Unpacking the Myths and Mysteries of Chapter 14

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1. Code § 2701: The First of the Special Valuation Rules[1]

   a. Generally, Code § 2701 applies any time an individual "transfers" an equity interest in a privately held entity to a "member of the transferor's family," if, immediately after such transfer, the transferor or one or more "applicable family members" holds an equity interest in the entity that is classified as an "applicable retained interest."[2]

   b. If Code § 2701 applies, the gift tax value of the transferred interest is determined under the so-called "subtraction method."[3] In its most simple form, the subtraction method determines the gift tax value of the transferred equity interest by subtracting the value of all equity interests in the entity held by the transferor (and applicable family members) immediately after the transfer from the aggregate value of all equity interests in the entity held by the transferor (and applicable family members) immediately before the transfer.

   c. If the retained equity interest is an applicable retained interest, its value for purposes of applying the subtraction method is zero (the "zero value rule").[4] The result of the zero value rule is that, for gift tax purposes, the transferor is treated as transferring not only the actual gifted interest, but all applicable retained interests as well. This can result is a significant, unexpected gift tax liability.

   d. Code § 2701 is riddled with defined terms that must be fully understood before one can properly determine whether Code § 2701 applies. What follows is a summary of some of the more important defined terms within Code § 2701.

      i. Transfer – Code § 2701 applies only if there has been a "transfer" of an equity interest in an entity. Transfer for purposes of Code § 2701 is broadly defined and includes traditional transfers, such as gifts and sales, as well as certain "deemed" transfers, such as capital contributions to a new or existing entity, recapitalizations and changes in the capital structure of any entity (discussed below).[5]

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[1] Portions of this section were adapted from an outline entitled "Transfer Tax Planning with Carried Interests in Hedge and Private Equity Funds", presented at the ABA 2013 Joint RPTE-Tax Fall CLE Meeting by N. Todd Angkatavanich, Christine R. W. Quigley, and Ivan Taback.
[2] I.R.C. § 2701.
[3] Treas. Reg. § 25.2701-1(a)(2); Treas. Reg. § 25.2701-3.
[4] I.R.C. § 2701(a)(3)(A).
[5] Treas. Reg. § 25.2701-1(b)(2)

ii. Member of the Transferor's Family – Code § 2701 applies only if the equity interest is transferred to an individual who falls within a limited defined group of individuals, each member of which is referred to as a "member of the transferor's family." A member of the transferor's family includes –

1. The transferor's spouse;

2. A lineal descendant of the transferor or the transferor's spouse; or

3. The spouse of any lineal descendant of the transferor or his or her spouse.[6]

4. Generally speaking, Code § 2701 applies only if the equity interest is transferred to a younger generation family member. Note that because aunts, uncles, nieces and nephews are not lineal descendants of the transferor, such individuals are not treated as members of the transferor's family, and, thus, Code § 2701 does not apply to transfers to such individuals.

iii. Applicable Family Member – Code § 2701 applies only if after the transfer of an equity interest to a member of the transferor's family, the transferor or an "applicable family member" holds an equity interest in the entity. An applicable family member includes –

1. The transferor's spouse;

2. An ancestor of the transferor or of the transferor's spouse; or

3. The spouse of any ancestor of the transferor or of the transferor's spouse.[7]

4. Generally speaking, Code § 2701 applies only if the transferor or a senior generation family member holds an equity interest in the entity immediately after the transfer.

iv. Applicable Retained Interest – Code § 2701 applies only if the equity interest held by the transfer or applicable family member immediately after the transfer is classified as an "applicable retained interest." An equity interest will be classified as an applicable retained interest if it confers upon its holder either an "extraordinary payment right," or in the case of a controlled entity, a "distribution right."[8]

[6] I.R.C. § 2701(e)(1); Treas. Reg. § 25.2701-1(d)(1).
[7] I.R.C. § 2701(e)(2); Treas. Reg. § 25.2701-1(d)(2).
[8] I.R.C. § 2701(b); Treas. Reg. § 25.2701-2(b)(1).

1. Extraordinary Payment Right

    a. An extraordinary payment right is a liquidation, put, call or conversion right, or a similar right, the exercise or nonexercise of which affects the value of the transferred interest.[9] A call right includes any warrant, option, or other right to acquire one or more equity interests.[10]

    b. Extraordinary payment rights do not include any right that must be exercised at a specific time and at a specific amount.[11]

    c. Thus, a liquidation, put, call or conversion right will generally only be an extraordinary payment right when the holder of such a right has discretion as to whether (or when) to exercise them.

    d. Extraordinary payment rights do not include certain nonlapsing rights to convert to a fixed number or percentage of units or shares of the same class as the transferred interest (or which would be of the same class but for nonlapsing differences in voting power).[12]

    e. Reasoning for Applying Zero Value Rule to Extraordinary Payment Rights – For purposes of Code § 2701, it is assumed that discretionary extraordinary payment rights will never be exercised by a senior family member. As a result, greater value will pass to the younger generation family members holding common interests. On this logic, senior equity "applicable retained interests" are ascribed zero value in determining the worth of the transferred interest for gift tax purposes under the subtraction method.

2. Distribution Rights

    a. A distribution right is the right to receive discretionary distributions with respect to an equity interest in an entity that is "controlled" by the transferor and/or applicable family members.[13,14]

[9] I.R.C. §§ 2701(b)(1)(B), 2701(c)(2)(A).
[10] Treas. Reg. § 25.2701-2(b)(2).
[11] I.R.C. § 2701(c)(2)(B)(i).
[12] I.R.C. § 2701(c)(2)(C); see additional applicable requirements in that section.
[13] I.R.C. § 2701(b)(1)(A).
[14] I.R.C. § 2701(b)(2)(C); Treas. Reg. § 25.2701-2(b)(5)(i). As a note of caution, "applicable family member" for purposes of determining whether an entity is controlled under Code § 2701(b) is defined in Code § 2701(b)(1)(2)(C) to include any lineal descendant of any parent of the transferor or the transferor's spouse. In other words, for this

b. A distribution right does not include –

   i. Any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest.

   ii. Any extraordinary payment right.[15]

c. A right to distributions in an entity that is *junior* to the rights of the transferred interest is not a distribution right and therefore not an applicable retained interest.[16] This is commonly referred to as a "reverse freeze".

d. As noted above, a right to receive distributions with respect to an equity interest is a distribution right for purposes of Code § 2701 only if the transferor and/or applicable family members control the entity immediately prior to the transfer.[17]

   i. As a note of caution, "applicable family member" for purposes of determining whether an entity is controlled under Code § 2701(b) is defined in Code § 2701(b)(1)(2)(C) to include any lineal descendant of any parent of the transferor or the transferor's spouse. In other words, for this purpose only, the term "applicable family member" includes junior generation family members. Contrast the general definition of "applicable family member" contained in Code § 2701(e)(2) as, with respect to any transferor, the spouse, an ancestor of the transferor or his or her spouse, or the spouses of such ancestors (i.e., senior generations only).

e. <u>Corporations</u> – Control, in the case of a corporation, is defined as holding at least 50% of the total voting power or 50% of the fair market value of the equity interests in a corporation.[18]

   i. Voting rights do not include the right to vote on a limited group of matters, such as liquidation,

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purpose only, the term "applicable family member" includes junior generation family members. Contrast the general definition of "applicable family member" contained in 2701(e)(2) as, with respect to any transferor, the spouse, an ancestor of the transferor or his or her spouse, or the spouses of such ancestors (*i.e.*, senior generations only).

[15] Treas. Reg. § 25.2701-2(b)(3).

[16] I.R.C. § 2701(c)(1)(B)(i).

[17] I.R.C. § 2701(b)(1)(A); Treas. Reg. 25.2701-2(b)(5)(i).

[18] I.R.C. § 2701(b)(2)(A); Treas. Reg. § 25.2701-2(b)(5)(ii)(A).

merger and similar events, or the right to vote upon the occurrence of a contingency that has not occurred (other than a contingency within the control of the holder of the right).[19]

ii. A voting right held in a fiduciary capacity is held considered by each beneficial owner and by each individual who is a permissible recipient of the income.

f. Basic Partnerships Rule – Control, in the case of a partnership, is defined as holding at least 50% of either the capital interest or the profits interest (without regard to any right to a guaranteed payment of a fixed amount under Code § 707(c)).[20]

g. Special Rule for Limited Partnerships – Control, in the case of a limited partnership, means holding *any* interest in the limited partnership "as a general partner".[21]

i. Query whether an interest "in the general partner" of the limited partnership is the same as an interest "as a general partner" of the limited partnership.

ii. For example, in the private investment fund context, the general partner of the fund typically will be structured as an LLC. As a result, the fund manager will not have an interest in the fund "as a general partner." Rather, the fund manager will have an interest "in the general partner" of the fund. Most practitioners take the conservative position that a fund manager will be treated as controlling a fund if the fund manager owns any equity interest in the general partner of the fund.[22]

h. For purposes of determining whether an entity is controlled, the attribution rules of Code § 2701(e)(3) and Treasury Regulations § 25.2701-6, explored below, apply.[23]

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[19] Treas. Reg. §. 25.2701-2(b)(5)(ii)(B)
[20] Treas. Reg. § 25.2701-2(b)(5)(iii).
[21] Treas. Reg. § 25.2701-2(b)(5)(iii).
[22] PLR 9639054 (June 21, 1996) would support the position that an interest in the general partner is not necessarily equal to an interest as a general partner for purposes of determining control of a limited partnership. However, such a position is merely implicit in the ruling.
[23] I.R.C. § 2701(b)(1), "…after application of subsection (e)(3)"; see also Treas. Reg. § 25.2701-2(b)(5)(ii)(B).

i. Why is "control" required for distribution rights but not for extraordinary payment rights?

   i. The holder has discretion whether to exercise extraordinary payment rights.

   ii. The entity has discretion to make any distributions associated with a distribution right.

   iii. Reasoning for Applying Zero Value Rule to Distribution Rights – The assumption here is that a family controlled entity will not make discretionary distributions to senior family members, so that greater value will remain in the entity, thereby benefiting the junior family members holding the common interests.

v. Qualified Payment Rights **–** A qualified payment right with respect to an equity interest in a controlled entity is a distribution right for purposes of Code § 2701 and, thus, an applicable retained interest. However, a qualified payment right is not subject to Code § 2701's zero value rule. Rather, a qualified payment right is valued under traditional valuation principles for purposes of Code § 2701, unless it is combined with one or more extraordinary payment rights.

1. A qualified payment right is a right to receive "qualified payments."

2. A "qualified payment" is a distribution that is **–**

   a. A dividend payable on a periodic basis (as least annually) under any cumulative preferred stock, to the extent such divided is determined at a fixed rate;[24]

   b. Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or

   c. Any distribution right for which an election has been made to treat such distribution right as a qualified payment.[25]

[24] For purposes of Code § 2701, a payment rate that bears a fixed relationship to a specified market interest rate is a payment determined at a fixed rate. Treas. Reg. § 25.2701-2(b)(6)(i)(C).
[25] Treas. Reg. § 25.2701-2(b)(6).

3. Partnerships that rely upon the qualified payment right to structure a preferred "frozen" interest are often referred to as preferred partnerships or freeze partnerships.

4. The "lower of" rule applies if a qualified payment right is held in conjunction with an extraordinary payment right. In that case, the value of all rights is determined by assuming that each extraordinary payment right is exercised in a manner resulting in the lowest total value being determined for all the rights.[26]

5. Qualified Payment Right Election

    a. Election to Treat Qualified Payment Right as other Than a Qualified Payment Right – An individual holding an equity interest which confers upon the holder a qualified payment right may elect to treat the qualified payment right as a distribution right that is not a qualified payment right.[27]

    b. Election to Treat Other Distribution Right as a Qualified Payment Right – An individual holding an equity interest which confers upon the holder a distribution right that is not otherwise classified as a qualified payment right may elect to treat such distribution right as a qualified payment right.[28]

    c. If the qualified payment right is held by an applicable family member, a special election must be made to treat the payment right as a qualified payment right, even if it otherwise qualifies as such.[29]

    d. An election assumes for Code § 2701 purposes that a fixed annual payment will be made to the holder of the interest (regardless of whether or not the partnership or corporation has adequate cash-flow).

6. Payment of the Qualified Payment/ Due Date

    a. The due date with respect to any qualified payment is the date specified in the governing instrument as the date on which payment is to be made.

    b. If no due date is specified in the governing instrument, the

[26] Treas. Reg. § 25.2701-2(a)(3) and examples at (a)(5).
[27] Treas. Reg. § 25.2701-2(c)(1).
[28] Treas. Reg. § 25.2701-2(c)(2). Such an election may not cause the value of the applicable retained interest conferring the distribution right to exceed the fair market value of the applicable retained interest (determined without regard to Code § 2701).
[29] Treas. Reg. § 2701-2(c)(4).

due date is the last day of each calendar year.[30]

c. Any payment of a qualified payment made before or during the four year period beginning on the due date of the payment is treated as being made on the due date. Thus, this rule permits a four year grace period.[31]

d. The qualified payment right may be satisfied with a debt obligation, provided that the debt obligation bears compound interest from the original due date at an appropriate discount rate and the term of the debt obligation does not exceed four years.[32]

e. Therefore with these two provisions, the qualified payment due in year one may first be extended by the four year grace period, and then at the termination of that period an interest-bearing promissory note with a maximum maturity of another four years may be issued to satisfy such payment, for a total of eight years of deferral.[33]

f. If a qualified payment is not made within the four year grace period, certain increases are made under the "compounding rule" upon the subsequent transfer of the interest by gift or by death to account for such arrearages.

vi. Rights That Are Neither Extraordinary Payment Rights Nor Distribution Rights

1. Certain rights may be retained by the transferor or an applicable family member in connection with preferred interests, which do not fall within the definition of an extraordinary payment right or a distribution right, and, therefore, are not "applicable retained interests" that trigger the application of Code § 2701:

a. Mandatory Payment Rights: Right to receive a payment required to be made at a specific time for a specific amount (e.g., mandatory redemption required at certain date at certain value).[34]

b. Liquidation Participation Right: Right to participate (in contrast to a right to compel) in a liquidating distribution.[35]

[30] Treas. Reg. § 2701-4(c)(2).
[31] Treas. Reg. § 25.2701-4(c)(5).
[32] Treas. Reg. § 25.2701-4(c)(5).
[33] *See*, Treas. Reg. § 25.2701-4(c).
[34] Treas. Reg. § 25.2701-2(b)(4)(i).
[35] Treas. Reg. § 25.2701-2(b)(4)(ii).

c. Guaranteed Payment Right: Right to a guaranteed fixed amount payment, without contingencies, under Code § 707(c).[36]

d. Non-Lapsing Conversion Right: Non-lapsing right to convert an equity interest into a specific number or percentage of shares (if the entity is a corporation), or into a specified interest (if the entity is a partnership).[37]

2. In addition, debt will never be an applicable retained interest,[38] unless it is recharacterized as disguised equity.[39]

3. Leases, employment arrangements, and other economic interests that are not of an equity nature are not applicable retained interests.[40]

e. Exceptions to Code § 2701. Code § 2701 does not apply to determine the gift tax value of the following:

i. Market Quotations Readily Available: Market quotations are readily available (as of the date of the transfer) for such interest on an established securities market.[41]

ii. Same Class: Such interest is of the same class as the transferred interest,[42] meaning that the rights associated with the retained interest are identical (or proportional) to the rights associated with the transferred interests, except for non-lapsing differences in voting rights (or, for partnerships, non-lapsing differences with respect to management and limitations on liability). Non-lapsing provisions necessary to comply with partnership allocation requirements of the Code (e.g., Code § 704(b)) are non-lapsing differences with respect to limitations on liability.[43]

iii. Proportionate Transfers: Also known as the "Vertical Slice" approach, Code § 2701 does not apply where the transfer results in a proportionate reduction of each class of equity interest held by the transferor and applicable family members immediately before the transfer.[44]

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[36] Treas. Reg. § 25.2701-2(b)(4)(iii).
[37] Treas. Reg. § 25.2701-2(b)(4)(iv).
[38] PLR 9436006, holding that Code § 2701 doesn't apply to debt.
[39] To the extent that a debt instrument has the characteristics of an equity instrument, it may be recharacterized as such by the Service. *See, e.g.,* I.R.C. § 385, *In re Lane,* 742 F.2d 1311 (11th Cir. 1984); *see also Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972).
[40] See, e.g., PLR 9350016
[41] I.R.C. § 2701(a)(2)(A).
[42] I.R.C. § 2701(a)(2)(B).
[43] Treas. Reg. § 25.2701-1(c)(3).
[44] I.R.C. § 2701(a)(2)(C); Treas. Reg. § 25.2701-1(c)(4).

f. The Attribution Rules Under Code § 2701

i. Code § 2701 applies whether the interest is held directly or indirectly.[45] Indirect holdings are determined under Treasury Regulation § 25.2701-6:

1. Attribution to Individuals

a. An individual is treated as holding an equity interest to the extent the interest is held indirectly through a corporation, partnership, estate, trust, or other entity. [46]

b. If an equity interest is treated as held by an individual in more than one capacity, then it is treated as being held by the individual in the manner that attributes to the individual the largest total ownership of the equity interest.[47]

c. If an entity holds an equity interest in another entity, the attributions rules apply a tiered attribution approach. For example, if an individual owns 50 percent of the preferred stock of corporation X, which in turn owns 50 percent of the preferred stock of corporation Y, 25 percent of the preferred stock of corporation Y is considered held by the individual under these rules.[48]

2. Interests Held By Corporations

a. A person [as opposed to an individual] is considered to hold an equity interest held by or for a corporation[49] in the proportion that the fair market value of the stock the person holds bears to the fair market value of all the stock in the corporation (determined as if each class of stock were held separately by one individual).[50]

b. The Regulations imply that the proportion of equity attributable to an interest in a corporation is determined

[45] I.R.C. § 2701(e)(3).
[46] Treas. Reg. § 25.2701-6(a)(1).
[47] *Id.*
[48] *Id*.
[49] Or an association taxable as a corporation. Treas. Reg. § 25.2701-6(a)(2).
[50] Treas. Reg. § 25.2701-6(a)(2).

without regard to minority discounts and without regard to the special valuation rules of Chapter 14.[51]

3. Interests Held by Partnerships

   a. A person [as opposed to an individual] is considered to hold an equity interest held by or for a partnership[52] in proportion that the fair market value of the larger of the person's profits interest or capital interest in the partnership bears to the total fair market value of the corresponding profits interests or capital interests in the partnership, as the case may be (determined as if each class were held by one individual).[53]

4. Interests Held by Estates and Trusts

   a. Basic Trust Attribution Rules

      i. A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person.[54]

      ii. If stock is specifically bequeathed to one beneficiary, it will not be attributed to the residuary beneficiaries.

      iii. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust…is not considered the holder of the equity interest.[55]

      iv. Nonetheless, any person who may receive distributions from a trust is considered to hold an equity interest held by the trust if the distributions may be made from current or accumulated income

[51] Treas. Reg. § 25.2701-6(b), ex. 2.
[52] Or an entity classified as a partnership for federal income tax purposes. Treas. Reg. § 25.2701-6(a)(3).
[53] Treas. Reg. § 25.2701-6(a)(3).
[54] Treas. Reg. § 25.2701-6(a)(4)(i).
[55] *Id.*

from or the proceeds from the disposition of the equity interest, *even though under the terms of the trust the interest can never be distributed to that person.*[56] Thus, even a person who has an income interest only may be deemed to "hold" a share of the corpus of the trust.[57]

v. In addition, the rules do not distinguish between a present and a future interest. As a result, even an individual who does not have a present right to distributions may be deemed to indirectly hold a share of the underlying equity.[58]

b. Grantor Trust Attribution Rules

i. An additional set of attribution rules need to be considered if the trust at issue is a "grantor trust" for income tax purposes under Code §§ 671-679.

ii. These provisions provide that an individual will be treated as holding an equity interest held by or for a trust if the individual is considered an owner of the trust for income tax purposes (i.e., the trust is a grantor trust with respect to the individual).

iii. If an individual is treated as the owner of only a fractional share of a grantor trust because there are multiple grantors, the individual holds each equity interest held by the trust, except to the extent that the fair market value of the interest exceeds the fair market value of the fractional share.

iv. The grantor of an irrevocable grantor trust is often not a discretionary beneficiary of such trust and, therefore, would not be attributed ownership of any portion of the equity interest held by such trust under the basic trust attribution rules.

v. However, this special grantor trust attribution rule broadens the attribution of equity interests to include those treated as grantors for income tax purposes – even if they are not permissible beneficiaries of the trust.

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[56] *Id.*
[57] Treas. Reg. § 25.2701-6(b), ex. 4 and 5.
[58] Treas. Reg. § 25.2701-6(b), ex. 4 and 5.

vi. This may result in both the trust beneficiaries and the grantor of the trust being attributed ownership of a particular interest.

g. The Multiple Attribution Rules under Code § 2701

i. If the attribution rules result in an equity interest being attributed to more than one person, ordering rules determine to whom ownership is attributable for purposes of applying Code § 2701.

ii. The ordering rules differ depending on whether the equity interest in question is an applicable retained interest or a subordinate equity interest.[59]

1. Applicable Retained Interests

a. If ownership of an applicable retained interest is attributed to more than one of the transferor and applicable family members, it is attributed within that class in the following order:

i. If the interest is held in a grantor trust, to the individual treated as the holder thereof;

ii. To the transferor;

iii. To the transferor's spouse; or

iv. To each applicable family member on a pro rata basis.[60]

2. Subordinate Equity Interests. [61]

a. If ownership of a subordinate equity interest is attributed to more than one individual in a class consisting of the transferor, applicable family members, and members of the transferor's family, the interest is attributed within that class in the following order:

i. To the transferee;

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[59] Treas. Reg. § 25.2701-3(a)(2)(iii).

[60] Treas. Reg. § 25.2701-6(a)(5)(i).

[61] A subordinate equity interest is an equity interest as to which an applicable retained interest is a senior equity interest. Treas. Reg. § 25.2701-3(a)(2)(iii). A senior equity interest is an equity interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. Treas. Reg. § 25.2701-3(a)(2)(ii).

ii. To each member of the transferor's family on a pro rata basis;

iii. If the interest is held in a grantor trust, to the individual treated as the holder thereof;

iv. To the transferor;

v. To the transferor's spouse; or

vi. To each applicable family member on a pro rata basis.[62]

3. The existence of separate ordering rules appears to be motivated by two goals:

   a. Maximizing the chance that ownership of an applicable retained interest will be attributed to the transferor or an applicable family member and

   b. Maximizing the chance that ownership of a subordinate equity interest will be attributed to membership of the transferor’s family.

4. The multiple attribution rules do not create attribution where there otherwise was none. In other words, the multiple attribution rules only apply if ownership of an equity interest is attributed to multiple persons under Treasury Regulations § 25.2701-6(a).

h. Deemed and Indirect Transfers

i. As noted above, Code § 2701 applies not only to gifts, but to all *transfers.*

ii. For purposes of Code § 2701, a transfer includes the following transactions:

1. Sale for Full and Adequate Consideration – Code § 2701 applies to a transfer that would not otherwise be a gift under general gift tax principles because it was a transfer for full and adequate consideration.[63]

2. Capital Contribution **–** A contribution to the capital of a new or existing entity.[64]

[62] Treas. Reg. § 25.2701-6(a)(5)(ii).
[63] Treas. Reg. § 25.2701-1(b)(1).
[64] Treas. Reg. § 25.2701-1(b)(2)(i)(A).

3. Capital Structure Transaction – A redemption, recapitalization or other change in the capital structure of an entity (a "capital structure transaction"), if –

    a. The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

    b. The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity that is junior to the applicable retained interest and receive property other than an applicable retained interest; or

    c. The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate equity interest) and the fair market value of the applicable retained interest is increased.[65]

4. Termination of Indirect Holding – The termination of an indirect holding in an entity (or a contribution to the capital of an entity to the extent an individual indirectly holds an interest in the entity) if –

    a. The property is held in a trust as to which the indirect holder is treated as the owner under the grantor trust rules of Code §§ 671-679;

        i. For example, an indirect transfer may occur when the transferor relinquishes the rights retained with respect to the property held in the grantor trust that caused the trust to be a grantor trust.

    OR

    b. If the termination (or contribution) is not treated as a transfer under the preceding provision, to the extent that the value of the indirectly held interest would have been included in the value of the indirect holder's gross estate for Federal estate tax purposes if the indirect holder died immediately prior to termination.[66]

iii. For purposes of Code § 2701, a transfer does not include the following

[65] Treas. Reg. § 25.2701-1(b)(2)(i)(B).
[66] Treas. Reg. § 25.2701-1(b)(2)(i)(C).

transactions:

1. A capital structure transaction will not be treated as a transfer if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[67]

    a. This is not the same as the exceptions described above for retained interests "of the same class as" or "proportional to" the transferred interests.

    b. Those exceptions merely provided that Code § 2701 would not apply to determine value.

    c. This exception is an exclusion from the definition of the word "transfer" for purposes of Code § 2701.

2. A shift of rights occurring upon the execution of a qualified disclaimer under Code § 2518 is not a transfer.[68]

3. A shift of rights occurring upon the release, exercise or lapse of a non-general power of appointment is not a transfer, except to the extent that it would otherwise be a transfer (a taxable gift) under chapter 12.[69]

i. The Valuation Rules of Code § 2701

    i. If Code § 2701 applies, the gift tax value of the transferred interest is determined under the so-called "subtraction method."

    ii. Generally speaking, the subtraction method determines the gift tax value of the transferred interest by subtracting the value of all equity interests in the entity retained by the transferor immediately after the transfer from the aggregate value of all equity interests in the entity held by the transferor immediately before the transfer.

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[67] Treas. Reg. § 25.2701-1(b)(3)(i). See also PLR 9427023 (contribution to existing LP not subject to Code § 2701 because interests remained substantially the same) & PLR 199947034 (conversion to LLC not subject to Code § 2701 where shareholders receive identical rights, preferences, and restrictions in membership interests as they had in the company). For these purposes, common stock with non-lapsing voting rights and nonvoting common stock are interests that are substantially the same.
[68] Treas. Reg. § 25.2701-1(b)(3)(ii).
[69] Treas. Reg. § 25.2701-1(b)(3)(iii).

iii. If the retained equity interest is an applicable retained interest, its value for purposes of applying the subtraction method is zero (the "zero value rule").[70]

iv. The result of the zero value rule is that, for gift tax purposes, the transferor is treated as transferring not only the actual gifted interest, but all applicable retained interests as well.

v. The value of a qualified payment right is determined without regard to Code § 2701 (*i.e.*, it is valued under traditional valuation principles), unless it is held in connection with an extraordinary payment right.[71]

vi. <u>Lower of Rule</u> – If an applicable retained interest confers upon its holder both a qualified payment right (generally valued at fair market value) and an extraordinary payment right (valued at zero), the value of the applicable retained interest is determined as if each extraordinary payment right were exercised in the manner resulting in the lowest possible value being determined for all such rights.[72]

1. <u>Example</u>: P, an individual, holds all 1,000 shares of X Corporation's $1,000 par value preferred stock bearing an annual cumulative dividend of $100 per share and holds all 1,000 shares of X's voting common stock. P has the right to put all the preferred stock to X at any time for $900,000. P transfers the common stock to P's child and immediately thereafter holds the preferred stock. Assume that at the time of the transfer, the fair market value of X is $1,500,000, and the fair market value of P's annual cumulative dividend right is $1,000,000. Because the preferred stock confers both an extraordinary payment right (the put right) and a qualified payment right (*i.e.*, the right to receive cumulative dividends), the lower of rule applies and the value of these rights is determined as if the put right will be exercised in a manner that results in the lowest total value being determined for the rights (in this case, by assuming that the put will be exercised immediately). The value of P's preferred stock is $900,000 (the lower of $1,000,000 or $900,000). The amount of the gift is $600,000 ($1,500,000 minus $900,000).

vii. <u>10% Minimum Value Rule</u> – If Code § 2701 applies to the transfer of an interest in an entity, the value of a junior equity interest shall not be less than its pro-rata portion of 10% of the sum of –

1. The total value of all equity interests in the entity, and

[70] I.R.C. § 2701(a)(3)(A).
[71] I.R.C. § 2701(a)(3)(C).
[72] I.R.C. § 2701(a)(3)(B).

2. The total amount of any indebtedness of the entity owed to the transferor and applicable family members.[73]

For purposes of the 10% minimum value rule, junior equity interest means common stock, or, in the case of a partnership, any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests.[74]

j. Planning Around Code § 2701

i. Carried Interest and the Vertical Slice

1. It is possible that Code § 2701 may apply to the transfer of a general partner interest in a private investment fund (that holds the carried interest) if the fund manager retains his or her entire limited partnership interest in the fund. This is because under most fund partnership agreements, the limited partnership interests in the fund entitle the holder to distribution rights that have preference over, or are senior to, the distribution rights associated with the general partner interest. As a result, if the fund manager is deemed to control the fund, the limited partnership interests will be classified as an applicable retained interest.

2. If Code § 2701 applies, the fund manager may be treated as making not only an actual gift of the general partner interest, but also a deemed gift of all of the fund manager's limited partnership interests in the fund. Because a fund manager often invests a sizeable amount of capital into a fund as a limited partner, such a deemed gift could be problematic from a gift tax perspective – if the amount of the fund manager's investment as a limited partner in the fund is large enough, the amount of the deemed gift could be dramatic and could cause a significant deemed gift tax liability; despite the fact that the fund manager had not actually transferred his limited partner interest nor intended to do so.

3. Set forth in Treas. Reg. § 25.2701(c)(4), the vertical slice exception provides that Code § 2701 does not apply to a transfer to the extent that such transfer results in a proportionate reduction of each class of equity interest held by the transferor and all applicable family members in the aggregate immediately before the transfer.

4. In the fund context, the vertical slice exception requires the fund principal to transfer not only his or her carried interest, but also a proportionate amount of all other equity interests in the fund (*e.g.*,

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[73] I.R.C. § 2701(a)(4)(A); Treas. Reg. § 25.2701-3(c)(1).
[74] Treas. Reg. § 25.2701-3(c)(2).

the fund principal's capital interest in the fund either through the GP or in the fund directly as an LP).

5. The logic behind the vertical slice exception, presumably, is that because by making a vertical slice transfer reduces every interest in the entity on a pro-rata basis, and consequently, the opportunity to disproportionately shift wealth to the next generation, through the retention of some artificially inflated equity interests and the transfer of an artificially depressed different interest, does not exist. Instead, the vertical slice ensures that the younger generation and parent would share proportionally in the future growth, or decrease in value, of the entity and thus not allow for a shift in value away from the parent to the younger generation by way of the non-exercise of discretionary rights.

ii. Code § 2701 Preferred Partnerships

1. Preferred Partnerships are also referred to as freeze partnerships because such partnerships in effect "freeze" the return of one class of partnership interests at a fixed rate. Such interests are preferred vis-à-vis the common interests in that they have priority over the common interests with respect to the payment of a fixed coupon on the holder's investment and in the event of a bankruptcy. They do not, however, participate in the upside growth of the partnership as all the future appreciation in excess of the preferred coupon inures to the benefit of the other class of partnership interests, typically held by the younger generation or trusts for their benefit. The preferred interests are usually held by a senior generation family member.

2. A parent's preferred partnership interest is typically structured as a "qualified payment right" under Code § 2701 to ensure that the parent's contribution of assets to the preferred partnership is not a deemed gift under the Code § 2701 "zero value" rule of the subtraction method.

3. To be a qualified payment right, the parent must receive a fixed percentage payment on his or her capital contribution, payable at least annually and on a cumulative basis. The use of this "qualified payment right" structure will result in the parent's preferred interest being valued under traditional valuation principles for gift tax purposes, and not the extremely unfavorable "zero value" rule of Code § 2701.

4. Typically, the preferred interest would also provide the parent with a priority liquidation right in addition to the preferred coupon; meaning that upon liquidation, the parent will receive a return of his or her capital before the common interest holders receive their

capital. Parent, however, will not receive any of the potential upside growth in the preferred partnership based on his or her preferred interest. Anything in excess of the amount needed to pay the preferred coupon will accrue to the benefit of the common interest holders (*i.e.*, child, or trust for the child's benefit).

5. For purposes of avoiding the "lower of" rule of Code § 2701, it is critical that no extraordinary payment rights be retained by the parent, including discretionary rights, such as puts, calls, conversion rights and rights to compel liquidation, the exercise or non-exercise of which affects the value of the transferred interest.[75]

6. The restriction on extraordinary payment rights is intended to make sure that the preferred interest holder does not retain any discretionary rights that could otherwise ascribe additional value to the parent's retained preferred interest, but if not exercised would shift value to the common interests as a result of such inaction. Inadvertently retaining an extraordinary payment right along with a qualified payment right would result in a deemed gift upon the parent's capital contribution under the so-called "lower of" rule.[76]

7. <u>Valuation of the Preferred Coupon</u>

    a. Even if the parent's preferred interest is properly structured to avoid the draconian aspects of Code § 2701, there are still deemed gift issues to consider as the foregoing structure merely ensures that the parent's preferred interest is not valued at zero for purposes of determining parent's gift to younger generation family members. There may still be a partial gift under traditional valuation principals if the parent's retained preferred coupon is less than what it would have been in an arms'-length situation. For example, if the parent's retained coupon under the partnership agreement is 5% but a 7% return would be required in an arms'-length transaction, then a deemed gift has still been made by the parent to the extent of the shortfall; albeit not as dramatic a gift as would occur by violating Code § 2701.

    b. Vital to arriving at the proper coupon rate is the retention of a qualified appraiser to prepare a valuation appraisal to determine the preferred coupon required for the parent to receive value equal to par value for his or her capital contribution. In preparing the appraisal, the appraiser will need to take into account the factors set forth by the IRS in

[75] Treas. Reg. § 25.2701-1(a)(2)(i).
[76] Treas. Reg. § 25.2701-2(a)(3).

Revenue Ruling 83-120.[77] The starting point under this guidance is to analyze comparable preferred interest returns on high quality publicly-traded securities. Additional factors for consideration include the security of the preferred coupon, the size and stability of the partnership's earnings, asset coverage, management expertise, business and regulatory environment and any other relevant facts or features of the Preferred Partnership.

c. The partnership's coverage of the preferred coupon, which is the ability to pay the required coupon when due, and its coverage of the liquidation preference, which is its ability to pay the liquidation preference upon liquidation of the partnership, will impact the required coupon. A higher percentage of the partnership interests being preferred interests, and correspondingly less common interests, puts greater financial pressure on the partnership's ability to pay the coupon on time; this translates to weaker coverage of the coupon, and thus greater risk, and ultimately a higher required coupon to account for the greater risk. Conversely, a partnership that has a higher percentage of common interests relative to preferred would provide stronger coverage which would result in lower risk and consequently a lower required coupon. A lower coupon may be more desirable from a wealth transfer standpoint as growth above the lower coupon will shift to the younger generation owning the common interests.

k. CCA 201442053 – Code § 2701 Applied to a Recapitalization

i. Facts

1. In CCA 201442053, the IRS determined that Code § 2701 was triggered in connection with the recapitalization of an LLC. In the CCA, an LLC was initially created by mother as a single class LLC, followed by gifts of LLC interests to her two sons and her grandchildren all of whom shared capital, profits and losses in proportion to their percentages interests. The LLC was later recapitalized. As a result, all future profits or gains were allocated to the sons only as consideration for the sons agreeing to manage the LLC. Following the recapitalization, the mother’s only interest was the right to the return of her capital account upon liquidation based on her membership interest as it existed immediately prior to the recapitalization.

[77] Rev. Rul. 83-120, 1983-2 C.B. 170.

ii. Conclusion

1. The IRS determined that the recapitalization was a Code § 2701 "transfer" under Treasury Regulation § 25.2701-1(b)(2)(B)(2). It reasoned that the mother held an applicable retained interest (her "Distribution Right") both before and after the recapitalization, and that her sons' right to receive future profits was a subordinate interest.[78]

iii. Criticism

1. In his article, Richard L. Dees argues that the IRS should withdraw the CCA and criticizes it as containing a rather muddled analysis in determining that the mother's retained interest was an "Applicable Retained Interest" due to the fact that "[b]oth before and after the recapitalization, Donor held an Applicable Retained Interest, an equity interest in Company coupled with a Distribution Right." Dees argues that the mother's right to receive her capital account upon termination of the LLC was not an "Applicable Retained Interest;" rather, such right would have been either a "Mandatory Payment Right" or a "Liquidation Participation Right," neither of which is subject to valuation under Code § 2701. Additionally, he points out that mother did not retain an "Extraordinary Payment Right" since she did not have the discretionary right to withdraw her capital interest from the LLC which was subject to a stated term. (Since the publication of Dees' article, it has since been determined that mother had a large enough percentage interest to unilaterally liquidate the LLC, which would have constituted an Extraordinary Payment Right.[79]) After the recapitalization, mother retained no rights to receive distributions with respect to her equity interests, but only the right to a return of her capital account.

2. <u>Code § 2702 - "Special Valuation Rules in Case of Transfers of Interests in Trusts"</u>[80]

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[78] For a comprehensive and critical commentary on this CCA, *see* Richard L. Dees, *Is Chief Counsel Resurrecting The Chapter 14 "Monster?"* TAX NOTES (December 15, 2014).
[79] Richard L. Dees, *The Preferred Partnership Freeze And The Reverse Freeze (Part II) - IRC Section 2701 And The Regulatory Scheme, Forty-First Notre Dame Tax and Estate Planning Institute*, at 6-39 (September 17-18, 2015).
[80] This section was adapted from a portion of an outline entitled "Chapter 14 'Soup to Nuts': A Practitioner's Guide Through the Minefield", presented at the 2016 Heckerling Institute on Estate Planning by N. Todd Angkatavanich.

a. Code § 2702 Overview

   i. Code § 2702 applies a "zero valuation" rule to determine the amount of a gift when an individual makes a transfer in trust to or for the benefit of a "Member of the Family" if such individual or an "Applicable Family Member" retains an interest in the trust.

   ii. If Code § 2702 applies to a transfer and the retained interest is not a "Qualified Interest," or some other exception does not apply, the retained interest is valued at zero and the amount of the gift is equal to the entire value of the transferred property.

   iii. If the retained interest is a "Qualified Interest," its value is determined actuarially and subtracted from the value of the transferred interest to determine the amount of the taxable gift.

b. Code § 2702 and its definition of a "Qualified Interest" provides the statutory basis for many estate planning vehicles involving transfers to trusts, such as Grantor Retained Annuity Trusts ("GRATs") and Qualified Personal Residence Trusts ("QPRTs").

c. Additionally, Code § 2702(c) contains provisions with respect to certain joint purchases of property and other property interests being treated as transfers held in trust, which are likewise subject to the zero valuation rule.

d. Code § 2702 may have important implications in the case of joint purchases between family members, when term interests are acquired, and should be considered whenever contemplating such a transaction.

e. General Definitions

   i. Member of the Family – The term "Member of the Family" means with respect to an individual transferor, such transferor's spouse, any ancestor or lineal descendant of the transferor or the transferor's spouse, any brother or sister of the transferor, and any spouse of the foregoing.[81]

   ii. Applicable Family Member – The term "Applicable Family Member" means with respect to the individual transferor, the transferor's spouse, and any ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor.[82]

[81] I.R.C. § 2704(e); I.R.C. § 2704(c)(2); Treas. Reg. § 25.2702-2(a)(1).

[82] I.R.C. § 2701(e)(2); Treas. Reg. § 25.2701-1(d)(2).

iii. Qualified Interest

1. Qualified Annuity Interest – Any interest which consists of the right to receive fixed amounts payable not less frequently than annually.[83]

2. Qualified Unitrust Interest – Any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust determined annually.[84]

3. Qualified Remainder Interest – Any noncontinget remainder interest if all other interest are Annuity Interests or Unitrust Interests.[85]

iv. Fixed Amount – A "Fixed Amount" means either:

a. A stated dollar amount, payable periodically (at least annually), but only to the extent the dollar amount does not exceed 120% of the stated dollar amount payable in the preceding year;[86] or

b. A fixed fraction or percentage of the initial fair market value of the property transferred to the trust, payable periodically (at least annually), but only to the extent the fractional percentage does not exceed 120% of the fixed fractional percentage payable in the preceding year.[87]

f. Grantor Retained Annuity Trusts

i. A GRAT is a statutorily blessed vehicle under Code § 2702, whereby assets are transferred into an irrevocable trust that provides a stream of annuity payments, typically to the grantor, for a selected term of years. If the grantor survives the selected term of years, upon the termination of the annuity stream, the remaining assets pass to the remainder beneficiaries, either outright or in further trust, without the imposition of additional gift tax.

ii. Gift Value

1. When an individual transfers assets to the GRAT, he or she will be treated as making a taxable gift to the GRAT. However, because the individual will retain the right to receive annuity payments

[83] I.R.C. § 2702(b)(1); Treas. Reg. § 25.2701-1(b)(1).
[84] I.R.C. § 2702(b)(2); Treas. Reg. § 25.2701-1(b)(2).
[85] I.R.C. § 2702(b)(3); Treas. Reg. § 25.2701-1(b)(3)
[86] Treas. Reg. § 25.2702-3(b)(1)(ii)(A).
[87] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

from the GRAT, the value of the gift is not the full value of the assets contributed to the GRAT, but rather, the value of the interest passing to the remainder beneficiaries.

2. The value of the interest passing to the remainder beneficiaries is calculated by subtracting the present value of individual's retained right to receive the annuity payments (determined using the federal statutory interest rate under Code § 7520 (the "§ 7520 rate")) from the total value of the assets contributed to the GRAT.

3. The retained annuity interest in the GRAT is often structured so that the value of the interest passing to the remainder beneficiaries is a nominal amount. This is often referred to as a "zeroed-out GRAT."[88]

4. If the GRAT assets appreciate at a rate exceeding the § 7520 rate used to determine the present value of the retained annuity interest, the excess appreciation passes to the remainder beneficiaries gift tax-free.

5. If the assets of the GRAT fail to beat the § 7520 rate or decrease in value, all of the trust assets will return to the transferor as annuity payments and he or she will be in the same position economically as if he or she had never made the transfer.[89]

iii. Adjustment Feature

1. Some practitioners consider GRATs to be relatively conservative planning vehicles, (e.g., as compared to a sale to an IDGT, etc.) because this technique is specifically authorized under Code § 2702. Additionally, the Regulations specifically provide for a valuation adjustment feature to ensure that no unanticipated additional gift will occur from the creation of a GRAT.[90]

2. Thus, if the value of the asset contributed into a GRAT is increased on a gift tax audit, the amount of the annuity payment due will be automatically recalculated to result in a larger annuity payment, but still result in the same gift amount (or, in the case of a zeroed-out GRAT, will still result in a gift of roughly zero).[91]

[88] *Walton v. Comm'r*, 115 T.C. 589 (T.C. 2000), *acq. in result*, I.R.S. Notice 2003-72, 2003-2 C.B. 964.

[89] The § 7520 Rate is equal to 120% of the AFR. Accordingly, there is potential that the GRAT will underperform a sale to an IDGT in exchange for a promissory note, where the hurdle rate is the AFR..

[90] Treas. Reg. § 25.2702-3(b)(2).

[91] In contrast, a sale to an IDGT generally cannot have such an adjustment feature without risk of the IRS challenging the validity of such a feature as being contrary to public policy.

iv. Mortality Risk

1. While GRATs may be considered "more conservative," there are relative pros and cons that should be considered. Mortality risk is the most significant downside to the GRAT; the grantor must outlive the trust term to remove the gifted assets from his estate under Code § 2036(a)(1). If the grantor dies during the trust term, then a portion of the assets necessary to produce the remaining annuity payments will be included in the grantor's gross estate.[92]

v. Rolling GRATs

1. Many GRATs are structured as short-term (e.g., two or three year) GRATs, or as a series of "rolling" short-term GRATs in which annuity payments from existing GRATs are used to fund additional short-term GRATs.

2. This results in a reduced mortality risk by increasing the chance that the grantor will survive the term of each GRAT.

3. In addition, the short-term nature of each of GRAT allows for an opportunity to "lock-in" the upside of the volatile market, while reducing the potential negative effects of a volatile market's downside.

vi. Payment of Annuity Amount

1. The GRAT must prohibit payment of the annuity with a note, other debt instrument, option or other similar financial instrument.[93]

2. 105 day Grace Period – The annuity must be paid within 105 days for the due date.[94]

vii. GRAT GST Issue: The ETIP Issue

1. The general inability to allocate generation skipping transfer ("GST") tax exemption to a GRAT is another negative planning aspect, as it effectively prevents practitioners from structuring GRATs as multi-generational, GST-exempt trusts, in a tax-efficient manner. This is because of the "estate tax inclusion period" rule (the "ETIP Rule"), which basically provides that GST exemption cannot be allocated to a trust during its trust term if the

[92] Treas. Reg. § 20.2036-1(c)(2)(i).
[93] Treas. Reg. § 25-2702-3(d)(6).
[94] Treas. Reg. § 25-2702-3(b)(4).

assets would otherwise be included in the grantor's estate if he or she died during that term.[95]

2. If the grantor were to die during the annuity term, a portion of the GRAT assets would be included in his or her estate. As a result, the ETIP Rule would preclude the grantor from allocating GST exemption to a GRAT until the end of the ETIP (i.e., the end of the annuity term).

3. Because of this limitation, there would be little if any ability to leverage the grantor's GST exemption with a GRAT. Allocation of the grantor's GST exemption to the trust at the end of the ETIP would have to be made based upon the then values of the trust's assets, and therefore would be an inefficient use of GST exemption.

4. As a result, GST exemption is commonly not allocated to a trust remaining at the expiration of a GRAT annuity term, which results in the GRAT assets will either be subject to estate tax at the death of the second generation beneficiaries or will be subject to a GST tax upon a GST event at the second generation's death.

g. <u>Qualified Personal Residence Trusts ("QPRTs")</u>

i. A QPRT is an estate planning vehicle which is authorized under Code § 2702. A QPRT allows an individual to transfer the future ownership in a personal residence typically to the next generation at a significantly reduced gift tax cost, while continuing to enjoy the use of the property for a set period of years.

ii. QPRTs Generally

1. With a QPRT, the grantor transfers his or her personal residence to an irrevocable trust that satisfies the requirements of a QPRT. Under the provisions of the trust, the grantor retains the right to live in the house for a specified period of years rent free. If the grantor outlives the stated trust term, the residence is removed from the grantor's estate; if the grantor dies during the trust term, the residence is fully included in the grantor's estate at the date of death value. At the end of the QPRT term, ownership of the home passes automatically to the remainder beneficiaries of the QPRT, typically to the grantor's children or a continuing trust for their benefit.

[95] I.R.C. § 2632(c)(4).

2. During the QPRT Term

   a. During the QPRT term, the trust is disregarded for income tax purposes, allowing the grantor to take full advantage of all deductions (such as real estate taxes) associated with the home and any capital gains exclusions available for the sale of a primary residence.

   b. During the trust term, the grantor, as Trustee, may have control over the home and can even sell it, though the proceeds of the sale would remain in trust and generally would need to be used to purchase a replacement home.

   c. If some or all of the proceeds from the sale of the house are not used to purchase a new residence, then the proceeds are paid out to the Grantor as an annuity over the remainder of the QPRT term.

3. After the QPRT Term

   a. At the end of the QPRT term, the remainder beneficiaries and the grantor may (or may not) agree to rent the property from the new owners at fair market value and to continue to live in the home.

   b. The rental payments allow the grantor to pass additional wealth to his or her children in a gift tax-free manner.

   c. If the residence continues in a trust for the grantor's children, and the continuation trust is a "grantor trust" as to the grantor, the rental payments will be both income tax and gift tax free.

4. Factors Determining the Gift

   a. When the QPRT is funded with the residence, the grantor's children or their trusts, as the remainder beneficiaries of the QPRT, are treated as receiving a gift of a future interest in the residence. In calculating the taxable gift, the IRS permits a reduction to account for the grantor's use of the residence during the QPRT term. The value of the gift of the future interest in the residence is influenced by three factors:

      i. First, the gift is impacted by the § 7520 Rate. The higher the interest rate, the greater the value of the grantor's retained term interest and therefore the smaller the gift. Thus, QPRTs are more effective vehicles in high interest rate environments;

ii. Second, the gift value is impacted by the length of the QPRT term. The longer the QPRT term, the greater the value of the grantor's term interest and, thus, the smaller the value of the gift. However, a longer term has greater estate tax risk since the grantor must survive the trust term to remove the residence from the gross estate; and

iii. Third, the gift is impacted by the grantor's life expectancy. The older the grantor, the greater the actuarial possibility that he or she may die before the QPRT term is completed, causing a "reversion" or taxable inclusion in the grantor's estate.

iv. Thus, assuming the grantor outlives the trust term, a QPRT will afford greater transfer tax savings when the QPRT term is longer, when interest rates are higher and when the grantor is older.

iii. Disadvantages

1. There are some potential negative aspects of utilizing a QPRT. It is not advisable to use a QPRT on a mortgaged home, as each mortgage payment will be treated as an additional gift to the trust which would have to be reported and would be rather cumbersome. Hence, it is advisable for any mortgage on the residence to be paid in full before gifting it to a QPRT.

2. Also, the trust must prohibit the sale of the residence to the grantor, grantor's spouse or a controlled entity either during or after the QPRT term.

3. Additionally, the residence contributed to a QPRT will not receive a "step-up" in basis to its fair market value upon the owner's death, as it otherwise would had the grantor retained ownership of the home instead. Accordingly, the children, as remainder beneficiaries of the QPRT, will be liable for capital gains tax on any appreciation in the value of the residence contributed to the QPRT on its subsequent sale.

4. Further, a QPRT is inefficient for GST tax planning purposes due to the ETIP Rule, discussed above.

5. Finally, some people are uncomfortable with the prospect of giving up future control over their residence and the idea of having to pay

rent to their children to live in their own home. Since a QPRT is an irrevocable trust, it is a permanent estate planning technique.

h. <u>Certain Property Interests Treated as Held in Trust Under Code § 2702(c)</u>

i. Code § 2702(c) treats certain property interests as being held in trust, which will be subject to the zero valuation rule unless such property interests qualify as "Qualified Interests."

ii. Specifically, Code § 2702(c) can apply to joint purchases in which a family member retains a term interest, which, although not actually a transfer into trust, may be treated as a transfer in trust under Code § 2702(c).

iii. Deemed Transfers in Trust

1. A transfer of an interest in property with respect to which there are one or more term interests is treated as a transfer in trust.[96]

iv. Term Interests

1. A term interest is one of a series of successive (as contrasted with concurrent) interests.[97] For example, a life interest in property or an interest for a term of years is a term interest.

v. Joint Purchases

1. Solely for purposes of Code § 2702, if an individual acquires a term interest in property and, in the same transaction or series of transactions, one or more members of the individual's family acquire an interest in the same property, the individual acquiring the term interest is treated as acquiring the entire property so acquired, and transferring to each of those family members the interests acquired by that family member in exchange for any consideration paid by that family member.

2. The amount of the individual's gift will not exceed the amount of consideration furnished by that individual for all interests in the property.[98]

3. *Example*. A purchases a 20-year interest in an apartment building and A's child purchases the remainder interest in the property. A and A's child each provide the portion of the purchase price equal to the value of their respective interests in the property determined

[96] IRC 2702(c)(1).
[97] Treas. Reg. § 25.2702-4(a).

[98] Treas. Reg. § 25.2702-4(c).

actuarially under Code § 7520. Solely for purposes of Code § 2702, A is treated as buying the entire property and transferring the remainder interest to his child in exchange for the portion of the purchase price provided by A's child. To determine the amount of A's gift, A's retained interest is valued at zero because it is not a qualified interest.[99] In this example, if the entire value of the property is $10 million, and A's child paid consideration of $3 million, because A's retained interest is valued at zero, A would be deemed to have made a gift of $7 million to her child ($10 million - $3 million).

4. *Example*. K holds rental real estate valued at $100,000. K sells a remainder interest in the property to K's child, retaining the right to receive the income from the property for 20 years. Assume the purchase price paid by K's child for the remainder interest is equal to the value of the interest determined under Code § 7520. K's retained interest is not a qualified interest and is therefore valued at zero. K has made a gift in the amount of $100,000 less the consideration received from K's child.

3. Code § 2703. Certain Rights and Restrictions Disregarded.

   a. Although this section is generally thought of as applying to Buy-Sell Agreements, it applies regardless of whether the right or restriction is contained in a shareholders' agreement, partnership agreement, articles of incorporation, by-laws, or "implicit in the capital structure of an entity,"[100] to the extent that the agreement was executed or substantially modified after October 8, 1990.

   b. For estate tax purposes, the value of property is determined without regard to any right or restriction relating to the property. A right or restriction means any option, agreement, or other right to acquire or use the property at a price less than the fair market value or any restriction on the right to sell or use such property.[101] Stated differently, in determining the value of property, Code § 2703 disregards: [102]

      i. any option, agreement, or other right to acquire or use the property at a price less than fair market value (determined without regard to the option, agreement or right); or

      ii. any restriction on the right to sell or use the property.

[99] Treas. Reg. § 25.2702-4(d), Example 1.

[100] Treas. Reg. § 25.2703-1(a)(3).
[101] Treas. Reg. § 25.2703-1(a)(2).
[102] Treas. Reg. § 25.2703-1(a)(2).

c. Code § 2703 will not apply if <u>all</u> <u>three</u> of the following requirements are met:[103]

   i. The right or restriction is a bona fide business arrangement;

   ii. The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth; and

   iii. At the time the right or restriction is created, its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

d. Bona Fide Business Arrangement

   i. Not defined in statute or regulations.

   ii. The following have been found bona fide business arrangements (including in pre-2703 case law):

      1. Agreements whose purpose is to provide continuity of management and preservation of family control. *Slocum v. United States*, 256 F. Supp. 753 (S.D.N.Y. 1966); *Estate of Hall v. Comm'r*, 92 T.C. 312 (1989); *Estate of Reynolds v. Comm'r*, 55 T.C. 172 (1970); *Smith v. United States*, 2004 WL 1879212 (W.D. Pa. 2004).

      2. Agreements necessary to retain the services of a family employee. *Estate of Bensel v. Comm'r*, 36 B.T.A. 246, 253 (1937), *aff'd* 100 F.2d 639 (3d Cir. 1938) (bona fide arrangement between father and son-employee, who had an "unfriendly" relationship, when son was "the most able man in the employ of the company"); *Citizens Fid. Bank & Trust Co. v United States*, 209 F. Supp. 254 (W.D. Ky. 1962) (option granted to family employee to secure continued services).

      3. Agreements meeting the desire of the decedent's conservator to mitigate the risks of a minority interest and to plan for future liquidity needs of the decedent's estate. *Estate of Amlie v. Comm'r*, T.C. Memo 2006–76.

      4. Agreements to create an incentive for effective management where an owner wished to withdraw from management of a business; *Cobb v. Comm'r*, T.C. Memo 1985-208 (1985).

      5. Agreements to ensure the continued employment of the stockholders who were valued employees and to facilitate a

[103] Treas. Reg. § 25.2703-1(b).

transition of the ownership of the company between the shareholders, thereby ensuring the permanency of the company; I.R.S. Priv. Ltr. Rul. 8541005 (June 21, 1985). Note that some of the stockholders were not family members.

6. Agreements that would have the effect of avoiding expensive appraisals in determining the purchase price, preventing the transfer to an unrelated party, or providing a market for the equity interest. 136 Cong. Rec. S15681 (Oct. 18, 1990).[104]

iii. On the other hand, purposes such as estate planning, tax reduction, wealth transference, protection against dissipation by children, and education for children are not bona fide business purposes. *Holman v. Comm'r*, 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).

e. Devices to Transfer Wealth

i. Requires an inquiry into the intent of the parties at the inception of the agreement;

ii. Courts have bifurcated the Code § 2703(b)(2) requirement into a two-part test: (1) the "testamentary purpose test", and (2) the "adequacy-of-consideration test."

1. Testamentary Purpose Test. A buy-sell agreement cannot have a testamentary purpose. In *Estate of True* (T.C. Memo. 2001-167 (2001)), the Tax Court listed eight factors that would tend to indicate that a buy-sell agreement will fail the testamentary purpose test:

a. The decedent's poor health when he entered into the agreement;

b. No negotiation of agreement terms;

c. Inconsistent enforcement of buy-sell agreement provisions;

d. Failure to seek significant professional advice in selecting a formula price;

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[104] In explaining Code § 2703, the Committee on Finance stated its understanding of the section in the Congressional Record as follows:

> the committee believes that buy-sell agreements . . . are generally entered into for legitimate business reasons . . . buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance.

e. Failure to obtain or rely on appraisals in selecting a formula price;

f. Exclusion of significant assets from the formula price;

g. No periodic review of the formula price; and

h. The decedent's business arrangements fulfilled his testamentary intent (e.g., that the children received equal percentage interests in the business despite their different management responsibilities, indicated that the transfers were based on family relationships, not business relationships).

2. In the subsequent *Estate of* Smith case, the court found that the testamentary purpose may be evidenced by the transferor's health at the time, significant changes in the business subject to the restrictive agreement, selective enforcement of the restrictions, and the nature and extent of the negotiations regarding the terms of the restrictions; *Smith v. United States*, 2004 WL 1879212 (W.D. Pa. 2004).

3. Adequacy-of-Consideration Test. Courts appear to apply two different standards in determining the adequacy of consideration under a buy-sell agreement: one where the buy-sell agreement is between unrelated parties and another when it is between related parties.

    a. Unrelated Parties. Where the parties to the agreement are unrelated and there is no apparent intent for the agreement to serve as a testamentary device, courts have stated that "the mutual promises of the parties to a restrictive shareholders agreement generally provide full and adequate consideration for the agreement where the parties deal at arm's length." *Estate of Lauder v. Comm'r*, T.C. Memo 1992-736 (1992).

    b. Related Parties. However, where the parties to the agreement are family members, "it cannot be said that the mere mutuality of covenants and promises is sufficient to satisfy the taxpayer's burden of establishing that the agreement is not a testamentary device. Rather, it is incumbent on the estate to demonstrate that the agreement establishes a fair price for the subject stock." *Estate of Lauder*.

iii. Transfer wealth…but to whom?

1. Under Code § 2703(b)(2), must not be a device to transfer wealth to *members of the decedent's family* for less than full and adequate consideration.

2. Under Treasury Regulations § 25.2703-1(b)(3), "for purposes of this section, members of the transferor's family" include:

    a. The transferor's spouse;

    b. Ancestors of the transferor or the transferor's spouse, or the spouse of any such ancestor;

    c. Lineal descendants of the parents of the transferor or of the transferor's spouse; and

    d. Natural objects of the transferor's bounty.[105] *[This language does not appear in the statutory text, but is consistent with pre-2703 case law.]*

f. Terms Comparable to an Arms Length Transaction

i. A right or restriction is treated as comparable if it could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. The regulations provide that determining whether a fair bargain exists involves considering "such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted." [106]

ii. The terms of a right or restriction need not parallel the terms of any particular agreement. Evidence of general business practice is not met by showing isolated comparables. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.[107]

iii. *Smith v. United States.*[108] In dicta, the court appears to have set out a very difficult evidentiary standard for a taxpayer to meet in order to satisfy this third-prong of Code § 2703(b). Both the IRS and the taxpayer agreed that "it would be inherently difficult to find an agreement between unrelated

[105] *See also* Treas. Reg. § 25.2703-1(b)(2)(ii), must not be a device to transfer property to *the natural objects of the transferor's bounty* for less than full and adequate consideration.
[106] Treas. Reg. § 25.2703-1(b)(4)(i).
[107] Treas. Reg. § 25.2703-1(b)(4)(ii).
[108] *Smith v. United States*, 2004 U.S. Dist. LEXIS 14839 (W.D. Pa. 2004). Please note that subsequent citations refer to Lexis pagination.

parties dealing at arms' length that would be comparable to a family limited partnership, which, by its terms, is restricted to related parties."[109] Yet, in rejecting as conclusory the affidavits of two attorneys attesting to the comparability of the arrangement, the judge appears to have set out just such a requirement.

iv. *Estate of Blount*.[110] The Tax Court stated that "the regulations under § 2703 . . . contemplate the introduction of evidence of actual comparable transactions."[111]

g. What if the exception is not met?

i. If any of the above 3 requirements are not met, and certain terms of an agreement are disregarded, the value of the business interests at issue will not be determined according to the agreement.

ii. This is true even though the transferor (including a decedent's estate) may be obligated to sell stock at an agreed upon price. As a result, tax could be paid on a much higher value than that which is actually realized or received by the transferor.

4. Code § 2704. Treatment of Certain Lapsing Rights and Restrictions.

a. Under Code § 2704, if there is a lapse of any voting or liquidation right in a corporation or partnership, and the individual holding the right and members of his or her family control the entity both before and after the lapse, then the lapse is treated as a transfer.[112]

i. A "voting right" is the right to vote with respect to any matter of the entity. In the case of a partnership, the right of a general partner to participate in partnership management is a voting right. [113]

ii. A "liquidation right" means a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity, including by reason of aggregate voting power.[114]

1. Under these regulations, the right or ability to cause the dissolution of the entity is a liquidation right. *See* TAM 9352001 (1993) (stating a sole shareholder's ability to dissolve the corporation at will was a liquidation right for purposes of Code § 2704).

[109] *Id*. at 22.
[110] *Estate of Blount v. Comm'r*, T.C. Memo 2004-116 (2004), *aff'd by*, 428 F.3d 1338 (11th Cir. 2005).
[111] *Id*. at 747.
[112] I.R.C. § 2704(a)(1).
[113] Treas. Reg. § 25.2704-1(a)(2)(iv).
[114] Treas. Reg. § 25.2704-1(a)(2)(v).

iii. Member's of the holder's family include (i) the individual's spouse, (ii) any ancestor or lineal descendant of the individual or the individual's spouse, (iii) any brother or sister of the individual, and (iv) any spouse of any of the preceding individuals.[115] The attribution rules of Code § 2701 apply for the purposes of determining the interest held by an individual.[116]

iv. For corporations, "control" means holding at least 50 percent (by vote or value) of the stock of the corporation; for partnerships, it means holding at least 50% of either the capital interest or the profits interest in the partnership. "Control" does not require the ability to restore the lapsed right.[117]

b. A lapse of a voting or liquidation right in a controlled entity is treated as a gift (if it occurs during life) or is includable in the decedent's gross estate (if it occurs at death). The amount of the transfer is treated as the difference between the interests held before the lapse (determined without regard to the lapse) and the value of the interests immediately after the lapse.[118]

c. Code § 2704(a) does not apply if after the lapse of a liquidation right, the holder, his estate or his family cannot liquidate an interest that could have been liquidated before the lapse.[119] State law, as modified by the governing instrument, determines whether or not after the lapse the interest can be liquidated.[120]

d. Timing of lapse.

i. The lapse of a voting right does not occur when the restriction is created but at the time a presently exercisable voting right is restricted or eliminated.[121]

ii. Similarly, a lapse of a liquidation right occurs when a presently exercisable liquidation right generally is restricted or eliminated.[122] A transfer of an interest that results in the lapse of a liquidation right is not subject to Code § 2704 if the rights with respect to the transferred interest are not restricted or eliminated. However, a transfer that results in the elimination of the transferor's right or ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest is a lapse of a liquidation right with respect to the subordinate interest. In this regard, a transfer resulting in the lapse of a liquidation right is subject to Code § 2704 if:

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[115] I.R.C. § 2704(c)(2).
[116] I.R.C. § 2704(c)(3).
[117] *See* Treas. Reg. § 25.2704-1(a)(2)(i) (referencing Treas. Reg. § 25.2701-2(b)(5)); *Estate of Smith v. U.S.*, 103 Fed. Cl. 533 (2012)
[118] Treas. Reg. § 25.2704-1.
[119] *See* Treas. Reg. §25.2704-1(c)(2)(i)(A).
[120] *See* Treas. Reg. §25.2704-1(c)(2)(i)(B).
[121] Treas. Reg. § 25.2704-1(b).
[122] Treas. Reg. § 25.2704-1(c)(1).

1. immediately before the transfer, the transferor possesses an interest having a liquidation right;

2. the transferred interest is senior to the interest retained by the transferor; and

3. the transfer results in the termination of the liquidation right attributable to the transferor's retained junior interest.[123]

iii. If the lapse of a right is temporary, and such right may be restored by some future event, not within the control of the holder (or members of the holder's family), the lapse occurs when the lapse is permanent with respect to the holder.[124]

e. Amount of Gift

i. The amount of the gift is the excess of the value of all interests held by the holder before the lapse (determined as if the rights were nonlapsing) over the value of the rights immediately after the lapse (determined as if all such interests were held by one individual).[125]

f. However, "applicable restrictions," are disregarded in determining the value of the transfer, and the transferred interest is valued as if the restriction does not exist.[126]

i. "Applicable restrictions" include those restrictions that limit the ability of the corporation or partnership to liquidate which either (i) lapse, in whole or in part, after the transfer or (ii) the transferor, either alone or with members of his family, has the right to remove, in whole or in part, after the transfer. See, e.g. Kerr v. Comm'r, 113 T.C. 449 (1999). The Service's position is that an applicable restriction is any limitation on an owner's right under state law to have his or interest redeemed.[127]

ii. Applicable restrictions also do not include "any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either." The regulations further state that the

[123] TAM 9352001 (1993). A retained interest is senior if it "carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest." Treas. Reg. § 25.2704-1(a)(2)(vi) (referring to Treas. Reg. § 25.2701-3(a)(2)(iii) for the definition of "subordinate"); Treas. Reg. § 25.2701-3(a)(2)(ii).
[124] Treas. Reg. § 25.2704-1(a)(3).
[125] I.R.C. § 2704(a)(2); Treas. Reg. § 25.2704-1(d).
[126] I.R.C. § 2704(b); Treas. Reg. § 25.2704-2(c).
[127] S*ee, e.g.*, TAM 9735003 (asserting that a restriction on a member's ability to withdraw that is more restrictive than state law is an applicable restriction). However, Tax Court cases have held that the term "applicable restriction" refers to the right to have the entity itself liquidated, not the interest of the owner. Estate of Jones v. Comm'r, 116 T.C. 121 (2001); Knight v. Comm'r, 115 T.C. 506 (2000); Haper v. Comm'r, T.C. Memo 2000-202; Kerr v. Comm'r, 113 T.C. 449 (1999).

financing must be for the entity's "trade or business operations whether in the form of debt or equity." [128]

iii. Applicable restrictions also exclude any restrictions imposed, or required to be imposed, by any Federal or State law. A restriction on the ability to liquidate is not an "applicable restriction" if the restriction is not more restrictive than the limitations that would apply under applicable state law in the absence of the restriction.[129]

g. Selected Exceptions to Code § 2704

i. Code § 2704(a) does not apply to the lapse of a *liquidation right* to the extent the holder and members of the holder's family cannot liquidate an interest immediately after the lapse that he or she could have liquidated before the lapse.[130] Whether an interest can be liquidated immediately after the lapse is determined under state law, as modified by the governing documents, without regard to any applicable restriction disregarded under Code § 2704(b).

ii. No lapse occurs upon "a transfer of an interest…if the rights with respect to the transferred interest are not restricted or eliminated."[131]

1. Note, the regulations provide this language with respect to the lapse of liquidation rights. However, the general rule that a lapse occurs "at the time a presently exercisable right is restricted or eliminated" applies equally to both voting rights and liquidation rights. The language simply *clarifies* the application of that rule with respect to liquidation rights but should not be interpreted as an exception only applicable to the lapse of liquidation rights. Those exceptions are specifically provided for in Treasury Regulations § 25.2704-1(c)(2).

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[128] I.R.C. § 2704(b)(3); Treas. Reg. § 25.2704-2(b); I.R.C. § 267(b). I.R.C. 267(b) includes as related parties: (1) members of a family; (2) an individual and a corporation in which the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock; (3) two corporations which are members of the same controlled group; (4) a grantor and a fiduciary of any trust; (5) a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; (6) a fiduciary of a trust and a beneficiary of the trust; (7) a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts; (8) a fiduciary of a trust and a corporation in which more than 50% of the value of the outstanding stock is owned, directly or indirectly, by or for the trust or a person who is a grantor of the trust; (9) a person and an organization to which IRC §501 applies and which is controlled directly or indirectly by such person or by members of the family of such individual; (10) a corporation and a partnership if the same persons own more than 50% of the value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership; (11) an S corporation and another S corporation, if the same persons own more than 50% of the value of the outstanding stock of each corporation; (12) an S corporation and a C corporation, if the same persons own more than 50% of the value of the outstanding stock of each corporation; or (13) an executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

[129] I.R.C. § 2704(b)(3); Treas. Reg. § 25.2704-2(b).

[130] Treas. Reg. § 25.2704-1(c)(2)(i)(A).

[131] Treas. Reg. § 25.2704-1(c).

a. Under example 4 of Treasury Regulations § 25.2704-1(f), D's transfer of un-restricted stock to his three children does not constitute a lapse even though it results in the loss of D's ability to liquidate "because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer."

2. Under example 7, D transfers a portion of the voting shares to D's child such that D no longer has the required vote to liquidate the corporation. Code § 2704(a) does not apply "because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated" and "because the preferred stock is not subordinate to the transferred common stock."

iii. On the other hand, if the transferor retains an interest subordinate to the transferred interest, there is a lapse of a liquidation right if the transfer "results in the elimination of the transferor's right or ability to compel the entity to acquire the [subordinate] interest retained by the transferor." An interest is subordinate to a senior equity interest if that senior interest carries a preferred right to distributions of income or capital. [132]

h. Like Code § 2701, Code § 2704 may apply to reorganizations. For example, in TAM 9352001, the IRS reviewed the recapitalization of a Corporation from 500 outstanding single class of shares to 10,000 shares of voting common stock and 10,000 shares of nonvoting common stock. The decedent owned the 500 original shares. The decedent then surrendered those shares to the Corporation in exchange for 500 nonvoting common shares of the recapitalized corporation. Then, the decedent exchanged $3.21 million of property in exchange for the remaining 9,500 nonvoting common shares. Later, the decedent's child's spouse (the Child's Spouse) received the voting shares, with a preferred interest, in return for services rendered to the Corporation pursuant to an Employment Agreement. In its discussion, the IRS made no mention of whether the exchange of the 500 original shares for 500 nonvoting common shares in the recapitalized organization constituted a lapse of a voting right. Rather, the focus was on whether there was a lapse of a liquidation right upon the Child's Spouse receiving the voting shares. Although the decedent only retained nonvoting shares, as the sole shareholder, the decedent could initially liquidate the Corporation at will pursuant to the state's business code. However, once the voting shares were distributed to the Child's Spouse the decedent's liquidation right lapsed. Because "the Employment Agreement conferred a preferred equity interest on Child's Spouse that was senior to the decedent's retained interest" and "the decedent's liquidation right…lapsed as a result of the transfer," there was "a gift by the decedent for purposes of section 2704(a)."

[132] Treas. Regs. § 25.2704-1(a)(2)(vi)(citing Treas. Regs. § 25.2701-3(a)(2)(iii)).

i. The Current Chatter: Proposed New Regulations Under Code § 2704(b). Under Code § 2704(b)(4): The Secretary may by the regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the Transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

    i. Under Code § 2704(b), "applicable restrictions," are disregarded in determining the value of the transfer, and the transferred interest is valued as if the restriction does not exist.[133]

    ii. "Applicable restrictions" include those restrictions that limit the ability of the corporation or partnership to liquidate which either (i) lapse, in whole or in part, after the transfer or (ii) the transferor, either alone or with members of his family, has the right to remove, in whole or in part, after the transfer.[134]

        1. The Service's position is that an applicable restriction is any limitation on an owner's right under state law to have his or interest redeemed.[135]

        2. However, the Tax Court has determined that withdrawal rights are not "applicable restriction" within the meaning of Code § 2704(b), because the section pertains to restrictions on dissolution (liquidation), which is distinguishable from restrictions on withdrawal.[136]

    iii. Applicable restrictions also do not include "any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either." The regulations further state that the

[133] I.R.C. § 2704(b); Treas. Reg. § 25.2704-2(c).
[134] *See, e.g.* Kerr v. Comm'r, 113 T.C. 449 (1999).
[135] *See, e.g.*, TAM 9735003 (asserting that a restriction on a member's ability to withdraw that is more restrictive than state law is an applicable restriction). However, Tax Court cases have held that the term "applicable restriction" refers to the right to have the entity itself liquidated, not the interest of the owner. Estate of Jones v. Comm'r, 116 T.C. 121 (2001); Knight v. Comm'r, 115 T.C. 506 (2000); Harper v. Comm'r, T.C. Memo 2000-202; Kerr v. Comm'r, 113 T.C. 449 (1999).
[136] *Kerr v. Comm'r*, 113 T.C. 449 (1999), *aff'd by*, 292 F.3d 490, 491 (5th Cir. 2002) On appeal, the Fifth Circuit did not reach the issue of whether the Tax Court was correct in its conclusion that a restriction on a partnership withdrawal does not constitute a "restriction on liquidation" under § 2704(b). Rather, the Fifth Circuit upheld the decision for the taxpayer because a non-family member held a partnership interest and, therefore, the restriction on withdrawal could not be an "applicable restriction" under § 2704(b)(2)(ii) because the family did not alone have the ability to remove the restriction; *Estate of Harper v. Commissioner*, T.C. Memo 2000-202 (2000).

financing must be for the entity's "trade or business operations whether in the form of debt or equity." [137]

iv. Applicable restrictions also exclude any restrictions imposed, or required to be imposed, by any Federal or State law. A restriction on the ability to liquidate is not an "applicable restriction" if the restriction is not more restrictive than the limitations that would apply under applicable state law in the absence of the restriction.[138]

j. Code § 2704(b) Proposals to Limit Valuation Discounts

i. Under Code § 2704(b)(4):

> The Secretary may by the regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the Transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

The question is whether the IRS has authority under this section to add "applicable restrictions" that are ignored in determining value of a closely held entity.

ii. Prior Greenbook proposals.

1. Proposals for the expansion of Code § 2704(b) appeared in the Obama Administration's Greenbook for each of fiscal years 2010-2013. These proposals have not appeared in the Greenbook for fiscal years 2015-2017.

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[137] I.R.C. § 2704(b)(3); Treas. Reg. § 25.2704-2(b); Code § 267(b). Code § 267(b) includes as related parties: (1) members of a family; (2) an individual and a corporation in which the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock; (3) two corporations which are members of the same controlled group; (4) a grantor and a fiduciary of any trust; (5) a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; (6) a fiduciary of a trust and a beneficiary of the trust; (7) a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts; (8) a fiduciary of a trust and a corporation in which more than 50% of the value of the outstanding stock is owned, directly or indirectly, by or for the trust or a person who is a grantor of the trust; (9) a person and an organization to which IRC §501 applies and which is controlled directly or indirectly by such person or by members of the family of such individual; (10) a corporation and a partnership if the same persons own more than 50% of the value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership; (11) an S corporation and another S corporation, if the same persons own more than 50% of the value of the outstanding stock of each corporation; (12) an S corporation and a C corporation, if the same persons own more than 50% of the value of the outstanding stock of each corporation; or (13) an executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

[138] I.R.C. § 2704(b)(3); Treas. Reg. § 25.2704-2(b).

2. When the Service first announced in 2015 that Regulations were forthcoming, the estate planning community expected that the Regulations would be in line with the Greenbook proposals.

3. The Greenbook proposals expand the current scope of Code § 2704(b) by creating an additional category of restrictions (known as "Disregarded Restrictions") that would be ignored in valuing interests in a family controlled-entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family.

    a. Instead, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in the regulations.

    b. The new category of Disregarded Restrictions would include

        i. (i) limitations on a holder's right to liquidate that holder's interest that are more restrictive than those standards identified in the regulations, and

        ii. (ii) limitations on a transferee's ability to be admitted as a full partner (in the case of a partnership) or to hold an equity interest in the entity.

4. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family.

5. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of Code § 2704(b).

    a. Some commentators have suggested that the proposed regulations may include a carve-out for active or "genuine" family-owned businesses.[139] Citing the particular difficulties attendant to valuing active businesses and the relative policy preference favoring family-owned operating businesses, these commentators believe the proposed regulations will exempt such businesses from the sometimes mechanical application of Code § 2704(b).

[139] Ronald D. Aucutt, *ACTEC Capital Letter No. 38: Anticipated Valuation Discount Regulations* (Jul. 20, 2015).

iii. Richard Dees' Open Letter to Treasury & IRS Chief Counsel

1. In August 2015, Richard Dees published an open letter to Treasury and IRS Chief Counsel, arguing that, absent Congressional action, Regulations based on the Greenbook proposals would be invalid.[140]

2. In support of this conclusion, Dees argues that:

   a. the legislative history and existing case law under Chapter 14, generally, and Code § 2704(b), specifically, are intended to protect traditional valuation discounts and to prohibit family attribution in valuing business interests. The Senate Report accompanying the enactment of Chapter 14 specifically indicated:

      i. "This bill does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally in all items of income, deduction, loss and gain in the same proportion" and

      ii. "The bill does not affect minority discounts or other discounts available under present law."

   b. Treasury's authority under Code § 2704(b)(4) does not extend to the creation of new categories of disregarded restrictions, the imposition of regulatory defaults, or the inclusion of charities and other organizations as members of a family for purposes of Code § 2704(b).

   c. Code § 2704(b)(4) grants the Secretary the authority to "by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family, if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

      i. The authority to "disregard" restrictions is not the authority to substitute different valuation assumptions for specified provisions or to rewrite statutory or common law that would apply in place of the disregarded provisions.

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[140] *See* Richard L. Dees, *Possible New Regulations under Internal Revenue Code Section 2704(b)*, TAX NOTES (August 31, 2015).

ii. Treasury Regulations § 25.2704-2(c) already provides that, if an applicable restriction is disregarded, the transferred interest is valued "as if the restriction does not exist" and "as if the rights of the transferor are determined under the State law that would apply but for the restriction."

d. There is no statutory authority for expansion of the definition of "family" to encompass "charity."

i. Under the Greenbook proposal, for "purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in the regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family."

ii. Chapter 14 defines a "member of the family" to include the transferor's spouse, an ancestor or lineal descendant of the transferor or his or her spouse, the transferor's siblings, or the spouse of any such individual. It does not provide that the Secretary may amend or expand this definition.

e. Statutory and case law explicitly disallow family attribution in determining valuation discounts.[141]

f. Limitations on a transferee's ability to be admitted as a full partner or hold an equity interest in the entity should not be "disregarded restrictions." Such limitations are consistent with existing state law. State partnership and LLC statutes commonly provide that a transferee is accorded only the status of an assignee of profits, and is not admitted as a full partner or member, absent affirmative action of the remaining members.

g. "Safe harbors" in proposed regulations would repeat the failures of Code § 2036(c), including potentially causing the transfer tax imposed with respect to family entities to be significantly larger than the tax imposed with respect to non-family held entities.

i. Although commentators have suggested that there may be a carve out for (active) family-held

[141] *See* Rev. Rul. 93-12, determining that minority discount was appropriate when 100% owner transferred shares equally to his five children. *See also* TAM 9449001.

operating businesses, nothing in Chapter 14 distinguishes active businesses from passive investment entities.

iv. In November 2015, Leslie Finlow, IRS senior technician review, indicated that the IRS was looking to the statute, and not the Greenbook proposals, in formulating the new Code § 2704 regulations.[142] This fueled speculation that the IRS may be revising regulations so as to not overstep the bounds allowed by statute – including with respect to defining family and disregarding interests held by charity in determining family control.

[142] BNA Daily Tax Report, 1/13/2016, "*IRS Plan to Curb Valuation Discounts Alive and Well*" by Diane Freda.