TAX SECTION
State Bar of Texas

August 7, 2017

Via e-mail: Notice.Comments@irscounsel.treas.gov
and FedEx Overnight Delivery

Internal Revenue Service
CC:PA:LPD:PR (Notice 2017-38)

Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: Comments in Response to Notice 2017-38 Regarding Proposed Regulations Under Sections 2704 and 6035

Dear Ladies and Gentlemen:

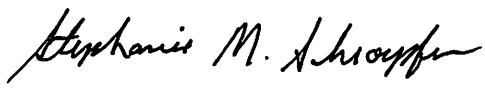
On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and Internal Revenue Service (the "Service") in the Notice 2017-38, Implementation of Executive Order 13789 (Identifying and Reducing Tax Regulatory Burdens) issued on June 14, 2017 (the "Notice").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED

BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Treasury and Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,



Stephanie M. Schroepfer, Chair
State Bar of Texas, Tax Section

SS/lab
Enclosure

COMMENTS ON NOTICE 2017-38
IMPLEMENTATION OF EXECUTIVE ORDER 13789

These comments on the Notice (the "Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Celeste C. Lawton, Co-Chair of the Estate and Gift Tax Committee, Laurel Stephenson, Co-Chair of the Estate and Gift Tax Committee, and Carol G. Warley, Vice-Chair of the Estate and Gift Tax Committee. Henry Talavera, Co-Chair of the Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments on behalf of COGS. Lora G. Davis, CLE Co-Chair of the Tax Section, reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. INTRODUCTION

These Comments are provided in response to Treasury and the Service's request for comments regarding whether certain regulations described in the Notice should be rescinded or modified, and in the latter case, how the regulations should be modified in order to reduce burdens and complexity. We appreciate the opportunity to comment on the Proposed Regulations.

II. SUMMARY

1. We respectfully recommend that the Service either rescind or modify the Proposed Regulations under section 2704 of the Internal Revenue Code of 1986, as amended ("Code") in accordance with previous comments submitted by the Tax Section of the State Bar of Texas.

2. We respectfully recommend that the Service revise the Proposed Regulations under section 6305 of the Code as follows:

(a) Permit taxpayers to resubmit to the Service (at the same address the Form 8971 is to be submitted) the applicable estate tax return schedules that disclose information relevant to ascertaining estate tax value as an attachment to Schedule(s) A to Form 8971 in certain circumstances as discussed below.

(b) If capital gain or capital loss is recognized by the estate because property is distributed to a beneficiary in kind to satisfy a pecuniary bequest, we respectfully request that the executor not be required to report such property on a Schedule A to such beneficiary.

III. PROPOSED REGULATIONS UNDER SECTION 2704 OF THE CODE ON RESTRICTIONS ON LIQUIDATION OF AN INTEREST FOR ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAXES (REG-163113-02; 81 FED. REG. 51413 (OCT. 4, 2016)) ("Proposed 2704 Regulations")

The Proposed 2704 Regulations regarding Section 2704 set forth rules concerning the valuation of interests in certain business entities for transfer tax purposes, specifically with respect to the treatment of certain lapsing rights and liquidation restrictions in determining the value of intra-family transfers of interests in such entities. We believe that the Proposed 2704 Regulations impose an undue financial burden on the U.S. taxpayer by disregarding certain restrictions that are placed, pursuant to local law or the terms of the governing instrument, on interests held by a taxpayer in certain family-owned entities. We also believe that the Proposed 2704 Regulations may have exceeded Congressional authority by broadening the family attribution principles beyond what Congress intended, as explained in the comments that we previously submitted regarding these issues in a letter dated November 2, 2016, which comments are attached to this letter and incorporated by reference ("Original Submission"). We respectfully request that the Proposed 2704 Regulations be rescinded or, at a minimum, modified in accordance with our Original Submission.

IV. PROPOSED REGULATIONS UNDER SECTION 6035 OF THE CODE REGARDING BASIS REPORTING BETWEEN ESTATE AND PERSON ACQUIRING PROPERTY FROM DECEDENT (REG-127923-15; 81 Fed. Reg. 11486 (Mar. 4, 2016)) ("Proposed 6035 Regulations")

We respectfully request that Treasury also consider the undue financial burden imposed on U.S. taxpayers by the Proposed 6035 Regulations as further explained below. Section 6035(a)(1) requires an executor of an estate that is required to file an estate tax return to provide the Service and each beneficiary "acquiring any interest" in the property included on the estate tax return a statement (i.e., Schedule A to Form 8971) identifying the value of the "interest in such property." Proposed 6035 Regulation § 1.6035-1(c)(3) provides that if an executor has not determined which assets a beneficiary will receive by the date the Schedule(s) A and Form 8971 are to be provided to the Service and each beneficiary, the executor must list on the beneficiary's Schedule A all items of property "that the executor could use to satisfy that beneficiary's interest." The Proposed 6035 Regulations provide exceptions for certain types of property that do not need to be reported on Schedule A, including but not limited to, "[p]roperty sold, exchanged, or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized."

We believe the Proposed Regulations impose an undue financial burden on U.S. taxpayers by requiring the taxpayers subject to the Proposed Regulations to resubmit information to the Service that it has already received, in a manner that often requires substantial time and expense to the taxpayer. Currently, executors of estates required to file Form 8971 and Schedule(s) A must include a detailed listing of each item on the Schedule A and are prohibited from attaching the estate tax return to Schedule A in lieu of this detailed reporting. A significant portion of this additional taxpayer burden will be avoided if the taxpayer is allowed to resubmit to the Service (at the same address the Form 8971 is to be submitted) the applicable estate tax return schedules that disclose information relevant to ascertaining estate tax value as an attachment to Schedule(s) A to Form 8971.

The burden on U.S. taxpayers is especially evident when the executor, who is responsible for filing the Form 8971 and Schedule(s) A, is the only person to whom one or more Schedule(s) A must be provided and the estate tax return provides no less information than that which is required to be reported on the applicable Schedule A. For example, it is common for a decedent to leave all of his or her property outright to the surviving spouse or in a trust for the surviving spouse and to also name the surviving spouse as both executor of the decedent's estate and the trustee of any trust created for the surviving spouse. It is also common for such trusts for the surviving spouse to be unfunded at the time the Schedules A and Form 8971 are due to the Service and each beneficiary.

In such case, the executor/beneficiary would prepare a Schedule A:

(i) Listing the date of death value of any property passing outright to the surviving spouse, which would consist of no less information than the information already included on Schedule M of the estate tax return under "All other property"; and

(ii) For each trust that is a beneficiary, which would consist of all other property listed in the estate tax return not reported on the Schedule A described in (i) above.

Requiring the executor/beneficiary to prepare Schedules A and Form 8971 in accordance with the Proposed 6035 Regulations in these circumstances is an unnecessary expense and use of time that could be eliminated if the executor could instead use the estate tax return schedules to report that information as discussed above.

We believe the Proposed 6035 Regulations also impose an undue financial burden on U.S. taxpayers in the event that property is distributed in kind to satisfy a pecuniary bequest using the date of distribution value. If property is distributed in kind to satisfy a pecuniary bequest, the estate will recognize a taxable gain to the extent that the fair market value of the property on the date it is distributed to satisfy the pecuniary bequest exceeds the estate tax value of the property (i.e., the value of the property that is reported on Schedule A). As a result of the estate recognizing the gain on such distribution, the beneficiary's basis in the property is equal to the fair market value of the property on the date it is distributed to the beneficiary.

Nevertheless, the Proposed Regulations require the executor to deliver to the beneficiary a Schedule A reporting estate tax value, which is completely irrelevant to the beneficiary and, in fact, could be interpreted by the beneficiary in a manner that may the lead the beneficiary into incorrectly reporting basis at a later time because of the misleading nature of Schedule A. Although the Proposed Regulations provide that property disposed of by the estate in a transaction in which capital gain is recognized does not need to be reported on Schedule A, this exception excludes property that is distributed to the beneficiary. If capital gain is recognized by the estate because property is distributed to a beneficiary in kind to satisfy a pecuniary bequest, the beneficiary's basis in the property is equal to the date of distribution value, rather than the estate tax value. Therefore, the executor should not be required to provide a Schedule A to the beneficiary that necessarily reports the date of death value of such property because providing such Schedule A to the beneficiary and Service does not achieve the purpose of Schedule A, which is to provide the beneficiary and Service with the initial basis of any property received by such beneficiary. Requiring the Schedule A to be prepared with this irrelevant information and delivered to such a beneficiary is an unnecessary expense and an undue financial burden on the U.S. taxpayer. Similar concerns would arise in the funding of a pecuniary bequest with loss assets or with assets that result in a gain or loss that is not capital in nature.

TAX SECTION
State Bar of Texas

November 2, 2016

Via Federal eRulemaking Portal at www.regulations.gov

CC:PA:LPD:PR (REG-163113-02)
Room 5203
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations Regarding Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of Treasury ("Treasury") and Internal Revenue Service ("IRS") in the Notice of Proposed Rulemaking (REG-163113-02) issued on August 4, 2016 (the "Proposed Regulations"). The Proposed Regulations provide rules concerning the valuation of interests in certain business entities for estate, gift, and generation-skipping transfer tax purposes, specifically including the treatment of certain lapsing rights and liquidation restrictions in determining the value of intra-family transfers of interests in corporations, partnerships, and other entities.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS.

1414 Colorado Street, Austin, TX 78701
(512) 427-1463 or (800) 204-2222

THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Treasury and the IRS for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED REGULATIONS REGARDING ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES; RESTRICTIONS ON LIQUIDATION OF AN INTEREST

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Celeste C. Lawton, Co-Chair of the Estate and Gift Tax Committee, Laurel Stephenson, Co-Chair of the Estate and Gift Tax Committee, Matthew S. Beard, Vice-Chair of the Estate and Gift Tax Committee, and Carol Warley, Vice-Chair of the Estate and Gift Tax Committee. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Ira. A. Lipstet, Co-Chair of COGS, reviewed these Comments. Lora G. Davis, a current member of the Tax Section Council, and Melissa Willms, a former member of the Tax Section Council, also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: November 2, 2016

I. INTRODUCTION

These Comments are in response to the Proposed Regulations regarding the rules concerning the valuation of interests in certain business entities for estate, gift, and generation-skipping transfer tax purposes, specifically with respect to the treatment of certain lapsing rights and liquidation restrictions in determining the value of intra-family transfers of interests in corporations, partnerships, and other entities.

We recognize the time and thoughtful work invested by Treasury and the IRS in preparing the Proposed Regulations and the accompanying explanatory preamble to the Proposed Regulations (the "Preamble"). It is our intent to present items for consideration that may help support Treasury and the IRS to provide clear regulatory guidance.

For ease of discussion, we have opted to address our concerns with regard to the Proposed Regulations in a limited partnership context. However, we have identical concerns with regard to the application of the Proposed Regulations in corresponding corporate and limited liability company contexts.

II. COMMENTS REGARDING PROPOSED REGULATIONS UNDER CODE[1] § 2704

A. Interaction of Proposed Regulations with Code § 1014(f)

Code § 1014(f) provides that the initial basis of certain property acquired from a decedent "shall not exceed" its final value determined for estate tax purposes (or as otherwise reflected on Schedule(s) A to an IRS Form 8971). However, the Proposed Regulations expressly apply only "for purposes of subtitle B (relating to estate, gift and generation-skipping transfer taxes)" and not for income tax purposes. Technically, it appears that the IRS could argue pursuant to Code § 1014(a) that an interest acquired from a decedent in an entity described in Code § 2704 should have an initial income tax basis equal to its fair market value as of the decedent's date of death and not the estate tax value resulting from disregarding, pursuant to Code § 2704 and the Proposed Regulations, lapsing rights and liquidation restrictions that are otherwise relevant in establishing the interest's fair market value.

We believe the IRS and Treasury have no intention of taking this position, given that they clearly state in the preamble to Prop. Reg. § 1.1014-10 that Code § 1014(f) is intended to ensure consistency between the income tax basis of property acquired from a decedent and its estate tax value. Accordingly, we respectfully request the IRS and Treasury clarify that lapsing rights and liquidation restrictions disregarded pursuant to Code § 2704 and the Proposed Regulations for establishing the estate tax value of an interest acquired from a decedent in an entity described in Code § 2704 are also to be disregarded in establishing its income tax basis so that its initial basis

[1] All references herein to the "Code §" or "Section" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "Prop. Reg. §" are to the current and the proposed regulations promulgated thereunder, respectively.

will be equivalent to its final value determined for estate tax purposes (or as otherwise reflected in a Form 8971 and accompanying Schedule A).

We recognize that the suggested clarification may be more appropriate in conjunction with Prop. Reg. § 1.1014-10, particularly in light of an arguably similar need for clarity with regard to the impact of Code § 2703 and its regulations on the valuation, for both estate tax and income tax basis purposes, of entity interests transferred by a decedent. Consequently, we respectively request clarification and defer to the IRS in determining the manner in which this clarification may be best addressed.

B. Three-Year "Inclusion Window" Provided by Prop. Reg. § 25.2704-1(c)(1)

1. Recommended Alternative to Proposed Three-Year Inclusion Window

Currently, Treas. Reg. § 25.2704-1(c)(1) provides an exception to Code § 2704(a) for a transfer of an interest in an entity that results in a lapse of a liquidation right, as long as the rights associated with the transferred interest are not restricted or eliminated, although the transferor's loss of an ability to compel the entity to acquire a retained subordinate interest will be treated as a lapse with regard to it (the "Current Exception"). Prop. Reg. § 25.2704-1(c)(1) narrows the Current Exception to apply only to a transfer "occurring" more than three years prior to the transferor's death but also expands the exception to cover a lapse of a voting right associated with such a transfer (the "Proposed Narrowed Exception"). Conversely, a lapse of a voting or liquidation right resulting from a transfer within three years of the transferor's death will be treated as a lapse occurring at the transferor's death, includible in the transferor's gross estate pursuant to Code § 2704(a). These changes result in a potential three-year "inclusion window."

We do not believe that an inclusion window is appropriate. However, we believe that if one is to be adopted, it should more precisely address the concerns with "deathbed" transfers noted by the IRS and Treasury in the Preamble. We understand the practical benefits of incorporating a bright-line test to address the perceived abuses of deathbed transfers that are motivated solely by a desire to avoid inclusion of a controlling interest in a family entity in the transferor's estate for estate tax purposes. However, a strict application of the proposed three-year inclusion window will invariably produce a punitive tax result for a transferor who dies unexpectedly after transferring an entity interest without any "deathbed" motivations.

We propose instead that a lapse of a voting or liquidation right resulting from a gift be treated as occurring at the transferor's death only if he or she was "terminally ill" at the time of the gift, as determined in accordance with Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), and 25.7520-3(b)(3). Admittedly, an adoption of the "terminally ill" test will not provide in many instances the bright-line result otherwise achievable with the proposed three-year inclusion window. However, the "terminally ill" standard provides a workable and balanced approach to addressing the IRS's and Treasury's concerns with abusive deathbed transfers while avoiding penalizing transferors who are engaging in lifetime planning without deathbed objectives but die unexpectedly within a relatively short time thereafter.

2. Recommended Clarity on Effective Date of Three-Year Inclusion Window, if Retained

Prop. Reg. § 25.2704-4(b)(1) provides that Prop. Reg. § 25.2704-1(c)(1) will only apply to lapses of rights created after October 8, 1990 occurring on or after the date the Proposed Regulations are published as final in the Federal Register (the "Effective Date"). If despite our recommendation the three-year inclusion window is retained, it is unclear how Prop. Reg. § 25.2704-1(c)(1) will apply if an interest is transferred prior to the Effective Date but the transferor dies after the Effective Date and within three years of the transfer. Arguably, a lapse otherwise ignored at the time of the transfer prior to the Effective Date could ultimately be deemed to have occurred upon the transferor's death after the Effective Date, causing the value of the asset attributable to the lapse to be included in the transferor's estate for estate tax purposes.

Treasury and the IRS have historically provided effective dates for proposed regulations based in part upon their appreciation of planners' duties to their clients and the need to counsel them on the risks associated with different planning techniques based upon laws in effect at the time those techniques are implemented. We accordingly believe Prop. Reg. § 25.2704-1(c)(1) is intended to apply solely to lapses of voting or liquidation rights associated with lapses actually occurring after the Effective Date. If that belief is correct, then we propose that the last sentence of Prop. Reg. § 25.2704-1(c)(1) be revised to include the underlined text as follows: "The lapse of a voting or liquidation right as a result of the transfer of an interest after the Effective Date set forth in § 25.2704-4(b)(1) and within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a)."

3. Recommended Clarity on Valuation of Lapse Deemed to Occur at Death

We would also appreciate guidance with regard to the valuation of the voting or liquidation right deemed to have lapsed on the transferor's death pursuant to Prop. Reg. § 25.2704-1(c)(1) (the "phantom asset"). The Preamble makes it clear that Prop. Reg. § 25.2704-1(c)(1) is intended to address "deathbed" transfers designed to avoid estate taxation of a controlling interest. Given that objective, it appears that inclusion of the value of the phantom asset in the transferor's estate is intended to recapture the discounts otherwise properly applied in valuing both the retained interest and the transferred interest. Based upon this premise, it seems that the phantom asset is properly valued as the excess of (i) the value (as of the decedent's date of death) of the transferred and retained interests (both deemed owned at that point by the decedent), determined as though the liquidation and/or voting rights were non-lapsing over (ii) the value (as of the decedent's date of death) of the transferred and retained interests immediately after the lapse(s) that is deemed to have occurred, with the transferred and retained interests valued as though they were includible in the decedent's gross estate for estate tax purposes, but not aggregated for purposes of determining the value of each interest. We would appreciate regulatory guidance confirming that this is the proper approach for valuing the "phantom asset."

We would also appreciate guidance with regard to the manner in which the "applicable restriction" and "disregarded restriction" rules will be applied, or not applied, in the event that Prop. Reg. § 25.2704-1(c)(1) requires the inclusion of the "phantom asset," so that a double taxation of value is avoided.

C. Determination of Minimum Value

1. Recommended Determination if Entity Holds Operating Business or Other Illiquid Assets

We would appreciate clarity with regard to the manner in which the "minimum value" for an interest in a family-controlled entity is to be determined in certain circumstances. Prop. Reg. § 25.2704-3(b)(ii) defines "minimum value" as an interest's share of the entity's net value as of the date of liquidation or redemption. As a general rule, an entity's net value will be equal to the fair market value of its property reduced by its outstanding obligations that would meet the deductibility standard of Code § 2053 if they were claims against an estate (a "Net Asset Value"). If an entity holds an operating business, Prop. Reg. § 25.2704-3(b)(ii) directs that its net value may be appropriately determined by also considering additional factors such as prospective earning capacity, dividend-paying capacity, and goodwill.

An interest's minimum value is effectively calculated based upon its holder's deemed ownership of a proportionate share of the entity's underlying assets (if assigned a Net Asset Value) or its operating business (if appropriately valued by consideration of the expanded list of factors). Given that, we request that if an interest's minimum value is in part derived from a proportionate share of an illiquid interest owned by an entity (e.g., real estate or an operating business) then that interest's value is to be determined by also taking into consideration any valuation discounts that would be appropriately considered in valuing an undivided interest held directly in such an illiquid interest.

For an example of why this proposed modification is suggested, assume that family members A, B, C, and D each own outright a 25% fractional interest in real property with a fair market value of $1,000,000. By its very nature, the interest each of A, B, C, and D owns in the real property is not worth $250,000. Instead, the value of each person's interest should take into account discounts for lack of control and lack of marketability and consequently be valued at some amount less than $250,000.

Further assume that A, B, C, and D transfer their interests in the real property to an entity, resulting in the entity owning the real property in its entirety. Thus, the minimum value of each individual's interest in the entity is $250,000, or $1,000,000 (the property's fair market value) multiplied by 25% (each individual's interest in the property). Pursuant to Prop. Reg. § 25.2704-3(b)(1)(ii), the minimum value of each person's interest is deemed to be $250,000 upon contribution of the property to the entity. We believe that the Proposed Regulations in this regard unduly penalize for transfer tax purposes individuals who include restrictions in business arrangements to secure creditor protections and other nontax benefits provided by owning real estate and operating businesses via an entity rather than co-owning those assets directly.

Thus, we respectfully request that Treasury and the IRS revise the Proposed Regulations to provide a look-through rule in the following suggested new last sentence to Prop. Reg. § 25.2704-3(b)(1)(ii): "Notwithstanding the preceding, if the entity holds an operating business, real estate, or other property with regard to which the value of an interest therein would typically be affected by the degree of control of such business or property that interest represents (an "Illiquid Asset"), then the "minimum value" of an interest in such entity shall be equal to (i) the fair market value, as of the date of liquidation or redemption, of such interest's share of the property held by the entity (as determined pursuant to section 2031 or 2512 and the applicable regulations), provided that any value attributable to such interest's share of an Illiquid Asset shall be determined by taking into consideration any discounts that would otherwise be appropriately applied in establishing the value of an undivided interest in such Illiquid Asset if it were held directly by an individual, reduced by (ii) such interest's proportionate share of the outstanding obligations of the entity meeting the criteria set forth above, if the net value of the entity is determined based upon its Net Asset Value."

2. Requested Clarity in Establishing Minimum Value of Interest in a Parent Entity Holding an Interest in a Subsidiary with an Operating Business

The Proposed Regulations are unclear regarding the appropriate method of valuing an operating business for purposes of determining minimum value in certain circumstances. The Preamble states that for purposes of determining minimum value, "if the entity holds an operating business, the rules of §20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer." Those provisions direct that the valuation of an interest in an operating business involves more than simply valuing its assets and netting its obligations against the total asset value. It requires consideration of factors such as its prospective earning capacity, dividend-paying capacity, and goodwill. It is unclear whether those valuation rules are to be applied only when a parent entity conducts an operating business or whether they also apply in determining the value of a parent entity's interest in a subsidiary entity that conducts an operating business.

The Preamble and Prop. Reg. § 25.2704-3(b)(ii) initially seem to suggest that for purposes of determining minimum value, the fair market value of an operating business held via a subsidiary should be valued by considering the expanded list of factors for consideration outlined in Treas. Reg. §§ 20.2031-2(f)(2), 20.2031-3, 25.2512-2(f)(2) and 25.2512-3. However, the last sentence of Prop. Reg. § 25.2704-3(b)(ii) provides that if the property held by the entity directly or indirectly includes an interest in another entity (which could be an operating business) with regard to which transfers by the transferor would trigger an application of Code § 2704(b), the parent entity will be treated as owning a share of the property held by the other entity "determined and valued in accordance with the provisions of section 2704(b) and the regulations thereunder." It is therefore not entirely clear if the minimum value of a parent entity's interest in an operating business held via a subsidiary entity should be based strictly on the value of the operating business's underlying property in accordance with the last sentence of Prop. Reg. § 25.2704-3(b)(ii) or whether its value should be determined after valuing the subsidiary based upon a consideration of the expanded list of additional factors referred to above.

We respectfully request that Treasury and the IRS clarify which of the preceding interpretations is the intended result under the Proposed Regulations and provide examples that would clearly identify how minimum value should be determined with respect to operating businesses held by a family-controlled entity via a subsidiary entity.

D. Recommended Clarity on Existence of "Put Right"

We appreciate the assurances provided by representatives of Treasury and the IRS that the Proposed Regulations are not to be interpreted as imputing a "put right" to holders of interests in family-controlled entities and welcome a clarification in that regard in the final regulations. If correctly understood, the assurances alleviate our prior concern that a transfer of an interest that results in a lapse of a liquidation right could cause the gifted and retained interests' liquidation values to be taxed twice via an application of the "disregarded restriction" rules and the rules of Prop. Reg. § 25.2704-1(c)(1) that would be applicable if the transfer does not qualify for the Proposed Narrowed Exception. We respectfully request that clarification of this issue be included in any revised regulatory guidance that is released.

E. Requested Clarity Regarding Individuals Required to "Control" Entity for Purposes of Prop. Reg. §§ 25.2704-2 and 25.2704-3

Each of Prop. Reg. §§ 25.2704-2 and 25.2704-3 provides that it applies only if "the transferor and/or members of the transferor's family" control an entity immediately prior to a transfer of an interest in it. Each Proposed Regulation directs that "member of the family" be defined by Treas. Reg. § 25.2702-2(a)(1), which defines that term to include the transferor's spouse, ancestors and descendants of either the transferor or the transferor's spouse, the transferor's siblings, and spouses of the foregoing. Code § 2704(c)(2) provides an identical definition for "member of the family."

Existing Treas. Reg. § 25.2704-2 references Treas. Reg. § 25.2701-2(b)(5) as providing the definition for the term "control." However, Prop. Reg. §§ 25.2704-2 and 25.2704-3 reference Treas. Reg. § 25.2701-2(b)(5) (also modified pursuant to the Proposed Regulations) as providing the definition of the term "controlled entity" but do not direct that it or any other regulation define the term "control." Curiously, "controlled entity" does not appear to be a term of consequence in either of those Proposed Regulations, although each uses the term "family-controlled entities" in a seemingly descriptive manner and not as a term with any apparent technical significance. The reference to Treas. Reg. § 25.2701-2(b)(5) in each of Prop. Reg. §§ 25.2704-2 and 25.2704-3 for a definition of "controlled entity" and not simply "control" has created confusion as to the individuals who are required to possess control of an entity in order for transfers of interests in it to be subject to Code § 2704(b).

The confusion stems from the two-part manner in which Prop. Reg. § 25.2701-2(b)(5) defines "controlled entity." It outlines the type and level of interests for determining "control" of each type of entity. However, in Treas. Reg. § 25.2701-2(b)(5)(i), it also lists the individuals whose ownership of those interests "count" for purposes of characterizing an entity as a "controlled entity," and those individuals are not identical to those defined as "members of the transferor's family." For determining what constitutes a controlled entity, "applicable family

members" must be considered. Specifically, spouses of the transferor's descendants are "members of the transferor's family," but any interests they hold in an entity do not "count" in determining whether it is a "controlled entity" for purposes of Code § 2701. Conversely, neither (i) descendants of the transferor's siblings nor (ii) siblings or descendants of siblings of the transferor's spouse are to be considered "members of the transferor's family" but any interests they hold in an entity do "count" in determining whether it is a "controlled entity" because they are applicable family members.

We believe that the individuals who are required to hold control of an entity in order for transfers of interests in it to be subject to Code § 2704(b) are solely those referenced in the definition of "member of the family." We believe that any attempt by the Treasury and the IRS to expand that list of individuals to include those additional individuals referenced in the definition of "controlled entity" would be an inappropriate exercise of the authority provided to them pursuant to Code § 2704(b)(4) to issue the Proposed Regulations. If Treas. Reg. § 25.2702-2(a)(1) is confirmed as providing the appropriate listing of those individuals, then we propose that the first sentence of each of Prop. Reg. § 25.2704-2(c) and Prop. Reg. § 25.2704-3(c) be revised to read: "For the definition of control, see § 25.2701-2(b)(5)(ii), (iii), or (iv), as applicable."

F. Requested Clarity Regarding Apparent Broadening of Family Attribution Principles

Code § 2704(b)(3)(B) (the "Exception") provides that the term "applicable restriction" shall not include any restriction imposed, or required to be imposed, by federal or state law. Treas. Reg. § 25.2704-2(b) currently provides that an applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under state law generally in the absence of the restriction. Thus, Treasury and the IRS have interpreted the word "imposed" to refer to the default provisions of state law applicable in the absence of a contrary provision in an entity's governing instrument.

However, Treasury and the IRS have now proposed a narrower interpretation of the Exception in Prop. Reg. § 25.2704-2(b)(4)(ii) (for applicable restrictions) and § 25.2704-3(b)(5)(iii) (for "disregarded restrictions"). Together, those sections direct that a provision of state or federal law that may be overridden in the partnership agreement or otherwise superseded (whether by the partners or otherwise) is not a restriction that is "imposed or required to be imposed by federal or state law." As explained in the Preamble, Treasury and the IRS feel this narrower interpretation is now appropriate because the "current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws" that may on their face substantiate the need for valuation discounts but in Treasury's and the IRS's estimation are likely to be circumvented by the other partners' willingness to accommodate a family member's request that those restrictions be removed.

Effectively, Treasury and the IRS now seem to interpret "impose" as a reference to a non-waivable state or federal restriction, which begs the question of what is to be considered a restriction "required to be imposed" by state or federal law. Some practitioners have speculated that this second prong of the Exception may refer to a state or federal law requiring the actual

incorporation in the partnership agreement of a specific restriction on a limited partner's withdrawal right or the right of a limited partnership to liquidate.

We are unaware of any state law provision restricting a limited partner's withdrawal right or the right of a limited partnership to liquidate that cannot be overridden in the partnership agreement. We are also unaware of any state or federal law that requires such a non-waivable provision be incorporated in a partnership agreement. Thus, it seems unlikely that any restriction in a partnership agreement on a limited partner's withdrawal right or the right of a limited partnership to liquidate will qualify for the Exception, as interpreted in the Proposed Regulations. We are concerned that Treasury and the IRS have consequently narrowed the Exception to the extent it will have little or no effect and thus will have been rendered meaningless, which suggests that the Treasury and the IRS have exceeded their Congressional authority in adopting this interpretation. The Proposed Regulations appear to have broadened the application of family attribution principles beyond the few instances in which Congress intended that it be assumed that family members will unite to disregard actual lapses of voting or liquidation rights or restrictions on an entity's liquidation to substantiate an artificially higher value for a transferred (or deemed transferred) limited partnership interest than would otherwise apply.

Congress indicated in the legislative history to Chapter 14 its awareness of the courts' refusal to consider familial relationships among co-owners in valuing transferred interests in family entities and its intent that Chapter 14 not affect discounts available under then present law. 136 Cong. Rec. 15679, 15681 (October 18, 1990); H. Conf. Rept. 101-964, at 1137 (1990), 1991-2 C.B. 560, 606. We believe this effective invalidation of the Exception and corresponding expansion of family attribution principles conflicts with Congress's intent in enacting Chapter 14 and case law of continuing precedential value and may only be undertaken by Treasury and the IRS pursuant to an explicit Congressional directive.

In light of the foregoing, we respectfully suggest that Treasury and the IRS revise Prop. Reg. §§ 25.2704-2(b)(4)(ii) and 25.2704-3(b)(5)(iii) to retain the "no more restrictive standard" set forth in § 25.2704-2(b) of the current regulations. Alternatively, if the Treasury and the IRS will not return to the standard of the current regulations, we respectfully request that Treasury add additional examples to the Proposed Regulations that illustrate circumstances under which the Exception will have effect under the new standard contained in Prop. Reg. §§ 25.2704-2(b)(4)(ii) and 25.2704-3(b)(5)(iii).

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.