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October 31, 2016

Mr. John D. MacEachen
CC:PA:LLPDD:PR (REG-163113-02), Room 5203
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

Submitted Electronically to Federal eRulemaking portal at:
http://www.regulations.gov (IRS Reg163113-02)

RE: Proposed Rules on Estate, Gift and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of Interest ("Proposed Section 2704 Regulations") /Comments by The Florida Bar Tax Section and The Florida Bar Real Property, Probate and Trust Law Section

Dear Mr. MacEachen:

Enclosed herewith are comments with respect to the Proposed Section 2704 Regulations submitted jointly by The Florida Bar Tax Section (the "Tax Section") and The Florida Bar Real Property, Probate and Trust Law Section (the "RPPTL Section"). These comments represent the efforts of a number of members of both referenced Florida Bar sections under the auspices of the Estate and Trust Tax Planning Committee of RPPTL, and the Federal Tax Division and the Legislation and Regulations Committee of the Tax Section. These comments have been reviewed by David Akins and Diana Zeydel on behalf of RPPTL, by Joseph B. Schimmel, Brian M. Malec, James H. Barrett, Patrick J. Duffey and the undersigned on behalf of the Tax Section, and by Edward F. Koren on behalf of both Sections. Mr. Koren is a past Chair of both Sections.

Although members of the Tax Section and RPPTL Section who participated in preparing these comments may have clients who would be affected by these regulations as ultimately adopted, no member so involved has been engaged by a client to make a submission with respect to, or to influence the development or outcome of, the subject matter of these comments. We request that questions regarding the comments be delivered to:

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The Florida Bar Real Property, Probate and Trust Law Section is comprised of over 10,000 members of The Florida Bar, a significant cadre of which practices estate planning. The Florida Bar Tax Section is comprised of approximately 2,000 members of The Florida Bar who practice in all areas of tax law, including Federal individual, corporate and partnership income taxation, federal estate, gift and generation-skipping transfer taxation; international, state and local taxation; employee benefits tax law; and state and federal tax controversies.

The views expressed herein represent only those of the Tax and RPPTL Sections of The Florida Bar, and are not to be ascribed to The Florida Bar or its Board of Governors.

We will be pleased to provide additional commentary as requested. Please do not hesitate to contact us.

Respectfully yours,

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THE FLORIDA BAR

TAX SECTION

AND

REAL PROPERTY, PROBATE AND TRUST LAW SECTION

COMMENTS TO PROPOSED REGULATIONS UNDER SECTION 2704

Introduction.

Proposed Regulations to section 2704[1] (the "Proposed Regulations") were released on August 2, 2016. Section 2704, like the rest of Chapter 14, provides a special rule for the valuation of certain interests for estate, gift, and generation-skipping transfer tax purposes; specifically, it addresses interests in entities that have "lapsing" rights or restrictions as well as interests in entities that are subject to "applicable restrictions." The Proposed Regulations seek to clarify the application of those existing rules and expand the scope of Section 2704 to address an entirely new class of limitations, termed "disregarded restrictions."

The comments address six areas of concern: **(1)** disregarding the interests of nonfamily members, as set forth in Proposed Regulations section 25.2704-3(b)(4); **(2)** the effect on valuation of the "minimum value" element of disregarded restrictions, as set forth in Proposed Regulations section 25.2704-3(b)(1)(ii); **(3)** failing to distinguish between investment entities and active businesses; **(4)** applying the effective date provisions, as set forth in Proposed Regulations section 25.2704-4(b)(1), to the three-year rule under Proposed Regulations section 25.2704-1(c)(1); **(5)** clarifying the application or non-application of rules in the Proposed Regulations to the value of entity interests determined pursuant to options or agreements that satisfy section 2703, and **(6)** removing the addition of cross references in the Proposed Regulations under section 2704 to the term "controlled entity" as used in section 2701.

Disregarding Interests of Nonfamily Members.

The Proposed Regulations would disregard certain interests held by certain nonfamily members for purposes of determining whether the transferor (or the transferor's estate) and members of the transferor's family are able to unilaterally remove a restriction on the ability to redeem or liquidate an interest in an entity.[2] Specifically, the Proposed Regulations would disregard any interest in an entity held by a person who is not a member of the transferor's family if, at the time of the transfer: (1) the

[1] Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest, REG-163113-02, 81 Fed. Reg. 51,413 (August 4, 2016). A correction to the Proposed Regulations was published October 4, 2016. 81 Fed. Reg. 68,378 (October 4, 2016). References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code").
[2] Prop. Regs. § 25.2704-3(b)(4).

interest has been held by such person for less than three years (the "Nonfamily Member Lookback Rule"); (2) the interest constituted less than 10% of the value of all of the equity interests in a corporation, or constituted less than 10% of the capital and profits interests in a business entity described in Regulations section 301.7701-2(a) other than a corporation (the "10% Rule"); (3) the interest, when combined with the interests of all other persons who are not members of the transferor's family, constituted less than 20% of the value of all of the equity interests in a corporation, or constituted less than 20% of the capital and profits interests in a business entity described in Regulations section 301.7701-2(a) other than a corporation (the "20% Rule"); or (4) that person did not have an enforceable right to receive in exchange for such interest, on no more than six months' prior notice, the "minimum value" of the interest (the "Put Right Rule").

The Preamble justifies Proposed Regulations section 25.2704-3(b)(4) primarily through explanations that "the grant of an insubstantial interest in the entity to a nonfamily member should not preclude the application of section 2704(b)"[3] and 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." The Preamble further states that "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." While we support the objective of providing a reasonable bright line test, we believe that improvements should be made to all of these rules, and that two of them—the 10% Rule and the Put Right Rule– are based on flawed reasoning and should be substantially modified.

Nonfamily Member Lookback Rule.

The Preamble states that an interest held by a nonfamily member "should be recognized only where the interest is an economically substantial and longstanding one that is likely to have a more substantive effect."[4] Proposed Regulations section 25.2704-3(b)(4)(i)(A) would disregard interests that have not been held by a nonfamily member for at least three years.

The Nonfamily Member Lookback Rule should be revised to allow tacking of holding periods if a nonfamily member has received the interest from another nonfamily member. The Rule should be further revised to account for newly created entities that are less than three years old.

Valuing Interests Under the 10% Rule and 20% Rule.

Implicit in the 10% Rule and the 20% Rule is the need to value a member's interest in "the capital and profits" of a business entity other than a corporation. The Preamble suggests that the 10% Rule and 20% Rule are bright line rules.[5] Nonetheless, measuring the "capital" or "profits" is not as straightforward as the regulations suggest.

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[3] Note 1, *supra*, at 51,415.
[4] *Id*.
[5] Note 1, *supra*, at 51,415 ("A bright-line test will avoid [a] fact-intensive inquiry . . . .").

Neither the current Regulations nor the Proposed Regulations provide a method for measuring "capital" or "profits." Partnership agreements that provide for liquidation in accordance with positive capital accounts have become rarer, but we may see their resurgence, as the ability to measure "capital" or "profits" under the section 704(b) regulations is difficult, and their reporting is subject to varying interpretation. Calculations to determine whether such liquidation rights fall within the scope of the Proposed Regulations would be difficult and made more so by the lack of guidance.

If measuring capital is difficult, it would be even more difficult in a capital-intensive partnership with a waterfall allocation of profits and preferred returns on unreturned capital—almost to the point that, without further clarification, certain taxpayers may be unable to apply the 10% Rule and 20% Rule to their specific circumstances.

10% Rule.

The 10% Rule and the 20% Rule each appear to be supported by the justification that an interest must be economically substantial. We recognize that the 20% Rule can be supported by many other examples in the Internal Revenue Code, such as those described below:

- Section 332(a) provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation, provided that the receiving corporation owns at least 80% of the liquidating corporation (*i.e.*, no more than 20% is owned by other shareholders).
- Section 337(a) provides that in a complete liquidation to which section 332 applies, no gain or loss shall be recognized by the liquidating corporation on the distribution to the 80% distributee.
- Section 355(g)(2)(B)(iv) provides for a look-through rule for 20% controlled entities.
- Section 1504(a) provides that a corporation may be included in an affiliated group, provided that no more than 20% of the corporation's voting power and total value is owned outside of the group.

However, the 10% Rule appears to be an arbitrary and unnecessary requirement. Generally, Subtitle B of the Code imposes very few rules that are tied to percentage ownership of an entity. Notable (and perhaps the only) exceptions are section 2036(b)(2) (retained right to vote shares of a 20%-controlled corporation), sections 2107 and 2501(a)(5) (applying the expatriation rules to certain 10%-controlled corporations for pre-2008 expatriations), and of course Chapter 14 of the Code. Section 6166, which provides an extension of time for the payment of estate tax, disregards an interest in a closely held business only if (1) less than 20% of the total capital interest or voting stock is includible in a decedent's gross estate, and (2) the entity has 45 or fewer owners.

If the purpose of the 10% Rule is to disregard minority owners with interests so insubstantial that the owners are indifferent to the operation of the entity, then perhaps a reference to a pecuniary minimum value (similar to the structure of the so-called "5 and 5" rule of section 2041) may be appropriate. Otherwise, the 10% Rule might produce absurd results; by way of example, the owner of a 9% interest in a billion dollar company would own an interest worth (before discounts) $90,000,000 and would nevertheless be ignored under the 10% rule because his interest in the company is deemed too "insubstantial" to warrant his attention.

Further, the stated purpose for imposing requirements on the interests of non-family members (*i.e.*, that interests of nonfamily members be economically substantial) is satisfied merely by the existence of the 20% Rule; therefore, the 10% Rule is unnecessary. It should not matter whether each of two nonfamily members owns 10% or each of twenty nonfamily members owns 1%. Both situations lead to the same result - that nonfamily members own 20% of the value of the entity which, in the aggregate, constrain the ability of a family to remove a restriction on the liquidation of an individual interest.

If, however, the 10% Rule is to be retained, it can be improved in several respects, while maintaining its "bright line" aspect:

(1) Attribution should be applied among members of the family of non-controlling owners. For example, assume that A owns 76% of a corporation's stock, B owns 24% of the corporation's stock, and that A and B are unrelated. Further assume that B dies, leaving B's stock in equal shares to B's children. The number of B's children should be irrelevant to the application of section 2704. Whether B has two children (each receiving 12% of the corporation's stock) or three (each receiving 8%) is unlikely to have any effect on A's ability to remove restrictions.

(2) Interests received in arms'-length transactions should be exempt from the 10% Rule. The Proposed Regulations instead treat the gift of an interest to a nonfamily member no differently than the common situations when a nonfamily member invests in the venture. The latter owner is far more likely to be actively involved in the venture in order to protect his or her investment.

The Put Right Rule.

The Put Right Rule requires that, in order to be considered for purposes of determining whether the transferor and his family are able to unilaterally remove a limitation on liquidation or redemption, a non-family member must possess the ability to liquidate his or her interest, for cash or "other property" equal to the minimum value of the interest, within six months of providing notice to the entity of his or her intent to withdraw.[6] To say that a right of this nature is unusual radically understates the scarcity of such a right. Indeed, no member of the committee charged with the final review of these comments could recall a single instance in which an owner of a business—family member or not, operating or otherwise—possessed such a significant liquidation right.

In the context of entities operating active trades or businesses, such a put right is simply untenable as a practical reality. Thus, to require such a right before considering the ability of non-family members to affect governance of the entity would result in essentially *all* non-family members being disregarded for purposes of this aspect of section 2704. If this is the desired result, a far simpler section

[6] Prop. Regs. § 25.2704-3(b)(4)(i)(D) referencing Prop. Regs. § 25.2704-3(b)(6).

25.2704-3(b)(4) could have been crafted. Alternatively, if the purpose of the disregarded non-family member analysis is indeed to ignore outside interests that are "economically insubstantial," the Put Right Rule is grossly overbroad and adds nothing meaningful to the 20% rule.

The Effect of "Minimum Value" on the Valuation of Entities that are Subject to Section 2704.

The Proposed Regulations use the term "minimum value" for purposes of determining when a restriction on the ability to redeem or liquidate an interest in an entity should be disregarded.[7] The "minimum value" of an interest in an entity means "the interest's share of the net value of the entity determined on the date of liquidation or redemption.[8] The "net value of the entity" is defined as "the fair market value . . . of *the property held by the entity*, reduced by the outstanding obligations of the entity." [Emphasis added]. In other words, the "net value of the entity" refers to an entity's "net asset value."

Revenue Ruling 59-60[9] recognized that "net asset value" is especially relevant to the value of the stock of a closely held investment company and real estate holding company, but that earnings are of primary consideration when valuing stocks of companies that sell products or services to the public. When determining the fair market values of the assets of a company, the costs of liquidation "merit consideration."[10] Generally speaking, valuations of interests in closely held entities under Revenue Ruling 59-60 consider prior sales of interests (the "sales method"), as well as earnings (the "income method") and liquidation value (the "asset method"). By placing undue emphasis on "net asset value," the Proposed Regulations gut Revenue Ruling 59-60, and replace it with the adoption of a "liquidation value only" method. To the extent that the Internal Revenue Service intends by the Proposed Regulations to overrule any portion of Revenue Ruling 59-60, the intent should have been stated explicitly.

Overall, the effect of the minimum value rule is to move away from long-standing reference to fair market value, which is the polestar of the federal transfer tax regime, as provided in Treasury Regulations §§ 20.2031-1(b) and 25.2512-1. If the regulatory goal is to clarify valuation rules so that certain restrictions applicable to an interest are to be disregarded within the determination of the interest's fair market value, then we suggest that revised proposed regulations so provide, by listing those restrictions which business valuation professionals must ignore in providing opinions of fair market value, by scrapping that the convoluted "minimum value rule".

Furthermore, the notion of an imputed "put right" or the lack of an actual put right, in connection with the minimum value rule, is at odds with normal business practices that rarely result in either the use of or the granting of, put rights in common business ownership arrangements.

Nevertheless, if the Internal Revenue Service continues to utilize the notion of "minimum value," then in the case of operating businesses the definition of "minimum value" may substantially

[7] Prop. Regs. § 25.2704-3(b)(1)(ii). See also § 25.2704-3(b)(6) (using the concept in the definition of "put right").
[8] Prop. Regs. § 25.2704-3(b)(1)(ii).
[9] Rev. Rul. 59-60, 1959-1 CB 237
[10] *Id*. at Sec. 5(b).

undervalue an interest in an entity and, consequently, the concept may not provide a deterrent to the use of restrictions in many instances.

Finally, if adopted, the term "minimum value" should take into account adjustments for income taxes attributable to built-in gains. Although the development of the practice of making the adjustment for built-in gains has been rocky, it previously has been accepted by most courts, as well as the Internal Revenue Service.[11]

Exceptions for Operating Entities.

The Proposed Regulations make only minor concessions for the significant differences between entities primarily holding passive investment assets ("Investment Entities") and entities engaged in an active trade or business ("Operating Entities"). This treatment contrasts with the purported purpose of the Proposed Regulations (as set out in the Preamble) insofar as the structure of Operating Entities is generally a creature of business necessity. Restrictions imposed on owners of Operating Entities generally are not imposed for the purpose of avoiding the application of section 2704.

The Proposed Regulations provide that a commercially reasonable restriction on liquidation will not be disregarded if such restriction is imposed by an unrelated person providing capital to an Operating Entity for the entity's trade or business operations, whether in the form of debt or equity.[12] An unrelated person is defined as "any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b) . . . ." (with an exception for publicly held banks defined in section 581).[13] In addition, the "put" exception to the definition of "disregarded restriction" provides that a "restriction" on liquidation or redemption will not be disregarded if, *inter alia*, the consideration payable to the holder consists of cash or property other than a note or other obligation issued by the entity, another holder of interests in the entity, or a person related to the entity or another interest holder.[14] If, however, the entity is an Operating Entity and at least 60% of the entity's value consists of non-passive assets, then the consideration may include a note that is adequately secured, requires periodic payments, is subject to interest at market rates, and has a fair market value on the date of liquidation equal to the liquidation proceeds.[15]

These exceptions for Operating Entities are extremely narrow in scope and have limited application, but demonstrate at least a concession that Operating Entities are fundamentally different from Investment Entities. The Final Regulations should provide a broader exception for Operating Entities, as the Proposed Regulations would cause significant hardships for Operating Entities when the death of an owner of the business results in the imposition of a large estate tax. We suggest that the final Regulations include an exception for Operating Entities under Proposed Regulations section

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[11] *E.g.*, *Davis v. Commissioner*, 110 T.C. 530 (1998); *Eisenberg v. Commissioner*, 155 F.3d 50 (2nd Cir. 1998), AOD 1999-001 (1/29/1999).
[12] Prop. Regs. § 25.2704-3(b)(5)(ii).
[13] *Id*.
[14] Prop. Regs. §§ 25.2704-3(b)(5)(v), -3(b)(6).
[15] *Id*.

25.2704-3(b)(5), and make a corresponding revision to Proposed Regulations section 25.2704-3(b)(1)(iv), as set forth below.

The primary change would be the addition of a new section 25.2704-3(b)(1)(vi) to clarify that the Proposed Regulations are inapplicable to Operating Entities by reference to the same standard currently used by the Proposed Regulations in permitting such entities to make payment of a redemption or liquidation right via a promissory notes.[16] We recommend the following addition to section 25.2704-3(b)(1):

> § 25.2704-3(b)(5)(vi) *Entities engaged in active trades or businesses*. A disregarded restriction does not include a restriction imposed on the holder of an interest in an entity that is engaged in an active trade or business, as that phrase is used in section 6166(b)(1), provided that at least 60 percent of the value of such entity consists of non-passive assets of that trade or business.

If the above addition to section 25.2704-3(b)(1) is made, it would negate the need for an exception to the payment rule under sections 25.2704-3(b)(1)(iv) and 25.2704-3(b)(6) that permits satisfaction of a liquidation or redemption right by way of a promissory note. Accordingly, we recommend the following ~~revisions~~:

> § 25.2704-3(b)(1)(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.

> § 25.2704-3(b)(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

[16] Prop. Regs. §§ 25.2704-3(b)(5)(1)(iv).

> 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.

If the above changes are not adopted, we believe that the Proposed Regulations should, at a minimum, broaden the Commercially Reasonable Restriction exception to include limitations on liquidation or redemption rights that are imposed on Operating Entities by a third party business entity as a result of the underlying trade or business. We therefore recommend the following additions to section 25.2704-3(b)(5)(ii):

> § 25.2704-3(b)(5)(ii) Commercially reasonable restriction. A disregarded restriction does not include a commercially reasonable restriction on liquidation or redemption that is imposed by an unrelated person or entity as part of a bona fide business arrangement. A commercially reasonable restriction includes a limitation that is imposed by a lender or investor providing capital to the entity for the entity's trade or business operations (whether in the form of debt or equity); a licensor (including a franchisor) providing a license or other authorization to use property (whether tangible or intangible) that is related to the entity's trade or business operations; or a governing body that sanctions or otherwise authorizes one or more aspects of the entity's trade or business operations. 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.

Application of the Effective Date Provisions to the Three-Year Rule.

The Proposed Regulations would apply on and after the date the regulations are published as final regulations in the Federal Register, except that Proposed Regulations section 25.2704-3 (transfers subject to disregarded restrictions) would apply to transfers occurring thirty or more days after the date the regulations are published as final regulations.[17] Nevertheless, Proposed Regulations section 25.2704-1(c)(1), relating to transfers made within three years of death (the "Three-Year Rule"), could be interpreted as applying retroactively in some cases. We believe that retroactive application is unreasonable and would create inequities among taxpayers. Therefore, we recommend that the Proposed Regulations be clarified to provide that the Three-Year Rule only applies to transfers made after the date the Proposed Regulations are published as final regulations.

Specifically, Proposed Regulations section 25.2704-1(c)(1) states, in pertinent part, that "[t]he lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a)."[18] The Proposed Regulations would "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."[19] It is unclear whether this effective date language applies to the actual lapse that occurs at the time of the transfer or to the deemed lapse occurring at death pursuant to Proposed Regulations section 25.2704-1(c)(1). If the effective date language applies to the deemed lapse occurring at death, then the Three-Year Rule could apply to transfers made before the date that the regulations are published as final regulations (and perhaps before the date that the Proposed Regulations were issued) if the transferor died after the regulations were published as final but within three years of the date of transfer.

Pursuant to section 7805(a), the Secretary of the Treasury may prescribe necessary rules and regulations. Section 7805(b) expands that authority to include the retroactive effect of such rules and regulations, however, such regulations must fall within one of the several specified categories, and generally only may be applied to taxable years that did not expire before the notice of proposed regulations was published in the Federal Register or the date "on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public."[20]

The Commissioner of the Internal Revenue Service has stated unofficially that regulations are to be applied retroactively only when it would benefit taxpayers.[21] Through litigation, limitations on Treasury's discretionary authority to apply regulations retroactively have emerged, which generally seek to protect the taxpayer against unfair and inequitable effects of the retroactive application of

[17] Prop. Regs. § 25.2704-4(b).
[18] Prop. Regs. § 25.2704-1(c)(1).
[19] Prop. Regs. § 25.2704-4(b)(1).
[20] Code § 7805(b)(1).
[21] David W. Ball, "*Retroactive Application of Treasury Rules and Regulations*," 17 N.M. L. Rev. 139, 152 (Winter 1987).

regulations. [22] Therefore, generally speaking, regulations have historically only been applied retroactively when the fair and reasonable treatment of taxpayers is not jeopardized in so doing.[23]

We believe it would be unfair and unreasonable if the Three-Year Rule applied to transactions that occurred prior to the publication of the final regulations. Specifically, if a taxpayer today transferred property by gift the fair market value of which is determined under current law, and if the taxpayer died within three years of the transfer, at which time the Proposed Regulations had been published as final regulations, the effect of the Three-Year Rule contained in Proposed Regulations section 25.2704-1(c)(1) could result in significant amounts being included improperly in that taxpayer's estate. At the time of the transaction, however, the taxpayer reasonably relied on an interpretation of section 2704 under current law in which such amounts would not be includible in his or her estate. To require the taxpayer to evaluate his or her decision to move forward with the transaction not based on current law, but instead, based on proposed regulations that were not final and subject to change, is unreasonable.

Moreover, it also would be inequitable in certain circumstances for the Three-Year Rule to apply retroactively. For example, if the transaction involved the transfer of an interest subject to section 2704 to a trust for the taxpayer's family, the taxpayer very well may have weighed the estate tax savings of transferring the interest to the trust versus the income tax benefit of receiving a step up in basis if such interest were to be included in the taxpayer's estate upon his or her death. If the taxpayer decided to move forward with the transaction given the estate tax savings under current law, he or she would be consciously foregoing the income tax benefit to the taxpayer's heirs of the step up in basis. If, however, the taxpayer died within three years of that transfer and the Three-Year Rule under Proposed Regulations section 25.2704-1(c)(1) applied retroactively to the transaction, the Internal Revenue Service would be imputing a result that the taxpayer did not intend and which could not have been foreseen under the law applicable at the time of the transaction. This would be fundamentally inequitable to the taxpayer, as it would not allow the taxpayer to modify his or her behavior to select the most tax efficient course of action given the taxpayer's personal objectives within the confines of the current tax law.

We therefore recommend that Proposed Regulations section 27.2704-4(b) be modified to clarify that the Three-Year Rule contained in Proposed Regulations section 25.2704-1(c)(1) only applies prospectively with respect to transfers occurring after the Proposed Regulations are published as final regulations. As such, the Proposed Regulations would not have a retroactive effect with respect to the transfer of interests made before the Proposed Regulations are published as final regulations.

We also suggest that as a matter of sound tax policy, if the intent of the Three-Year Rule is to capture and discourage "deathbed" lapsing of restrictions, a three year time frame is overbroad. Reference instead to the "terminal illness rule" expressed in Treas. Reg. § 1.7520-3(b)(3)(i) should be considered, which provides an effective framework that is acceptable to the Service and already familiar to tax practitioners.

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[22] *E.g., LeSavoy Foundation v. Commissioner*, 238 F.2d 589 (3rd Cir. 1956); *International Business Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966); *Helvering v. R.J. Reynolds Tobacco Co.*, 206 U.S. 110 (1939).

[23] Ball, *supra* Note 19 at 152.

Clarifying the Application or Non-application of Section 2704 to Section 2703 Options and Agreements.

Buy-sell agreements are commonly used among business owners (whether related or unrelated) to establish a clear procedure for the purchase of an owner's interest upon a transfer during life or at death. These agreements set forth the manner for calculating the purchase price of the departing owner's interest as well as the terms for payment of that amount. Section 2703 generally states that the value of any property (which includes an interest in a family-owned business) may not be determined for transfer tax purposes pursuant to the terms of an option or agreement unless such option or agreement, among other things, is a bona fide business arrangement with terms that are comparable to similar arrangements entered into by persons in an arms' length transaction and the option or agreement is not a device to transfer property to members of the owner's family for less than full and adequate consideration. As developed in case law[24] section 2703 also requires a showing that the method for determining the purchase price bears a reasonable relationship to the fair market value of the interest. Thus, it is common for owners to have an independent appraisal prepared for purposes of establishing a purchase price under the terms of an option or agreement that is intended to satisfy the requirements of section 2703. Such an appraisal often will account for the presence of limitations or restrictions on the ability of the interest holder to liquidate the interest that is governed by the section 2703 option or agreement.

The Preamble to the Proposed Regulations states 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."[25] Further, Proposed Regulations section 25.2704-2(b)(4)(iii) states that "an option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction." Similarly, Proposed Regulations section 25.2704-3(b)(5)(iv) states that "an option, right to use property, or agreement that is subject to section 2703" is not a disregarded restriction.

The reference in the Proposed Regulations to an agreement that is "subject to section 2703" is confusing because all buy-sell agreements are "subject to" section 2703[26] even though not all buy-sell agreements meet the requirements of section 2703(b). Therefore, we believe it is important to clarify whether only options or agreements that satisfy section 2703 (as opposed to being "subject to" section 2703) are intended to fall within the exceptions of Proposed Regulations sections 25.2704-2(b)(4)(iii) and 25.2704-3(b)(5)(iv).

Further, it is unclear whether and how the Proposed Regulations are intended to affect the value of an interest that is established for federal transfer tax purposes by an option or agreement that satisfies the requirements of section 2703. In other words, if an option or agreement satisfying the requirements of section 2703 provides for the value of an interest to be determined pursuant to an

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[24] *E.g.*, *Estate of Lauder v. Commissioner*, T.C. Memo 1992-736; *Estate of True v. Commissioner,* 390 F. 3d 1210 (10th Cir. 2004).

[25] Note 1, *supra*, at 51,417.

[26] Other than certain grandfathered buy-sell agreements. See, *e.g.*, P.L. 101-508, § 11602(e)(1).

independent appraisal that accounts for all characteristics of the interest, including restrictions on the ability of the interest holder to redeem or liquidate his or her interest, would the appraiser be required to disregard the liquidation restriction due to the Proposed Regulations when valuing the interest for purposes of the option or agreement, or does the fact that the buy-sell agreement satisfied section 2703, by itself, eliminate the need to apply the Proposed Regulations under section 2704? It would be helpful if the final regulations clarified the interplay of sections 2703 and 2704.

Section 2704 References to "Controlled Entity."

The Proposed Regulations use the term "control" but define it by reference to the term "controlled entity" from the section 2701 regulations.[27] In contrast, section 2701 provides a definition for the term "control." The cross-reference to the section 2701 regulations, rather than the statute itself, is likely an effort to include the "patch" added by the Proposed Regulations to section 25.2701-2(b)(5), which clarifies that business entities other than corporations and partnerships are to be considered in the analysis. Unfortunately, this cross-reference also causes confusion because "controlled entities" is defined by reference to a very specific family group that differs from the group used elsewhere in the Proposed Regulations.

The term "controlled entity" is defined for purposes of the section 2701 regulations as a corporation or partnership that is controlled, immediately before a transfer, by the transferor, *applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse*.[28] In contrast, the Proposed Regulations use the phrase "the transferor and/or *members of the transferor's family* control the entity immediately before the transfer,"[29] but give no indication of the extent to which the definition of "controlled entity" applies. Put another way, the question is which family group is relevant for the control analysis under the Proposed Regulations: the family group from Section 2702 (because the phrase is "*members of the transferor's family* control") or from section 2701 (because "control" is defined by reference to "controlled entity")?

The answer to this question is important because the class of family members considered for purposes of determining a "controlled entity" under section 2701 includes the transferor's nieces, nephews, and more remote lineal descendants of the parents of the transferor and the transferor's spouse, while the "members of the [transferor's] family" considered for purposes of section 2702 does not.[30] Thus, the control tests under the Proposed Regulations may be substantially different from the controlled entity test from section 2701, despite the explicit cross-reference. We recommend that the cross-references to "controlled entity" in the Proposed Regulations under section 2704 be clarified, due to the potential for taxpayer confusion.

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[27] Prop. Regs. § 25.2704-2(c), -3(c).
[28] Treas. Regs. § 25.2701-2(b)(5)(i).
[29] Prop. Regs. § 25.2704-3(b)(5)(iii) (emphasis added).
[30] The Proposed Regulations adopt the definition of "member of the family" from 25.2702-2(a)(1). *See* Prop. Regs. §§25.2704-1(a)(2)(ii) and 25.2704-3(c).