November 2, 2016

Mr. John D. MacEachen,
Office of the Associate Chief Counsel (Passthroughs and Special Industries)
CC:PA:LPD:PR (REG-163113-02), Room 5203
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

Via e-mail: john.d.maceachen@irscounsel.treas.gov

Re: Comments on Proposed Regulations under Section 2704
of the Internal Revenue Code [REG-163113-02]
(Federal Register Number: 2016-18370)

Dear Mr. MacEachen:

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 26,000 CPAs in public practice, business, government and education, is pleased to offer its comments concerning the Proposed Regulations under Section 2704 of the Internal Revenue Code [REG-163113-02].

The NYSSCPA's Estate Planning Committee has reviewed and prepared the attached comment letter. If you would like additional discussion with us, please contact Ruth Raftery, chair of the Estate Planning Committee, at 646-677-3146, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

F. Michael Zovistoski
President

Attachment

NEW YORK STATE SOCIETY OF

CERTIFIED PUBLIC ACCOUNTANTS

Comments on Proposed Regulations Under Section 2704 of the Internal Revenue Code [REG-163113-02]

(Federal Register Number: 2016-18370)

November 2, 2016

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The New York State Society of Certified Public Accountants

Comments on Proposed Regulations Under Section 2704 of the Internal Revenue Code [REG-163113-02]

The NYSSCPA respectfully submits this comment letter setting forth its comments in response to the notice of proposed rulemaking and notice of public hearing issued by the IRS and the Treasury Department on August 4, 2016[1] containing proposed regulations (the "Proposed Regulations") under section 2704 of the Internal Revenue Code of 1986, as amended (the "Code"),[2] concerning the valuation of interests in corporations and partnerships for estate, gift and generation-skipping transfer ("GST") tax purposes.[3]

This comment letter is organized in four parts. Parts I through III request clarification of various matters set forth in the Proposed Regulations. Thereafter, in Part IV, we explain the basis for our concern that Prop. Reg. § 25.2704-3 has exceeded Congress's grant of authority to Treasury under the plain language of section 2704(b)(4), is unsupported by adequate agency fact-finding, and therefore would be invalid if it were finalized in its present form.

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1 Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest, 81 Fed. Reg. 150, 51413 (proposed August 4, 2016) (to be codified at 26 C.F.R. pt 25).

2 The Proposed Regulations are set forth at the following link: https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-18370.pdf

3 Unless otherwise indicated, section references in this comment letter are to the Code and the Treasury Regulations promulgated thereunder.

I. <u>Disregarded Restrictions</u>

A. Overview of Prop. Reg. § 25.2704-3

Prop. Reg. § 25.2704-3 establishes a new category of restrictions known as "disregarded restrictions." Prop. Reg. § 25.2704-3(a) provides that "if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family and the transferor and/or members of the transferor's family control the entity immediately before the transfer, *any restriction described in paragraph (b) of this section is disregarded, and the transferred interest is valued as provided in paragraph (f) of this section*." (emphasis added) The Proposed Regulations clarify that these rules apply to limited liability companies, in addition to partnerships and corporations, and that the detailed family attribution rules of Treas. Reg. § 25.2701-6 apply as well.

Prop. Reg. § 25.2704-3(b)(1) states that, in general, "[t]he term <u>disregarded restriction</u> means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to paragraph (b)(4) of this section), either alone or collectively." (emphasis in original)

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

(ii) The provision limits or permits the limitation (such as through amendment) of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a "***minimum value***." The term "minimum value" means the interest's share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined for federal estate or gift tax purposes, as the case may be, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those deductions were claims against an estate. (As further discussed below, the implications of this cross-reference to section 2053 are not entirely clear.)

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

(iv) The provision authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property. Solely for this purpose, except as provided in the following sentence, a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related to either the entity or any holder of an interest in the entity, is deemed *not* to be property. The only exception to the exclusion of a note or other obligation as property arises in the case of an entity that is engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, in which case to the extent that the liquidation proceeds are not attributable to passive assets, such proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds.

For purposes of determining whether the restriction either lapses after the transfer or can be removed by the transferor or any member of the transferor's family either alone or collectively, Prop. Reg. § 25.2704-3(b)(4) provides that the interests of nonfamily members are themselves "disregarded" unless (A) the interest has been held by the nonfamily member for at least three years immediately before the transfer; (B) the nonfamily member holds at least a 10% equity interest in the entity; (C) the total of the equity interests held by all nonfamily members constitutes at least 20 percent of all equity interests in the entity; *and* (D) each nonfamily member has a "put right" to obtain a pro-rata share of the entity's "minimum value" within six months of providing notice of an intent to withdraw.

Prop. Reg. § 25.2704-3(b)(5) provides that the following types of restrictions will ***not*** be considered "disregarded restrictions," and therefore can potentially be considered in valuing the transferred interest:

(i) an "applicable restriction" as defined in Prop. Reg. § 25.2704-2;

(ii) "a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations in the form of debt or equity" (whether a person is considered "unrelated" is generally determined by reference to section 267(b));

(iii) certain very limited restrictions imposed or required to be imposed by federal or state law;

(iv) an "option, right to use property, or agreement that is subject to section 2703" (as further discussed, the implications of this cross-reference to section 2703 are not entirely clear); and

(v) certain rights to put interests to the entity that are described in Prop. Reg. § 25.2704-3(b)(6). The term "put right" is defined to mean a right on liquidation or redemption of the holder's interest, enforceable under applicable local law, to receive cash and/or other property from the entity or from one or more other holders within six months after the date the holder gives notice of the holder's intent to withdraw with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption. For this purpose, 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, except in the case of certain entities engaged in trades or businesses that meet certain criteria. (Prop. Reg. § 25.2704-3(b)(6))

According to Prop. Reg. § 25.2704-3(f), if a restriction is disregarded under Prop. 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. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized."

The new rules of Prop. Reg. § 25.2704-3 governing "disregarded restrictions" are proposed to apply to "transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the Federal Register." (Prop. Reg. § 25.2704-4(b)(3))

B. Comments

1. Determination of Minimum Value – Prop. Reg. § 25.2704-3(b)(1)(ii)

■ ***<u>Effect of Cross-Reference to Section 2053</u>***

Prop. Reg. § 25.2704-3(b)(1) states that, in general, "[t]he term <u>disregarded restriction</u> means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in any more or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to paragraph (b)(4) of this section), either alone or collectively." (emphasis in original) These restrictions include the following one that is set forth in Prop. Reg. § 25.2704-3(b)(1)(ii):

> *"The provision limits or permits the limitation (such as through amendment) of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a "**minimum value**." The term "minimum value" means the interest's share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined for federal estate or gift tax purposes, as the case may be, of the property held by the entity reduced by the outstanding obligations of the entity.* ***Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those deductions instead were claims against an estate."*** (Prop. Reg. § 25.2704-3(b)(1)(ii)) (emphasis added)

It is unclear what the last sentence of the above quoted provision means in the context of these Proposed Regulations. Among other things, what is the effect, if any, of the general requirement of Reg. § 20.2053-1(d)(1) that a claim must be "actually paid" in order to be deducted? It would appear that, by using the parenthetical "(if paid)" in Prop. Reg. § 25.2704-3(b)(1)(ii), Treasury's intent is to dispense with the "actually paid" general requirement of Reg. § 20.2053-1(d)(1). If this construction is correct, it should be clarified.

Another issue warranting clarification arises from the fact that Reg. § 20.2053-1(d)(5) authorizes a "protective claim for refund" to preserve the estate's right to claim a refund in connection with claims that are not paid by the estate until after the federal estate tax return has been filed. Such claims do not meet the requirement for deductibility for estate tax purposes at the time the estate tax return is filed -- due, for example, to either their contingent nature or the fact that their amounts were not ascertainable when the estate tax return was filed -- but then may later become ascertainable due to subsequent events. The incorporation into the Proposed Regulations of this aspect of the section 2053 regulations should be considered as well.

Further, clarification is warranted concerning the incorporation of Reg. § 20.2053-4(b) with respect to counterclaims. This provision states that "[i]f a decedent's gross estate includes one or more claims or causes of action and there are one or more claims against the decedent's estate in the same or a substantially related matter, or, if a decedent's gross estate includes a particular asset and there are one or more claims against the decedent's estate integrally related to that particular asset, the executor may deduct on the estate's United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) the current value of the claim or claims against the estate, even though payment has not been made," provided that certain requirements have been satisfied. Among other requirements is that "the aggregate value of the related claims or assets included in the decedent's gross estate exceeds 10 percent of the decedent's gross estate." (Reg. § 20.2053-4(b)(vi)) This 10 percent of gross estate threshold requirement does not lend itself well to the context of the Proposed Regulations. We therefore recommend that the Proposed Regulations clarify that this 10 percent threshold does not apply for purposes of the incorporation by reference of Section 2053.

2. Meaning of Right "Subject to Section 2703" – Prop. Reg. § 25.2704-3(b)(5)(iv)

Prop. Reg. § 25.2704-3(b)(5) provides that certain categories of restrictions will ***not*** be considered "disregarded restrictions," and therefore can potentially be considered in valuing the transferred interest. Included among them is an "option, right to use property, or agreement that is subject to section 2703." (Prop. Reg. § 25.2704-3(b)(5)(iv)) This raises the question of what it means for an option, right to use property, or agreement to be "subject to section 2703." Does this refer to an option, right to use property, or agreement that is subject to review under section 2703 and is ultimately invalidated for transfer tax purposes under that section? Or, alternatively, does it also extend to an option, right to use property, or agreement that is subject to scrutiny under section 2703 and successfully withstands such scrutiny? We note that the preamble to the Proposed Regulations asserts (on page 16) that there is no overlap between section 2703 and section 2704(b). Taking into account the language of the preamble, it would appear that the former (and more limited in scope) interpretation may have been intended by Treasury, and if so, that should be clarified.

3. Guidance on Valuation Where There is a Disregarded Restriction — Prop. Reg. § 25.2704-3(f)

a. General Guidance on Valuation Principles

Guidance is needed on how interests are to be valued where there is a disregarded restriction. According to Prop. Reg. § 25.2704-3(f), if a restriction is disregarded under Prop. 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. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized."

This raises a host of questions, and there has been considerable speculation that the implication of the Proposed Regulations is to read "deemed put rights" into the governing documents and local law for valuation purposes as if the interest holder were granted the affirmative right to withdraw its interest in exchange for a pro-rata share of the entity's "minimum value" upon six months' notice. Such an interpretation, however, does not appear to be indicated by the Proposed Regulations, which instead call for the fair market value of the transferred interest to be "determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law or otherwise." (Prop. Reg. § 25.2704-3(f)) The Proposed Regulations appear to suggest that the disregarded restriction is simply to be "disregarded" by an appraiser who shall accordingly assume that an arm's length negotiation will then ensue between the entity's fiduciaries and other interest holders in the entity on the one hand, and the transferee on the other hand, concerning the terms of redemption or withdrawal, taking into account the relative lack of bargaining power that the transferee may possess under those hypothetical circumstances. Presumably, the appraiser would be required to apply the traditional willing buyer–willing seller test to this hypothetical negotiation, as set forth in Treas. Reg. *§* 20.2031-1(b) for estate tax purposes (and in Treas. Reg. § 25.2512-1 for gift tax purposes), which states:

> *"The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate." (Treas. Reg.* § *20.2031-1(b))*

In applying the willing buyer– willing seller test to this hypothetical negotiation, the appraiser presumably will need to take into account the following factors:

- Whether, and to what extent, the entity is engaged in an active trade or business;
- The extent to which the assets of the entity are liquid or illiquid;
- The risk that the holder of the interest may be unable to negotiate a favorable buyout;
- The risk that a hypothetical willing buyer would incur in dealing with an unrelated family;
- The transferee's lack of ability to control or influence the entity as a going concern, including the resulting availability of a lack-of-continuity discount;
- In the case of an operating business, the illiquidity or other obstacles to the business's redemption of the interest;
- In the case of an operating business, the possible lesser relevance of a redemption or asset-based approach to valuation; and

- In the case of both an operating business and an entity that holds real estate, the fact that the managers or majority owners may not consider a partial liquidation to be in the best interests of the entity.

b. Effect of Disregarded Restriction on Other Interest Holders in Valuing the Disregarded Restriction

The effect of a disregarded restriction upon other holders of interests in the entity is also relevant to the valuation analysis. It would appear that, for valuation purposes, the hypothetical demands of other interest holders to have their respective interests redeemed or liquidated in exchange for a proportionate share of the entity's assets should likewise be taken into account without regard to the disregarded restriction. As a result, the transferee, facing this competition from the other interest holders, would likely be willing to accept a reduced payout (*i.e.*, a further discount) in exchange for its interest.

4. Guidance on Commercially Reasonable Restrictions

Prop. Reg. § 25.2704-3(b)(5) enumerates various types of restrictions that will ***not*** be considered "disregarded restrictions," and therefore can potentially be considered in valuing the transferred interest. These include "(ii) a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations in the form of debt or equity."[4] We believe that it would be helpful if Treasury were to provide examples illustrating what is meant by the phrase "a commercially reasonable restriction on liquidation."

5. Guidance on Non-Gift Transfers

[4] The Proposed Regulations state that whether a person is considered "unrelated" is generally determined by reference to section 267(b).

It would also be helpful if Treasury could provide guidance that specifically addresses the effect of disregarded restrictions on transactions that would not otherwise constitute gifts within the meaning of section 2511 and the regulations thereunder. In this connection, Prop. Reg. § 25.2704-3(g), Example 6 provides as follows:

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

The application of these same principles to the following transactions would appear to be fully consistent with this Example 6 and, accordingly, the appropriate treatment should be clarified:

- The satisfaction in kind of an annuity amount by a grantor retained annuity trust (GRAT) with an entity interest that has a disregarded restriction;
- The satisfaction in kind of a debt obligation with an entity interest that has a disregarded restriction; and
- The exercise of a power of substitution within the meaning of section 675(4)(C) that involves the exchange of an interest in an entity that has a disregarded restriction.

6. Grandfathering for Transfers of Property Subject to Restrictions Created on or before October 8, 1990

The rules of Prop. Reg. § 25.2704-3 apply to "transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the Federal Register." (Prop. Reg. § 25.2704-4(b)(3)) It is unclear how these rules could potentially apply to transfers of property subject to restrictions created *on or before October 8, 1990*, and more specifically, under what circumstances, if any, a post-October 8, 1990 modification to an entity or other agreement, or to applicable state law, could be deemed to implicate these proposed rules with respect to an otherwise grandfathered transfer. Accordingly, clarification of this point is required.

7. Extending the Effective Date for Disregarded Restrictions to 90 Days after Final Regulations are Published in the Federal Register

Finally, Prop. Reg. § 25.2704-4(b)(3) calls for an effective date with respect to the disregarded restrictions of Prop. Reg. § 25.2704-3 that is 30 days after final regulations are published in the Federal Register. Given the tremendous complexity of these proposed new rules, we respectfully submit that a 90 day period would be much fairer to both taxpayers and their advisors to allow a sufficient amount of time for advisors to fully digest the final regulations so that they can properly advise their clients.

II. Applicable Restrictions

A. Overview of Prop. Reg. § 25.2704-2

The Proposed Regulations expand the scope of an “applicable restriction” under Treas. Reg. § 25.2704-2. Prop. Reg. § 25.2704-2(a) provides that if an interest in an entity, “whether domestic or foreign, is transferred to or for the benefit of a member of the transferor’s family, and the transferor and/or members of the transferor’s family control the entity immediately before the transfer, any applicable restriction is disregarded in valuing the transferred interest.” The Proposed Regulations clarify that these rules apply to limited liability companies, in addition to partnerships and corporations, and that the detailed family attribution rules of Treas. Reg. § 25.2701-6 apply as well.

Prop. Reg. § 25.2704-2(b)(1) defines the term “applicable restriction” as “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.” (Prop. Reg. § 25.2704-3 instead governs restrictions on the ability to liquidate a particular holder’s interest *in the entity*.) The applicable restriction may be imposed under the entity’s governing documents or by local law.

Prop. Reg. § 25.2704-2(b)(4) provides that the following restrictions on the ability to liquidate an entity are *excluded* from the definition of an applicable restriction:

(i) “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 defined by reference to section 267(b));

(ii) certain restrictions imposed by federal or state law;

(iii) an “option, right to use property, or agreement that is subject to section 2703” (as further discussed, the implications of this cross-reference to section 2703 are not entirely clear); and

(iv) a “put right” as defined in Prop. Reg. § 25.2704-3(b)(6).

Prop. Reg. § 25.2704-2(e) addresses the consequences of an applicable restriction and provides that “[i]f an applicable restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction (whether in the governing documents, applicable law, or both) does not exist.” (Prop. Reg. § 25.2704-2(e))

The provisions of the Proposed Regulations dealing with applicable restrictions apply to transfers of property subject to restrictions created after October 8, 1990 occurring on or after the date these regulations are published as final regulations in the Federal Register.

B. Comments

1. Meaning of Right “Subject to Section 2703" – Prop. Reg. § 25.2704-2(b)(4)(iii)

Prop. Reg. § 25.2704-2(b)(4) provides that certain categories of restrictions will ***not*** be considered “applicable restrictions,” and therefore can potentially be considered in valuing the transferred interest. Included among them is an “option, right to use property, or agreement that is subject to section 2703.” (Prop. Reg. § 25.2704-2(b)(4)(iii)) This raises the question of what it means for an option, right to use property, or agreement to be “subject to section 2703.” Does this refer to an option, right to use property, or agreement that is subject to review under section 2703 and is ultimately invalidated for transfer tax purposes under that section? Or, alternatively, does it also extend to an option, right to use property, or agreement that is subject to scrutiny under section 2703 and successfully withstands such scrutiny? We note that the preamble to the Proposed Regulations asserts (on page 16) that there is no overlap between section 2703 and section 2704(b). Taking into account the language of the preamble, it would appear that the former (and more limited in scope) interpretation may have been intended by Treasury. If this construction is correct, it should be clarified.

2. Guidance on Commercially Reasonable Restrictions

Prop. Reg. § 25.2704-2(b)(4) enumerates various types of restrictions that will ***not*** be considered "applicable restrictions," and therefore can potentially be considered in valuing the transferred interest. These include "(i) 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."[5] As in the case of "disregarded restrictions," we believe that it would be helpful if Treasury were to provide examples illustrating what is meant by the phrase "a commercially reasonable restriction on liquidation," perhaps cross-referencing to examples to be set forth with respect to "disregarded restrictions."

3. Guidance on Non-Gift Transfers

It would also be helpful if Treasury could provide guidance that specifically addresses the effect of applicable restrictions on transactions that would not otherwise constitute gifts within the meaning of section 2511 and the regulations thereunder. This would include the following:

[5] The Proposed Regulations define an "unrelated person" in this context by reference to section 267(b).

- The satisfaction in kind of an annuity amount by a grantor retained annuity trust (GRAT) with an entity interest that has an applicable restriction;
- The satisfaction in kind of a debt obligation with an entity interest that has an applicable restriction; and
- The exercise of a power of substitution within the meaning of section 675(4)(C) that involves the exchange of an interest in an entity that has an applicable restriction.

4. Grandfathering for Transfers of Property Subject to Restrictions Created on or Before October 8, 1990

The rules of Prop. Reg. § 25.2704-2 apply to "transfers of property subject to restrictions created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register." (Prop. Reg. § 25.2704-4(b)(2)) It is unclear how these rules could potentially apply to transfers of property subject to restrictions created *on or before October 8, 1990*, and more specifically, under what circumstances, if any, a post-October 8, 1990 modification to an entity or other agreement, or to applicable state law, could be deemed to implicate these proposed rules with respect to an otherwise grandfathered transfer. Accordingly, clarification of this point is required.

III. <u>Lapses of Voting or Liquidation Rights</u>

A. Overview of Prop. Reg. § 25.2704-1

The Proposed Regulations expand the lapse provisions of § 25.2704-1 and create a bright-line rule that can potentially produce estate tax inclusion of the value that is attributable to lapsed voting or liquidation rights if a person transfers an interest in a family-controlled entity and dies within three years of such transfer. As currently written, the Proposed Regulations could cause this addition in value, or "clawback," to apply to transactions occurring up to three years before the date that the Proposed Regulations are published as final regulations in the Federal Register. This would suggest that this clawback could potentially apply to transactions occurring substantially before the date of issuance of the *Proposed Regulations*.

Prop. Reg. § 25.2704-1(a)(1) provides that "the lapse of a voting or liquidation right in an [entity], whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is controlled by the holder and/or members of the holder's family immediately before and after this lapse." Once again, the term "entity" for this purpose includes corporations, partnerships and limited liability companies, and the detailed family attribution rules of Treas. Reg. § 25.2701-6 apply as well. In the case of a limited liability company, the right of a member to participate in company management is a voting right. 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 purposes of testing the ability of the holder's family to liquidate, an interest held by a person other than a member of the holder's family may be disregarded applying the analysis under Prop. Reg. § 25.2704-3(b)(4) (which applies to "disregarded restrictions") as if such section 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. (Prop. Reg. § 25.2704-1(c)(2)(i)(B))

Prop. Reg. § 25.2704-1(a)(5) also addresses the issue of "assignee interests" and states that "[a] transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights." The Proposed Regulations give the example of a transferee of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights associated with the transferred interest.

Significantly, the Proposed Regulations will cause certain transfers of entity interests within three years of death to trigger this expanded new rule. Prop. Reg. § 25.2704-1(c)(1) states that "[e]xcept as otherwise provided, a transfer of an interest occurring more than three years before the transferor's death that results in the lapse of a voting or liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated." However, "[t]he lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a)." (Prop. Reg. § 25.2704-1(c)(1)) The Proposed Regulations give two examples to illustrate this point, which are set forth in Part B of this section of the Report.

The effective date provisions of Prop. Reg. § 25.2704-4(b)(1) state that Prop. Reg. § 25.2704-1 applies to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register. Prop. Reg. § 25.2704-1(c)(1), in turn, states that "[t]he lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a)." This appears to indicate that transactions entered into as far back as three years prior to the date of death of a decedent who dies subsequent to the finalization of these regulations may be subject to this clawback -- even though the transactions involved may have *preceded* Treasury's release of the Proposed Regulations on August 2, 2016.

B. Comments

1. Deemed Lapses as a Result of Transactions Occurring More than Three Years Before Death – Prop. Reg. § 25.2704-1(c)(1), -1(f), Examples 4 and 7

As discussed above, the Proposed Regulations will cause certain transfers of entity interests within three years of death to trigger this expanded new rule. Prop. Reg. § 25.2704-1(c)(1) states that "[e]xcept as otherwise provided, a transfer of an interest occurring more than three years before the transferor's death that results in the lapse of a voting or liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated." However, "[t]he lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a)." (Prop. Reg. § 25.2704-1(c)(1)) The Proposed Regulations provide the following examples to illustrate this point:

> *Example 4. * * * More than three years before D's death, D [who had held an 84% interest in an entity known as "Y," the by-laws of which require a 70% vote by interest to liquidate] transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(b) does not apply to the loss of D's ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death.* ***However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.*** (Prop. Reg. § 25.2704-1(f), Example 4) (emphasis added)

> *Example 7. * * * More than three years before D's death, D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D's death. * * ** ***However, had the transfer occurred within three years of D's death, the transfer would have been treated as the lapse of D's liquidation right with respect to the common stock occurring at D's death.*** (Prop. Reg. § 25.2704-1(f), Example 7) (emphasis added)

As stated above, Prop. Reg. § 25.2704-1 applies to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register. (Prop. Reg. § 25.2704-4(b)(1)) Prop. Reg. § 25.2704-1(c)(1) states that "[t]he lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a)." This raises the possibility that transactions entered into three years prior to the date of death of a decedent that is subsequent to the finalization of these regulations may be subject to this clawback. This could apply even to transactions that occurred *prior to* August 2, 2016, the date of issuance of the Proposed Regulations.

We believe that this retroactive result is fundamentally unfair and question whether this retroactive consequence was in fact specifically intended by Treasury. We accordingly request that Treasury revise the effective date provisions of Prop. Reg. § 25.2704-4(b)(1) to provide that, notwithstanding any other provision to the contrary, Prop. Reg. § 25.2704-1 shall not apply to any transactions that are entered into prior to the date that the Proposed Regulations are published as final regulations in the Federal Register.

2. Marital and Charitable Deduction Harmonization for Section 2704(a) Clawback Amount

We are concerned that the amount includible in the gross estate under section 2704(a) is a "phantom asset" and, as such, may not be eligible to fund a disposition qualifying for the estate tax marital deduction under section 2056, or the estate tax charitable deduction under section 2055. If the addition in value under section 2704(a) were considered "not to pass" for estate tax marital or charitable deduction purposes, this could potentially produce a mismatch of values between (1) the decedent's gross estate for estate tax purposes (which would include the section 2704(a) clawback amount) and (2) the decedent's estate tax marital or charitable deduction attributable to the fair market value of the property that actually passes to the surviving spouse or to charity, as the case may be (which would *not* include the Section 2704(a) addition in value).[6] Cf. Estate of Turner v. Commissioner, 138 T.C. No. 14 (2012) (Turner II) (illustrating an addition in value for estate tax inclusion purposes under section 2036 that is ineligible to qualify for the estate tax marital deduction).[7]

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[6] Furthermore, the effects of this mismatch between gross estate and marital or charitable deduction values resulting from this section 2704(a) clawback can be severely intensified where the disposition to the surviving spouse or to charity is from residue and the Will's estate tax apportionment clause (or in the absence thereof, the default estate tax apportionment provisions under applicable state law) apportions the estate tax attributable to this Section 2704(a) addition in value against residue. This is due to the interrelated estate tax calculation that results where assets that would otherwise qualify for the estate tax marital deduction or charitable deduction are used to fund the payment of estate taxes, which increases the estate tax, thereby reducing the marital or charitable deduction, and so on and so forth in a circular manner. As a result of the Proposed Regulations' creation of this addition in value for estate tax purposes, transactions entered into well before the Proposed Regulations were first announced by Treasury (on August 2, 2016) could potentially result in very significant estate tax liabilities even where the taxpayer's estate planning documents contain standard formula provisions that are intended to defer all estate taxes until the death of the surviving spouse (or to eliminate estate taxes entirely through charitable dispositions). This is inconsistent with the tax policy objective of the estate tax marital deduction, *i.e.*, of treating a married couple as a single economic unit, and is moreover inconsistent with the substantial public interest in encouraging gifts to charity under taxpayers' estate planning documents.

[7] Estate of Turner v. Commissioner, 138 T.C. No. 14 (2012) (Turner II), arose from a motion for reconsideration of the Tax Court memorandum opinion in Estate of Turner v. Commissioner, T.C. Memo 2011-209 ("Turner I"). In Turner I, the decedent transferred property to a family limited partnership in exchange for limited and general partnership interests. The decedent then gifted away some of his limited partnership interests during his lifetime. The Tax Court held that the decedent's lifetime transfers of property to the family limited partnership ("FLP") were subject to IRC § 2036 and would be brought back into his gross estate.

Prop. Reg. § 25.2704-3(e) recognizes the existence of this problem in the case of disregarded restrictions and attempts to create a uniform valuation rule for gross estate and marital and charitable deduction purposes in the case of disregarded restrictions. In addition, Prop. Reg. § 25.2704-2(f) establishes a corresponding rule in the case of applicable restrictions. We accordingly request that a similar uniform valuation rule for gross estate and marital and charitable deduction purposes be instituted as well in the case of lapses of voting or liquidation rights under Prop. Reg. § 25.2704-1.

On its motion for reconsideration, the estate argued that it had met the "bona fide sale for full and adequate consideration" exception to section 2036 because there was a significant non-tax purpose for creating the FLP. The estate also argued that no estate tax should be due because the decedent's estate planning documents contained standard reduce-to-zero formula marital deduction provisions.

The Tax Court rejected both of the estate's contentions. First, it rejected the estate's position that the consolidation of asset management constituted a significant non-tax purpose for forming the limited partnership at issue because no partnership assets required active management or special protection.

With respect to the marital deduction issue, the decedent owned a 27.7554 percent limited partnership interest and a 0.5 percent general partnership interest in the FLP at his death. The decedent had transferred most of his limited partnership interests to his children during his lifetime.

The court observed that the application of section 2036 to FLPs raises two issues with respect to the marital deduction. The first occurs when family partnership interests, which have been discounted for federal estate tax purposes, are brought back into the estate at full fair market value. This produces a mismatch between the values for gross estate inclusion purposes and marital deduction purposes and can result in tax being paid because the marital deduction allowed for discounted FLP interests may be less than the value at which the FLP's underlying assets are included in the gross estate. This type of mismatch did *not* present itself in Turner II, however, as the Service chose not to litigate this issue -- possibly because, as the general partner, the surviving spouse may have possessed the unilateral right to liquidate the FLP thereby eliminating any grounds to claim such discount. *(*See Turner II at note 9)

The second type of marital deduction mismatch issue occurs in the section 2036 context where a decedent gifts a partnership interest during his lifetime to someone other than his spouse and section 2036 pulls the assets underlying the partnership interest back into his gross estate at his death. This was the situation presented in *Turner II*. The court concluded that the partnership interests which the decedent had gifted away to third parties did not *pass* to his surviving spouse. Therefore, the underlying FLP property brought back into his gross estate under Section 2036 was ineligible to qualify for the estate tax marital deduction. *This type of marital deduction mismatch issue could be similarly presented in the context of a lapsed voting or liquidation right subject to section 2704(a).*

3. Computation of Amount of Lapse Deemed to Occur at Death

Clarification is also needed concerning the computation of the lapse that is treated as occurring at the decedent's death. Among other things, Treasury should clarify that the lapse is based on values for estate tax purposes as of the date of the decedent's death (or as of the alternative valuation date under section 2032, to the extent applicable), rather than the date of the transaction prior to death that is deemed to occur as of the decedent's death as a result of Prop. Reg. § 25.2704-1(c)(1).

4. Computation of Amount of Lapse Deemed to Occur at Death Where Section 2704(b) Also Applies

In addition, clarification is needed to confirm that the same transfer will not effectively be taxed twice where both section 2704(a) and section 2704(b) apply to the transferred interest. For example, if a gift is valued with a reduction in discount under the new proposed valuation rules of section 2704(b), then the amount of any deemed lapse at death should also be computed without any such reduction in discount, and not by using the traditional willing-buyer-willing-seller test of Treas. Reg. § 20.2031-1(b). Presumably, there should not be any lapse for section 2704(a) purposes under these circumstances.

5. Grandfathering for Lapses of Rights Created on or Before October 8, 1990

The rules of 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 the Federal Register." (Prop. Reg. § 25.2704-4(b)(1)) It is unclear how these rules could potentially apply to lapses of rights created *on or before October 8, 1990*, and more specifically, under what circumstances, if any, a post-October 8, 1990 modification to an entity or other agreement, or to applicable state law, could be deemed to implicate these proposed rules with respect to an otherwise grandfathered lapse. Accordingly, clarification of this is warranted.

IV. Prop. Reg. § 25.2704-3 Has Exceeded Congress's Grant of Authority to Treasury Under Section 2704(b)(4), is Unsupported by Adequate Agency Fact-Finding, and Therefore Would be Invalid If It Were Finalized in Its Present Form

Finally, we are concerned that, in issuing its Proposed Regulations concerning disregarded restrictions under Prop. Reg. § 25.2704-3, Treasury has exceeded Congress's grant of authority to it under the plain language of section 2704(b)(4). That section provides that Treasury may issue regulations regarding certain restrictions only "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***."

Section 2704(b)(4) requires Treasury to do two things:

FIRST, determine that such restriction "has the effect of reducing the value of the transferred interest for purposes of this subtitle" (*i.e.*, for estate, gift and GST tax purposes), and

SECOND, determine that such restriction "***does not ultimately reduce the value of such interest to the transferee***."

Prop. Reg. § 25.2704-3 makes no distinction, however, between **(1)** an active trade or business, **(2)** a situation in which there is 50% ownership by unfriendly or hostile nonfamily members, **(3)** a situation where family members are hostile to each other and may be embroiled in protracted litigation with each other, or **(4)** family-controlled entities with "friendly" family situations that hold passive assets and do not engage in any trade or business. Rather, the Proposed Regulations effectively treat these circumstances as exactly the same ***and conclusively presume – without any fact-finding -- that in none of these situations will the restriction reduce the value of the transferred interest to the transferee.*** This absence of reasoned analysis is arbitrary and capricious, and if the Proposed Regulations were finalized in their present form, they would be invalid under Section 706 of the Administration Procedure Act (the "APA"), 5 U.S.C. § 551 *et seq*.

Section 706 of the APA[8] sets forth the standards governing a court's review of agency rulemaking, and requires a court to invalidate agency action that is "arbitrary, capricious, an abuse of direction, or otherwise not in accordance with law."[9] In Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.,[10] ("State Farm"), the United States Supreme Court explained that an agency must have engaged in reasoned decisionmaking, which means the agency must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made.[11]

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[8] The full text of 5 U.S.C. § 706 is set forth below.

> To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall –
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> (1) compel agency action unlawfully withheld or unreasonably delayed; and
>
> (2) hold unlawful and set aside agency action, findings, and conclusions found to be –
> (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;
> (B) contrary to constitutional right, power, privilege, or immunity;
> (C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;
> (D) without observance of procedure required by law;
> (E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or
> (F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.
>
> In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error.

[9] 5 U.S.C. § 706(2)(A).

[10] 463 U.S. 29 (1983).

[11] See id. at 42-44.

The Supreme Court further elaborated upon this standard in Chevron v. Natural Resources Defense Council,[12] adopting a two-part test for evaluating the validity of an agency's action. Under the first step, the court must determine whether Congress has specifically addressed the question at issue. If Congress has not addressed the issue, or if the statute is ambiguous, the second part of the test requires the court to determine whether the agency's determination is based on a "reasonable" or "permissible" construction of the statute. [13]

In Altera Corp. v. Comm'r,[14] ("Altera"), a unanimous Tax Court found that Treasury failed to engage in reasoned decision-making under the APA and State Farm in connection with Treasury's issuance of regulations under section 482, which required participants in qualified cost-sharing agreements to include stock-based compensation costs in the cost pool to comply with the arm's length standard of section 482. Specifically, the court concluded that, in failing to rationally connect the choice made with the facts, Treasury had engaged in arbitrary and capricious decision-making. In addition, Treasury had failed to engage in material fact finding or to follow evidence-gathering procedures, and the regulatory record lacked any evidence to support the result adopted in the Treasury regulations.[15] Accordingly, the Tax Court held that Treasury's section 482 regulations were invalid.

In short, the Tax Court held in Altera that tax regulations must be the product of reasoned decision-making. Accordingly, they must have a basis in fact, there must be a rational

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[12] 467 U.S. 837 (1984).

[13] See id. at 842-43. In Mayo Found. For Med. Educ. & Research v. United States, 562 U.S. 44, 57 (2011), the Supreme Court made clear that the APA applies to tax rules and regulations.

[14] 145 T.C. No. 3 (2015).

[15] See Altera, 145 T.C. No. 3, at 49-59. The Tax Court also found that Treasury failed to respond to significant comments when it issued its section 482 regulations, and that Treasury's conclusion that its section 482 regulations were consistent with the arm's-length standard in fact was contrary to all of the evidence before it. See Altera, 145 T.C. No. 3, at 59-69.

connection between the facts found and the choice made, significant comments must be responded to, and the final rule may not be contrary to the evidence presented before the final rule is issued.[16]

The Proposed Regulations present a similar situation to Altera.[17] The Proposed Regulations, including the Preamble, fail to articulate any factual basis to support Treasury's across-the-board conclusive presumption that, notwithstanding the particular facts and circumstances surrounding the entity in connection with which a transfer has been made to another family member, ***there will never be any reduction in the value of the transferred interest to the transferee***. Treasury, simply put, has "`entirely failed to consider an important aspect of the problem'"[18] that is presented in Section 2704(b)(4) -- namely the identification of restrictions that do "***not ultimately reduce the value of such interest to the transferee.***" (Section 2704(b)(4)) In short, Treasury has lumped together **(1)** active trades or businesses, **(2)** situations in which there is 50% ownership by unfriendly or hostile nonfamily members, **(3)** situations where family members are hostile to each other and may be embroiled in protracted litigation with each other, and **(4)** family-controlled entities with "friendly" family situations that hold passive assets and do not engage in any trade or business. Each of these scenarios is being targeted without any distinction with the same broad brush notwithstanding the highly differing

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16 See Altera, 145 T.C. No. 3, at 49-69. See also Dominion Resources Inc. v. U.S., 681 F.3d 1313 (Fed. Cir. 2012) (applying the arbitrary and capricious standard to invalidate Treasury regulation section 1.263A-11(e)(1)(ii)(B) on the ground that Treasury failed to provide an explanation of the reasons behind the regulation).

17 Altera is currently on appeal to the United States Court of Appeals for the Ninth Circuit and the NYSSCPA does not express any view with respect to this pending appeal. The NYSSCPA notes, however, that the analysis in Altera is based upon the APA's reasoned decision-making standard that was promulgated by the Supreme Court in State Farm, and that the Supreme Court in Mayo Found. For Med. Educ. & Research v. United States, 562 U.S. 44, 57 (2011), applied the APA's reasoned decision-making standard to tax rules and regulations. Accordingly, the NYSSCPA's analysis of this issue would be unchanged even if the Altera case had never been decided by the Tax Court.

18 Altera, 145 T.C. No. 3, at 37 (quoting State Farm, 463 U.S. at 43).

circumstances to be faced by a transferee who wishes to liquidate or redeem its interest. Otherwise stated, Prop. Reg. § 25.2704-3 fails to consider what Congress in section 2704(b)(4) expressly required Treasury to consider, *i.e.*, the finding of ***no reduction in value*** to the transferee of the transferred interest. Moreover, the effect of this failure to distinguish among these sharply differing scenarios can be substantial -- indeed, in the first three of the above-described scenarios, restrictions on the ability to liquidate or redeem an entity interest can serve to very significantly reduce the value of such interest to the transferee.[19] Accordingly, we respectfully submit that if Prop. Reg. § 25.2704-3 were finalized in the form in which it is presently written, it would be invalid as arbitrary and capricious under State Farm and its progeny, and in excess of Congress's grant of authority to Treasury under the plain language of Section 2704(b)(4).

[19] Prop. Reg. § 25.2704-3 moreover fails to withstand scrutiny under both the first and the second steps of the Chevron analysis because (1) Congress has spoken on the precise question at issue in setting forth a standard to govern Treasury rulemaking (which has not been heeded here) and (2) Treasury's action is not "based on a permissible construction of the statute." Chevron, 437 U.S. at 842-43.