Proposed Regulations under

Code § 2704

(Excerpted from

Structuring Ownership of Privately-Owned Businesses:

Tax and Estate Planning Implications)

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TABLE OF CONTENTS

Page

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III.B.4.f. Code § 2704 Overview

Code § 2704 applies for estate, gift, and generation-skipping transfer tax purposes.[4310]

III.B.4.f.i. Code § 2704 – Current Law

In a family-controlled business, Code § 2704(a) treats as a transfer the lapse of any voting or liquidation right in a corporation or partnership.[4311] Code § 2704(b) disregards restrictions on liquidation that are not commercially reasonable and are more restrictive than state law defaults.

In the context of an affirmative transfer of an equity interest, regulations do not apply these rules regarding liquidation restrictions to the ability to liquidate one's equity interest.[4312] Thus, Code § 2704 generally will not be significant in most cases involving incentive compensation or the transfer of an equity interest.

If the entity is not family-controlled (using a combination of Code § 2701 and 2704 principles), then Code § 2704 does not apply.

III.B.4.f.ii. Practical Planning Implications of Controversial 2016 Proposed Regulations

Controversial proposed regulations issued August 4, 2016[4313] would change rules for valuing interests in business entities. The regulations would require using, for estate, gift, and generation-skipping transfer tax purposes, values that ignore some of the parties' legal rights and liabilities. Thus, the regulations would inflate the value of business interests beyond their true values.

For many years, taxpayers have been placing nonbusiness assets in business entities. Because business entities that are not publicly traded are illiquid and certain ownership interests lack input into how the entities are run, the ownership interests are worth much less than a pro rata share of the entities' assets. The IRS has had only limited success increasing the value to a pro rata share of the entities' assets.

Fourteen years after losing a case in which the court suggested that the government consider changing the relevant regulations, the government took action. The statute authorizes the government to promulgate regulations providing that various "restrictions shall be disregarded in determining the value of the transfer of any interest in a

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[4310] See fn. 865, found in part II.H.2.j Effect of Chapter 14 on Basis Step-Up.

[4311] The lapse of voting rights at death was includible in the decedent's gross estate in the *Estate of Rankin Smith v. U.S.*, 103 Fed. Cl. 533 (2012). Why the decedent did not do a voting/nonvoting right recap and plan accordingly is not mentioned. The bona fide business arrangement is an exception to Code § 2703, not Code § 2704.

[4312] *Kerr*, 292 F.3d 490 (5th Cir. 2002); compare Reg. § 25.2704-2(b) (for a transferred interest, an "applicable restriction" is a limitation on the ability to liquidate the entity") with Reg. § 25.2704-1(a)(2)(v) (for a lapse, liquidation right means right to compel the entity to redeem the interest).

[4313] REG-163113-02.

corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

Generally, practitioners assumed that the regulations would attack entities formed to hold nonbusiness assets. However, the proposed regulations apply to operating businesses. They would ignore any restrictions on an owner's ability to cash out in six months or to cause the business to liquidate if the family could remove those restrictions. Furthermore, they do not distinguish between restrictions under the entity's governing documents and restrictions imposed by "provisions" of state law. Consider that all state laws provide rules for forming and liquidating an entity, the latter of course having the effect of liquidating each owner's interest in the entity. Although the government agrees that it cannot create rights, disregarding restrictions on exercising rights might have the effect of granting rights. State law expressly prohibiting a limited partner from withdrawing and being cashed out absent a contrary provision in the partnership agreement is a "provision" that would be disregarded. Is a shareholder's inability to withdraw and cash out (including placing a term governing the entity's dissolution date) a "provision," given that this inability is implicit and not explicit? I have seen some of the top estate planning lawyers in the country lock horns on this issue. My understanding is that the government did not intend to eliminate all minority discounts or to impose a deemed put right. However, that intent is not clear from the proposed regulation. Thus one might hope that the government would clarify these positions while at the same time preparing for the possibility that the final regulations might not sufficiently clarify this intent and that an examiner or a judge would take a different view.

The proposed regulations respect "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."

Any person who owns, or whose family owns, at least half of the entity would be subject to these rules. In determining whether an owner of that entity can cash out, one must assume that the family will act together to remove a covered restriction on cashing out and that nonfamily members cannot vote unless together they own at least 20% and are qualified: To count a nonfamily member's ownership, the person must have been an owner for at least 3 years, own at least 10%, and have a right to cash out with six months' notice for "minimum value" in exchange for a note at market interest rates that is adequately secured and requires periodic payments on a non-deferred basis. As a practical matter, a business is not going to want to let its owners cash out whenever they wish, and the proposed regulations disregard any covered restrictions on a person who owns, or whose family owns, at least half of the entity. Furthermore, this "minimum value" would not respect any contingent liabilities, without any explanation how one would draw the line between business risks that affect the business' going concern value and contingent liabilities.

The proposed regulations also provide that, if a person transfers part or all of the controlling interest within 3 years of death, that person's estate is treated as holding that level of control at death. For example, a sale to an unrelated party could create a lapse,

given that the unrelated party held the property for less than 3 years and therefore is disregarded. However, the estate would not receive a marital or charitable deduction for that level of control, because that level of control does not pass to the surviving spouse or charity.

The proposed regulations apply to restrictions created after October 8, 1990, occurring either one or after day that, or at least 30 days after, the proposed regulations are finalized, depending on the provision of the proposed regulation. Written comments are due November 2, and on December 1 the government will hold a hearing, granting each speaker 10 minutes. My understanding is that, as of October 22, 2016, the government had processed 200 comments and had received but not yet processed another 3,200 comments. The usual process is to cross-reference each comment to each provision it references, although many of the comments express general dissatisfaction with the proposed regulations and do not provide comments on any particular provision. My understanding is that regulations usually take a year to finalize and that comments of this complexity might take three years to finalize. That being said, the regulations under Code § 385 were quite complex (over 500 pages between preamble and final regulations governing international financing transactions) but took just over 6 months to finalize. Given that a political announcement accompanied the proposed regulations, the prospect of a change in Administration might affect the timing. My understanding is that the government could have given 60 days for comments but chose to provide 90 days, a sign that the government did not appear to want to rush comments. As Yogi Berra said, "It's hard to predict – especially the future."

Action items include:

1. Consider making transfers before the proposed regulations become final. These transfers might be gifts, sales, or perhaps using other estate planning tools. This might be of all of the client's interest, of enough to reduce the client's interest below 50%, or of enough to reduce the client's holding to below the liquidation right threshold. Revise the governing documents to require a level of consent for liquidation higher than whatever the client owns now.

2. Note that owning property 50/50 would cause the proposed regulations to apply. One lawyer suggested to me that each owner contribute an equal amount to a Code § 501(c)(4) organization.

3. Review buy-sell agreements to consider whether any additional estate tax would apply under these rules and plan for who should pay that tax. Exercise caution in changing any provisions that existed on October 8, 1990.

4. When reviewing commercial loan agreements, carefully review any covenants that affect the owners' ability to cash out and document the extent to which these covenants require buy-sell provisions to prevent cashing out.

5. Some planners have suggested holding real estate as tenants in common instead of in an LLC or other entity, to avoid the new rules that would apply to business entities.

Active rental can cause a tenant-in-common arrangement to be treated for state law purposes and tax purposes as a general partnership. General partners are subject to joint and several liability and have rights to cash out of their arrangements that would undermine valuation discounts, so expert advice is required before delving into this area. See part II.C.7 Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership. Note, also, that the proposed regulations under Code § 2704 are vague as to what is an "arrangement" that constitutes a business entity.

Appraisers might need to do more than one appraisal per transfer.

When preparing gift tax returns reporting transfers after the August 2016 promulgation of the proposed regulations, consider whether to attach a statement describing any position taken that is contrary to any proposed regulations published at the time of the transfer.[4314] Given that the proposed regulations were not proposed to apply to that period, this does not appear necessary, but each person can develop his or her own comfort level.

Also see part II.H.2.j Effect of Chapter 14 on Basis Step-Up, suggesting that taxpayers file an estate tax return to take advantage of the basis step-up for this inflated value.

III.B.4.f.iii. Prop. Reg. § 25.2704-1 Regarding Lapses

The new rules apply only if the entity is controlled by the holder and/or members of the holder's family immediately before and after the lapse.[4315]

For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), the lapse of a voting or a liquidation right[4316] in a corporation or a partnership (an entity),[4317] whether domestic or foreign, is a transfer by the individual directly or

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[4314] Reg. § 301.6501(c)-1(f)(2)(v).

[4315] Prop. Reg. § 25.2704-1(a)(1). Prop. Reg. § 25.2704-1(a)(2)(i) would add the following to the end of existing Reg. § 25.2704-1(a)(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.

Prop. Reg. § 25.2704-1(a)(2)(i) would add the following before the third sentence of existing Reg. § 25.2704-1(a)(2)(iii):

> In the case of a limited liability company, the right of a member to participate in company management is a voting right.

[4316] Prop. Reg. § 25.2704-1(a)(4) provides:

> *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.

[4317] Prop. Reg. § 25.2704-1(a)(1) provides:

> 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

indirectly holding the right immediately before its lapse (the holder) to the extent provided in the rules below.[4318]

A lapse includes 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, specifically including the transfer of a voting partnership interest to an assignee who cannot vote.[4319]

Notwithstanding the repeal of rules against transfers in contemplation of death and the limitation of a 3-year rule in Code § 2035, the new rule would impose Code § 2704 estate inclusion on 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.[4320]

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 Code § 2704(b) and the regulations thereunder.[4321] See part III.B.4.f.iv Prop. Reg. §§ 25.2704-2 and 25.2704-3 Artificially Increasing Value.

Transfers made within 3 years of death might also constitute a lapse,[4322] including transfers approved by Rev. Rul. 93-12.[4323]

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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.

[4318] Prop. Reg. § 25.2704-1(a)(1).

[4319] Prop. Reg. § 25.2704-1(a)(5).

[4320] Prop. Reg. § 25.2704-1(c)(1).

[4321] Prop. Reg. § 25.2704-1(c)(2)(i)(B), which further provides:

> 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 nonfamilymember 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.

[4322] Prop. Reg. § 25.2704-1(f), Example (7), would revise the third and fourth sentences and add a new conclusion:

> 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.

[4323] See the regulation reproduced in fn. 3621, which is accompanied by a paragraph explain Rev. Rul. 93-12 in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers.

The three-year period was purportedly to capture transfers in contemplation of death. However, it would apply if a very healthy person died accidentally and could have unfair results. For example, a young, healthy married person with a marital deduction designed to generate no estate tax transfers assets subject to this rule. The transferor is hit by a bus two years later. The phantom asset in the transferor's estate does not pass to the spouse and therefore might generate estate tax. My understanding is that comments would suggest that this be changed to whether, using Code § 7520 principles, the taxpayer is expected to live at least one year, which would still benefit the government more than current law.

The effective date of the lapse provision is unclear. If a transferor dies within three years, the lapse is treated as occurring at the date of death. If the transfer is made before the regulations' effective date and the transferor dies after the regulations' effective date, would the regulations capture the lapse? My understanding is that the final regulations are expected to clarify that the answer is no.

Note that selling one's interest to an unrelated third party in a sale that results in the transferor losing control may constitute a lapse that this provision reaches.

III.B.4.f.iv. Prop. Reg. §§ 25.2704-2 and 25.2704-3 Artificially Increasing Value

III.B.4.f.iv.(a). Prop. Reg. § 25.2704-2 Disregarding "Applicable Restrictions" Generally

If an interest in an entity is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any applicable restriction is disregarded in valuing the transferred interest.[4324]

"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."[4325]

An "applicable restriction" may arise under an entity's governing documents or applicable law.[4326] Almost every law is subject to being disregarded.[4327]

[4324] Prop. Reg. § 25.2704-2(a).

[4325] Prop. Reg. § 25.2704-2(b)(1), which further provides, "See § 25.2704-3 for restrictions on the ability to liquidate a particular holder's interest in the entity."

[4326] Prop. Reg. § 25.2704-2(b)(2) provides:

> *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,

"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."[4328]

However, 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."[4329]

"An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction."[4330]

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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.

[4327] Prop. Reg. § 25.2704-2(b)(4)(ii) provides:

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

n 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.

[4328] Prop. Reg. § 25.2704-2(b)(3), which further provides:

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 f or 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.

[4329] Prop. Reg. § 25.2704-2(b)(4)(i), which further provides:

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.

Also, a put right as described further below is not an "applicable restriction."[4331]

Some of the calculations in examples need clarification or correction.

III.B.4.f.iv.(b). Prop. Reg. § 25.2704-3 Disregarding Restrictions under Governing Documents and State Law to Artificially Increase Value

For purposes of subtitle B (relating to estate, gift and generation-skipping transfer taxes), and notwithstanding Reg. § 25.2704-2, if an interest in an entity is transferred to or for the benefit of a member of the transferor's family,[4332] and the transferor and/or members of the transferor's family control the entity immediately before the transfer, certain restrictions are disregarded and the transferred interest is valued using special rules.[4333]

A "disregarded restriction" is a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described as follows, 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 certain exceptions), either alone or collectively:[4334]

1. The provision limits or permits the limitation of the ability of the holder of the interest to compel liquidation or redemption of the interest.[4335]

2. 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 (described further below).[4336]

3. 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.[4337]

4. 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 (described further below).[4338]

[4330] Prop. Reg. § 25.2704-2(b)(4)(iii).
[4331] Prop. Reg. § 25.2704-2(b)(4)(iv), referring to Reg. § 25.2704-3(b)(6), which is described in the text accompanying fn. 4359 in part III.B.4.f.iv.(b) Prop. Reg. § 25.2704-3 Disregarding Restrictions under Governing Documents and State Law to Artificially Increase Value.
[4332] Prop. Reg. § 25.2704-3(c) includes as family members descendants of the transferor's siblings when determining whether the entity is controlled by the transferor and the transferor's family but does not when determining family members otherwise.
[4333] Prop. Reg. § 25.2704-3(a).
[4334] Prop. Reg. § 25.2704-3(b)(1).
[4335] Prop. Reg. § 25.2704-3(b)(1)(i).
[4336] Prop. Reg. § 25.2704-3(b)(1)(ii).
[4337] Prop. Reg. § 25.2704-3(b)(1)(iii).
[4338] Prop. Reg. § 25.2704-3(b)(1)(iv).

"Minimum value" means the interest's share of the net value of the entity determined on the date of liquidation or redemption:[4339]

- The net value of the entity is the fair market value, as determined under Code § 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 Code § 2053 if those obligations instead were claims against an estate.

- Subject to the above limitation on outstanding obligations, if the entity holds an operating business, the rules of Reg. § 20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of Reg. § 25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer. This proposed rule modifying the valuation under those regulations by taking into account only Code § 2053 deductions is heavily criticized. Sound valuation principles, as well as the fundamental Rev. Rul. 59-60, require considering various business risks across the continuum, many of which do not even rise to the level of a contingent liability. Although a regulation can certainly overrule a revenue ruling, this rule would seem punitive as applied to operating businesses.

- The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. The interest's share takes 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 Code § 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 Code § 2704(b) and the regulations thereunder.

- Note that the above rules do not describe how one defines "net value." Does it consider business risks, even though obligations other than Code § 2053 deductions are ignored? Does it consider whether the interest being valued is a minority interest that cannot control related-party transaction that reduce the entity's value as a going concern but that would be normalized if the whole business were sold to a controlling owner? Does it assume that the business is liquidated to satisfy the put rights that the proposed regulations encourage?

[4339] Prop. Reg. § 25.2704-3(b)(1)(ii).

The prohibition against paying other than in cash or property referred to further above is subject to the following rules:[4340]

- For purposes of this prohibition, 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 this context, a related person is any person whose relationship to the entity or to any holder of an interest in the entity is described in Code § 267(b).[4341]

- However, if the entity is engaged in an active trade or business, at least 60% of whose value consists of the nonpassive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of Code § 6166(b)(9)(B), those 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 Reg. § 25.2512-8.

The above test seems harsh. If the note is from an unrelated party, shouldn't it be respected regardless of whether the entity is an active trade or business?

A disregarded restriction includes a restriction that is:[4342]

- 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,
    - 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.
    - Mandatory restrictions under federal or state law.

[4340] Prop. Reg. § 25.2704-3(b)(1)(iv).
[4341] However, in applying the related party rule, the term fiduciary of a trust as used in Code § 267(b) does not include a bank as defined in Code § 581 that is publicly held.
[4342] Prop. Reg. § 25.2704-3(b)(2).

Mandatory restrictions are those imposed or required to be imposed by federal or state law:[4343]

- "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 owners, managers, or otherwise) is not a restriction that is imposed or required to be imposed by 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 Code § 2704, is not a restriction that is imposed or required to be imposed by 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 Code § 2704 is a disregarded restriction.

- For purposes of determining the type of entity, the three categories of entities are corporations, partnerships (including limited partnerships), and other business entities.

- A restriction is not imposed or required to be imposed by law if that law also provides (either at the time the entity was organized or at some later time) an optional provision that:

    - does not include the restriction or that allows it to be removed or overridden, or

    - 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.

This last provision – that an optional provision is disregarded – proves too much. All states have rules for creating and terminating entities. All of the owners can get together to vote to liquidate. Thus, any restriction on liquidation can be overridden and is therefore disregarded. Many commentators view this as creating a deemed put right – a result that government representatives emphatically deny. My understanding is that the government intended for "provision" to apply to anything requiring more than a majority vote to liquidate. Of course, those representatives will not be looking over an IRS

[4343] Prop. Reg. § 25.2704-3(b)(5)(iii).

examiner's shoulder or whispering into a judge's ear, so that understanding is worthless until the government integrates it into final regulations.

Those who say that these concerns exaggerate the proposed regulations' impact argue that, even if one ignored these restrictions, the owners would need to negotiate with each other over the terms of that liquidation. However, as will be seen later, the very existence of some owners is ignored. Even those who are left would need to negotiate on the basis of their legal rights. If their legal rights to block liquidation are ignored, then what is the basis for these negotiations? All that would remain is a slight delay in marshalling assets. Again, government representatives assure the public that is not the case, but skeptics will continue to assume the worse until final regulations clearly rebut this concern.

Returning to the proposed regulation's rules, a restriction is disregarded 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:[4344]

- 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 Reg. § 25.2701-6,[4345] in addition to interests held directly. As described further below, the interests of nonfamily members will be disregarded because the proposed regulations provide unrealistic requirements for considering them.[4346] Thus, the transferor and the transferor's family members will be deemed to have the power to remove restrictions.

- 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

[4344] Prop. Reg. § 25.2704-3(b)(3).
[4345] See fns. 4219-4221, found in part III.B.4.b.i Code § 2701 Definitions.
[4346] Prop. Reg. § 25.2704-3(b)(4).

- otherwise.

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 under Prop. Reg. § 25.2704-3(b), a nonfamily-member's ownership is disregarded unless all of the following are satisfied:[4347]

(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% of the value of all of the equity interests in the corporation, and, in the case of a business entity[4348] other than a corporation, the interest constitutes at least a 10% interest in the business entity, for example, a 10% 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% of the value of all of the equity interests in the corporation, and, in the case of a business entity[4349] 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% of all the interests in the entity, for example, a 20% interest in the capital and profits of a partnership; and

(D) Each nonfamily member, as owner, has a put right as described in Reg. § 25.2704-3(b)(6).

In applying the 10% and 20% 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 Reg. § 25.2704-3(d) (described further below) apply in:[4350]

- determining the interest held by a nonfamily member, and

- measuring the interests owned through other entities.

The three-year holding requirement of (A) above is not unreasonable, except that it should be the lesser of three years or since the entity's inception, to avoid prejudicing start-up businesses. The Reg. § 25.2704-3(b)(6) put right described further below in is totally unrealistic, as operating businesses cannot afford to set aside liquidity to cash out owners without impairing their ability to operate, grow, and hopefully fulfill The American Dream.

[4347] Prop. Reg. § 25.2704-3(b)(4)(i).
[4348] Within the meaning of Reg. § 301.7701-2(a).
[4349] Within the meaning of Reg. § 301.7701-2(a).
[4350] Prop. Reg. § 25.2704-3(b)(4)(iii).

If a nonfamily-member interest is disregarded under the above rule, Reg. § 25.2704-3 applies as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.[4351]

The following are not applicable restrictions:[4352]

- An applicable restriction on the liquidation of the entity as defined in and governed by Reg. § 25.2704-2.[4353]

- 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,[4354] and 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 Code § 267(b).[4355] Given that the restriction is being imposed by an unrelated person, one wonders why the proposed regulations regulate the use of the funds.

- A mandatory restriction under federal or state law.[4356]

- An option, right to use property, or agreement that is subject to Code § 2703.[4357]

- A put right (described immediately below).[4358]

"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:[4359]

- 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 definition, 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, if the entity is engaged in an active trade or business, at least 60% of whose value consists of the non-passive assets of that

[4351] Prop. Reg. § 25.2704-3(b)(4)(ii).
[4352] Prop. Reg. § 25.2704-3(b)(5).
[4353] Prop. Reg. § 25.2704-3(b)(5)(i).
[4354] Prop. Reg. § 25.2704-3(b)(5)(ii).
[4355] As applied here, "fiduciary of a trust" under Code § 267(b) does not include a is publicly held bank under Code § 581.
[4356] Prop. Reg. § 25.2704-3(b)(5)(iii), as described in the text accompanying fn. 4343.
[4357] Prop. Reg. § 25.2704-3(b)(5)(iv).
[4358] Prop. Reg. § 25.2704-3(b)(5)(v).
[4359] Reg. § 25.2704-3(b)(6).

trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of Code § 6166(b)(9)(B), "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 Reg. § 25.2512-8.

- The minimum value of the interest is the interest's share of the net value of the entity, as described above.[4360]

As mentioned above in the text accompanying fn. 4347, failure to give a put right to an unrelated person means that the unrelated person is treated as not being an owner.[4361] Furthermore, if a restriction is disregarded under Reg. § 25.2704-3, 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.[4362]

When applying Code § 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 as if the disregarded restriction does not exist in the governing documents, local law, or otherwise, then that part is treated as a single, separate property interest.[4363] 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.[4364]

Given that nonfamily members' interests will be disregarded because nobody will ever qualify and that which legal restrictions are given effect is unclear, one might argue that Prop. Reg. § 25.2704-3 treats the transferor and the transferor's family as if no restrictions on liquidating their interest existed. One might also argue that "provisions" of governing law that do not apply are a much more narrow range, so that most aspects of the governing are given effect and far-reaching liquidation rights are not assumed. In light of this uncertainty, one might want to hope for the best and plan for the worst.

Although the proposed regulations encourage a put right for minimum value, they do not deem that right to exist. They merely use it as benchmarks for determining whether various restrictions exist. Although disregarded obligations that are not Code § 2035

[4360] Reg. § 25.2704-3(b)(1)(ii), described in the text accompanying fn. 4339.

[4361] Reg. § 25.2704-3(b)(4)(ii) provides:

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.

[4362] Reg. § 25.2704-3(f), which further provides, "For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized."

[4363] Reg. § 25.2704-3(e).

[4364] Reg. § 25.2704-3(e), which references Reg. § 25.2704-3(g), Example 4.

debts might cause minimum value to be much higher than fair market value, consider that, if the entity liquidated, its owners could not collectively obtain more than fair market value. One of the best appraisers in the country suggested that this fair market value maximum is itself a mandatory restriction under applicable law that would be respected. Other comments appraisers have made include:

- Does one consider tenancy in common or restricted management agreements? How about rights of first refusal?

- A history of redemptions would tend to affect value.

- For an at-will general partnership, examiners argue under current law no discounts. However, the process required to liquidate can cause delay and uncertainty and require valuation adjustments. Although that adjustment might be relatively low, one appraiser reported settling for 20% where the liquidation process was going to be cumbersome and lengthy.

- Scrutinize control premiums, because merely deriving them public market minority discounts does not tell the whole story. Fair value would have normalized expenses, whereas fair market value might not. Control means different things for different types of businesses or investment portfolios.

- Environmental liabilities, key man risks, agreements that lock in executive compensation, and other business risks need to be considered in valuing a business. These can be larger issues than discounts, and minimum value should not disregard them the way that they might be doing under the proposed regulations.

- Family members do not necessarily work together. Although the proposed regulations may require that one assumes that they act together when deciding whether to liquidate, they might not agree how to operate the business or how to liquidate.

- What happens to the business when it sells assets to fund a redemption? Consider the tax and other economic issues.

- For pass-through entities, consider owners bargaining with each other and Code § 336, 338(h)(10) elections.[4365]

- How much of the value is based on a particular owner's vision and skills? Consider personal goodwill and similar issues.[4366]

- How about a lender's restrictions on the ability to liquidate? Although the proposed regulations provide an exception, the exception is not necessarily available.

[4365] See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[4366] See part II.Q.1.c Personal Goodwill and Covenants Not to Compete.

Furthermore, even if the family member is deemed to have a liquidation right, would liquidating the family member's interest generate a fire sale, due to the lender's restrictions?

- The right to a minority oppression lawsuit adds value under current law, and disregarding minority discounts also disregards the value given to that premium.

- If the family is cohesive, they might not let an unrelated party withdraw or might impose a withdrawal penalty.

- An owner who is difficult to deal with or imposes reputational risk to the business might reduce value.

- The proposed regulations' increasing the value in appraisals done for estate planning purposes might provide arguments for dissenting owners to argue to be bought out at a higher price.

- Complexity of corporate structure may reduce value.[4367]

- Be careful when comparing the business' value against hedge funds' values. Hedge fund managers have incentive to be fair, because they want to sell future hedge funds, whereas a family member might not have that incentive. Hedge fund restrictions on withdrawal allowed them to weather market downturns so that they didn't have to liquidate assets at depressed values.

- One would need to do a liquidity analysis regarding cashing out owners.

[4367] *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990).