

**Spokane Estate Planning Council**

**Presentation Outline**

**The Practical Implications of the Regulations Restricting Valuations Discounts for Estate and  
Gift Tax Purposes**

**September 13, 2016**

**Presented by Thomas M. Culbertson**

5:45 – 6:00 p.m. - Welcome

**THOMAS M. CULBERTSON** is a principal in the Spokane office of Lukins & Annis, PS, practicing in both Washington and Idaho. He received his B.A. from Princeton University (1971), his J.D. from the University of Hawaii (1977), and his LL.M. in Taxation from the University of Denver (1990). He is a fellow in the American College of Trust and Estate Counsel, a past chair of the Real Property, Probate & Trust Section of the WSBA, past executive committee member of the Taxation Section, and past chair and current member of that section's Estate & Gift Tax Committee. Mr. Culbertson has served as a member of numerous WSBA task forces dealing with such things as the Uniform Tax Apportionment Act, the Uniform Trust Code, the Uniform Principal and Income Act, and state administrative rules concerning state QTIP elections, and recent legislation regarding directed trusts and trustee delegation. He is also co-editor in chief of the WSBA Estate Planning, Probate and Trust Administration Deskbook scheduled to be published in 2017.

6:00 – 7:00 p.m.

Program Description: Continuing Education Credits

The 2016 Proposed regulations related to section 2704 may affect certain valuation discounts used by planners helping their clients discount LLC interests among other situations. This program will discuss:

- ✓ Proposed Regulations. When will they be effective? What do they purport to limit? Existing judicial or regulatory limitations on proposal? How is this different than current law?
- ✓ Validity and historic justification of valuation discounts.
- ✓ Planning considerations. Documentation? Accelerated transfers?
- ✓ Impact on valuation professionals and appraisal documentation?

7:00 – 7:15

Questions and Answers from the Audience:

1. What information do you still need to assist your clients?
2. Where to go for resources



This document is scheduled to be published in the Federal Register on 08/04/2016 and available online at <http://federalregister.gov/a/2016-18370>, and on [FDsys.gov](http://FDsys.gov)

## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 25

[REG-163113-02]

RIN 1545-BB71

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

AGENCY: Internal Revenue Service (IRS), Treasury.

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

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

DATES: Written and electronic comments must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

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

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-163113-02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044.

Submissions also may be hand delivered Monday through Friday between the hours of

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

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

#### SUPPLEMENTARY INFORMATION:

##### **Background**

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

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

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

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

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

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

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

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

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

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

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

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

The Treasury Department and the IRS have determined that the current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws and by other subsequent developments. First, courts have concluded that, under the current regulations, section 2704(b) applies only to restrictions on the ability to liquidate an entire entity, and not to restrictions on the ability to liquidate a transferred interest in that entity. Kerr v. Commissioner, 113 T.C. 449, 473 (1999), aff'd, 292 F.3rd 490 (5<sup>th</sup> Cir. 2002). Thus, a restriction on the ability to liquidate an individual interest is not an applicable restriction under the current regulations.

Second, as noted above, the current regulations except from the definition of an applicable restriction a restriction on liquidation that is no more restrictive than that of the state law that would apply in the absence of the restriction. The Tax Court viewed this as a regulatory expansion of the statutory exception to the application of section 2704(b) contained in section 2704(b)(3)(B) that excepts “any restriction imposed, or required to be imposed, by any Federal or State law.” Kerr, 113 T.C. at 472. Since the promulgation of the current regulations, many state statutes governing limited partnerships have been revised to allow liquidation of the entity only on the



unanimous vote of all owners (unless provided otherwise in the partnership agreement), and to eliminate the statutory default provision that had allowed a limited partner to liquidate his or her limited partner interest. Instead, statutes in these jurisdictions typically now provide that a limited partner may not withdraw from the partnership unless the partnership agreement provides otherwise. See, e.g., Tex. Bus. Orgs. Ann. § 153.110 (West 2016) (limited partner may withdraw as specified in the partnership agreement); Uniform Limited Partnership Act (2001) § 601(a), 6A U.L.A. 348, 448 (Supp. 2015) (limited partner has no right to withdraw before completion of the winding up of the partnership). Further, other state statutes have been revised to create elective restrictions on liquidation. See, e.g., Nev. Rev. Stat. § 87A.427 (2016) (limited partnership electing to be restricted limited partnership may not make any distributions for a 10-year period). Each of these statutes is designed to be at least as restrictive as the maximum restriction on liquidation that could be imposed in a partnership agreement. The result is that the provisions of a partnership agreement restricting liquidation generally fall within the regulatory exception for restrictions that are no more restrictive than those under state law, and thus do not constitute applicable restrictions under the current regulations.

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

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

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

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

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

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

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

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

### **Explanation of Provisions**

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

### **Covered Entities**

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

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

#### Classification of the Entity

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

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

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

#### Control of the Entity

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

#### Lapses under Section 2704(a)

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

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

#### Applicable Restrictions under Section 2704(b)

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

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

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

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



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

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

#### Disregarded Restrictions

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

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

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

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

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

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

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

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

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

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

## Coordination with Marital and Charitable Deductions

Section 2704(b) applies to intra-family transfers for all purposes of subtitle B relating to estate, gift and GST taxes. Therefore, to the extent that an interest qualifies for the gift or estate tax marital deduction and must be valued by taking into account the special valuation assumptions of section 2704(b), the same value generally will apply in computing the marital deduction attributable to that interest. The value of the estate tax marital deduction may be further affected, however, by other factors justifying a different value, such as the application of a control premium. See, e.g., Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987).

Section 2704(b) does not apply to transfers to nonfamily members and thus has no application in valuing an interest passing to charity or to a person other than a family member. If part of an entity interest includible in the gross estate passes to family members and part of that interest passes to nonfamily members, and if (taking into account the proposed rules regarding the treatment of certain interests held by nonfamily members) the part passing to the decedent's family members is valued under section 2704(b), then the proposed regulations provide that the part passing to the family members is treated as a property interest separate from the part passing to nonfamily members. The fair market value of the part passing to the family members is determined taking into account the special valuation assumptions of section 2704(b), as well as any other relevant factors, such as those supporting a control premium. The fair market value of the part passing to the nonfamily member(s) is determined in a similar manner, but without the special valuation assumptions of section 2704(b). Thus, if the sole nonfamily member receiving an interest is a charity, the interest generally will have

the same value for both estate tax inclusion and deduction purposes. If the interest passing to nonfamily members, however, is divided between charities and other nonfamily members, additional considerations (not prescribed by section 2704) may apply, resulting in a different value for charitable deduction purposes. See, e.g., Ahmanson Foundation v. United States, 674 F.2d 761 (9<sup>th</sup> Cir. 1981).

### **Effective Dates**

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

### **Special Analyses**

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

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

### **Comments and Public Hearing**

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

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



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

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

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

### **Drafting Information**

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

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

Gift taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the Regulations**

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

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

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

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

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

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

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

\* \* \* \* \*

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

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

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

The revision and additions read as follows:

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

\* \* \* \* \*

(b) \* \* \*

(5) \* \* \*

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

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

\* \* \* \* \*

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

\* \* \* \* \*

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

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

The revision and addition reads as follows:

§25.2701-8 Effective dates.

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

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

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

1. In paragraph (a)(1), the first two sentences are revised and four sentences are added before the third sentence.
2. In paragraph (a)(2)(i), a sentence is added at the end.
3. Paragraph (a)(2)(iii) is removed.
4. Paragraphs (a)(2)(iv) through (vi) are redesignated as paragraphs (a)(2)(iii) through (v), respectively.
5. In newly designated paragraph (a)(2)(iii), a sentence is added before the third sentence.
6. Paragraph (a)(4) is revised.
7. Paragraph (a)(5) is added.
8. In paragraph (c)(1), the second sentence is revised and a sentence is added at the end.
9. Paragraph (c)(2)(i)(B) is revised.
10. In paragraph (f) Example 4, the third and fourth sentences are revised and a sentence is added at the end.
11. In paragraph (f) Example 6, the third sentence is removed.
12. In paragraph (f) Example 7, the third and fourth sentences are revised and a sentence is added at the end.

The revisions and additions read as follows:

§25.2704-1 Lapse of certain rights.

(a) \* \* \*

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

(2) \* \* \*

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

\* \* \* \* \*

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

\* \* \* \* \*

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

(5) Assignee interests. A transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights. For example, the transfer of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest.

(c) \* \* \*

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

(2) \* \* \* \*

(i) \* \* \* \*

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

\* \* \* \* \*

(f) \* \* \*

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

\* \* \* \* \*

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

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

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

1. Paragraphs (a) and (b) are revised.
2. Paragraphs (c) and (d) are designated as paragraphs (e) and (g), respectively.
3. New paragraphs (c), (d), and (f) are added.
4. The first sentence of newly designated paragraph (e) is revised.
5. The third sentences of newly designated paragraph (g) Example 1. and Example 3. are removed.
6. The third sentence of newly designated paragraph (g) Example 5. is revised.

The revisions and additions read as follows:

§25.2704-2 Transfers subject to applicable restrictions.

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(g) \* \* \*

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

\* \* \* \* \*

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

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

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

§25.2704-3 Transfers subject to disregarded restrictions.

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

The addition reads as follows:

§25.2704-4 Effective date.

\* \* \* \* \*

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

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

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

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

John Dalrymple

Deputy Commissioner for Services and Enforcement

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