



January 13, 2017

The Honorable John A. Koskinen  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

The Honorable William J. Wilkins  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Avenue, NW  
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Mr. Thomas West  
Tax Legislative Counsel  
Department of the Treasury  
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Ms. Donna M. Young  
Acting Associate Chief Counsel for  
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Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: IRS [Proposed Regulations](#) under Section 2704 Regarding Restrictions on Liquidation of an Interest ([REG-163113-02](#) (8/4/16), Docket ID [IRS-2016-0022](#))

Dear Messrs. Koskinen, Wilkins, and West, and Ms. Young:

The American Institute of CPAs (AICPA) respectfully submits the attached comments on the proposed regulations (REG-163113-02 (8/4/16)) under section<sup>1</sup> 2704 regarding the valuation of interests in corporations and partnerships for estate, gift, and generation-skipping transfer (GST) tax purposes. These comments are intended to supplement AICPA's [testimony](#) at the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) hearing on December 1, 2016.<sup>2</sup>

The AICPA urges Treasury and the IRS to formally withdraw the proposed regulations. The regulations are overly broad and expand the breadth of section 2704 in a manner not contemplated by Congress. If the proposed regulations are not formally withdrawn, in order to satisfy the adequate disclosure rules to start the running of the statute of limitations on a gift tax return, taxpayers and practitioners will continue to need to include a disclosure statement with the gift tax return when the value of a gift may not be consistent with the proposed regulations. The regulations place unnecessary burdens on owners of family businesses who want to ensure the business remains in the family. There are valid, non-tax reasons for the restrictions that exist in the operating agreements of family-owned businesses that Treasury and the IRS will subject to

<sup>1</sup> All references herein to "section" or "§" are to the Internal Revenue Code of 1986 (Code), as amended, or the Treasury Regulations promulgated thereunder.

<sup>2</sup> See December 1, 2016, Treasury and the IRS hearing on the section 2704 proposed regulations [AICPA oral testimony](#) on [technical tax issues](#) and [valuation issues](#) and available at <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Testimony-Ransome-and-Gallagher-12-1-2016.pdf>. Also see [listing](#) of the December 1, 2016 IRS hearing government panel and [speakers](#).

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these proposed regulations. The proposed regulations would place an undue financial burden on these family businesses and treat family-owned businesses differently than similarly situated businesses without family ownership.

If the regulations are not formally withdrawn, Treasury and the IRS should take into consideration the concerns and recommendations that we and other commentators have identified and issue new, clarified proposed regulations for public comment. For example, the final regulations should apply only to entities that do not carry on an active trade or business, or at a minimum, not apply to the extent an entity's assets are used in the active conduct of a trade or business.

Treasury and the IRS should also delay any effective date until at least six months from issuance of regulations and provide a grandfathering rule to exempt transactions occurring prior to the issuance of final regulations. Taxpayers have relied on prior rules in their planning and will need time to analyze, consider and understand the implications of the new regulations.

Our comment letter recommends and explains several changes along with our rationale for why the Treasury and the IRS should formally withdraw the proposed regulations.

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The AICPA is the world's largest member association representing the accounting profession, with more than 418,000 members in 143 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium size businesses, as well as America's largest businesses.

We welcome the opportunity to discuss further these comments or answer any questions that you may have. You may contact me at (408) 924-3508, or [annette.nellen@sjsu.edu](mailto:annette.nellen@sjsu.edu); or you may contact Justin Ransome, Chair, AICPA FLP Issues Task Force, at (202) 327-7043 or [justin.ransome@ey.com](mailto:justin.ransome@ey.com); or Eileen Sherr, AICPA Senior Manager, at (202) 434-9256, or [eileen.sherr@aicpa-cima.com](mailto:eileen.sherr@aicpa-cima.com).

Sincerely,



Annette Nellen, CPA, CGMA, Esq.  
Chair, Tax Executive Committee

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cc: Ms. Catherine Veihmeyer Hughes, Estate and Gift Tax Attorney Advisor, Office of Tax Policy, Department of the Treasury  
Ms. Melissa Liquerman, Chief, Branch 4, Office of the Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service  
Ms. Leslie Finlow, Senior Technician Reviewer, Branch 4, Office of Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service  
Mr. John MacEachen, Attorney, Office of the Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service  
Ms. Charlotte Chyr, Special Counsel to the Associate Chief Counsel for Passthroughs and Special Industries, Office of the Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service  
Ms. Regina Johnson, Publication Regulation Specialist, Internal Revenue Service

**THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**  
**COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 2704 REGARDING**  
**RESTRICTIONS ON LIQUIDATION OF AN INTEREST**  
**(REG-163113-02 (8/4/16))**  
**JANUARY 13, 2017**

**GENERAL BACKGROUND**

On August 4, 2016, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) issued proposed regulations under section 2704 aimed at restricting discounts for lack of marketability and lack of control for estate and gift-related transfers of ownership interests in family-owned businesses.

The proposed regulations would amend Treas. Reg. § 25.2701-2 to address what constitutes control of a limited liability company (LLC) or other entity or arrangement that is not a corporation, partnership or limited partnership. The proposed regulations would amend Treas. Reg. § 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 Treas. Reg. § 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, Prop. Reg. § 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.

The below comments are intended to supplement AICPA’s [testimony](#) at the Treasury and IRS hearing on December 1, 2016.<sup>3</sup>

**ISSUES**

The American Institute of CPAs (AICPA) provides analysis and recommendations to Treasury and the IRS on the following issues:

1. Formal withdrawal of the proposed regulations;
2. Exception for active trades or businesses;
3. Valuations (including redefining fair market value (FMV), redefining family control, redefining marketability, disregarded entities, and appraiser penalties);
4. Items that pertain to multiple provisions in the proposed regulations (including interaction of the proposed regulations with Subtitle A (Income Taxes) (including income tax basis, substitution power, net value of S corporations, and split-interest trusts); and

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<sup>3</sup> See December 1, 2016, Treasury and the IRS hearing on the section 2704 proposed regulations [AICPA oral testimony](#) on [technical tax issues](#) and [valuation issues](#) and available at <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Testimony-Ransome-and-Gallagher-12-1-2016.pdf>. Also see [listing](#) of the December 1, 2016 IRS hearing government panel and [speakers](#).

attribution rules (including clarification of the definition of “family members” considered in determining control and clarification of the attribution rules in the context of a Qualified Terminable Interest Property (QTIP) trust);

5. Three-year look back rule;
6. Transfers subject to applicable restrictions (including lapse of applicable restriction, commercially reasonable restrictions, and right to put interest to an entity); and
7. Disregarded restrictions (including the addition of disregarded restrictions to existing restrictions covered by section 2704(b), lapse of a disregarded restriction, commercially reasonable restrictions, and the right to put interest to an entity).

## **RECOMMENDATIONS**

### **I. Formal Withdrawal of the Proposed Regulations**

The AICPA urges Treasury and the IRS to formally withdraw the proposed regulations.

We encourage Treasury and the IRS to take time to digest the many comments on this set of proposed regulations. If the proposed regulations are not formally withdrawn, Treasury and the IRS should take into consideration the concerns and recommendations that we and other commentators have identified and issue new, clarified proposed regulations for public comment.

Treasury and the IRS should also delay any effective date until at least 6 months from issuance of regulations and provide a grandfathering rule to exempt transactions occurring prior to the issuance of final regulations.

We understand the concerns of Treasury and the IRS in issuing the proposed regulations. However, these proposed regulations are overly broad in addressing these concerns. The creation of disregarded restrictions in the regulations expands the breadth of section 2704 in a manner not contemplated by Congress. While we recognize that section 2704 gives Treasury and the IRS authority to expand the scope of section 2704, we urge Treasury and the IRS to reconsider whether these proposed regulations are the most efficient way to address these concerns.

Assuming Treasury and the IRS incorporate major changes in the regulations, practitioners will need more time to analyze the next set of proposed regulations or final regulations in order to properly advise their business clients.

Delaying the effective date of the provisions until at least six months from issuance of the regulations will allow taxpayers and their appraisers needed time to become familiar with, and understand, the new business valuation definitions in revised proposed regulations or final regulations.

Because taxpayers have relied on prior rules in their planning and will need time to consider, analyze and understand the implications of the new regulations, the new regulations should

include a grandfathering rule to exempt transactions occurring prior to the issuance of final regulations.

## **II. Exception for Active Trades or Businesses**

The AICPA recommends applying the revised proposed regulations or final regulations only to entities that do not carry on an active trade or business, or at a minimum, not applying the final regulations to the extent an entity's assets are used in the active conduct of a trade or business.

We understand that the proposed regulations are targeted at family-controlled entities that do not carry on active trades or businesses – entities that may contain lapsing rights and restrictions. However, these regulations, as currently proposed, will also affect family-owned businesses that carry on active trades or businesses. There are valid, non-tax reasons for the restrictions that exist in the operating agreements of these operating businesses that Treasury and the IRS will subject to the proposed regulations. The proposed regulations would place an undue financial burden on these family businesses.

For purposes of determining whether an entity carries on an active trade or business, we recommend that Treasury and the IRS consider a business as “active” if it generates expenses that are deductible pursuant to section 162.

## **III. Valuations**

### **A. Redefining FMV**

The AICPA recommends that Treasury and the IRS not define value for purposes of section 2704 as a value other than FMV. If Treasury and the IRS nonetheless provide that value is other than FMV, Treasury and the IRS should clarify whether business appraisers are required to assume hypothetical conditions that are in conflict with the definition of FMV in their opinions. If hypothetical conditions are required, Treasury and the IRS should clarify if they will accept such opinions as qualified appraisals that meet adequate disclosure requirements.

There are many implications to the new definition of value in the proposed regulations.

The proposed regulations introduce the new term “minimum value,” which includes limitations on debt deductions under section 2053, resulting in business appraisers having to either make determinations themselves, or seek guidance from a tax specialist. If business appraisers use the traditional definition of FMV, taxpayers will need to file adequate disclosure statements, indicating that gift tax returns are being filed with positions contrary to proposed or final regulations.

Treasury and the IRS are asking business appraisers to rely on a new concept or definition of FMV, which appears closer to what business appraisers call “Investment Value.” Investment Value, as defined by the International Glossary, is “the value to a particular investor based on individual investment requirements and expectations.”

The proposed regulations include a bright-line three-year test that would require recapture in the transferor's estate of the value of a lapse right that gave rise to discounts if the transferor dies

within three years of the transfer. By changing or bifurcating the definition of FMV, Treasury and the IRS are requiring business appraisers to perform valuations using different methodologies (control versus minority based) for assets affected by the proposed rules, depending upon whether the asset was transferred to family donees/heirs, third parties (non-family members), and/or charities. Appraisers also may need a different valuation for income tax or employee stock ownership plan (ESOP) purposes, as the definition of fair market value for those purposes may now differ from those definitions related to gift and estate transfers.

The new definition of value is not aligned with the definition of value in AICPA [professional standards](#) (the “Standards”).

The AICPA issued detailed [professional standards](#) for business appraisal conclusions,<sup>4</sup> effective January 1, 2008, with which all AICPA members must comply. The majority of licensing jurisdictions for CPAs also require compliance with these professional standards, which apply to appraisal opinions used in support of values of ownership interests in closely held businesses for a broad range of applications, including gift and estate tax planning and compliance.

These standards are codified by AICPA as VS 100 (previously known as SSVS1 for the Statement on Standards for Valuation Services No. 1). The Standards include reference to the definition of FMV, ratified within the [International Glossary of Business Valuation Terms](#).<sup>5</sup>

According to the International Glossary used by business appraisers, the definition used by CPA business appraisers when rendering an opinion using the FMV standard of value is:

Fair Market Value – the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

This definition is consistent with Treas. Reg. § 20.2031-1(b), which the courts have consistently relied on for over two decades, as well as [Revenue Ruling 59-60](#)<sup>6</sup> and a number of other Treasury and IRS references, such as publications.

As stated in Prop. Reg. § 25.2704-3(a):

For purposes of subtitle B, ... and notwithstanding any provision of Treas. Reg. § 25.2704-2, if an interest in a corporation or partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the

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<sup>4</sup> See [AICPA Statements on Standards for Valuation Services](#), available at [https://www.aicpa.org/InterestAreas/ForensicAndValuation/Resources/Standards/DownloadableDocuments/SSVS\\_Full\\_Version.pdf](https://www.aicpa.org/InterestAreas/ForensicAndValuation/Resources/Standards/DownloadableDocuments/SSVS_Full_Version.pdf).

<sup>5</sup> See International Glossary of Business Valuation Terms, available at <http://www.aicpa.org/InterestAreas/ForensicAndValuation/Membership/DownloadableDocuments/Intl%20Glossary%20of%20BV%20Terms.pdf>. These terms, including FMV, were adopted and approved by the AICPA, American Society of Appraisers, National Association of Certified Valuation Analysts, The Canadian Institute of Chartered Business Valuators, and The Institute of Business Appraisers.

<sup>6</sup> Rev. Rul. 59-60, 1959-1 C.B. 237.

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) or this section is disregarded, and the transferred interest is valued as provided in paragraph (f) of this section.

Proposed Reg. § 25.2704-3(f) then states:

If a restriction is disregarded under this section, the fair market value of the transferred interest is determined **under generally accepted valuation principles** as if the disregarded restriction does not exist in the governing documents, local law, or otherwise [emphasis added].

Treasury and IRS should not change the definition of value in the regulations because the definition of FMV used universally by business appraisers assumes both a hypothetical willing buyer and seller, dealing at arm's length.<sup>7</sup> Treasury and the IRS should continue to use the same definition of value used in the landmark Revenue Ruling 59-60 in the section 2704 regulations. Revenue Ruling 59-60 embraces the same commonly accepted definition of FMV of willing buyer, willing seller, arm's length definition of FMV that CPA business appraisers use.

The proposed regulations require the business appraiser to disregard governing documents and local law when certain restrictions on liquidation rights exist for business interests in family-owned entities. This requirement will force business appraisers to make hypothetical assumptions that are contrary to fact or unlikely to occur.

We are concerned that the proposed regulations are not realistic and commercially reasonable when valuing interests in closely-held businesses because available market data broadly supports that the FMV of a non-controlling interest in an asset holding company is worth less than its pro-rata value (i.e., closed-end mutual funds, real estate limited partnerships (RELPs), etc.).

The proposed regulations also create a significant administrative burden on the taxpayer, who would have an asset with two different values and two different basis amounts to track – one basis for income tax and another basis for estate tax. Taxpayers will also have the additional burden of filing adequate disclosure statements, indicating gift tax returns are filed with “contrary” positions.

## **B. Redefining Family Control**

The AICPA recommends that Treasury and the IRS revise the definition of family control to not include all applicable family members.

Under the proposed regulations, all applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse, fall under the definition of control. This lower threshold aggregates family members that Treasury and the IRS have historically not included in family attribution considerations. The new family control provisions represent a subtle attack on the business purposes of family asset-holding companies. There are many valid business reasons to form a family owned entity.

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<sup>7</sup> Treas. Reg. § 20.2031-1(b).

Under the proposed regulations, all family members (those with controlling interests and non-controlling interests alike) are assumed to work and interact together, which is not reality. Most people can think of at least one family member with whom they would never want to do business. Issues of family control and attribution were litigated for years, resulting in the IRS acquiescence of this position with the issuance of Revenue Ruling 93-12.<sup>8</sup> The definition of control in the proposed regulations is in direct conflict with Revenue Ruling 93-12.

The proposed regulations provide stringent requirements before ownership interests held by unrelated third parties are relevant to the analyses. An unrelated equity holder must have at least a 10 percent interest, the aggregate interests of all third parties must equal at least 20 percent, and those third parties must have held those interests for three years. These requirements are not commercially reasonable.

Under generally accepted valuation principles, an adjustment for lack of control is often used to compensate for the inability of a minority interest holder to control any company decisions. Available market data broadly supports that the FMV of a non-controlling interest, even in an asset holding company, is worth less than its pro-rata value of the company as a whole. Sources for this market data include closed-end mutual funds, RELPs, and others. The proposed regulations require the business appraiser to disregard this market data.

In addition to ignoring certain unrelated third party owners and market data, under the proposed regulations, business appraisers are required to disregard governing documents and local law when certain restrictions exist. These requirements will force business appraisers to make hypothetical assumptions that are contrary to fact or unlikely to occur and, again, are not consistent with the definition of FMV.

### **C. Redefining Marketability**

The AICPA recommends that Treasury and the IRS:

- Remove or clarify the provisions regarding valuation and the assumption of a “put right” in the final regulations.
- Remove other commercially unreasonable provisions from assumptions regarding value for section 2704 purposes.

Marketability is the ability to quickly convert an ownership interest to cash, with minimal cost and maximum certainty about the price that is received. Under generally accepted valuation principles, an adjustment for lack of marketability is often used to compensate for the difficulty of selling an interest in a closely-held company that is not traded on any exchange.

The proposed regulations include what appears to tax and valuation experts as a mandatory put right, which would change how business appraisers assess the marketability (or lack thereof) of an ownership interest in a closely-held business.

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<sup>8</sup> Rev. Rul. 93-12, 1993-1 C.B. 202.

A put right is commonly defined as a right to sell a security at a specified price within a specific time. With the proposed regulations requiring assumptions related to liquidating interests at a “minimum value,” in cash, within six months, we easily see how many experts are interpreting this as a deemed put right. This deemed put right would increase the risk of any operating entity where all holders have such a right, and it is not commercially reasonable to assume that each member of a closely-held entity would have unlimited put rights like this. The deemed put right also would appear to override all other provisions of the proposed regulations; arms’ length parties (or families, for that matter) would never negotiate such arrangements.

Other provisions in the proposed regulations that are related to marketability and are not commercially reasonable include:

- Disregarding limitations on the ability of an interest holder to compel liquidation is not realistic because such limitations commonly are placed in company agreements to facilitate the operation of entities to achieve their business purposes.
- Limitations on interest holders’ redemption and liquidation amounts to at least “minimum value” are unreasonable because closely-held businesses are typically illiquid, and there are no guaranteed minimum values for any investment.
- Limitation of the deferral of full redemption/liquidation payment to no more than six months after the holders give notice is unreasonable because such terms are generally not offered by closely-held businesses as such terms would likely put them out of business.
- Payment of any portion of the full amount in any manner other than cash is unreasonable because it is not possible for illiquid companies and can result in a forced liquidation of the entity. In addition, businesses generally do not limit redemption transactions to cash-only arrangements. Often it is not feasible for a closely-held family business to obtain financing to redeem interests. If the business is able to obtain such financing, the leverage may substantially increase company risk and debt costs.

If the proposed regulations are not revised to address the perceived put right and these commercially unreasonable provisions, business appraisers will need alternative methods and guidance for determining marketability adjustments for closely-held business interests, such as comparable put right methods.

#### **D. Disregarded Entities**

The AICPA recommends that Treasury and the IRS explain the rationale for a change in valuation rules for disregarded entities (or clarify that there is no change in the valuation rules).

The proposed regulations provide the following representative language regarding the types of entities covered by section 2704 and the proposed regulations:

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.* [Emphasis added.]<sup>9</sup>

For Treasury and the IRS to disregard an entity – S corporation or LLC – there is a 100% ownership requirement: (a) by its parent S corporation; (b) by its upper tier LLC; or (c) in the case of individuals, by its single member. The proposed regulations do not comment on the rationale for valuing the disregarded entity separate from its sole owner. Given the regulatory enforcement and taxpayer compliance costs associated with valuing these 100% interests separate and independent from simply including the disregarded entity in valuing the interests held by the owners in the common parent entity, we request that Treasury and the IRS explain the rationale for what appears to us as an unnecessary burden to all parties regarding valuation (or clarify that there is no change in the normal valuation rules applicable to these kinds of “consolidated” and common business structures).

### **E. Appraiser Penalties**

The AICPA recommends that Treasury and the IRS:

- Revise Prop. Reg. § 25.2704-3 to limit the time period for the lapse or removal of a disregarded restriction to three years.
- Exclude penalties if a hypothetical appraisal is performed solely to comply with the regulations under section 2704, or at least exclude the penalty if a valuation uses the “known or knowable” method for reporting.
- For valuations performed prior to the regulations becoming final, exclude from penalties valuations performed in compliance with valuation standards applicable prior to the date the final regulations are issued.

Appraisers, including members of the AICPA performing valuations, are subject to penalties for incorrect appraisals.

Section 6695A, added by the [Pension Protection Act of 2006](#), and referred to in [Internal Revenue Manual \(IRM\) 20.1.12.1](#), refers to a penalty of 10% of the amount of the underpayment or 125% of the gross income received from the appraisal.

IRS examiners are instructed in IRM 20.1.12.1 to assert the penalty if “that appraisal results in a substantial misstatement (within the meaning of section 6662(e)), a substantial estate and gift understatement (within the meaning of section 6662(g)), or a gross valuation misstatement (within the meaning of section 6662(h)) with respect to such property.”

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<sup>9</sup> See e.g., Prop. Reg. § 25.2704-2(a).

The Supreme Court decision in *U.S. v. Cartwright*<sup>10</sup> and Revenue Ruling 59-60 both suggest appraisers use FMV as the standard. It appears that the proposed regulations will substitute a hypothetical value for estate and gift tax purposes, replacing FMV for reporting on family-controlled entities.

The Preamble to the proposed regulations regarding Prop. Reg. § 25.2704-3 states:

In the case of a family-controlled entity, any restriction described below on a shareholder's, partner's, member's, or other owner's rights 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 interest held by non-family members, may remove or override the restriction [emphasis added].

In determining FMV, both the courts and appraisers have included information known or knowable. As “will lapse at any time after the transfer” in Prop. Reg. § 25.2704-3 is too broad, if the proposed regulations are adopted, Treasury and the IRS should revise Prop. Reg. § 25.2704-3 to limit the time period for the possible lapse to no more than three years.

With regards to penalties for appraisers, we think the regulations should specifically exclude penalties if a hypothetical appraisal is performed solely to comply with the regulations under section 2704, or at least exclude the penalty if a valuation uses the “known or knowable” method for reporting.

We also think for fairness reasons that for valuations performed prior to the issuance of final regulations, Treasury and the IRS should specifically exclude from penalties valuations performed in compliance with valuation standards applicable prior to the date the final regulations are issued.

#### **IV. Items that Pertain to Multiple Provisions in the Proposed Regulations**

##### **A. Interaction of the Proposed Regulations with Subtitle A (Income Taxes)**

Section 2704 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. Generally, the special valuation rules in the proposed regulation will, in a majority of situations, result in a higher value of such interests for transfer tax purposes (their “section 2704 value”) than their FMV. The resulting valuation increase may cause some unusual results for income tax purposes.

##### **1. Income Tax Basis**

Section 1014 provides that the income tax basis in the asset received from a decedent is the FMV. Section 1014(f) ensures that a subset of assets covered by section 1014(a) are reported consistently between the estate and the beneficiary. It follows that the section 2704 value is used to determine the beneficiary's basis in the assets under section 1014.

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<sup>10</sup> 411 U.S. 546 (May 7, 1973).

### **a. Losses**

The AICPA recommends that Treasury and the IRS:

- Provide an example of a pecuniary bequest of property from a qualified revocable trust covered by a section 645 election.

We recommend that this example would conclude that the long-term capital loss is allowed on the estate's [Form 1041](#), *U.S. Income Tax Return for Estates and Trusts*. To the extent that the estate terminates and the loss is unused, Treasury and the IRS should allow the allocation of the loss to the beneficiaries under the rules of section 642(h).

- Provide an example of a pecuniary bequest of property from a qualified revocable trust not covered by a section 645 election.

We recommend that this example would conclude that the long-term capital loss is disallowed on the trust's Form 1041 by reason of section 267 until the beneficiary disposes of the property. To the extent the trust terminates and the loss is unused, it will disappear.

- Provide an example of a sale of an asset for a loss greater than \$2,000,000.

We recommend that this example would conclude that the long-term capital loss is allowed on the estate's Form 1041, but also require the reporting of the loss as a reportable transaction on [Form 8886](#), *Reportable Transaction Disclosure Statement*. To avoid this result, we request that section 165 loss reportable transactions specifically exclude assets valued using the section 2704 method.

In the most simplistic example, to the extent that the FMV is less than the section 2704 value, the beneficiary will recognize a loss on the disposition if the beneficiary disposes of the interest immediately following the decedent's death. In most cases, this situation will result in a long-term capital loss. However, there are instances regarding losses where we think the result is not clear, which we think the proposed regulations should address: (1) a pecuniary bequest of property from a qualified revocable trust covered by a section 645 election and not covered by such an election; and (2) a sale of an asset for a loss greater than \$2,000,000.

### **b. Gifts**

The AICPA recommends that Treasury and the IRS:

- Provide an example showing the calculation of a part sale/part gift when the section 2704 value is higher than the True FMV in a "net gift" situation.
- Provide an example under section 1015(d) illustrating the allocation of the gift tax to the unrealized appreciation in the interest gifted when FMV has a lower value than the section 2704 value.

Section 1015 provides that the donee's basis is, generally, the basis of the donor. However, to the extent there is a relief of liabilities (such as a gift of a partnership interest or a "net gift"), the

transfer results in a part sale/part gift. The part sale/part gift may, or may not, result in income inclusion to the donor. Additionally, to the extent the donor pays gift tax on the transfer, the basis is increased under the rules of section 1015(d).

## **2. Substitution Power**

The AICPA recommends that Treasury and the IRS address how section 2704 interacts with the power to substitute assets described in section 675(4)(C) in two situations: (1) when a person has the ability to substitute assets of a trust, and the trust holds an asset where its FMV is less than its section 2704 value; and (2) when the section 675(4)(C) power holder owns the section 2704 asset.

Section 675(4)(C) provides that the grantor is treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. The term “power of administration” includes a power to reacquire the trust corpus by substituting other property of an equivalent value. Treas. Reg. § 1.675-1(b)(4)(iii) provides that the circumstances that may cause Treasury and the IRS to consider administrative controls as exercisable primarily for the benefit of the grantor include the existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term “powers of administration” includes a power to reacquire the trust corpus by substituting other property of an equivalent value. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

The AICPA has identified two situations regarding how section 2704 interacts with the power to substitute assets described in section 675(4)(C) that we think Treasury and the IRS should address in the final regulations. Both situations concern “equivalent value” when dealing with an asset covered by section 2704. In the first situation, if a person has the ability to substitute assets of a trust, and the trust holds an asset where its FMV is less than its section 2704 value, it seems that since section 2704 only applies to Subtitle B, the owner should use the true FMV as the “equivalent value.” But for Subtitle B purposes, it seems that this transaction is a constructive distribution to the owner that could possibly invoke section 2036 to cause inclusion of the entire trust in the owner’s estate. Conversely, in the second situation, the section 675(4)(C) power holder owns the section 2704 asset. If the owner uses the FMV as the “equivalent value,” would the substitution of assets constitute a deemed gift? In both situations, if the section 2704 value is used, the amounts substituted are above the FMV. In this case, one may view it as an act by the power holder that exceeds the authority conferred to the power holder, which may result in fiduciary liability to the trustee if the trustee does not attempt to block the transfer.

## **3. Net Value of S Corporations**

The AICPA recommends that Treasury and the IRS amend Treas. Reg. § 1.1361-1(l) to provide that a cross-purchase or redemption agreement that uses “minimum value” (as defined in the

proposed regulations) is a safe harbor to the second-class of stock rules, or provide that any agreement covered by Treas. Reg. § 1.1361-1(l) is respected for purposes of section 2704.

One of the exceptions applicable to the definition of a disregarded restriction applies if 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.

Currently, the safe harbor covers agreements between book value and FMV. Given the unusual calculation of net value, Treasury and the IRS would disregard all non-family shareholders that have conforming buy/sell agreements in place under the proposed regulations. Any buy/sell agreement using the section 2704 minimum value will put the corporation’s S election at risk due to the second class of stock rules in Treas. Reg. § 1.1361-1(l).

#### **4. Split-Interest Trusts**

The AICPA recommends that Treasury and the IRS provide that section 2704 is inapplicable to transfers to inter-vivos split interest trusts.

In the case of inter-vivos transfers to split interest trusts, charitable remainder trusts (CRTs) and charitable lead trusts (CLTs), the value of the gift will generate a deduction under section 170 and section 2522. However, these transfers are to both a taxable beneficiary and a charitable beneficiary. The proposed regulations provide that 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. In the case of these trusts, that is not the case. Based on the proposed rules, taxpayers would need two appraisals – one for section 170 purposes and another for section 2522 purposes. In the case of CLTs, the income tax deduction is less than the gift tax deduction, resulting in an inability to zero-out a CLT by making the lead payments equal to the property contributed for both income and gift tax purposes.

### **B. Attribution Rules**

#### **1. Clarification of “Family Members” Considered in Determining Control**

The AICPA recommends that Treasury and the IRS:

- Clarify that “member of the family” does not include lineal descendants of any parent of the transferor (or of their spouse).
- Clarify, preferably with examples, the mechanics of the test for determining control.

The proposed regulations, as drafted, result in uncertainty over the determination of which members of a family are included in assessing control of an entity.

Sections 2704(a) and 2704(b) apply if the transferor and members of the transferor’s family control an entity. Section 2704(c)(2) defines the term “member of the family” to include (i) the individual’s spouse, (ii) any ancestor or lineal descendant of the individual, (iii) any brother or sister of the individual, and (iv) the spouse of any individual described in (ii) or (iii).

Section 2704(c)(1) provides that “control” has the meaning given to such term under section 2701(b)(2). This section provides a definition of control, but also provides for a more expansive description of a family member than the definition provided by section 2704(c)(2). Specifically, section 2701(b)(2) delineates “an applicable family member” as “any lineal descendant of any parent of the transferor or the transferor’s spouse.”

Similarly, Prop. Reg. § 25.2704-2(c) and § 25.2704-3(c) refer to existing Treas. Reg. § 25.2701-2(b)(5) for a more expansive definition of family members than what is provided by section 2704(c)(2). As with the above, under existing Treas. Reg. § 25.2701-2(b)(5), a family member also includes “any lineal descendant of any parent of the transferor or the transferor’s spouse.”

Several of our members have noted that these expanded definitions may result in the potential inclusion of the transferor’s nieces and nephews in the determination of entity control. However, such an expansion appears to exceed the intended scope of section 2704.

The final regulations (if issued) should clarify that “member of the family” does not include lineal descendants of any parent of the transferor (or of their spouse). For example, assume grandfather (deceased) left his business to his three children (A, B and C), one-third to each. B and C are deceased. Each had previously left their respective one-third interest to their own children (i.e., the grandchildren of the founder). A still maintains her one-third interest. Presumably, this entity is not considered a controlled entity under section 2704 for purposes of transfers made by A (i.e., there is no deemed ownership to A of the other two-thirds interests held by her nieces and nephews).

We also think the final regulations should have examples regarding how the attribution rules are applied for determining control. We further think the final regulations should clarify that there is no “double counting” of family members in the test. For example, assume two brothers each own 10%. The children of each brother own 15%. By first tier attribution, each brother owns 25%. Thereafter, when examining the ownership for control purposes, does a transferor brother own 35% (i.e., 10% owned outright, plus 15% owned by his children, plus 10% owned by his brother), or is this transferor brother deemed to own 50% (i.e., after including the 15% ownership of the transferor’s nieces and nephews)?

## **2. Clarification of the Attribution Rules in Context of a QTIP Trust**

The AICPA recommends that Treasury and the IRS clarify the full extent of the intended rules on attribution in the context of a QTIP trust.

The section 2704 proposed regulations attribute ownership in an overly expansive manner. Courts have previously rejected excessive attribution approaches when assessing control for valuation purposes. One such instance of overly broad control attribution involves the problematic ascription of ownership from a QTIP trust to a surviving spouse.

Proposed Reg. § 25.2704-2(d) and § 25.2704-3(d) reference existing Treas. Reg. § 25.2701-6 to determine whether an individual is treated as owning an interest in an entity that is owned by another entity or by a trust or estate in which the individual has an interest. For example, under Treas. Reg. § 25.2701-6, the IRS may consider a surviving spouse to control an entity due to the

attribution of ownership through a QTIP trust because such interest is includible in the gross estate of the surviving spouse under section 2044.

Courts have consistently rejected a doctrine of “family attribution” and, furthermore, have specifically addressed the inherent problem of attributing control to a surviving spouse as a result of the surviving spouse’s beneficial ownership in a QTIP trust. *See, e.g., Estate of Bonner*.<sup>11</sup> In *Bonner*, the Fifth Circuit noted:

Although section 2044 contemplates that the QTIP property will be treated as having passed from [the surviving spouse] for estate tax purposes, the statute does not require, nor logically contemplate that in so passing, the QTIP assets would merge with other assets. The assets in the QTIP trust could have been left to any recipient of [the decedent’s] choosing, and neither [the surviving spouse] nor the estate had any control over their ultimate disposition...

\* \* \* \*

In this case, [the decedent] controlled the disposition of her assets, first into a trust with a life interest for [the surviving spouse] and later to the objects of her largesse. The assets, although taxed as if they passed through [the surviving spouse’s] estate, in fact were controlled at every step by [the decedent], which a tax valuation with a fractional interest discount would reflect. At the time of [the surviving spouse’s] death, his estate did not have control over [the decedent’s] interests in the assets such that it could act as a hypothetical seller negotiating with willing buyers free of the handicaps associated with fractional undivided interests. The valuation of the assets should reflect that reality...<sup>12</sup>

Furthermore, in [Revenue Ruling 93-12](#)<sup>13</sup> (prior to *Bonner*), the government previously acquiesced to the holdings of cases similar to *Bonner*, including the case of *Bright* (noted above), and generally affirmed a more limited approach to the attribution of control than that which is contained in the proposed regulations.

The final regulations should clarify the full extent of the intended rules on attribution in the context of a QTIP trust. For example, assume a surviving spouse owns 25% of stock in Company A, which is included in her gross estate under section 2033. The surviving spouse’s deceased husband owned 25% of stock in Company A. Upon his death, a QTIP election was made such that the value of her husband’s interest is included in her gross estate under section 2044. Upon the death of the surviving spouse, does section 2704 apply to the stock included in her estate under sections 2033 and 2044?

## V. Three-Year Look Back Rule

The AICPA recommends that Treasury and the IRS:

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<sup>11</sup> *Estate of Bonner*, 84 F.3d 196 (5th Cir. June 4, 1996) (affirming [Estate of Bright v. United States](#), 658 F. 2d 999 (5<sup>th</sup> Cir. Oct. 1, 1981) (en banc)).

<sup>12</sup> *Bonner*, 84 F.3d at pp. 198-199.

<sup>13</sup> Rev. Rul. 93-12, 1993-1 C.B. 202.

- Formally withdraw the three-year look back rule in Prop. Reg. § 25.2704-1.
- If Treasury and the IRS do not adopt this recommendation:
  - Clarify the three-year look back rule does not apply to transactions that occurred before the effective date of the final regulations.
  - Provide that the proper date to apply section 2704(a)(2) for purposes of the three-year rule is the date of transfer.
  - Provide examples as to the calculation of the amount brought back into the estate under section 2704(a)(2) and Treas. Reg. § 25.2704-1(d).

Under section 2704(a)(1), a lapse of any voting or liquidation right in a corporation or partnership that is controlled by an individual and members of his family both before and after the lapse is treated as a transfer by the individual by gift or a transfer includible in the gross estate of the decedent. Pursuant to section 2704(a)(2), the amount of the transfer is calculated as the fair market value of all of the interests held by the individual immediately prior to the lapse over the fair market value of these interests after the lapse.

A liquidation right is defined in Treas. Reg. § 25.2704-1(a)(2)(v) as the right or ability to compel the entity to acquire all or part of the holder's equity interest in the entity, whether or not this would cause the entity to liquidate. Treasury Reg. § 25.2704-1(c)(1) provides that a lapse of a liquidation right occurs when an exercisable liquidation right is restricted or eliminated. However, the regulation further provides that this rule generally does not apply if the rights with respect to the transferred interest are not restricted or eliminated. As a result of this exception, if an interest holder with the aggregate voting power to compel the entity to acquire the holder's interest makes an inter-vivos transfer of a minority interest that results in the loss of the interest holder's ability to compel the entity to acquire his or her interest, the transfer is not treated as a lapse.

Citing the legislative history, the preamble to the proposed regulations explains that section 2704 "is intended, in part, to prevent results similar to that in [\*Estate of Harrison v. Commissioner\*](#),"<sup>14</sup> in which the decedent and two of his children held general partnership interests in a partnership immediately before the decedent died. In addition to a general partnership interest, the decedent held all of the limited partner interests in the partnership. The general partnership interest carried with it the right to liquidate the partnership. The general partner's right to liquidate, however, terminated upon the general partner's death. In determining the estate tax value of the decedent's limited partnership interests, the court determined that the estate could not take the right of liquidation into account because it lapsed at the decedent's death. As a result, the court concluded that the value of the limited partner interests for transfer tax purposes was lower than its value either to the decedent immediately before he died or to the other general partners immediately after his death.

Regarding the exception in Treas. Reg. § 25.2704-1(c)(1), the preamble to the proposed regulations explains that Treasury and the IRS "believe that this exception should not apply

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<sup>14</sup> *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8 (Jan. 6, 1987).

when the inter-vivos transfer that results in the loss of the power to liquidate occurs on the decedent's deathbed," because, although these transfers "generally have minimal economic effects," they "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." The preamble states that the purpose of section 2704 was "to prevent this result." Treasury and the IRS assert that the exception established in Prop. Reg. § 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."

The proposed regulations would amend Treas. Reg. § 25.2704-1(c)(1) to provide that the exception regarding transfers of interests that do not result in the restriction or elimination of rights associated with the transferred interest are limited to transfers that occur more than three years before the transferor's death.

### **1. The Proposed Rule Creates Phantom Assets in a Decedent's Gross Estate**

We are concerned that including the value of a lapse of an interest in a decedent's gross estate after the interest was transferred amounts to the inclusion of a phantom asset in the decedent's gross estate. While sections 2035 through 2043 all include provisions for the inclusion of the value of certain assets in a decedent's gross estate, there is nothing in section 2704 that would require such an inclusion if such asset was not otherwise a part of the decedent's gross estate. Although we recognize the power given to Treasury and the IRS by section 2704 to apply it to rights similar to voting and liquidation rights, we ask Treasury and the IRS to reconsider whether they should use this power to create phantom assets in a decedent's gross estate when the statute does not call for such treatment.

### **2. The Proposed Rule is Unnecessary**

The proposed rule is unnecessary given that a transfer of an interest in a family controlled entity to another member of the family is subject to the disregarded restrictions contained in Prop. Reg. § 25.2704-3(b)(1). If the transfer was subject to these regulations at the time of transfer, it is unnecessary to have the three-year rule as the value is the same. Although Treasury and the IRS have indicated in comments at recent appearances before groups affected by these proposed regulations that practitioners and taxpayers should not read these proposed regulations as broadly as taxpayers have claimed, the lack of specificity in the proposed regulations does little to calm fears that these disregarded restrictions do not have broad applicability. If the value of the lapse is brought back into the estate, the same value is subject to the transfer tax twice without a mechanism to prevent such double taxation.

### **3. The Proposed Rule Should Not Apply to Transfers Before the Final Regulations are Issued**

Proposed Reg. § 25.2704-4(b)(1) (regarding the effective date of the regulations) provides that the amendments to Prop. Reg. § 25.2704-1 apply to "lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in Federal Register." Specifically included is the "second and last sentences of paragraph (c)(1) . . ." The last sentence of paragraph (c)(1) contains the three-year look back rule.

We are concerned that Treasury and the IRS may apply the three-year look back rule to transfers that occurred three years prior to the effective date of the final regulations. If the three-year look back rule were to apply to such transfers, it would unfairly subject taxpayers to the provisions of new final regulations even though they made transfers prior to the date the final regulations are issued. We think that no regulations should have retroactive effect, and it appears that, as currently drafted, the proposed regulations would have a retroactive effect for transfers caught by the three-year rule.

#### **4. Clarification is Needed Regarding of How the Three-year Rule Applies to Transfers**

Pursuant to section 2704(a)(2), the amount of the transfer is calculated as the FMV of all of the interests held by the individual immediately prior to the lapse over the FMV of these interests after the lapse. Treas. Reg. § 25.2704-1(d) restates section 2704(a)(2) as follows:

The amount of the transfer is the excess if any of:

(1) The value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right was nonlapsing); over

(2) The value of the interests described in the preceding paragraph immediately after the lapse (determined as if all such interests were held by one individual).

We are not clear as to how section 2704(a)(2) would apply to a transfer that is subject to the three-year rule. The first question that arises is the proper date to apply section 2704(a)(2): (1) the date of transfer; or (2) the date of death. As the purpose of section 2704(a) is to measure the decline in value due to a transfer, we think the date of transfer is the proper date to apply section 2704(a)(2). To use the date of death values would allow appreciation or depreciation to enter into the calculation, which is clearly not contemplated by section 2704(a)(2).

The second question that arises is how the taxpayer should calculate the decrease in the lapse. The addition of the parentheticals in Treas. Reg. § 25.2704-1(d) to the calculation are the source of our confusion. The examples in the current regulations and as amended by the proposed regulations do not contain an example regarding the calculation of the amount subject to gift or estate tax under section 2704(a)(2).

**Example:** On April 1 of Year 1 (after the final regulations are issued), Mother owns 100 shares of XYZ Corporation which represent 100 percent of its outstanding shares. The operating agreement of XYZ Corporation contains restrictions on the right to liquidate a shareholder's interest in the corporation unless a majority of the shareholders consent to the liquidation. XYZ Corporation has an appraised value of \$100,000 which means that each share of XYZ has a value of \$1,000 per share. On this same date, Mother transfers 25 shares to Daughter and 25 shares to Son. After applying applicable discounts for lack of control and lack of marketability, it is determined that the transferred shares have a value of \$700 per share. Mother dies on January 30 of Year 2.

Applying Prop. Reg. § 25.2704-1(d), we conclude that the value of all interests held by the individual immediately prior to the lapse is \$100,000, and the value of all interests after the lapse is \$100,000. Therefore, the decrease is zero. This result is the case in all instances if we were to treat the Mother as holding the interests both before and after the transfer. We assume this result is not the intended result.

Regarding partnerships, we think that the final regulations should provide clarity that when a partnership interest is gifted within three years of death and is “pulled back” into the gross estate, the outside basis in the partnership interest will increase particularly when the partnership has a section 754 election in effect. To the extent that this rule increases the outside basis in the partnership, we request clarity on whether the partnership must adjust the inside basis of its assets under section 743.

## **VI. Transfers Subject to Applicable Restrictions**

### **A. Lapse of Applicable Restriction**

The AICPA recommends that Treasury and the IRS limit the time period for the lapse of an applicable restriction or the ability to remove an applicable restriction, triggering the application of section 2704(b)(2) to no more than three years.

Under section 2704(b)(1), any “applicable restriction” is disregarded when valuing an interest that one family member, who holds an interest in a corporation or partnership, transfers to another family member (or for the benefit of a family member) and together the transferor and members of his family control the entity immediately before the transfer.

Section 2704(b)(2) defines an applicable restriction 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 the transferor or the transferor’s family, either alone or collectively, may remove it.

Proposed Reg. § 25.2702-2(b)(3) provides:

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. . .

Section 2704(b) does not provide a time period in which a lapse of a restriction must occur or when the interest holder must exercise the power to remove for treatment as an applicable restriction. The proposed regulations indicate that the time period is indefinite.

We are concerned that if the proposed regulations provide for an indefinite period, section 2704 will affect legitimate, non-tax reasons for future planning for an entity. We think that section 2704(b) was enacted to affect situations in which a transfer (either during life or at death) would immediately cause a lapse or a very short period would exist within which the interest holder would remove a restriction.

The preamble regarding Prop. Reg. § 25.2704-1 provides that a three-year bright line test is necessary in applying section 2704(a) to prevent death-bed planning regarding the transfer of an interest in an entity (which does not result in the rights with respect to the transferred interest being restricted or eliminated) that results in the loss of the interest holder's ability to compel the entity to acquire his or her interest. If Treasury and the IRS think that three years is sufficient to prevent manipulation of the FMV of an interest for section 2704(a) purposes that time should suffice for section 2704(b) purposes. Therefore, we recommend that Treasury and the IRS limit the applicable period of section 2704(b) to no more than three years.

## **B. Commercially Reasonable Restrictions**

The AICPA recommends that Treasury and the IRS expand the commercially reasonable restriction exception in Prop. Reg. § 25.2704-2(b)(4)(i) to include a “hypothetical” creditor.

Section 2704(b)(3) provides for exceptions to the definition of “applicable restrictions.” Section 2704(b)(3)(A) provides that an applicable restriction does not include any commercially reasonable restriction “which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee or a member of the family of either.”

Proposed Reg. § 25.2704-2(b)(4)(i) states:

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.

A “commercially reasonable” restriction contemplates a restriction that is made at arm's-length in the ordinary course of business. However, both the statute and the proposed regulations provide that an actual creditor of the entity must require the restriction. The AICPA suggests that Treasury and the IRS liberalize this provision (much as Treasury and the IRS did in Treas. Reg. § 25.2704-1(c)(1) regarding the exception to the lapse of a liquidation right) such that the exception is applied to a “hypothetical” creditor of the entity. Thus, if an unrelated party-creditor would otherwise require the restriction as a part of a commercial lending arrangement, Treasury and the IRS should not consider the restriction as an “applicable restriction.”

## **C. Right to Put Interest to an Entity**

The AICPA recommends that Treasury and the IRS clarify and provide in the final regulations more specifics as to when the put right in Prop. Reg. § 25.2704-2(b)(4)(iv) applies, including several examples.

For the reasons set forth above, we request that Treasury and the IRS provide more specifics as to when the put right in Prop. Reg. § 25.2704-2(b)(4)(iv) applies, including several examples.

## VII. Disregarded Restrictions

### A. Addition of Disregarded Restrictions to Existing Restrictions Covered by Section 2704(b)

The AICPA recommends that Treasury and the IRS formally withdraw Prop. Reg. § 25.2704-3.

As previously stated, section 2704(b)(2) defines an applicable restriction 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 the transferor or the transferor's family, either alone or collectively, may remove it. Regarding the highlighted language, in *Kerr v. Commissioner*,<sup>15</sup> the Tax Court ruled that a restriction on the holder of an interest in a partnership on the right to withdraw from the partnership was not a restriction that limited the ability of the entity to liquidate. Thus, such a restriction was not an applicable restriction within the meaning of section 2704(b). The Fifth Circuit agreed.<sup>16</sup> The addition of Prop. Reg. § 25.2704-3 is an attempt to overrule *Kerr* and expand the list of restrictions covered by section 2704(b).

The AICPA appreciates that section 2704(b)(4) grants Treasury and the IRS permission to provide other restrictions that are disregarded in determining the value of an interest in a family business if the restriction has the effect of reducing the value of the transferred interest for gift and estate tax purposes but does not ultimately reduce the value of such interest to the transferee. However, we think that any grant of authority under the statute must be in keeping with the spirit of section 2704(b).

The definition of an applicable restriction in section 2704(b)(2) focuses on a restriction that limits the ability of the family business to liquidate. The “disregarded restrictions” in Prop. Reg. § 25.2704-3 focus on the ability of a holder of an interest in the family business to liquidate his or her interest. While we recognize the authority Congress gave to Treasury and the IRS to expand the list of restrictions that are subject to section 2704(b), we question whether Prop. Reg. § 25.2704-3 is within the spirit of section 2704(b).

We also question whether Treasury and the IRS thought they had authority under the grant of section 2704(b)(4) to issue Prop. Reg. § 25.2704-3. In its 2003-2004 Priority Guidance Plan, Treasury and the IRS first listed a project under section 2704 entitled “Guidance under Section 2704 regarding the liquidation of an interest.” In 2009, the [President's budget proposals for the 2010 fiscal year](#) listed a proposal for section 2704 entitled “Modify Rules on Valuation Discounts.” The proposal sought legislation to clarify or enlarge Treasury's authority to provide a new category of “disregarded restrictions” under section 2704 that the interest holder would ignore in valuing an interest in a family-owned business. This proposal was included in the [President's budget proposals for fiscal years 2010-2013](#), but was removed for fiscal year 2014. Presumably, Prop. Reg. § 25.2704-3 embodies this statutory proposal. Thus, at some point, we presume there were leaders in Treasury and the IRS who thought Treasury and the IRS could not issue Prop. Reg. § 25.2704-3 without additional statutory authority. Indeed, after the proposed regulations were released, bills were introduced in both the House of Representatives ([H.R. 6042](#)

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<sup>15</sup> *Kerr v. Commissioner*, 113 T.C. 449 (1999).

<sup>16</sup> *Kerr v. Commissioner*, 292 F.3d 490 (5th Cir. June 10, 2002).

and [H.R. 6100](#)) and Senate ([S. 3436](#)) that would give no effect to the proposed regulations. H.R. 6100 had 92 co-sponsors at the end of the 114<sup>th</sup> Congress.

We do not believe that Prop. Reg. § 25.2704-3 is within the spirit of section 2704 and the Congressional intent granted to Treasury and the IRS under section 2704(b)(4). Thus, we recommend that Treasury and the IRS formally withdraw Prop. Reg. § 25.2704-3.

### **B. Lapse of a Disregarded Restriction**

The AICPA recommends that Treasury and the IRS limit the time period for the lapse of a disregarded restriction or the ability to remove a disregarded restriction to no more than three years.

For the reasons stated above, we request that Treasury and the IRS limit the time period for the lapse of a disregarded restriction or the ability to remove a disregarded restriction to no more than three years.

### **C. Commercially Reasonable Restrictions**

The AICPA recommends that Treasury and the IRS expand the commercially reasonable restriction exception in Prop. Reg. § 25.2704-3(b)(5)(ii) to include a “hypothetical” creditor.

For the reasons stated above, we request that Treasury and the IRS include a “hypothetical” creditor in the commercially reasonable restriction exception in Prop. Reg. § 25.2704-3(b)(5)(ii).

### **D. Right to Put Interest to an Entity**

The AICPA recommends Treasury and the IRS clarify and provide in the final regulations more specifics as to when the put right in Prop. Reg. § 25.2704-3(b)(6) applies, including several examples.

Under the exceptions to the disregarded restrictions contained in Prop. Reg. § 25.2704-3 is one for the right to put an interest to an entity. Prop. Reg. § 25.2704-3(b)(5)(v) states that “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.” Prop. Reg. § 25.2704-3(b)(6) provides that a “put right” is a right, enforceable under applicable local law, to receive from the entity or its 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 property with a value that is at least equal to the minimum value of the interest determined as of the date of liquidation or redemption.

Many of our members have interpreted this language to mean that if there is a transfer of an interest in a family-owned business to a family member, the interest holder is to determine the value of the transferred interest as if it included a put right at “minimum value” (as such term is defined in Prop. Reg. § 25.2704-3(b)(1)(ii)) because any restriction on the right to withdraw that is more restrictive than the put right set forth in the proposed regulations is disregarded. We also understand that this is a common interpretation among many other practitioners in the estate planning community.

We understand that on many occasions after the proposed regulations were published, representatives from Treasury and the IRS have stated that such an interpretation is incorrect and overly broad. However, if this is a common interpretation among many practitioners in the estate planning community as it is currently drafted, we think it is quite possible that IRS agents may form such an interpretation of this put right as well. Therefore, we request that Treasury and the IRS clarify and provide more specifics as to when this put right in Prop. Reg. § 25.2704-3(b)(6) applies, including several examples.