voting power to compel the entity to acquire the holder's interest is not treated as a lapse even though the transfer results in the loss of the transferor's presently exercisable liquidation right.

The Treasury Department and the IRS, however, believe that this exception should not apply when the inter vivos transfer that results in the loss of the power to liquidate occurs on the decedent's deathbed. Cf. Estate of Murphy v. Commissioner, T.C. Memo. 1990-472 (rejecting "attempts to avoid taxation of the control value of stock holdings through bifurcation of the blocks"). Such 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. See Harrison, supra. The enactment of section 2704 was intended to prevent this result. See Informal S. Rep. on S. 3209, supra; H.R. Conf. Rep. No. 101-964, supra. See also section 2704(a)(3) (conferring on the Secretary broad regulatory authority to apply section 2704(a) to the lapse of rights similar to voting and liquidation rights). The Treasury Department and the IRS have

concluded that the regulatory exception created in §25.2704-1(c)(1) should apply only to transfers occurring more than three years before death, where the loss of control over liquidation is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of a donor's subjective motive which is administratively burdensome for both taxpayers and the IRS. Cf. section 2035(a) (replacing the contemplation of death presumption of prior law with a bright-line, three-year test). Accordingly, the proposed regulations treat transfers occurring within three years of death that result in the lapse of a liquidation right as transfers occurring at death for purposes of section 2704(a).

Section 2704(b)(1) provides generally that, if a transferor transfers an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any "applicable restriction" is disregarded in valuing the transferred interest. Under section 2704(b)(2), an applicable restriction is defined as a restriction that effectively limits the ability of the entity to liquidate, but which, after the transfer, either in whole or in part, will lapse or may be removed by the transferor or the transferor's family, either alone or collectively. Section 2704(b)(3)(B) excepts from the definition of an applicable restriction any restriction "imposed, or required to be imposed, by any Federal or State law."

Section 2704(b)(4) provides that the Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of any interest in a corporation or a partnership transferred to a member of the transferor's family if the

restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee.

Section 25.2704-2(b) provides, in part, that an applicable restriction "is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."

The Treasury Department and the IRS have determined that the current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws and by other subsequent developments. First, courts have concluded that, under the current regulations, 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. Kerr v. Commissioner, 113 T.C. 449, 473 (1999), aff'd, 292 F.3rd 490 (5th Cir. 2002). Thus, a restriction on the ability to liquidate an individual interest is not an applicable restriction under the current regulations.

Second, as noted above, the current regulations except from the definition of an applicable restriction a restriction on liquidation that is no more restrictive than that of the state law that would apply in the absence of the restriction. The Tax Court viewed this as a regulatory expansion of the statutory exception to the application of section 2704(b) contained in section 2704(b)(3)(B) that excepts "any restriction imposed, or required to be imposed, by any Federal or State law." Kerr, 113 T.C. at 472. Since the promulgation of the current regulations, many state statutes governing limited partnerships 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 or her limited partner interest. Instead, statutes in these jurisdictions typically now provide that a limited partner may not withdraw from the partnership unless the partnership agreement provides otherwise. See, e.g., Tex. Bus. Orgs. Ann. § 153.110 (West 2016) (limited partner may withdraw as specified in the partnership agreement); Uniform Limited Partnership Act (2001) § 601(a), 6A U.L.A. 348, 448 (Supp. 2015) (limited partner has no right to withdraw before completion of the winding up of the partnership). Further, other state statutes have been revised to create elective restrictions on liquidation. See, e.g., Nev. Rev. Stat. § 87A.427 (2016) (limited partnership electing to be restricted limited partnership may not make any distributions for a 10-year period). Each of these statutes is designed to be at least as restrictive as the maximum restriction on liquidation that could be imposed in a partnership agreement. The result is that the provisions of a partnership agreement restricting liquidation generally fall within the regulatory exception for restrictions that are no more restrictive than those under state law, and thus do not constitute applicable restrictions under the current regulations.

Third, taxpayers have attempted to avoid the application of section 2704(b) through the transfer of a partnership interest to an assignee rather than to a partner. Again relying on the regulatory exception for restrictions that are no more restrictive than those under state law, and the fact that an assignee is allocated partnership income, gain, loss, etc., but does not have (and thus may not exercise) the rights or powers of a partner, taxpayers argue that an assignee's inability to cause the

partnership to liquidate his or her partnership interest is no greater a restriction than that imposed upon assignees under state law. Kerr, 113 T.C. at 463-64; Estate of Jones v. Commissioner, 116 T.C. 121, 129-30 (2001). Taxpayers thus argue that the assignee status of the transferred interest is not an applicable restriction.

Finally, taxpayers have avoided the application of section 2704(b) through the transfer of a nominal partnership interest to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a restriction. Kerr, 292 F.3rd at 494.

As the Tax Court noted in Kerr, Congress granted the Secretary broad discretion in section 2704(b)(4) to promulgate regulations identifying restrictions not covered by section 2704(b) that nevertheless should be disregarded for transfer tax valuation purposes. 113 T.C. at 474. The Treasury Department and the IRS have concluded that, as was recognized by Congress when enacting section 2704(b), there are additional restrictions that may affect adversely the transfer tax value of an interest but that do not reduce the value of the interest to the family-member transferee, and thus should be disregarded for transfer tax valuation purposes. H.R. Conf. Rep. No. 101-964, supra, at 1138. The Treasury Department and the IRS have determined that such restrictions include: (a) a restriction on the ability to liquidate the transferred interest; and (b) any restrictions attendant upon the nature or extent of the property to be received in exchange for the liquidated interest, or the timing of the payment of that property.

Further, the Treasury Department and the IRS have concluded that the grant of an insubstantial interest in the entity to a nonfamily member should not preclude the

application of section 2704(b) because, in reality, such nonfamily member interest generally does not constrain the family's ability to remove a restriction on the liquidation of an individual interest. Cf. Kerr, 292 F.3rd at 494 (noting that a charity receiving a partnership interest would "convert its interests into cash as soon as possible, so long as it believed the transaction to be in its best interest and that it would receive fair market value for its interest"). The interest of such nonfamily members does not affect the family's control of the entity, but rather, when combined with a requirement that all holders approve liquidation, is designed to reduce the transfer tax value of the family-held interests while not ultimately reducing the value of those interests to the family member transferees. The enactment of section 2704 was intended to prevent this result. See section 2704(b)(4) (conferring on the Secretary broad regulatory authority to apply section 2704(b) to other restrictions if the restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee). The Treasury Department and the IRS have concluded that the presence of a nonfamily-member interest should be recognized only where the interest is an economically substantial and longstanding one that is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of whether the interest of the nonfamily member effectively constrains the family's ability to liquidate the entity. Accordingly, the proposed regulations disregard the interest held by a nonfamily member that has been held less than three years before the date of the transfer, that constitutes less than 10 percent of the value of all of the equity interests, that when combined with the interests of other nonfamily members constitutes less than 20 percent of the value of all of the equity

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

Finally, since the promulgation of §§301.7701-1 through 301.7701-3 of the Procedure and Administration Regulations (the check-the-box regulations), an entity's classification for federal tax purposes may differ substantially from the entity's structure or form under local law. In addition, many taxpayers now utilize a limited liability company (LLC) as the preferred entity to hold family assets or business interests. The Treasury Department and the IRS have concluded that the regulations under section 2704 should be updated to reflect these significant developments.

**Explanation of Provisions**

The proposed regulations would amend §25.2701-2 to address what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership, or limited partnership. The proposed regulations would amend §25.2704-1 to address deathbed transfers that result in the lapse of a liquidation right and to clarify the treatment of a transfer that results in the creation of an assignee interest. The proposed regulations would amend §25.2704-2 to refine the definition of the term "applicable restriction" by eliminating the comparison to the liquidation limitations of state law. Further, the proposed regulations would add a new section, §25.2704-3, to address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interests held by persons who are not members of the family.

Covered Entities

The proposed regulations would clarify, in §§25.2704-1 through 25.2704-3, that section 2704 applies to corporations, partnerships, LLC's, and other entities and

arrangements that are business entities within the meaning of §301.7701-2(a), regardless of whether the entity or arrangement is domestic or foreign, regardless of how the entity or arrangement is classified for other federal tax purposes, and regardless of whether the entity or arrangement is disregarded as an entity separate from its owner for other federal tax purposes.

Classification of the Entity

Section 2704 speaks in terms of corporations and partnerships. Under the proposed regulations, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8), an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation that is separate from its parent owner. For most purposes under the proposed regulations, a partnership would be any other business entity within the meaning of §301.7701-1(a), regardless of how the entity is classified for federal tax purposes.

However, these proposed regulations address two situations in which it is necessary to go beyond this division of entities into only the two categories of corporation and partnership. These situations (specifically, the test to determine control of an entity, and the test to determine whether a restriction is imposed under state law) require consideration of the differences among various types of business entities under the local law under which those entities are created and governed. As a result, for purposes of the test to determine control of an entity and to determine whether a restriction is imposed under state law, the proposed regulations would provide that in

the case of any business entity or arrangement that is not a corporation, the form of the entity or arrangement would be determined under local law, regardless of how it is classified for other federal tax purposes, and regardless of whether it is disregarded as an entity separate from its owner for other federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity or arrangement is created or organized. Thus, in applying these two tests, there would be three types of entities: corporations, partnerships (including limited partnerships), and other business entities (which would include LLCs that are not S corporations) as determined under local law.

Control of the Entity

Section 2704(c)(1) incorporates the definition of control found in section 2701(b)(2). Control of a corporation, partnership, or limited partnership is defined in sections 2701(b)(2)(A) and (B). The proposed regulations would clarify, in §25.2701-2, that control of an LLC or of any other entity or arrangement that is not a corporation, partnership, or limited partnership would constitute the holding of at least 50 percent of either the capital or profits interests of the entity or arrangement, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. Cf. section 2701(b)(2)(B)(ii) (defining control of a limited partnership as including the holding of any interest as a general partner). Further, for purposes of determining control, under the attribution rules of existing §25.2701-6, an individual, the individual's estate, and members of the individual's family are treated as holding interests held indirectly through a corporation, partnership, trust, or other entity.

Lapses under Section 2704(a)

The proposed regulations would amend §25.2704-1(a) to confirm that a transfer that results in the restriction or elimination of any of the rights or powers associated with the transferred interest (an assignee interest) is treated as a lapse within the meaning of section 2704(a). This is the case regardless of whether the right or power is exercisable by the transferor after the transfer because the statute is concerned with the lapse of rights associated with the transferred interest. Whether the lapse is of a voting or liquidation right is determined under the general rules of section 25.2704-1.

The proposed regulations also would amend §25.2704-1(c)(1) to narrow the exception in the definition of a lapse of a liquidation right to transfers occurring three years or more before the transferor's death that do not restrict or eliminate the rights associated with the ownership of the transferred interest. In addition, the proposed regulations would amend §25.2704-1(c)(2)(i)(B) to conform the existing provision for testing the family's ability to liquidate an interest with the proposed elimination of the comparison with local law, to clarify that the manner in which liquidation may be achieved is irrelevant, and to conform with the proposed provision for disregarding certain nonfamily-member interests in testing the family's ability to remove a restriction in proposed §25.2704-3 regarding disregarded restrictions.

Applicable Restrictions under Section 2704(b)

The proposed regulations would remove the exception in §25.2704-2(b) that limits the definition of applicable restriction to limitations that are more restrictive than the limitations that would apply in the absence of the restriction under the local law generally applicable to the entity. As noted above, this exception is not consistent with section 2704(b) to the extent that the transferor and family members have the power to

avoid any statutory rule. The proposed regulations also would revise §25.2704-2(b) to provide that an applicable restriction does include a restriction that is imposed under the terms of the governing documents, as well as a restriction that is imposed under a local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. In applying this particular exception to the definition of an applicable restriction, this proposed rule is intended to ensure that a restriction that is not imposed or required to be imposed by federal or state law is disregarded without regard to its source.

Further, with regard to the exception for restrictions "imposed, or required to be imposed, by any Federal or State law," in section 2704(b)(3)(B), the proposed regulations would clarify that the terms "federal" and "state" refer only to the United States or any state (including the District of Columbia (see section 7701(a)(10)), but do not include any other jurisdiction.

A restriction is imposed or required to be imposed by law if the restriction cannot be removed or overridden and it is mandated by the applicable law, is required to be included in the governing documents, or otherwise is made mandatory. In addition, a restriction imposed by a state law, even if that restriction may not be removed or overridden directly or indirectly, nevertheless would constitute an applicable restriction in two situations. In each situation, although the statute itself is mandatory and cannot be overridden, another statute is available to be used for the entity's governing law that does not require the mandatory restriction, thus in effect making the purportedly mandatory provision elective. The first situation is that in which the state law is limited in its application to certain narrow classes of entities, particularly those types of entities

most likely to be subject to transfers described in section 2704, that is, family-controlled entities. The second situation is that in which, although the state law under which the entity was created imposed a mandatory restriction that could not be removed or overridden, either at the time the entity was organized or at some subsequent time, that state's law also provided an optional provision or an alternative statute for the creation and governance of that same type of entity that did not mandate the restriction. Thus, an optional provision is one for the same category of entity that did not include the restriction or that allowed it to be removed or overridden, or that made the restriction optional, or permitted the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining whether a restriction is imposed on an entity under state law, there would be only three types of entities, specifically, the three categories of entities described in §25.2701-2(b)(5) of the proposed regulations: corporations; partnerships (including limited partnerships); and other business entities. A similar proposed rule applies to the additional restrictions discussed later in this preamble.

If an applicable restriction is disregarded, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction does not exist (that is, as if the governing documents and the local law are silent on the question), and thus, there is deemed to be no such restriction on liquidation of the entity.

Disregarded Restrictions

A new class of restrictions is described in the proposed regulations that would be disregarded, described as "disregarded restrictions." This class of restrictions is

identified pursuant to the authority contained in section 2704(b)(4). Note that, although it may appear that sections 2703 and 2704(b) overlap, they do not. While section 2703 and the corresponding regulations currently address restrictions on the sale or use of individual interests in family-controlled entities, the proposed regulations would address restrictions on the liquidation or redemption of such interests.

Under §25.2704-3 of the proposed regulations, in the case of a family-controlled entity, any restriction described below on a shareholder's, partner's, member's, or other owner's right to liquidate his or her interest in the entity will be disregarded if the restriction will lapse at any time after the transfer, or if the transferor, or the transferor and family members, without regard to certain interests held by nonfamily members, may remove or override the restriction. Under the proposed regulations, such a disregarded restriction includes one that: (a) limits the ability of the holder of the interest to liquidate the interest; (b) limits the liquidation proceeds to an amount that is less than a minimum value; (c) defers the payment of the liquidation proceeds for more than six months; or (d) permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.

"Minimum value" is the interest's share of the net value of the entity on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate. For

example, and subject to the foregoing limitation on outstanding obligations, if the entity holds an operating business, the rules of §20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer. The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. For this purpose, the interest's share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity.

A disregarded restriction includes limitations on the time and manner of payment of the liquidation proceeds. Such limitations include provisions permitting deferral of full payment beyond six months or permitting payment in any manner other than in cash or property. For this purpose, the term "property" does not 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. An exception is made for the note of an entity engaged in an active trade or business to the extent that (a) the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), and (b) the note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value (when discounted to present value) equal to the liquidation proceeds. A fair market value determination assumes a cash sale. See Section 2 of Rev. Rul. 59-60, 1959-1 C.B. 237 (defining fair market value and stating that "[c]ourt decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing to trade…"). Thus, in the absence of immediate payment of the liquidation proceeds, the fair market value of any

note falling within this exception must equal the fair market value of the liquidation proceeds on the date of liquidation or redemption.

Exceptions that apply to applicable restrictions under the current and these proposed regulations also apply to this new class of disregarded restrictions. One of the exceptions applicable to the definition of a disregarded restriction applies if (a) each holder of an interest in the entity has an enforceable "put" right to receive, on liquidation or redemption of the holder's interest, cash and/or other property with a value that is at least equal to the minimum value previously described, (b) the full amount of such cash and other property must be paid within six months after the holder gives notice to the entity of the holder's intent to liquidate any part or all of the holder's interest and/or withdraw from the entity, and (c) such other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related either to the entity or to any holder of an interest in the entity. However, in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include a note or other obligation if such note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of the liquidation or redemption equal to the liquidation proceeds. A similar exception is made to the definition of an applicable restriction in proposed §25.2704-2(b)(4).

In determining whether the transferor and/or the transferor's family has the ability to remove a restriction included in this new class of disregarded restrictions, any interest in the entity held by a person who is not a member of the transferor's family is disregarded if, at the time of the transfer, the interest: (a) has been held by such person for less than three years; (b) constitutes less than 10 percent of the value of all of the equity interests in a corporation, or constitutes less than 10 percent of the capital and profits interests in a business entity described in §301.7701-2(a) other than a corporation (for example, less than a 10-percent interest in the capital and profits of a partnership); (c) when combined with the interests of all other persons who are not members of the transferor's family, constitutes less than 20 percent of the value of all of the equity interests in a corporation, or constitutes less than 20 percent of the capital and profits interests in a business entity other than a corporation (for example, less than a 20-percent interest in the capital and profits of a partnership); or (d) any such person, as the owner of an interest, does not have an enforceable right to receive in exchange for such interest, on no more than six months' prior notice, the minimum value referred to in the definition of a disregarded restriction. If an interest is disregarded, the determination of whether the family has the ability to remove the restriction will be made assuming that the remaining interests are the sole interests in the entity.

Finally, if a restriction is disregarded under proposed §25.2704-3, the fair market value of the interest in the entity is determined assuming that the disregarded restriction did not exist, either in the governing documents or applicable law. Fair market value is determined under generally accepted valuation principles, including any appropriate discounts or premiums, subject to the assumptions described in this paragraph.

Coordination with Marital and Charitable Deductions

Section 2704(b) applies to intra-family transfers for all purposes of subtitle B relating to estate, gift and GST taxes. Therefore, to the extent that an interest qualifies for the gift or estate tax marital deduction and must be valued by taking into account the special valuation assumptions 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. See, e.g., Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987).

Section 2704(b) does not apply to transfers to nonfamily members and thus has no application in valuing an interest passing to charity or to a person 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 nonfamily members, and if (taking into account the proposed rules regarding the treatment of certain interests held by nonfamily members) the part passing to the decedent's family members is valued under section 2704(b), then the proposed regulations provide that the part passing to the family members is treated as a property interest separate from the part passing to nonfamily members. The fair market value 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 fair market value of the part passing to the nonfamily member(s) is determined in a similar manner, but without the special valuation assumptions of section 2704(b). Thus, if the sole nonfamily 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 nonfamily members, however, is divided between charities and other nonfamily members, additional considerations (not prescribed by section 2704) may apply, resulting in a different value for charitable deduction purposes. See, e.g., Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).

**Effective Dates**

The amendments to §25.2701-2 are proposed to be effective on and after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. The amendments to §25.2704-1 are proposed to apply to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register**. The amendments to §25.2704-2 are proposed to apply to transfers of property subject to restrictions created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register**. Section 25.2704-3 is proposed to apply to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the **Federal Register**.

**Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. The proposed

regulations affect the transfer tax liability of individuals who transfer an interest in certain closely held entities and not the entities themselves. The proposed regulations do not affect the structure of such entities, but only the assumptions under which they are valued for federal transfer tax purposes. In addition, any economic impact on entities affected by section 2704, large or small, is derived from the operation of the statute, or its intended application, and not from the proposed regulations in this notice of proposed rulemaking. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely (in the manner described in "ADDRESSES") to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be available at www.regulations.gov, or upon request.

A public hearing on these proposed regulations has been scheduled for December 1, 2016, beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC 20224. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than

30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit comments by [**INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**], and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by [**INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**].

A period of 10 minutes will be allotted to each person for making comments. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal author of these proposed regulations is John D. MacEachen, Office of the Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the Treasury Department and the IRS participated in their development.

**List of Subjects in 26 CFR Part 25**

Gift taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 25 is proposed to be amended as follows:

PART 25--GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 1. The authority citation for part 25 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Section 25.2701-2 also issued under 26 U.S.C. 2701(e).

Section 25.2704-1 also issued under 26 U.S.C. 2704(a).

Sections 25.2704-2 and 25.2704-3 also issued under 26 U.S.C. 2704(b).

* * * * *

Par. 2. Section 25.2701-2 is amended as follows:

1. In paragraph (b)(5)(i), the first sentence is revised and five sentences are added before the last sentence.

2. Paragraph (b)(5)(iv) is added.

The revision and additions read as follows:

§25.2701-2 Special valuation rules for applicable retained interests.

* * * * *

(b) * * *

(5) * * *

(i) * * * For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of §301.7701-2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse. The form of the entity determines the applicable test for control. For purposes of determining the form of the entity, any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B) is a corporation. For this purpose, a qualified subchapter S subsidiary is treated as a corporation

separate from its parent corporation. In the case of any business entity that is not a corporation under these provisions, the form of the entity is determined under local law, regardless of how the entity is classified for federal tax purposes or whether it is disregarded as an entity separate from its owner for federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under whose laws the entity is created or organized. * * *

* * * * *

(iv) Other business entities. In the case of any entity or arrangement that is not a corporation, partnership, or limited partnership, control means the holding of at least 50 percent of either the capital interests or the profits interests in the entity or arrangement. In addition, control means the holding of any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part.

* * * * *

Par. 3. Section 25.2701-8 is amended as follows:

1. The existing text is designated as paragraph (a).

2. The first sentence of newly designated paragraph (a) is revised and paragraph (b) is added.

The revision and addition reads as follows:

§25.2701-8 Effective dates.

(a) Except as provided in paragraph (b) of this section, §§25.2701-1 through 25.2701-4 and §§25.2701-6 and 25.2701-7 are effective as of January 28, 1992. * * *

(b) The first six sentences of §25.2701-2(b)(5)(i) and (iv) are effective on the date these regulations are published as final regulations in the **Federal Register**.

Par. 4. Section 25.2704-1 is amended as follows:

1. In paragraph (a)(1), the first two sentences are revised and four sentences are added before the third sentence.

2. In paragraph (a)(2)(i), a sentence is added at the end.

3. Paragraph (a)(2)(iii) is removed.

4. Paragraphs (a)(2)(iv) through (vi) are redesignated as paragraphs (a)(2)(iii) through (v), respectively.

5. In newly designated paragraph (a)(2)(iii), a sentence is added before the third sentence.

6. Paragraph (a)(4) is revised.

7. Paragraph (a)(5) is added.

8. In paragraph (c)(1), the second sentence is revised and a sentence is added at the end.

9. Paragraph (c)(2)(i)(B) is revised.

10. In paragraph (f) Example 4, the third and fourth sentences are revised and a sentence is added at the end.

11. In paragraph (f) Example 6, the third sentence is removed.

12. In paragraph (f) Example 7, the third and fourth sentences are revised and a sentence is added at the end.

The revisions and additions read as follows:

§25.2704-1 Lapse of certain rights.

(a) * * *

(1) * * * For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), the lapse of a voting or a liquidation right in a corporation or a partnership (an entity), whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse (the holder) to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is controlled by the holder and/or members of the holder's family immediately before and after the lapse. For purposes of this section, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of §301.7701-2(a) of this chapter regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes. * * *

(2) * * *

(i) * * * For purposes of determining whether the group consisting of the holder, the holder's estate and members of the holder's family control the entity, a member of the group is also treated as holding any interest held indirectly by such member through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6.

* * * * *

(iii) * * * In the case of a limited liability company, the right of a member to participate in company management is a voting right. * * *

* * * * *

(4) Source of right or lapse. A voting right or a liquidation right may be conferred by or lapse by reason of local law, the governing documents, an agreement, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs voting or liquidation rights.

(5) Assignee interests. A transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights. For example, the transfer of a partnership interest to an assignee that 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.

(c) * * *

(1) * * * Except as otherwise provided, a transfer of an interest occurring more than three years before the transferor's death that results in the lapse of a voting or liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated. * * * The lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a).

(2) * * * *

(i) * * * *

(B) Ability to liquidate. Whether an interest can be liquidated immediately after the lapse is determined under the local law generally applicable to the entity, as modified by the governing documents of the entity, but without regard to any restriction (in the governing documents, applicable local law, or otherwise) described in section 2704(b) and the regulations thereunder. The manner in which the interest may be liquidated is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, revising the governing documents, merging the entity with an entity whose governing documents permit liquidation of the interest, terminating the entity, or otherwise. For purposes of making this determination, an interest held by a person other than a member of the holder's family (a nonfamily-member interest) may be disregarded. Whether a nonfamily-member interest is disregarded is determined under §25.2704-3(b)(4), applying that section as if, by its terms, it also applies to the question of whether the holder (or the holder's estate) and members of the holder's family may liquidate an interest immediately after the lapse.

* * * * *

(f) * * *

Example 4. * * * More than three years before D's death, D transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

* * * * *

Example 7. * * * More than three years before D's death, D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D's death. * * * However, had the transfer occurred within three years of

D's death, the transfer would have been treated as the lapse of D's liquidation right with respect to the common stock occurring at D's death.

Par. 5. Section 25.2704-2 is amended as follows:

1. Paragraphs (a) and (b) are revised.

2. Paragraphs (c) and (d) are designated as paragraphs (e) and (g), respectively.

3. New paragraphs (c), (d), and (f) are added.

4. The first sentence of newly designated paragraph (e) is revised.

5. The third sentences of newly designated paragraph (g) Example 1. and Example 3. are removed.

6. The third sentence of newly designated paragraph (g) Example 5. is revised.

The revisions and additions read as follows:

§25.2704-2 Transfers subject to applicable restrictions.

(a) In general. For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any applicable restriction is disregarded in valuing the transferred interest. For purposes of this section, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of

§301.7701-2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

(b) Applicable restriction defined--(1) In general. The term applicable restriction means a limitation on the ability to liquidate the entity, in whole or in part (as opposed to a particular holder's interest in the entity), if, after the transfer, that limitation either lapses or may be removed by the transferor, the transferor's estate, and/or any member of the transferor's family, either alone or collectively. See §25.2704-3 for restrictions on the ability to liquidate a particular holder's interest in the entity.

(2) Source of limitation. An applicable restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(4)(ii) of this section.

(3) Lapse or removal of limitation. A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the restriction may be removed after the transfer by any one or more members, either

alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family. For purposes of determining whether the ability to remove the restriction is held by any member(s) of this group, members are treated as holding the interests attributed to them under the rules contained in §25.2701-6, in addition to interests held directly. The manner in which the restriction may be removed is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

(4) Exceptions. A restriction described in this paragraph (b)(4) is not an applicable restriction.

(i) Commercially reasonable restriction. An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

(ii) Imposed by federal or state law. An applicable restriction does not include a restriction imposed or required to be imposed by federal or state law. For this purpose,

federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not 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 does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in §25.2701-2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

(iii) Certain rights under section 2703. An option, right to use property, or

agreement that is subject to section 2703 is not an applicable restriction.

(iv) Put right of each holder. Any restriction that otherwise would constitute an applicable restriction under this section will not be considered an applicable restriction if each holder of an interest in the entity has a put right as described in §25.2704-3(b)(6).

(c) Other definitions. For the definition of the term controlled entity, see §25.2701-2(b)(5). For the definition of the term member of the family, see §25.2702-2(a)(1).

(d) Attribution. An individual, the individual's estate, and members of the individual's family are treated as also holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6.

(e) * * * If an applicable restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction (whether in the governing documents, applicable law, or both) does not exist. * * *

(f) Certain transfers at death to multiple persons. Solely for purposes of section 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are not members of the decedent's family, and if the part passing to the members of the decedent's family is to be valued pursuant to paragraph (e) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property

interest. See paragraph (g) Ex. 4 of §25.2704-3.

(g) * * *

Example 5. * * * The preferred stock carries a right to liquidate X that cannot be exercised until 1999. * * *

* * * * *

§25.2704-3 [Redesignated as §25.2704-4]

Par. 6. Section 25.2704-3 is redesignated as §25.2704-4.

Par. 7. New §25.2704-3 is added to read as follows.

§25.2704-3 Transfers subject to disregarded restrictions.

(a) In general. For purposes of subtitle B (relating to estate, gift and generation-skipping transfer taxes), and notwithstanding any provision of §25.2704-2, if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any restriction described in paragraph (b) of this section is disregarded, and the transferred interest is valued as provided in paragraph (f) of this section. For purposes of this section, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of §301.7701-2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited

liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

(b) Disregarded restrictions defined--(1) In general. The term disregarded restriction means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to paragraph (b)(4) of this section), either alone or collectively.

(i) The provision limits or permits the limitation of the ability of the holder of the interest to compel liquidation or redemption of the interest.

(ii) The provision limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a minimum value. The term minimum value means the interest's share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate. For example, and subject to the foregoing limitation on outstanding obligations, if the entity holds an operating business, the rules of §20.2031-2(f)(2) or §20.2031-3 of this chapter apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or §25.2512-3 apply in the

case of an inter vivos transfer. The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. For this purpose, the interest's share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity. If the property held by the entity directly or indirectly includes an interest in another entity, and if a transfer of an interest in that other entity by the same transferor (had that transferor owned the interest directly) would be subject to section 2704(b), then the entity will be treated as owning a share of the property held by the other entity, determined and valued in accordance with the provisions of section 2704(b) and the regulations thereunder.

(iii) The provision defers or permits the deferral of the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder's intent to have the holder's interest liquidated or redeemed.

(iv) The provision authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property. Solely for this purpose, except as provided in the following sentence, 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 to either the entity or any holder of an interest in the entity, is deemed not to be property. In the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include such a note or other obligation if such note or other obligation is

adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See §25.2512-8. For purposes of this paragraph (b)(1)(iv), a related person is any person whose relationship to the entity or to any holder of an interest in the entity is described in section 267(b), provided that for this purpose the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

(2) Source of limitation. A disregarded restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, which governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(5)(iii) of this section.

(3) Lapse or removal of limitation. A restriction is a disregarded restriction only to the extent that the restriction either will lapse by its terms at any time after the transfer or may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family. For purposes of determining whether the ability to remove the restriction is held by any one or more members of this group, members are

treated as holding interests attributed to them under the rules contained in §25.2701-6, in addition to interests held directly. See also paragraph (b)(4) of this section. The manner in which the restriction may be removed is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

(4) Certain interests held by nonfamily members disregarded--(i) In general. In the case of a transfer to or for the benefit of a member of the transferor's family, for purposes of determining whether the transferor (or the transferor's estate) or any member of the transferor's family, either alone or collectively, may remove a restriction within the meaning of this paragraph (b), an interest held by a person other than a member of the transferor's family (a nonfamily-member interest) is disregarded unless all of the following are satisfied:

(A) The interest has been held by the nonfamily member for at least three years immediately before the transfer;

(B) On the date of the transfer, in the case of a corporation, the interest constitutes at least 10 percent of the value of all of the equity interests in the corporation, and, in the case of a business entity within the meaning of §301.7701-2(a) of this chapter other than a corporation, the interest constitutes at least a 10-percent interest in the business entity, for example, a 10-percent interest in the capital and profits of a partnership;

(C) On the date of the transfer, in the case of a corporation, the total of the equity interests in the corporation held by shareholders who are not members of the transferor's family constitutes at least 20 percent of the value of all of the equity interests in the corporation, and, in the case of a business entity within the meaning of §301.7701-2(a) of this chapter other than a corporation, the total interests in the entity held by owners who are not members of the transferor's family is at least 20 percent of all the interests in the entity, for example, a 20-percent interest in the capital and profits of a partnership; and

(D) Each nonfamily member, as owner, has a put right as described in paragraph (b)(6) of this section.

(ii) Effect of disregarding a nonfamily-member interest. If a nonfamily-member interest is disregarded under this section, the rules of this section are applied as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.

(iii) Attribution. In applying the 10-percent and 20-percent tests when the property held by the corporation or other business entity is, in whole or in part, an interest in another entity, the attribution rules of paragraph (d) of this section apply both in determining the interest held by a nonfamily member, and in measuring the interests owned through other entities.

(5) Exceptions. A restriction described in this paragraph (b)(5) is not a disregarded restriction.

(i) Applicable restriction. A disregarded restriction does not include an applicable restriction on the liquidation of the entity as defined in and governed by §25.2704-2.

(ii) Commercially reasonable restriction. A disregarded restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

(iii) Requirement of federal or state law. A disregarded restriction does not include a restriction imposed or required to be imposed by federal or state law. For this purpose, federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is a disregarded restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law

also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not 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 does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in §25.2701-2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

(iv) Certain rights described in section 2703. An option, right to use property, or agreement that is subject to section 2703 is not a restriction for purposes of this paragraph (b).

(v) Right to put interest to entity. Any restriction that otherwise would constitute a disregarded restriction under this section will not be considered a disregarded restriction if each holder of an interest in the entity has a put right as described in paragraph (b)(6) of this section.

(6) Put right. The term put right means a right, enforceable under applicable local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs liquidation or redemption rights with regard to

interests in the entity. For purposes of this paragraph (b)(6), the term other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or to any holder of an interest in the entity. However, in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), the term other property does include a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See §25.2512-8. The minimum value of the interest is the interest's share of the net value of the entity, as defined in paragraph (b)(1)(ii) of this section.

(c) Other definitions. For the definition of the term controlled entity, see §25.2701-2(b)(5). For the definition of the term member of the family, see §25.2702-2(a)(1).

(d) Attribution. An individual, the individual's estate, and members of the individual's family, as well as any other person, also are treated as holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6.

(e) Certain transfers at death to multiple persons. Solely for purposes of section 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that

includible interest passes to one or more persons who are nonfamily members of the decedent, and if the part passing to the members of the decedent's family is to be valued pursuant to paragraph (f) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest. See paragraph (g) Example 4 of this section.

(f) Effect of disregarding a restriction. If a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized.

(g) Examples. The following examples illustrate the provisions of this section.

Example 1. (i) D and D's children, A and B, are partners in Limited Partnership X that was created on July 1, 2016. D owns a 98 percent limited partner interest, and A and B each own a 1 percent general partner interest. The partnership agreement provides that the partnership will dissolve and liquidate on June 30, 2066, or by the earlier agreement of all the partners, but otherwise prohibits the withdrawal of a limited partner. Under applicable local law, a limited partner may withdraw from a limited partnership at the time, or on the occurrence of events, specified in the partnership agreement. Under the partnership agreement, the approval of all partners is required to amend the agreement. None of these provisions is mandated by local law. D transfers a 33 percent limited partner interest to A and a 33 percent limited partner interest to B.

(ii) By prohibiting the withdrawal of a limited partner, the partnership agreement imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor's family, acting collectively, by agreeing to amend the partnership agreement. Therefore, under section 2704(b) and paragraph (a) of this section, the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of each transferred interest. Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest determined under generally applicable valuation principles taking

into account all relevant factors affecting value including the rights determined under the governing documents and local law and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. See paragraphs (b)(1)(i) and (f) of this section.

NOTE: is only the prohibition on withdrawal by LP disregarded (minor effect), or the inability to w/d and get min. value?

Example 2. The facts are the same as in Example 1, except that, both before and after the transfer, A's partnership interests are held in an irrevocable trust of which A is the sole income beneficiary. The trustee is a publicly-held bank. A is treated as holding the interests held by the trust under the rules contained in §25.2701-6. The result is the same as in Example 1.

Example 3. The facts are the same as in Example 1, except that, on D's subsequent death, D's remaining 32 percent limited partner interest passes outright to D's surviving spouse, S, who is a U.S. citizen. In valuing the 32 percent interest for purposes of determining both the amount includible in the gross estate and the amount allowable as a marital deduction, the analysis and result are as described in Example 1.

Example 4. (i) The facts are the same as in Example 1, except that D made no gifts and, on D's subsequent death pursuant to D's will, a 53 percent limited partner interest passes to D's surviving spouse who is a U.S. citizen, a 25 percent limited partner interest passes to C, an unrelated individual, and a 20 percent limited partner interest passes to E, a charity. The restriction on a limited partner's ability to liquidate that partner's interest is a disregarded restriction. In determining whether D's estate and/or D's family may remove the disregarded restriction after the transfer occurring on D's death, the interests of C and E are disregarded because these interests were not held by C and E for at least three years prior to D's death, nor do C and E have the right to withdraw on six months' notice and receive their respective interest's share of the minimum value of X. Thus, the 53 percent interest passing to D's surviving spouse is subject to section 2704(b). D's gross estate will be deemed to include two separate assets: a 53 percent limited partner interest subject to section 2704(b), and a 45 percent limited partner interest not subject to section 2704.

(ii) The fair market value of the 53 percent interest is determined for both inclusion and deduction purposes under generally applicable valuation principles taking into account all relevant factors affecting value, including the rights determined under the governing documents and local law, and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. The 45 percent interest passing to nonfamily members is not subject to section 2704(b), and will be valued as a single interest for inclusion purposes under generally applicable valuation principles, taking into account all relevant factors affecting value including the rights determined under the governing documents and local law as well as the restriction on a limited partner's ability to liquidate that partner's interest. The 20 percent passing to charity will be valued in a similar manner for purposes of determining the allowable charitable deduction. Assuming that, under the facts and circumstances, the 45 percent interest and the 20 percent interest are subject to the same discount factor, the charitable deduction will equal four-ninths of the value of the 45 percent interest.

Example 5. (i) D and D's children, A and B, are partners in Limited Partnership Y. D owns a 98 percent limited partner interest, and A and B each own a 1 percent general partner interest. The partnership agreement provides that a limited partner may withdraw from the partnership at any time by giving six months' notice to the general partner. On withdrawal, the partner is entitled to receive the fair market value of his or her partnership interest payable over a five-year period. Under the partnership agreement, the approval of all partners is required to amend the agreement. None of these provisions are mandated by local law. D transfers a 33 percent limited partner interest to A and a 33 percent limited partner interest to B. Under paragraph (b)(1)(iii) of this section, the provision requiring that a withdrawing partner give at least six months' notice before withdrawing provides a reasonable waiting period and does not cause the restriction to be disregarded in valuing the transferred interests. However, the provision limiting the amount the partner may receive on withdrawal to the fair market value of the partnership interest, and permitting that amount to be paid over a five-year period, may limit the amount the partner may receive on withdrawal to less than the minimum value described in paragraph (b)(1)(ii) of this section and allows the delay of payment beyond the period described in paragraph (b)(1)(iii) of this section. The partnership agreement imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor's family, acting collectively, by agreeing to amend the partnership agreement.

(ii) Under section 2704(b) and paragraph (a) of this section, the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of the transferred interests. Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest, determined under generally applicable valuation principles taking into account all relevant factors affecting value, including the rights determined under the governing documents and local law, and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. See paragraph (f) of this section.

Example 6. The facts are the same as in Example 5, except that D sells a 33 percent limited partner interest to A and a 33 percent limited partner interest to B for fair market value (but without taking into account the special valuation assumptions of section 2704(b)). Because section 2704(b) also is relevant in determining whether a gift has been made, D has made a gift to each child of the excess of the value of the transfer to each child as determined in Example 5 over the consideration received by D from that child.

Example 7. The facts are the same as in Example 5, except, in a transaction unrelated to D's prior transfers to A and B, D withdraws from the partnership and immediately receives the fair market value (but without taking into account the special valuation assumptions of section 2704(b)) of D's remaining 32 percent limited partner interest. Because a gift to a partnership is deemed to be a gift to the other partners, D has made a gift to each child of one-half of the excess of the value of the 32 percent

limited partner interest as determined in Example 5 over the consideration received by D from the partnership.

Example 8. D and D's children, A and B, organize Limited Liability Company X under the laws of State Y. D, A, and B each contribute cash to X. Under the operating agreement, X maintains a capital account for each member. The capital accounts are adjusted to reflect each member's contributions to and distributions from X and each member's share of profits and losses of X. On liquidation, capital account balances control distributions. Profits and losses are allocated on the basis of units issued to each member, which are not in proportion to capital. D holds 98 units, A and B each hold 1 unit. D is designated in the operating agreement as the manager of X with the ability to cause the liquidation of X. X is not a corporation. Under the laws of State Y, X is neither a partnership nor a limited partnership. D and D's family have control of X because they hold at least 50 percent of the profits interests (or capital interests) of X. Further, D and D's family have control of X because D holds an interest with the ability to cause the liquidation of X.

Example 9. The facts are the same as in Example 8, except that, under the operating agreement, all distributions are made to members based on the units held, which in turn is based on contributions to capital. Further, X elects to be treated as a corporation for federal tax purposes. Under §25.2701-2(b)(5), D and D's family have control of X (which is not a corporation and, under local law, is not a partnership or limited partnership) because they hold at least 50 percent of the capital interests in X. Further, D and D's family have control of X because D holds an interest with the ability to cause the liquidation of X.

Example 10. D owns a 1 percent general partner interest and a 74 percent limited partner interest in Limited Partnership X, which in turn holds a 50 percent limited partner interest in Limited Partnership Y and a 50 percent limited partner interest in Limited Partnership Z. D owns the remaining interests in partnerships Y and Z. A, an unrelated individual, has owned a 25 percent limited partner interest in partnership X for more than 3 years. The governing documents of all three partnerships permit liquidation of the entity on the agreement of the owners of 90 percent of the interests but, with the exception of A's interest, prohibit the withdrawal of a limited partner. A may withdraw on 6-months' notice and receive A's interest's share of the minimum value of partnership X as defined in paragraph (b)(1)(ii) of this section, which share includes a share of the minimum value of partnership Y and of partnership Z. Under the governing documents of all three partnerships, the approval of all partners is required to amend the documents. D transfers a 40 percent limited partner interest in partnership Y to D's children. For purposes of determining whether D and/or D's family members have the ability to remove a restriction after the transfer, A is treated as owning a 12.5 percent (.25 x.50) interest in partnership Y, thus more than a 10 percent interest, but less than a 20 percent interest, in partnership Y. Accordingly, under paragraph (b)(4)(i)(C) of this section, A's interest is disregarded for purposes of determining whether D and D's family hold the right to remove a restriction after the transfer (resulting in D and D's children being deemed to own 100 percent of Y for this purpose).

However, if D instead had transferred a 40 percent limited partner interest in partnership X to D's children, A's ownership of a 25 percent interest in partnership X would not have been disregarded, with the result that D and D's family would not have had the ability to remove a restriction after the transfer.

Example 11. (i) D owns 85 of the outstanding shares of X, a corporation, and A, an unrelated individual, owns the remaining 15 shares. Under X's governing documents, the approval of the shareholders holding 75 percent of the outstanding stock is required to liquidate X. With the exception of nonfamily members, a shareholder may not withdraw from X. Nonfamily members may withdraw on six months' notice and receive their interest's share of the minimum value of X as defined in paragraph (b)(1)(ii) of this section. D transfers 10 shares to C, a charity. Four years later, D dies. D bequeaths 10 shares to B, an unrelated individual, and the remaining 65 shares to trusts for the benefit of D's family.

(ii) The prohibition on withdrawal is a restriction described in paragraph (b)(1)(i) of this section. In determining whether D's estate and/or D's family may remove the restriction after the transfer occurring on D's death, the interest of B is disregarded because it was not held by B for at least three years prior to D's death. The interests of A and C, however, are not disregarded, because each held an interest of at least 10 percent for at least three years prior to D's death, the total of those interests represents at least 20 percent of X, and each had the right to withdraw on six months' notice and receive their interest's share of the minimum value of X. As a result, D and D's family hold 65 of the deemed total of 90 shares in X, or 72 percent, which is less than the 75 percent needed to liquidate X. Thus, D and D's family do not have the ability to remove the restriction after the transfer, and section 2704(b) does not apply in valuing D's interest in X for federal estate tax purposes.

Par. 8. Newly designated §25.2704-4 is amended as follows:

1. The undesignated text is designated as paragraph (a).

2. In the first and second sentences of newly designated paragraph (a), the language "Section" is removed and the language "Except as provided in paragraph (b) of this section, §" is added in its place.

3. Paragraph (b) is added.

The addition reads as follows:

§25.2704-4 Effective date.

* * * * *

(b)(1) With respect to §25.2704-1, the first six sentences of paragraph (a)(1), the last sentence of paragraph (a)(2)(i), the third sentence of paragraph (a)(2)(iii), the first and last sentences of paragraph (a)(4), paragraph (a)(5), the second and last sentences of paragraph (c)(1), paragraph (c)(2)(i)(B), and Examples 4, 6 and 7 of paragraph (f), apply to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

(2) With respect to §25.2704-2, paragraphs (a), (b), (c), (d), and (f), the first sentence of paragraph (e), and Examples 1, 3 and 5 of paragraph (g) apply to transfers

of property subject to restrictions created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

(3) Section 25.2704-3 applies to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the **Federal Register**.

John Dalrymple

Deputy Commissioner for Services and Enforcement

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**Morrow, Edwin P**

**From:** stevesletters@leimbergservices.com
**Sent:** Monday, October 03, 2016 8:11 PM
**To:** Morrow, Edwin P
**Subject:** Ed Morrow on the Proposed 2704 Regulations' Effect on Basis: Would Higher Valuations Automatically Equal Higher Basis For Those Inheriting a Family Business? Steve Leimberg's Estate Planning Newsletter

**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2458**

**Date:** 03-Oct-16
**From:** Steve Leimberg's Estate Planning Newsletter
**Subject:** Ed Morrow on the Proposed 2704 Regulations' Effect on Basis: Would Higher Valuations Automatically Equal Higher Basis For Those Inheriting a Family Business?

*"On August 4, 2016, the Treasury Department formally released proposed regulations that would dramatically change the rules for valuation of family owned businesses for transfer tax purposes. Their issuance has ignited a firestorm of discussion and controversy about the depth of their effect and whether Treasury is attempting to exceed its authority. There is already intense lobbying to retract them and several pieces of legislation proposed in Congress to nullify them.*

*Most commentators have assumed that any higher estate valuation for family businesses under §2704 would automatically result in an equally higher basis at death. If so, this would mitigate the tax bite for affected estates that would pay more estate tax and appear to be a windfall for the much larger group of estates that don't. This optimism, however, is premature. The effect of §2704 on income tax basis in conjunction with IRC §1014 is uncertain and there may even be different and unfavorable income tax treatment for non-taxable estates. Practitioners should warn those with both taxable and nontaxable estates of this uncertainty, take proactive steps to remove the basis uncertainty for certain nontaxable estates and businesses, and petition the Treasury Department to clarify these issues as part of its review of the proposed §2704 regulations."*

**Ed Morrow** provides members with his commentary on the potential application of §2704 (and the proposed §2704 regulations) on income tax basis for affected businesses in both taxable and non-taxable estates.

**Edwin P. Morrow III, J.D., LL.M. (Tax), MBA, CFP®**, is a board certified specialist in estate planning and trust law through the Ohio State Bar Association and a Director in Key Private Bank's Family Wealth Consulting Group. He is reachable at edwin_p_morrow@keybank.com or edwin.morrow3@gmail.com.

Ed will touch on many of the issues associated with the proposed regulations and other estate and income tax planning for family business owners in two upcoming events:

- On October 24, 2016 in a CLE presentation for the Ohio State Bar Association. For more information and to register, click this link: Income Tax Planning for Family Business Entities, Including Potential Impact of New Sect 2704 Prop Regulations
- On Tuesday, October 11, 2016, from 1:00pm-2:30pm EDT, in a 90-minute CLE/CPE webinar with interactive Q&A. For more information and to register, click this link: Navigating the New Section 2704 Discount Valuation and Transfer Regulations: What Estate Planners Must Do Now

Now, here is Ed's commentary:

## EXECUTIVE SUMMARY:

On August 4, 2016, the Treasury Department formally released proposed regulations under IRC §2701 and §2704 that would dramatically change the rules for valuation of family owned businesses for transfer tax purposes (though how much is still open to debate and hopefully, will be clarified in their final form). Their issuance has ignited a firestorm of discussion about the breadth and depth of their scope and whether Treasury exceeded its authority to "rewrite" the law in such a manner. There are already several pieces of legislation proposed in Congress to nullify them.[1]

Few articles, however, have explored the potential impact of the regulations on the tax basis of assets received in a transfer subject to §2704.[2] The income tax effect has largely been ignored as an after-thought, or assumed to always be a beneficial byproduct of any §2704-enhanced valuation.[3]

The potential effect on basis is important for three key reasons – *first*, in some states, the combined federal, state and potentially even local income tax rates, coupled with the effect of AMT and various phase outs, can actually exceed the federal estate tax rate.[4] *Second*, if the regulations add to estate and gift tax value, but not to income tax basis at death (or for calculating a donee's basis), they are much more impactful than practitioners had thought. *Lastly, and most importantly*, nearly 20,000 times as many Americans are affected by income tax as are affected by the estate tax.[5]

Higher valuations would appear to be a boon to the 99+% of Americans who will likely have non-taxable estates – as a general rule this means higher income tax basis for the

beneficiaries who inherit the property, and potentially higher basis for those receiving gifts of property.[6] Higher basis means less ordinary income tax via greater depreciation, or less capital gains tax upon sale.[7] But before we cheer for this seemingly beneficial tax effect for the families of business owners who do not pay estate tax, we should verify the effect of the code and regulations, if finalized and upheld as is, on basis. *This optimism, however, may be misplaced.*

This newsletter will explore §2704's confusing and uncertain impact on basis, why the analysis is different for estates not required to file an estate tax return and what steps practitioners (and Treasury) should take in response to this uncertainty.

## COMMENT:

**Basics of New Basis at Death under IRC §1014**

Basis rules do not always have to follow estate tax determinations, and IRC §2704 explicitly states that it only applies "for purposes of this subtitle" (i.e., *not* income tax).[8] Let's first explore how the "step up" in basis typically works for bequests at death. First, to be clear, it can just as easily be a "step down" in basis, as many beneficiaries found out in 2008-2009. Despite the commonly used shorthand, it's more accurate to refer to death as creating a new basis as of the date of death (or alternate valuation date). But even this *new* basis does not apply to all assets – there are major exceptions, such as assets that are classified as income in respect of a decedent (e.g. traditional IRA/401(k), 403(b) plans), or IC-DISC stock.[9] More importantly, the relevant statute does ***not*** simply say that the basis of the property is the value for estate tax purposes. Let's quote from IRC §1014(a) and Treas. Reg. §1.1014-1(a) below:

> §1014(a) IN GENERAL Except as otherwise provided in this section, *the basis of property in the hands of a person acquiring the property from a decedent* or to whom the property passed from a decedent *shall*, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, *be*—
>
> (1) **the *fair market value* of the property at the date of the decedent's death**,
>
> §1.1014-1 (a) General rule. ***The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax***. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date.

Traditionally, we look at the phrase "fair market value" and presume that since the estate tax value usually incorporates a similar definition that it must then control the amount for Section 1014 new cost basis.[10] This is often true, but the purpose of this

newsletter is to investigate whether this *general* rule applies, or whether there is an exception or uncertainty for closely held businesses potentially set to be snared by the dragnet of the proposed §2704 regulations. We'll come back to Treas. Reg. §1.1014-1 and explore another important regulation, §1.1014-3, later, but let's first examine why the *general* rule above may face an exception when families are forced to report a higher value under §2704 for estate tax purposes.

## How §2704 Affects "Fair Market Value" and Why It's Uncertain to Apply to §1014

Now, let's place the above in context of IRC §2704 and the proposed §2704 regulations by examining the current statute, noting the statute's application to only certain code sections pertaining to estate, gift and generation skipping transfer tax, *not* income tax:

> **IRC §2704 (a) Treatment of lapsed voting or liquidation rights**
>
> (1) In general. ***For purposes of this subtitle [subtitle B, IRC §§2001-2081]***, if—
>
> > (A) there is a lapse of any voting or liquidation right in a corporation or partnership, and
> >
> > (B) 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 shall be treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate of the decedent***, whichever is applicable, in the amount determined under paragraph (2).
>
> ***
>
> **(b) Certain restrictions on liquidation disregarded**
>
> (1) In general ***For purposes of this subtitle [subtitle B, IRC §§2001-2081]***, 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.

Does this phantom transfer of an asset under §2704(a) or the disregarded restrictions

adding to value under §2704(b) add to the "fair market value," and most importantly, does it add to "fair market value" for purposes of §1014 and §1015?

Let's take the easier part of that question first. IRC §2704(b), if triggered, does seem to clearly add to the "fair market value" for estate tax purposes pursuant to the statute, because the restrictions are "disregarded in determining ***the value.***" While it does not refer to "*fair market* value" in the statute, the proposed regulations do consistently refer to its effect on "fair market value."[11] Similarly, while IRC §2704(a) does not refer to changing the *value*, the proposed regulation does.[12]

Thus, *whether we have a taxable estate or not*, if the proposed regulations are triggered, the *fair market value*, ***at least for estate, gift and GST purposes***, will include any enhanced value added by §2704(a) or §2704(b). But adding to fair market value for estate tax valuation is no help to beneficiaries unless it clearly adds to the *fair market value* for §1014 (and to a lesser extent, for gifts under §1015).

What should we make of the introductory limitation in *both* §2704(a) and §2704(b) that they expressly only apply "*for purposes of this subtitle?*" This is not a problem in the regulations, but in the *statute*. Congress could have stated "for purposes of subtitles A and B" or included a reference to §§1014-1015, but they did not. Could we be faced with two "fair market values" whenever §2704 applies – one for estate tax purposes and one for income tax basis? It is altogether possible – there may well be a higher *§2704-enhanced* fair market value for estate tax valuation, with our *traditional* fair market value for §1014 left undisturbed.

Despite the fact that Chapter 14 has been in the Internal Revenue Code since 1990, there is no reported case examining whether any additional value imputed under §2704 correspondingly adds to basis under §1014.[13] Until now, planners have been unbothered by this question, because we simply plan to avoid §2704 altogether. However, if something close to the proposed regulations are made final, we may no longer have that luxury. The regulation may extend the application of the statute to much more common estate and gift tax situations.

**Does "For Purposes of This Subtitle" Mean the IRS will Ignore its Application Elsewhere?**

Similar language ('for purposes of this subtitle") has long been in IRC §2518, well-known to many estate planners as the statute governing qualified disclaimers. Nonetheless, the IRS has cited and followed its core principles in the *income* tax area (subtitle A, outside of subtitle B).[14] For example, a qualified disclaimer of an IRA, qualified plan or non-qualified annuity pursuant to §2518 does not cause a taxable transfer for income tax purposes, triggering income tax or jeopardizing the tax-exempt nature of the account. While this analogy is interesting and perhaps lends hope that Treasury will do likewise with §2704, the comparison is

not apt enough to be persuasive, and certainly not the authority that we'd like to have if we are signing an income tax return for a donee or beneficiary.[15]

**Parsing the §1.1014-3(a) Presumption**

In addition to Treas. Reg. §1.1014-1 setting out a general rule, which implies there are exceptions, another §1014 regulation is more specific and goes further in establishing a presumption that the "fair market value" established for estate tax purposes is to be the same as for income tax purposes, but unfortunately, it still raises some questions, especially for estates not required to file an estate tax return:

> **§ 1.1014-3** Other basis rules.
>
> (a) Fair market value. For purposes of this section and § 1.1014-1, ***the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax*** or the alternate value as appraised for such purpose, whichever is applicable, ***shall be deemed to be its fair market value***. *If no estate tax return is required to be filed under section 6018, the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable*.

First, both of the §1014 regulations quoted above were made final long before §2704 was even enacted (1960 v. 1990), much less the §2704 *regulations*. Can we safely rely on regulations enacted in 1960 for guidance in interpreting the indirect effect of a statute that was passed 30 years *later* (or regulations effective 57 years later)? As a general rule, taxpayers are required to follow and entitled to rely on final regulations issued by Treasury, whatever their age. Unlike temporary regulations, they don't expire.[16] However, §2704 is clear that it only applies for transfer taxes – it says it not once, but twice, so Treasury may not feel it has much slack for liberal interpretation, or it may ultimately amend §1014 accordingly.

More importantly, even if we could rely on §1.1014-3 for the proposition that estate tax value equals fair market value for §1014, what about estates that *don't* file an estate tax return? Most estates are well under the filing threshold.[17] Does the phrase "as appraised for the purpose of the Federal estate tax" imply that you have to have a formal appraisal meeting estate tax compliance requirements? Does it mean, as implied by the sentence following it, that it only applies to a return that is *required* pursuant to §6018 (or a required state estate tax return, as we'll discuss shortly)? Is this "purpose" measured *subjectively* or *objectively*? Can the executor of a $1 million estate nowhere near the estate tax filing threshold file an estate tax return (with or without a §2704 affected interest) and simply claim that it was done for *estate tax purposes*? What about a $5.4 million estate with hard to value assets where there may be a legitimate concern of starting the statute of limitations? There is no clear

answer. There is a similar issue for gifts in the §1015 regulations, but the presumption is more generous since a gift tax return would technically be required whenever a gift exceeds the annual exclusion amount.[18]

A logical interpretation of why Treasury would include this §1014-3(a) presumption is that if there were potentially federal or state estate tax due the executor would have a fiduciary duty and financial incentive to report the value as low as possible, thus reducing the risk to Treasury of getting artificially high valuations when returns exceed the filing threshold. Thus, it would make no sense to have adopted a rule of presumption that allows someone to file an unnecessary return to create a presumption of a higher basis. Otherwise taxpayers would have an incentive to file unnecessary returns and report higher values for hard to value assets for non-taxable estates to seize the presumption. That said, there are extremely knowledgeable tax practitioners who voice a contrary opinion – that it is perfectly reasonable to apply a subjective test and that estate tax filings for smaller estates that are not required to file a return can equally ensure the higher basis to any §2704 affected assets. While this argument has some merit, especially in light of the complementary general rule in §1.1014-1, I would not count on its application. Until the issue is clarified, if the proposed regulations are made final, this may vastly increase the number of otherwise needless Form 706 filings by smaller estates with closely held business interests affected by §2704, just as portability has led to increased filing of otherwise "unrequired" returns.

Of course, it is illogical and unfair to permit or require the beneficiary of a closely held business in a $5.5 million gross estate to use a higher value for basis, yet force a beneficiary receiving the *exact same asset* on the *same day* from a *similarly related* donor to use a much lower value if it were part of a $5.4 million gross estate, simply because one estate is over and one estate is under the filing threshold. Clearly, neither Congress nor Treasury has considered any of this. If, indeed, only estates *required* to file an estate tax return are able to use the §2704-enhanced basis and §1.1014-3 presumption, then it may affect how we plan mid-sized estates and the tax system would unreasonably burden blended family situations due to favoring portability and marital trusts over traditional bypass trust planning.

For example, Husband and Wife each have $4 million estates comprised in part of various LLCs worth $6 million (but only $4 million with lack of control/marketability discounts) that will be affected by §2704. If they use a bypass trust, the survivor's estate will likely be well under the §6018 filing threshold and hence not entitled to the §1.1014-3(a) presumption, potentially costing the beneficiaries more step up in basis, *even for the survivor's share*.[19] By contrast, if they leave their respective estates to a marital trust for each other and elect portability (the deceased spousal unused exclusion amount), the survivor's estate will likely be well over §6018's estate tax filing threshold and therefore presumably be entitled to use the §1.1014-3(a) presumption and the §2704 enhanced valuation, leading to $2 million of additional basis to their beneficiaries without any estate tax burden, saving about $600,000 of eventual capital

gains tax. That's not small change.

Such a peculiar tax preference for estates over §6018's gross estate filing threshold would encourage the use of debt. Consider a taxpayer whose estate would be valued at $4.4 million with traditional discounts, but $5.4 million with "§2704 enhanced" valuation. If the taxpayer simply takes out a $100,000 margin loan or line of credit and deposits the funds, the gross estate is now $5.5 million with an offsetting §2053 deduction of $100,000 (the same net, but higher gross estate), yet now the higher gross estate is over the filing threshold, theoretically enabling the beneficiaries to use the §1.1014-3 presumption to seize an additional $1 million of basis.

It becomes even more bizarre when interpreting §1.1014-3(a)'s apparent presumption that occurs when only a ***state*** estate or inheritance tax return is required to be filed. Consider two $4 million estates with the exact same assets and date of death, partly comprised of §2704 enhanced business interests, one decedent in Ohio and one in New Jersey (or Washington, Oregon or any other state with a lower estate/inheritance tax filing threshold than federal). The beneficiaries of the estate in New Jersey can apparently rely on §1.1014-3(a) to use the §2704 enhanced value as the presumed *fair market value* (even if little or no state tax is paid, as would typically be the case when a marital deduction is used), whereas the beneficiaries of the estate in Ohio apparently cannot. This is clearly unfair tax treatment to those living in states without a separate estate tax, and unlike, e.g., community property treatment, it is not justified by different state law property characteristics of the underlying assets.[20] Should states enact a simple perfunctory estate tax filing requirement to permit their citizens from losing federal tax basis?

**Does the New §1014(f) Help Ensure That Any §2704 Enhanced Value Affects Basis?**

What about the recently enacted §6035 and §1014(f) requiring "consistency" between new date of death (or AVD) basis and reported estate tax value (previously it was merely a rebuttable presumption)?[21] Could this grant us the basis we're looking for? Does the new statute really mandate universal *consistency* as we hope, or does it merely establish a *ceiling* for reporting of basis for only a *small category of estates*?

> **(f) Basis must be consistent with estate tax return**. For purposes of this section—
>
> (1) In general
>
> The basis of any property to which subsection (a) applies ***shall not exceed—***
>
> (A) in the case of property *the final value* of which has been determined for purposes of the tax imposed by chapter 11 *on the estate* of such decedent, such

value, and

(B) in the case of property not described in subparagraph (A) and with respect to which a *statement has been furnished under section 6035(a)* identifying the value of such property, such value.

(2) Exception

***Paragraph (1) shall only apply to any property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11*** (reduced by credits allowable against such tax) on such estate.

Unfortunately, it appears that the new §1014(f) is more of a burden and trap rather than additional ammunition for taxpayers snared by §2704 to obtain additional basis, for several reasons. First, *it only applies to property whose inclusion would add to the estate tax*, leaving out non-taxable estates altogether, including very large estates that would avail themselves of a large marital and/or charitable deduction.[22] Second, it requires Form 8971 to be properly filed pursuant to §6035(a).[23] Lastly, even if the property would lead to additional estate tax liability and come under §1014(f) and the asset is properly reported on Form 8971, the statute does not say "you must (or even *may*) use the estate tax value for the income tax basis value," it merely establishes a ***ceiling*** above which the reported income tax basis "shall not exceed", though the preamble to the §1014(f) regulations does imply that a taxpayer can use the Form 8971 value for income tax basis purposes.[24] It's no help to have a higher ceiling if you can't reach it!

**Conclusion Regarding Application of §2704 to the Income Tax World of §1014 "Step Up"**

This uncertainty, *especially* for estates not required to file an estate tax return, will seem completely unfair to taxpayers and practitioners alike (maybe even to some IRS personnel), but that does not mean that a more favorable interpretation is guaranteed. Logical arguments against absurdity are not always victorious against the tax code, and not exactly comforting authority when filing a tax return. Treasury may ultimately amend the proposed regulations, and/or amend §1014 regulations to clarify that the date of death (or alternate valuation date) fair market value includes amounts added pursuant to §2704, despite §2704's instruction that it only applies for estate, gift and GST tax.[25] This would certainly be a welcome conclusion for both taxable and non-taxable estates - for taxable estates, beneficiaries may as well get the basis they essentially pay for through the additional estate tax (or eventually pay for, in the event a marital deduction delays the tax). For non-taxable estates, this interpretation would be a godsend, enhancing the income tax benefit without any negative estate tax tradeoff.[26] This could save a lot of practitioners from claims of imprudent advice (or lack thereof) in failing to notify clients of ways to increase the basis of closely held

entities at their death.

**Summary: What to Do In Light of Uncertainty for Family Business Owners**

In conclusion, practitioners should explain the potential effect of the proposed regulations to affected clients with taxable estates. Although larger estates required to file a federal estate tax return have a good argument under current §1014 regulations for using a higher basis despite the language in §2704, if those regulations are subsequently changed or not followed, the impact of the proposed §2704 regulations may be even worse than expected - greater estate tax without the mollifying benefit of increased basis to that same higher valuation. If so, the net additional tax wrought by the proposed regulations would not be merely 40% estate tax rate minus the long-term capital gains rate, it may be the full 40%.[27] Because the regulations will not go into effect until January of 2017 at the earliest, there is still time to plan while under the current regime (provided that the three year rule under the proposed regulations does not trap any donor who dies within three years of transfer, another uncertainty of the regulations beyond the scope of this article). All the usual suspects in our arsenal of leveraged gifting can be employed, from simple gifts of stock or LP/LLC interests, to installment sales of such assets to irrevocable grantor trusts (IGTs) or planning with Grantor Retained Annuity Trusts.[28]

Practitioners advising residents in states with a separate state estate or inheritance tax should find any state tax savings as an additional bonus, especially since most states do not even have a clawback for recent gifts, much less a gift tax.[29]

Just as importantly, practitioners should not ignore the ability to make improvements to closely held business entities and ownership dispositions to remove discounts (and potentially cause inclusion for otherwise non-included assets) for *non-taxable* estates, for several important reasons.[30] *First*, as discussed above, it's much more uncertain that higher estate tax valuation under §2704 translates to higher income tax basis for non-taxable estates. *Second*, even if Treasury concedes the basis issue, the regulations face stiff opposition from the tax bar and other lobbyists on behalf of those with large taxable estates and Treasury may back off considerably in promulgating the final form, which may in turn limit any net basis benefit for non-taxable estates. *Third*, even if the regulations are finalized in substantially the same form and Treasury concedes the income tax basis issue, the regulations may be overturned either in court, by Congress or by a new administration retracting or issuing new regulations. *Lastly*, even if the proposed regulations are finalized and upheld, and the basis issue is conceded, the proposed regulations will likely ***not*** remove all discounts. It may reduce them considerably, but how much so is still very much in question and may depend on the provision triggered – such as the confusion and debate over whether §2704(b) regulations effectively graft a six month put right or not for valuation purposes. It remains to be seen how appraisers and courts ultimately will calculate the effect of many of the provisions, but it may merely reduce a typical 25-40% discount to a 10-

25% discount. Why do you want any discount at all if you have a non-taxable estate!

Thus, those with non-taxable estates owning closely held entities should consider acting to remove all discounts if they can easily do so without causing estate tax, presuming the relationships and ownership structure of the entity would otherwise allow it. Not only would this secure a higher basis, but it would save the cost of more complicated appraisals and the uncertainty of to what extent §2704 really does affect common family business transfers. This would generally be beneficial whether the proposed regulations are made final and upheld *or not*. The IRS may attack the basis years after a sale of the business interest, or after years of depreciation taken. Removing the uncertainty of the amount of the discount after uncertain §2704 application means that much less to fight about.

Lastly, I implore the Treasury Department to clarify both §2704 and §1014 and their interaction, with practical examples, in a way that ensures fairness and equal application for income tax basis purposes regardless of where a taxpayer lives, the size of the estate or whether an otherwise unrequired estate tax return is filed.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

*Ed Morrow*

## CITE AS:

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[1] H.R. 6042, introduced by Rep. Jim Sensenbrenner (R.-WI) on September 15, 2016, available at https://www.congress.gov/bill/114th-congress/house-bill/6042/text. It's short, and would nullify even the less controversial portions of the proposed regulations:

"SECTION 1. NULLIFICATION OF CERTAIN PROPOSED REGULATIONS RELATING TO RESTRICTIONS ON LIQUIDATION OF AN INTEREST WITH RESPECT TO ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES. Regulations proposed for purposes of section 2704 of the Internal Revenue Code of 1986 relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes, published on August 4, 2016 (81 Fed. Reg. 51413), and any substantially similar regulations hereafter promulgated, shall have no force or effect." Dozens of Senators, trade and business owner groups are similarly up in arms, see e.g. this letter from a trade group with 3800 businesses signing on: http://documents.nam.org/PA/Treasury%20-%20Family%20Estate%20Tax%209.28.16.pdf?_ga=1.16141046.1760545002.1475157810 . But this newsletter is focusing on the income tax rather than estate tax impact.

[2] As we'll note later, whether §2704's application increases tax basis under IRC §§1014-1015 for donees and beneficiaries is actually a function of the language already in the statute, which would be unchanged by the proposed regulation, but since the new regulation may pull many more entities and transfers under the statute that would normally have avoided §2704's purview, it's still fair to say that the proposed regulations could have a tremendous potential impact on income tax basis on inherited (and to a lesser extent, gifted) businesses.

[3] For an article concluding that the proposed regulations would be a huge help to non-taxable estates owning closely held entities and concluding that Treasury will likely net less overall revenue if proposed regulations are made final, see *The Law of Unintended Consequences Meets the §2704 Proposed Regulations: Will Estate Tax Increases Cause Income Tax Reductions?* by Dominic Shirripa, J.D., LL.M., at http://www.bna.com/law-unintended-consequences-b57982077009/. Similarly, see presentation on August 11, 2016 by Ron Aucutt and Dennis Belcher of McGuire Woods available at https://www.mcguirewoods.com/Events/Firm-Events/2016/8/Webinar-on-Proposed-Section-2704-Regulations.aspx (concluding any increased valuation under §2704 corresponds to increased basis regardless of whether estate is taxable and therefore advantageous to non-taxable estates). Also see *Martin Shenkman, Jonathan Blattmachr, Ira S. Herman & Joy Matak: Proposed 2704(b) Regulations Will Zap Discounts, Wealthy Taxpayers Should Plan ASAP*, LISI Estate Planning Newsletter #2448 (August 22, 2016) (assuming the proposed regulations will lead to more tax basis to equal any increased estate tax valuation, regardless of the estate size). Many other articles fail to discuss it at all.

[4] Especially if assets are comprised of collectibles, which have a higher 28% long-term capital gains tax rate. Add 3.8% surtax and state/local income tax and this can easily exceed 40% for low basis assets. See IRC §1. Moreover, the additional depreciation available with a step up in basis for depreciable assets used in business may be able to offset *ordinary* income tax rates, which are even more likely to exceed 40%.

[5] Estimated estates paying estate tax in 2015: 5,300, according to the Tax Policy Center at http://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax. The number of income tax returns filed and those paying income tax in 2015: 143,400,000 and 93,800,000, respectively, many of which are married filing jointly: http://www.taxpolicycenter.org/model-estimates/tax-units-zero-or-negative-income-tax/tax-units-zero-or-negative-income-tax

[6] Donees of gifts do not always receive a carryover basis. One exception is when gift tax is paid (relatively rare these days), pursuant to IRC §1015(d). The more common exception is when the fair market value is less than the donor's cost basis, or what many refer to as "loss property". When there are discounted assets involved in gifting, there is an even greater chance of a donee receiving "loss property" because of the reduced fair market value of the property at the time of donation. See IRC §1015(a) for a discussion of how gains and losses are calculated differently for donees of such property upon subsequent sale.

[7] The depreciable assets inside of a limited liability entity do not automatically receive a new date of death basis, but partnerships (including LPs and LLCs taxed as partnerships) may elect to have the inside basis of the assets adjusted to reflect the adjustment to the outside basis at death in the partnership pursuant to IRC §754. Very large partnerships may prevent this election as administratively burdensome, but it would be a very common and often recommended in the closely held business context.

[8] Subtitle B covers IRC §§2001-2801, which includes estate, gift and GST tax, but **not** income tax, which is covered in Subtitle A.

[9] See, e.g. IRC §1014(c) for the special rule for income in respect of a decedent and §1014(d) for IC-DISC stock.

[10] See e.g., Treas. Reg. §20.2031-1(b), Treas. Reg. § 25.2512-1, Rev. Rul. 59-60

[11] Prop. Treas. Reg. §25.2704-3 Transfers subject to disregarded restrictions.

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

[12] Prop. Treas. Reg. §25.2704-2 Transfers subject to applicable restrictions

"(e) If an applicable restriction is disregarded under this section, the ***fair market value*** of the transferred interest is determined under generally applicable valuation principles as if the restriction (whether in the governing documents, applicable law, or both) does not exist."

[13] Actually, IRC §2703 has the same language, "for purposes of this subtitle", but this area is complicated enough without going into that as well.

[14] E.g. Rev. Rul. 2005-36

[15] Notably, qualified disclaimers normally just change the identity of someone receiving property rather than affect basis. For an article outlining how and when practitioners *can* use qualified disclaimers to dramatically increase basis for beneficiaries, see *Structuring Estates and Trusts with Disclaimers to Increase Basis: Busting the Myths and the Conventional Wisdom on Disclaimers*, Estate Planning Review – The Journal, June 2016

[16] IRC §7805(e)

[17] Just because filing a Form 706 is "required" to elect portability and claim the deceased spousal unused exclusion amount does not mean the estate is "required" to file under other statutory provisions, which is important for whether an estate filing a late estate tax return may elect portability – if the return was "required" per §6018, it cannot, but if it not required, it may be afforded 9100 relief, which has been already been granted in numerous PLRs. See 80 FR 34279 at https://www.federalregister.gov/articles/2015/06/16/2015-14663/portability-of-a-deceased-spousal-unused-exclusion-amount.

[18] Although this issue's importance to gifting is less impactful, the general rule of carry-over basis under §1015 contains an exception whenever the basis exceeds the "fair market value" at the time of gift. Consider a parent who owns and gifts a closely held business interest with an outside basis of $900,000 and a "fair market value" of $1,000,000 for gift tax purposes if §2704 principles apply, but a "fair market value" of $700,000 if they do not apply, due to traditional lack of marketability and lack of control discounts. If the donee thereafter sells the interest for $800,000, is the donee able to take a $100,000 capital loss, because §1015 incorporates the new §2704-enhanced value into "fair market value" for §1015 purposes, or is the loss prohibited because the traditional, non-§2704-enhanced fair market value must still be used? Although we have the same issues, the existing §1015 regulations contain a more generous presumption that should deem the higher §2704 enhanced gift tax value to be the "fair market value" for basis purposes whenever a gift tax return is required. Since a gift tax return would be required whenever a gift exceeds the annual exclusion amount, meeting this threshold is much easier than meeting an estate tax filing threshold. Treas. Reg. §1.1015-1(e) "Fair market value. For the purposes of this section, the value of property as appraised for the purpose of the Federal gift tax, or, if the gift is not subject to such tax, its value as appraised for the purpose of a State gift tax, **shall be deemed to be the fair market value** of the property at the time of the gift."

[19] IRC §6018(a) references the ***basic*** exclusion amount, not the ***applicable*** exclusion amount, reduced by adjusted taxable gifts. Of course, the bypass trust could include a testamentary formula general power of appointment, or a limited testamentary power of

appointment exercised in such a way as to trigger §2041(a)(3), but even these choices may not be as palatable for blended families, and this may inform how the cap on any formula testamentary power is drafted – for discussion and examples of various testamentary powers of appointment options, see this white paper: http://ssrn.com/abstract=2436964

[20] Community property is treated differently for basis purposes pursuant to IRC §1014(b)(6)

[21] See Rev. Rul. 54-97, which was essentially later incorporated into §1.1014-3 but added that the taxpayer could rebut with clear and convincing evidence; see also *Van Alen v. Commissioner*, T.C. Memo 2013-235

[22] Though for charity the basis is usually irrelevant, unless it is receiving an asset that may generate unrelated business income tax, such as S corporation stock, but the new regulations are unlikely to apply anyway, unless perhaps it is a quasi-charitable split interest trust.

[23] Moreover, in some circumstances where the Form 706/8971 filing is botched and not timely fixed, the "ceiling" for reporting of basis is ***$0.*** See proposed regulation §1.1014-10(c)(3)(i)(B) and discussion in preamble at https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-04718.pdf

[24] Although the preamble to the proposed §1014(f) regulations strongly implies that the beneficiary may use the Form 8971 value. From 81 FR 11486, *Section 1014(f)(1)—Consistency of Basis With Estate Tax Return*, available at https://www.federalregister.gov/documents/2016/03/04/2016-04718/consistent-basis-reporting-between-estate-and-person-acquiring-property-from-decedent: "the taxpayer uses the value reported on the statement required by section 6035(a) (the fair market value reported on the Federal estate tax return) to determine the taxpayer's basis for Federal tax purposes"

[25] After all, Treasury can and does simply ignore a clear statute if it assists in equitable treatment of taxpayers – for example, Congress mandated by statute that QTIP elections are "irrevocable", yet the IRS permits them to be revoked pursuant to Rev. Proc. 2001-38 and its recent successor issued this week modifying and superseding it, Rev. Proc. 2016-49. Treasury should similarly ignore the ill-considered "for purposes of this subtitle" in §2704, at least in regards to §1014-1015, to promote a more logical, workable and fair interpretation to result regarding consistency for the term "fair market value".

[26] Unless, perhaps, the estate is subject to a state estate or inheritance tax system that borrows from the federal estate tax value determination and additional §2704 value causes additional state taxes, which could be as high as 20%.

[27] The top federal rate for long-term capital gain for collectibles is 28%, for 1250 gain

25%, but normally the long-term capital gain top rate is 20%, plus 3.8% net investment income surtax, plus approximately 1.2% effect of Pease/PEP phase out, factor in some indirect AMT or other lost credits/deductions, and perhaps 5% state income tax and 30% is a good rough estimate. New York City, California, Hawaii, Oregon and others may of course be much higher tax rates. Generally, lower estate tax value = lower basis = higher eventual capital gains.

[28] Although it is unclear whether discounted assets can go into a GRAT, and if proposed regulations are made final, assets can come back out via annuity payments in kind at "undiscounted" §2704 enhanced values. Treasury will probably come out with guidance on this.

[29] Currently, the only state with a gift tax appears to be Connecticut, with a $2 million exemption – see http://www.ct.gov/drs/lib/drs/forms/2015forms/estate/ct-706-709_booklet.pdf

[30] In various CLEs, I refer to this concept of optimizing the operating agreement for more or less discount as the estate size warrants as an Optimal Basis Increase LLC, to be used in conjunction with ownership passing to an Optimal Basis Increase and Income Tax Efficiency Trust, also designed to maximize basis while still minimizing estate tax.

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