Family Values: An Evaluation of Internal Revenue Code Sections 2703 and 2704(b)

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Introduction

Valuation for transfer tax purposes can be an exceedingly difficult endeavor. When a robust market exists for a given asset, the calculus becomes simpler.[1] For closely-held business interests, however, markets often provide little guidance. Particularly when family-owned, these assets are distinctive by nature. These distinctive characteristics—including contracted restrictions and arrangements among owners—can be a reasonable basis for discounting assessed value. Restrictions can be imposed for good-faith business purposes. Under the traditional 'willing buyer/willing seller' test of value,[2] restrictions often materially decrease the present value of business interests. It is also true that, in addition to such warranted discounts, transfer tax-conscious owners have a natural incentive to self-impose artificial, value-depressing business entity restrictions in order to minimize their transfer tax liability. As such, ideal valuation rules strike a balance between respecting legitimate discounts and disregarding the chaff of artificial, tax-driven business arrangements. Rules that disallow legitimate discounts effectively create an additional tax on closely-held (as opposed to marketable) interests, while overly permissive rules create the inverse tax. Both outcomes are inefficient.

Sections 2703 and 2704(b) contend with this problem,[3] specifically as applied to discount-generating restrictions on family-owned property.[4] Section 2703 gives the IRS, when valuing such property, broad authority to disregard "any option, agreement, or other right to acquire or use" the property, as well as "any restriction on the right to sell or use such property."[5] The IRS must respect those agreements and restrictions only if they qualify for a safe harbor.[6] The safe harbor attempts to delineate (and respect) legitimate agreements and restrictions. Section 2704(b) follows, in form, a similar scheme.

When Congress enacted §§ 2703 and 2704(b) as part of Chapter 14's special transfer tax valuation rules,[7] the issue of balance was front and center. Congress had failed to achieve balance in § 2036(c), the overly-aggressive predecessor to Chapter 14.[8] As the Senate voted to replace § 2036(c) with Chapter 14, the Senate Finance Committee noted that the "complexity, breadth, and vagueness" of § 2036(c) posed "an unreasonable impediment" to family businesses.[9] However, Congress did not want to repeal § 2036(c) without a replacement. The Committee remained "concerned about potential estate and gift tax valuation abuses"[10]— hence the "targeted rules" of Chapter 14.[11] In particular, Congress noted a concern for even-handed application with § 2703.[12]

Nearly a quarter of a century after Chapter 14's enactment, it is worth considering whether §§ 2703 and 2704(b) have, in practice, achieved their congressionally-intended balance. These two sections offer an enlightening study in contrasts. In Part I, this Article argues that, on the whole, § 2703 has come to strike that congressionally-mandated balance successfully. However, Part II discusses two chief problems that remain in the provision's application. First, as illustrated through the dissenting opinion in *Holman v. Commissioner*,[13] drafting ambiguities have engendered unnecessary (though non-fatal) complexities regarding the provision's interrelation with earlier case law and regulations. Second, once restrictions are deemed ineligible for the § 2703(b) safe harbor, courts have taken a muddled approach to the quantitative valuation impact. Part III turns to § 2704(b). Reviewing the history and implementation of the statute, this Article argues that § 2704(b) has been an unmitigated failure. The poor drafting of § 2704(b) has rendered it too easy to circumvent. In Part IV, this Article considers the interrelation between §§ 2703 and 2704(b), as well as potential fixes to § 2704(b). While reparative legislation is necessary to fix § 2704(b), a partial remedy is possible through amendment to the provision's companion regulations. Also, if and when a legislative fix becomes feasible, this comparison with § 2703 points toward an approach that is more efficient than current proposals.

I. Section 2703: Legislative History and Post-Enactment Interpretation

A. Legislative History

In assessing § 2703, legislative history provides an important lens through which to consider certain interpretive issues with the statute. As can be charted through successive drafts of § 2703, the statute evolved from one primarily built on new tax law concepts to one that borrowed heavily from existing standards and regulations. In the initial 'discussion draft' of Chapter 14, the § 2703-equivalent was quite different from its enacted form.[14] The section had the same basic structure as the enacted § 2703. The first part required a general disregard of discount-generating restrictions on closely-held business interests, and the second part provided a safe harbor against that disregard.[15] However, while the form is similar, the substance diverges. In its first section, the discussion draft covered a narrower set of restrictions—only buy-sell options, rights of first refusal, and leases.[16] That contrasts with the far more capacious § 2703(a), which covers "any option, agreement, or other right to acquire or use" property,[17] along with "any restriction on the right to sell or use" the property.[18]

The discussion draft's safe harbor was also dramatically different from the one codified in § 2703(b). As a threshold issue, only buy-sell agreements were eligible for the safe harbor, so ROFRs and restrictive leases could not qualify.[19] Also, the safe harbor involved burdensome, bright-line requirements. To qualify, the buy-sell agreement had to be exercised,[20] and the buy-sell price had to be "reviewed" within the past three years.[21] These aspects of the safe harbor did little to delineate legitimate restrictions from artificial ones. The exercise requirement, for example, does nothing to get at the fairness of the price. If the buy-sell price is artificially low, then a family can fulfill that requirement by exercising at that bargain price. Overall, the safe harbor largely omitted existing valuation principles to instead create "a new set of rules."[22] The House's next legislative draft of § 2703 built on this discussion draft.[23] However, this House approach was jettisoned. The § 2703-equivalent in a subsequent Senate bill largely contained the language used in the enacted version,[24] and the House acquiesced to this Senate approach.[25]

In contrast to those House drafts, the Senate formulation pulled standards from existing law. The first two requirements of the Senate's three-pronged safe harbor—that the restriction be a "bona fide business arrangement" and also "not a device to transfer such property" at below FMV[26]—both came from existing Treasury Regulations and established case law.[27] The third prong—that the restriction "be comparable to similar arrangements entered into by persons in an arms' length transaction"[28]—was not an independent test in existing regulations.[29] However, even this allegedly novel 'arm's-length' requirement was found in prior case law.[30]

There are important interpretive lessons in this progression from "a new set of rules" to established standards.[31] First, because of this shift, the statute allows for precedential continuity.

When explicating § 2703, courts can—and do—reason from pre-section 2703 cases and regulations.[32] Absent some reason to the contrary, these established portions of § 2703 should be interpreted in accordance with their pre-enactment meaning.[33] However, precedential continuity is only part of the story. A complementary consideration is that proper interpretation should pay close attention to the ways in which the statute departed from established law. For instance, pre-section 2703 case law and regulations are chiefly targeted at buy-sell agreements.[34] Congress enacted a statute with far greater breadth. As the legislative history shows, Congress considered a statute that retained such a targeted approach to covered restrictions, [35] but that approach lost.

Lastly, while § 2703 codified existing standards, the statute was only a partial codification, one "meant to supplement, not replace, prior case law."[36] As the Senate Finance Committee stipulated, § 2703 was not intended to "alter the requirements for giving weight to a buy-sell agreement" or other covered restrictions.[37] As such, if the statute does not overrule a standard in prior case law or regulation, such a standard should be assumed to remain applicable.

B. Post-Enactment Interpretation

With those interpretive lessons in mind, it is possible to turn to the statute's subsequent judicial interpretation to determine whether § 2703 has achieved, in practice, its intended balance. In this analysis, it is most efficient to work through the statute piece-by-piece.

On its face, § 2703 sweeps broadly. Its first section—§ 2703(a)—seemingly covers any property "restriction" or "option."[38] If any "restriction" or "option" fails to qualify for the subsequent § 2703(b) safe harbor, then the valuation must be calculated "without regard to" that "restriction or "option."[39] One can see the potentially pervasive reach of that broad language. However, in the spirit of Congress's intention for "targeted rules" in Chapter 14,[40] regulations and related case law add effective, bright-line standards that delimit § 2703(a)'s reach. These bright-line standards respect most legitimate restrictions and options without permitting abuse.

The most impactful bright-line test is found in the companion regulations. Any restriction or option is deemed to fulfill the safe harbor automatically "if more than 50 percent of the value of the property subject to the right or restriction is owned…by individuals who are not members of the transferor's family."[41] In other words, if a businesses or property is not family-controlled, then it is deemed to comply with the safe harbor. This deemed compliance is only effective if the third-party owners are subject to the restriction "to the same extent" as the transferor.[42]

This deemed compliance provision is an elegant solution to potential overbroad application of § 2703. As will become evident below, the three prongs of the safe harbor require a laborious, fact-intensive inquiry to determine whether a given restriction qualifies. It takes considerable effort and creates planning uncertainty to require actual compliance with the full safe harbor. As such, § 2703(b) should only come into play in difficult, borderline situations where such effort is warranted. At the same time, the safe harbor is trying to answer one core question: is the restriction something that rational, arm's-length economic actors would accept? This deemed compliance regulation circumvents § 2703(b) when the nuances of the safe harbor are unnecessary to answer that question. Families and likely beneficiaries may be able to collusively self-impose value-destructive restrictions or options, but unrelated third parties are loath to destroy the long-term value of their property for the short-term transfer tax gain of minority owners. Importantly, "family" is broadly defined here to include any "natural objects of the transferor's bounty,"[43] so the third-party owners must be strictly disinterested when it comes to gifts or bequests from the transferor. Moreover, even when this deemed compliance is available, the option or restriction is still subject to other valuation requirements.[44] For instance, if a buy-sell option is only binding at death (and parties are otherwise "free to dispose of [the property]…at any price"), that option will be disregarded in transfer tax valuation notwithstanding the deemed compliance.[45] Third parties must be truly locked in to restrictions for them to retain effect under the deemed compliance regulation. In such circumstances, it is not necessary to postulate what third-party negotiators would do—their actions speak for themselves.

The other bright-line standards could be described as deemed *non*compliance rules. As noted above, § 2703 is only a partial codification of the relevant standards. To be respected, restrictions and options need to fulfill other requirements. Just as § 25.2703-1(b)(3) provides an effective heuristic to deem compliance without intensive § 2703(b) review, these other requirements can be applied as a threshold matter to disregard restrictions or options. The first set of requirements grow out of the "Wilson-Lomb test."[46] Any restriction or option must "be enforceable against the parties" and "bind transferors both during life and at death."[47] In other words, the restrictions or options must be real and legally enforceable, and the transferor cannot retain the unilateral ability to revoke them. The most common taxpayer issue here arises when the transferor has unilateral authority to remove or void the option or restriction.[48] In practice, these Wilson-Lomb components have been used to avoid the intensive § 2703(b) analysis.[49] The other avenue for 'deemed noncompliance' is when, as a matter of business entity law, a transferor fails to respect the entity to which a restriction or option relates.[50] Similarly, courts can apply the step transaction doctrine, although courts have employed that tactic sparingly.[51]

In sum, case law and regulations smartly limit § 2703. The broad language of § 2703(a) would otherwise pull far too many taxpayers into the exhaustive § 2703(b) analysis. The heuristics for deemed compliance and deemed noncompliance address estate freeze concerns efficiently, leaving only the hard cases for analysis under the safe harbor. However, that is not to say all circumscription of § 2703(a)'s broad language is good. The bright-line heuristics here only work because they accurately separate legitimate options and restrictions from artificial, tax-driven ones. An early 5th Circuit case illustrated how narrowing of § 2703(a) can be improper. In *Church v. United States*,[52] the court contended that, based on the legislative history, § 2703(a) was only intended to cover buy-sell agreements (and not other restrictions).[53] It is hard to see what aspect of the legislative history supports that conclusion. To the contrary, earlier versions of § 2703 specifically enumerated the types of covered restrictions,[54] but Congress rejected that approach for the capacious language of the enacted § 2703(a). Thankfully, while a later court gestured toward the *Church* view,[55] it has disappeared in subsequent case law.

While precedent and regulations efficiently winnow the cases that require a § 2703(b) analysis, it must be determined if, among the remaining cases, courts have employed the three prongs of § 2703(b) to discern accurately between legitimate and artificial restrictions. Two cases—*Holman* and *Estate of Amlie*[56]—illustrate where recent jurisprudence has drawn that line.

The first prong asks whether a restriction is "a bona fide business arrangement."[57] Precedent offers ample guidance for what qualifies as such an arrangement. A restriction can qualify, for instance, if it furthers "maintenance of family ownership and control" of a business.[58] For § 2703, that 'family control' rationale is vitally important, since true § 2703(b) analyses are often targeted at family-controlled entities.[59] This family control rationale is not just valid as a precedential matter, but also as a matter of economic reason. It makes economic sense that a value-maximizing family business could be motivated to contractually mandate sustained family control. A business often functions most efficiently when its owners share homogeneous goals and interests.[60] Family control can provide such homogeneity. That familial cohesion is perhaps the primary organizational advantage of the family business. Accordingly, rational family shareholders may be willing to decrease the immediate value of their holdings—through restrictions and buy-sell options—to cement family control. Such arrangements can be legitimate as a theoretical business matter, so § 2703(b)(1) should (and does) respect them.

However, this rationale loses its validity when the restrictions or options have no relation to the management of an actual business. The *Holman* court recognized as much.[61] In *Holman*, the taxpayers moved their public Dell stock—an immaterial amount relative to Dell's market capitalization—into a restrictive partnership and then gifted partnership interests to their children.[62] On their relevant gift tax returns, the taxpayers claimed steep discounts on the gifts' values.[63] In this context, the family control rationale has no relevance.[64] The partnership restrictions did nothing to further efficient family management of an enterprise, since there was no enterprise.[65] The restricted entity was "a mere asset container."[66] The *Holman* court rightly denied the 'family management/control' rationale as viable in this context for § 2703(b)(1).[67]

That is not to say that investment entities cannot qualify under § 2703(b)(1). On the investment front, the *Holman* court noted that the "strongest cases" for the taxpayers were three decisions where a legitimate business purpose was found for "investment entities with restrictions imposed to ensure perpetuation of an investment…strategy."[68] These cited cases all dealt with the "bona-fide sale" exception to § 2036(a).[69] Of the three cases, two are immediately distinguishable from the *Holman* facts.[70] In these cases—*Black* and *Murphy*—the taxpayers' families owned, through investment entities, sizable minority and/or majority stakes in companies and other investment assets.[71] The consolidated investment entities were a means to exercise meaningful managerial control over the operations of the underlying assets. As such, the family management and control rationale was as valid as it would be for an operating business. The difficult case to distinguish is *Estate of Schutt*.[72] In *Schutt*, much as with the Dell stock in

Holman, the investment entities held stakes in two massive public companies, Exxon and DuPont.[73] The size of the holdings was immaterial from a shareholder influence perspective.[74] The *Holman* court differentiated *Schutt* on the basis that the *Schutt* taxpayer, unlike those in *Holman*, were effectuating "a specific buy-and-hold investment strategy."[75] It is generous to describe the *Schutt* investment regime as a "strategy."[76] The taxpayer was merely, through decades, holding two blue-chip stocks.[77] If the *Holman* taxpayers had stipulated that they had a "specific…investment strategy"[78] of perpetually retaining Dell equity, their situation would be indistinguishable from *Schutt*. It is too easy and formalistic to allow cases to turn on such a nominal stated 'investment strategy.' Reading between the lines, it thus seems like *Schutt* is distinguished for other reasons. As one commentator noted, the judgment may be "that the bona fide business arrangement test is more difficult to satisfy than the bona fide sale exception to § 2036(a)."[79] In other words, to support the family control rationale under § 2703(b)(1) for an investment entity (as opposed to an operating business), the court was really looking for a fact pattern like those in *Black* and *Murphy*, where the investment entities facilitated real operational involvement with the underlying assets. This read of *Holman* rightly limits the family control rationale under § 2703(b)(1) to where it can make long-term economic sense.[80]

This interpretation was borne out in the subsequent *Fisher* case, where the taxpayers presented the type of nominal investment strategy that would have aligned the *Holman* fact pattern with *Schutt*.[81] In substance, the restricted LLC in *Fisher* was "a mere asset container" for personal-use lakefront property.[82] Instead of accepting the *Schutt*-style buy-and-hold strategy on its face, the *Fisher* court looked for substantive evidence of active commercial management. It found none and declared § 2703(b)(1) inapplicable on summary judgment.[83]

As the other leading § 2703(b)(1) case—*Estate of Amlie*[84]—illustrates, however, family control is not the only rationale to support a "bona fide business arrangement."[85] Passive interests can also qualify. In *Amlie*, the taxpayer held a substantial minority interest in a privately-held bank.[86] The stake was passive.[87] That bank merged into FABG, another bank.[88] At this point, the taxpayer's conservator deemed it prudent—and perhaps even required as a fiduciary matter—to secure a fixed-price repurchase guarantee from FABG.[89] This at-death reciprocal put/call option between the taxpayer and FABG provided "a hedge against the risk…in holding a minority interest in a closely held bank."[90] Due to litigation among beneficiaries, the put/call option was instituted between the taxpayer and one of the beneficiaries, her son Rod Amlie, rather than the taxpayer and the bank.[91] However, the hedging function remained. A couple of years later, Rod Amlie negotiated a substantially higher price with FABG for the repurchase of its shares once they passed to him through his mother's estate.[92]

Amlie presents the wrinkle of the second agreement with the beneficiary Rod Amlie, but for purposes of § 2703(b)(1), the important fact is that a passive minority shareholder in a closely-held business entered into a buy-sell agreement to hedge her minority-status risk. The *Amlie* court found that to be a legitimate rationale for a business arrangement to qualify under § 2703(b)(1).[93] That determination was correct. Minority ownership in a closely-held business is particularly risky,[94] and absent tax considerations, arm's-length parties will negotiate to hedge that risk. Thus, even when a transferor owns a purely passive interest, restrictions can still qualify for § 2703(b)(1). The key is that the underlying business must be closely-held, such that minority ownership presents real risks beyond the typical vicissitudes of the market, and the option (along with any related restrictions) must hedge that heightened risk.

While nuanced, a § 2703(b)(1) analysis can at least be decided on the presence (or absence) of specific business contexts.[95] It is an objective question whether those circumstances exist. Section 2703(b)(2) asks whether the option or restriction at issue is "a device to transfer such property" for below-market value.[96] This prong threatens to turn into a messy, subjective question of testamentary intent. Mercifully, "[C]ourts applying the device test often look to objective evidence in determining…'intent.'"[97] This approach assures objective, systematized analysis. Precedential continuity is vitally important here, providing the types of "objective evidence" that are considered.[98] In *Estate of True*, the court summed up the list of factors:

> (1) the decedent's ill health when entering into the agreement, (2) lack of negotiations between the parties before executing the agreement, (3) lack of (or inconsistent) enforcement of buy-sell agreements, (4) failure to obtain comparables or appraisals to determine the buy-sell agreement's formula price, (5) failure to seek professional advice in selecting the formula price, (6) lack of provision in buy-sell requiring periodic review of a stated fixed price, (7) exclusion of significant assets from the formula price, and (8) acceptance of below-market payment terms for purchase of decedent's interest.[99]

The *True* court was discussing these factors in the context of an at-death buy-sell agreement, but most apply to other § 2703-covered restrictions or options. These factors are "judged at the time the agreement is entered" rather than with hindsight.[100] As illustrated in *Holman* and *Amlie*, these factors can be weighed based on the particulars of the situation. In *Amlie*, factors two through eight weighed in the taxpayer's favor.[101] The buy-sell price was formulated through a professional appraisal based on comparable holdings, and the price adjusted upward over time.[102] Moreover, the price was aggressively negotiated among adversarial parties.[103] The transferor's health was deteriorating,[104] but that meant little in the circumstances, since the conservator was the self-initiating negotiator. The taxpayer deserved to qualify under § 2703(b)(2).[105]

In *Holman*, ill-health was not present, but the family members entered the ostensibly value-destroying partnership without negotiation, even though some Dell shares were transferred into the partnership from the children's custodial accounts.[106] The *Holman* Tax Court found that the partnership restrictions failed to qualify for § 2703(b)(2) primarily based on a version of the eighth factor.[107] The issue was the partnership's partner buyout provision for impermissible (i.e., any) transfers. The parental general partners could force the purchase of partnership interests from children trying to sell interests.[108] This partnership-interest purchase price was far below the value of the underlying Dell equity.[109] The benefit of that value discrepancy would accrue to the other children in the partnership.[110] The court thus found that the partnership restrictions constituted a vehicle for below-market transfer to those other children.

This approach to the § 2703(b)(2) analysis—weighing all or some of the *True* court's list of objective factors—is optimal. A subjective test of intent would more directly address the question that §2703(b)(2) is meant to answer, but evidentiary issues make a subjective approach impracticable.[111] On the other end of the spectrum, an inflexible objective test where a taxpayer had to satisfy all the relevant factors would be inequitable. This middle-ground—a menu of objective factors considered based on which are pertinent to the particular context—is the best approach. Multi-factor legal tests can become "redundant, incomplete and unclear,"[112] but that risk is most acute where, unlike here, the test involves imponderable moral (or otherwise incalculable) variables.[113] With § 2703(b)(2), these objective factors are either present or not, and the factors that should be considered pertinent are generally self-evident based on the context.

The final prong of § 2703(b) is the requirement that the terms of the restriction "are comparable to similar arrangements entered into by persons in an arms' length transaction."[114] This requirement is final in the sense that it comes last sequentially in the statute, but more than that, this prong should be the final one considered because it presents the most difficulty. At first blush, § 2703(b)(3) seems to invite a straightforward application: compare the terms of other business arrangements in the same industry. However, "[A]vailable data on arrangements entered into among private parties can be sparse, if any exist."[115] To combat this problem, one group of lawyers valiantly attempted to compile public partnership agreements for § 2703(b)(3) comparisons.[116] However, as they conceded, "[I]t may be impractical to identify arm's length partnership agreements that are in the same…business to that of the partnership" at issue.[117]

Courts thus have moved toward accepting expert testimony and—specifically for quantitative restrictions like a buy-sell option—appraisals. In earlier dicta in *Estate of Blount*, the Tax Court indicated that it wanted actual evidence of other, real-world business arrangements.[118] However, by *Amlie*, the Tax Court was satisfied with an appraisal methodologically similar to the one dismissed as insufficient in *Blount*.[119] In *Holman*, while neither the Tax Court nor the Eighth Circuit reached the § 2703(b)(3) issue, commentators were heartened by "the willingness of the court to accept testimony concerning the comparability requirement" as opposed to requiring actual agreements.[120] Looking to § 2703's legislative history, Congress stipulated that § 2703(b)(3) should not be made too high a hurdle,[121] and acceptance of expert testimony and appraisals is consonant with that concern. Moreover, as a matter of precedential continuity, pre-section 2703 arm's-length analyses did not require other business agreements as evidence.[122]

However, it is still advisable, as both *Holman* courts did, to consider § 2703(b)(3) only if a restriction satisfies the other safe-harbor requirements (and cannot otherwise be deemed compliant or noncompliant). Unlike § 2703(b)(2), where the fact and form of professional input and appraisal are important, § 2703(b)(3) is about the substance of those professional judgments. The judge needs to choose between each side's impeccably-credentialed appraisal experts and decide what qualifies as reasonable market practice. The courtroom is ill-suited to such business judgments.[123] Accordingly, the *Amlie* court exemplified the best approach to § 2703(b)(3)—a measure of deference and an aversion to hindsight bias. The *Amlie* court probed the relevant appraisal, though not too aggressively.[124] Although the equity at issue was priced at an over 84% markup to the buy-sell price within two years, the court noted the *ex post* factors that contributed to the higher price.[125] Functionally, the *Amlie* court employed § 2703(b)(3) as a sanity check on the buy-sell agreement, rather than an invasive analysis. This approach is the right one, and not only due to the limits of judicial business expertise. As noted above,[126] it is important to consider the ways in which § 2703 departed from established law. The independent § 2703(b)(3) requirement was one such departure. As such, it must add something to the analysis. However, that imperative must be balanced against congressional concern with applying § 2703(b)(3) too aggressively.[127] The *Amlie* court's sanity check approach, with an allowance for expert testimony, balances these two countervailing imperatives.

This Part concludes that courts have generally been balanced in their application of § 2703. Regulations and case law effectively winnow out cases without resorting to § 2703(b). Where a § 2703(b) safe-harbor analysis is necessary, the first two prongs of the safe harbor are decided based on fair, objective factors, with the final prong as a sanity check on the arrangement's substance. Post-enactment regulations and case law have thus addressed concerns about "highly subjective" application of the statute.[128] Certain commentators find § 2703, both in theory and in practice, too friendly to the IRS or to taxpayers.[129] However, judged against its congressionally-mandated aims, § 2703 has been, as a general matter, soundly implemented.

II. Remaining Interpretive Issues

This review of § 2703 not only serves to evaluate § 2703's implementation. It also provides the background necessary to resolve certain interpretive issues. This Part address two sets of those issues: (a) questions about the applicability of § 2703(b)(2) and (b) valuation problems once a restriction or option fails to qualify for the § 2703(b) safe harbor.

A. Section 2703(b)(2) and *Inter Vivos* Transfers: A Response to Judge Beam

In his *Holman* dissent, Judge C. Arlen Beam makes a compelling argument that § 2703(b)(2)—the safe harbor's second prong—is only applicable for estate (and not gift or *inter vivos* GST) tax purposes.[130] In other words, for *inter vivos* transfers, restrictions are only required to satisfy the safe harbor's first and third prongs. Judge Beam reaches this conclusion because § 2703(b)(2) only covers "a device to transfer…to members of the *decedent's* family."[131] Judge Beam notes—and it is, of course, hard to argue with him—that the term decedent unambiguously refers to a "dead person."[132] As such, by virtue of its plain language, § 2703(b)(2) only operates when a "dead person" is at issue,[133] i.e. in the estate tax or postmortem GST context. In Judge Beam's view, the companion regulation impermissibly expands the reach of § 2703(b)(2) by referencing "the transferor[]"[134] where the statute is clear in its narrower reference to "decedent[]."[135] Thus, he deems the regulation invalid.[136] Similarly, he argues that § 2703(b)(2) only covers "device[s]" to transfer to the decedent's "*family*."[137] Again, in Judge Beam's view, the regulation makes an end-run around the statute's unambiguous language by expanding § 2703(b)(2) to cover transfers to the broader "natural objects of…bounty."[138]

The majority did not address § 2703(b)(2), so Judge Beam's analysis goes unanswered. The IRS, however, argued the issue. The Service makes a two-step argument. First, as a matter of statutory interpretation, the *inter vivos* applicability of § 2703(b)(2) is ambiguous. Section 2703 is supposed to apply, by the statute's own terms, "[f]or purposes of this subtitle."[139] As the IRS notes, "this subtitle" is "Subtitle B of the Code, which includes the estate tax (Chapter 11), the gift tax (Chapter 12), and the tax on generation-skipping transfers (Chapter 13)."[140] These conflicting aspects of § 2703—the narrower reference to "decedent[]" and the broader reference to the entire "subtitle"[141]—engender ambiguity. This ambiguity moves the analysis to the deferential territory of the *Chevron* doctrine.[142] Under *Chevron*, if a statute is ambiguous, courts must respect an agency's interpretation if that interpretation is, in a broad sense, "reasonable."[143] The IRS asserted that *Chevron* required the court to defer to its § 2703(b)(2) interpretation in Treas. Reg. § 25.2703-1(b)(1)(ii).[144] The IRS also argued that its "subtitle" interpretation fulfilled another interpretive norm: holistic reading. As the Supreme Court has explained, "Statutory construction is a holistic endeavor, and…must account for a statute's full text, language as well as punctuation, structure, and subject matter."[145] In the IRS's telling, § 2702(b)(2) must be applied, in light of its subject matter, to cover all transfer tax contexts (and all natural objects of bounty). Commentators have reiterated strands of the IRS's argument.[146]

While the IRS's argument is colorable, their position feels inadequate relative to Judge Beam's plain-language obviousness. After all, *Chevron* deference does not apply if the statute is clear,[147] and in Judge Beam's telling, the statutory language could not be clearer. However, the interpretive lessons from Part I demonstrate that Judge Beam's argument is incorrect.

On this *inter vivos* issue, the key is that § 2703 was a partial (and not a full) codification of existing law. Prior to § 2703, law and regulation granted the IRS power to disregard buy-sell agreements or other § 2703-applicable restrictions for reasons other than those in the § 2703(b) safe harbor.[148] As Congress stipulated,[149] § 2703 was enacted to "supplement, not replace, prior case law."[150] Congress provided the example that § 2703 "leaves intact present law rules requiring that an agreement have lifetime restrictions in order to be binding on death."[151]

Prior to § 2703, it was well-established "that restrictive agreements, such as the buy-sell agreements…*generally do not control value for Federal gift tax purposes*."[152] For gifts, the IRS has long had tremendous leeway to disregard § 2703-type restrictions—much more so than in the estate tax context.[153] Several considerations motivate this gift treatment. The most salient for buy-sell options specifically is that, in the estate context, "the critical event (death) that subjects the stock to the purchase right has occurred, and…the seller-estate can receive no more than the formula price."[154] In contrast, gifts are voluntary. If a gift triggers an unwanted buy-sell option, the donor can choose not to give the gift. Where the donor makes the gift without tripping the buy-sell option (but the transferred property remains subject to the option), the option is, at most, a potential "factor to be considered" in appraisal.[155] The value of the interest may be affected, but not controlled, by the formula price at which it may eventually be sold.

It is thus irrelevant that the plain language of § 2703(b)(2) only refers to a "decedent[]."[156] If anything, given that regulatory background, § 2703(b) serves as a floor (and not a ceiling) for what the IRS can require to honor restrictions in the gift context. Insofar as the IRS has, for gifts, required no more than the satisfaction of § 2703(b)'s criteria, then that is the gift standard. Alternatively, this background law on gift treatment—when considered in interpreting § 2703(b)(2)—creates enough ambiguity to trigger *Chevron* deference. In either case, this gift background must also be considered through the lens of another interpretive norm. As the Supreme Court has stated, "The federal estate tax and the federal gift tax…are construed *in pari materia*."[157] The IRS's interpretation best actualizes that imperative. Accordingly, § 2703(b)(2) should apply equally in the estate and gift contexts. For what it is worth, after Chapter 14's enactment, many practitioners assumed that § 2703 would be so read.[158]

With that established, it is possible to resolve the issue of 'natural objects of bounty' as opposed to 'family.' The argument is similar. Pre-section 2703 standards like Treas. Reg. § 20.2031-2(h) used the 'natural bounty' standard for the test that would become § 2703(b)(2). Moreover, the term 'family' is not defined in § 2703, as in other Chapter 14 sections,[159] so that silence grants the IRS leeway. The section's other regulations also blur the distinction between family and natural objects of bounty,[160] so this slippage is not novel to § 2703(b)(2).

The analysis required to respond to Judge Beam is far from simple, and so this Part II.A illustrates the hazards in partial codification of an already rich area of law. A comprehensive version of § 2703 that fully codified all existing law would perhaps be clearer. Regardless, the general applicability of § 2703(b)(2) retains a solid interpretive foundation.

B. Valuation When § 2703(a) Applies

When the IRS and a taxpayer wrestle over § 2703, the safe-harbor determination is only half the battle. If the taxpayer loses that legal question, the fight moves to the particulars of the valuation. It is unclear from case law what, if any, weight should be given to § 2703-applicable restrictions that fail to meet the § 2703(b) safe harbor. The answer may seem self-evident. Section 2703(a) stipulates that value must be determined "without regard to" such restrictions,[161] and so such restrictions should be given no weight whatsoever. That answer is mostly right (with one caveat discussed later[162]), but the result in *Holman* has confused that plain meaning.

As has been discussed at length, the *Holman* court adjudged the examined partnership restrictions to be outside the § 2703(b) safe harbor.[163] After affirming on this point, the majority opinion moved to valuation, and it is here that the IRS's victory became somewhat pyrrhic.[164] Even though the taxpayers lost on the law, they ultimately received discounts of 22.4%, 25% and 16.5% on their three respective gifts.[165] A portion of those discounts was due to the unregistered nature of the underlying Dell shares,[166] but that only generated part of the discounts.

The court found that no examined restriction in the partnership agreement qualified under § 2703(b). Specifically, sections 9.1 through 9.3 of the partnership agreement—restrictions on the sale or assignment LP units—were deemed subject to § 2703(a).[167] So how did taxpayers still manage such steep discounts? They succeeded because the IRS did not challenge all the entity-level restrictions that it could have. In particular, the partnership also had limits on partner withdrawal in section 8.4.[168] There is no reason to think that section 8.4 would have survived the § 2703(b) analysis that the other partnership sections failed. If the IRS had also won on section 8.4, the willing buyer/willing seller test would produce no discount, aside from the discount for the unregistered nature of the underlying shares. Where withdrawal rights are unfettered, a rational buyer will buy the partnership interest for a price at (or close) to the market value of the underlying Dell shares. Subsequent to purchase, the buyer would be able to redeem its interest for that underlying value[169]—thereby justifying that price.

Perhaps because the IRS was not as aggressive as it could have been in *Holman*, § 2703(a)'s ultimate valuation effects have been questioned.[170] In light of this uncertainty, it is important to recognize that, for § 2703(a) valuation purposes, entities must treated as if § 2703(a)-subject restrictions do not exist. That is the imperative inherent in § 2703's "without regard to" language.[171] By its own terms, § 2703(a) is not concerned with relative weight—it is an absolute directive to ignore covered restrictions unless § 2703(b) is applicable.

An interesting challenge to this valuation rule arose in *Estate of Blount*.[172] The valuation in *Blount* runs counter to this proper § 2703 valuation method. This aspect of *Blount* represents a rare recent case where a court has misapplied § 2703. The nuances of the *Blount* issue are too complex to explicate here. The takeaway is that the *Blount* appellate court allowed a taxpayer, in valuing a business for estate tax purposes, to exclude from the valuation insurance proceeds paid to the business.[173] The exclusion was allowed because those proceeds were used to fund a shareholder-company buy-sell agreement (also known as a redemption agreement) that had been deemed subject to § 2703(a).[174] This decision was wrong. The "without regard to" valuation rule of § 2703 required that the buy-sell agreement be given no weight in the valuation.[175]

III. Section 2704(b): Legislative History and Post-Enactment Interpretation

There is, however, one material exception to § 2703's absolute disregard for restrictions that fail to qualify for § 2703(b). This exception is for certain restrictions on entity liquidation, and it arises because of the interaction between § 2703 and § 2704(b). To understand the scope of this exception, it is first necessary to review the history and prevailing interpretation of § 2704(b). As this review demonstrates, § 2704(b) has been, in application, a failure.

In form, § 2704(b) operates similarly to § 2703. The statute stipulates that whenever (i) someone transfers "an interest in a corporation or partnership"[176] to family and (ii) "the transferor and members of the transferor's family hold…control of the entity,"[177] any "applicable restriction" is "disregarded" in the transfer tax valuation.[178] An applicable restriction is any restriction that "effectively limits the ability of the corporation or partnership to liquidate,"[179] if the restriction either (i) lapses post-transfer or (ii) is removable by the "transferor or any member of the transferor's family…alone or collectively."[180] If a family controls a partnership or corporation and self-imposes a liquidation restriction, that restriction will be disregarded.

However, as with § 2703, the statute has a safe-harbor provision. Even if covered under § 2704(b)(1), a liquidation restriction will be respected if it is either (i) a "commercially reasonable restriction" [181] related to third-party financing arrangements or (ii) "imposed, or required to be imposed, by any Federal or State law."[182] The first safe-harbor option is analogous to the § 2703(b) safe harbor. As with § 2703(b), this financing safe harbor is attempting to sort out the types of "commercially reasonable" liquidations that arm's-length parties would accept.[183] The more relevant safe harbor—and crux of § 2704(b)'s problems—is the second one. As interpreted in the regulations, this second safe harbor covers liquidation restrictions "that would apply under the State law generally applicable to the entity in the absence of" any contracted liquidation restrictions in the corporate or partnership documents.[184] Put more plainly, the safe harbor protects liquidation restrictions that are less restrictive than (or equally restrictive as) state law defaults. This rule is best considered through example. Imagine Family *A*, members of which wholly-own Partnership *A*. Partnership *A*'s agreement requires at least 60% of partners to approve a liquidation. But for the safe harbor, that liquidation restriction would be a § 2704(b)(1) applicable restriction. However, Partnership *A* is subject to the laws of State *A*. Under State *A* law, the default is that 75% of partners must assent to liquidation. Since the 60% requirement is less restrictive than state law, it qualifies for the safe harbor.

Put bluntly, this interaction with state law defaults is a mess. Even absent tax planning, the reference to the default workings of state entity law renders the statute confusing. It is not simple to determine what qualifies as the default. If a fixed-term partnership is established in a state that follows the original or revised Uniform Limited Partnership Act, then the state law default will generally be that no partner has a liquidation right.[185] Is that the default, or should the statute involve a 'blank page' approach, which considers what the default would be without any other partnership terms in the agreement? One practitioner articulated the answer while explaining the fundamental problem with § 2704's safe harbor:

> The confusion…stems directly from the confusion inherent in [§ 2704(b)]. A statute drafted…with a reference…to another body of law generally, is known…as a 'referential statute'…few legislative drafting devices are more rife with ambiguity…
> ….
> In truth, there is nothing in I.R.C. § 2704(b)…which compels either view [on contextual or 'blank page' defaults]….There is no way to determine in a vacuum what limitations are imposed under state law generally applicable. Law is a formula, not a result.[186]

If that "inherent" ambiguity were not enough,[187] the default law safe harbor has come to swallow the whole rule due to subsequent state lawmaking. Numerous states have enacted more restrictive default entity liquidation rules to qualify under the § 2704(b)(3)(B) state-law safe harbor.[188] It is now easy to avoid application of § 2704(b)(1).

It is thus unsurprising that §2704(b) was "hurriedly drafted."[189] Unlike § 2703, which was refined through several bills and expert input,[190] § 2704(b) was not added until the Conference Committee's reconciled bill.[191] It is impossible to know exactly what happened in committee. However, the best guess is that they added § 2704(b) for fear that taxpayers could avoid § 2704(a)—which deals with liquidation rights that lapse at death—by never granting liquidation rights.[192] No one considered that § 2703 could cover ongoing restrictions.

Notwithstanding those flaws inherent in the statute, the IRS undertook a sustained effort to employ § 2704(b) aggressively. This effort ended in failure. In late-nineties TAMs, the IRS asserted that it could look to default state-law provisions for individual partner or shareholder withdrawal to define the scope of state law default liquidation rights for purposes of § 2704(b)(3)(B).[193] This position was a variation on the 'blank page' method for determining state law defaults.[194] The IRS claimed support for its reference to default withdrawal rights based on § 2704(b)'s companion regulations. The regulations refer to an ability to liquidate an entity "in whole or in part."[195] The IRS viewed withdrawal as a partial liquidation.[196] Under common state law, each partner in a 'blank page' partnership has a unilateral withdrawal right.[197] As such, by conflating withdrawal with partial liquidation, the IRS established a narrow view of most state-law defaults for the § 2704(b)(3)(B) safe harbor. The IRS also took an aggressive position on the types of liquidation restrictions that could be subject to § 2704(b) in the first instance. As noted above, to be an 'applicable restriction' under § 2704(b), the transferor or his or her family members must have the ability to remove the liquidation restriction post-transfer.[198] One could thus circumvent § 2704(b) by (i) requiring the consent of all partners or shareholders to liquidate and (ii) giving a sliver of equity to a cooperative third party. In that case, the family would not technically be able to liquidate the partnership on its own. The IRS took the quite aggressive position that it could disregard such third-party owners if it deemed them to be straw men.[199]

In *Kerr v. Commissioner*, [200] the Tax Court rejected the IRS's stance. In *Kerr*, the partnership agreement stipulated that the partnership would liquidate "upon the earlier of December 31, 2043, or by agreement of all the partners."[201] The entity was Texas law governed, and the Texas law default for partnership liquidation was equally (or arguably more) restrictive than that agreement.[202] The IRS pointed to Texas's default partner withdrawal rule, which allowed unilateral withdrawal upon notice.[203] The Tax Court rejected the Service's conflation of withdrawal and liquidation, noting the Service's position was inconsistent with examples in the regulations.[204] The court found that the liquidation restriction qualified for the safe harbor.[205]

At the appellate level, the 5th Circuit affirmed on other grounds.[206] The 5th Circuit did not dismiss the lower court's reasoning. Instead, the 5th Circuit rejected the IRS's other main § 2704(b) argument by finding that the liquidation restriction was not even an "applicable restriction" in the first instance.[207] The partnership had one non-family partner—the University of Texas (UT).[208] UT was the ideal candidate to test the Service's 'straw man' argument. The IRS and the taxpayer agreed that "UT would convert its interests into cash as soon as possible,"[209] so it was assumed that UT would always vote for liquidation. However, the IRS still lost. As the 5th Circuit found, "The Code provides no exception allowing us to disregard nonfamily partners who have stipulated their probable consent to a removal of the restriction."[210] The IRS's 'straw man' argument was invalid, even under the most IRS-friendly circumstances.

Kerr was a serious loss for the IRS. Like Charlie Brown trying to kick Lucy's football, the IRS made several more attempts to push its § 2704(b) arguments. It lost each time, with the

Tax Court curtly referring the Service back to *Kerr*.[211] The courts were right to reject these arguments. Nothing indicates that withdrawal should constitute partial liquidation, and that argument is contrary to common sense. If a large partnership redeems a small, withdrawing partner's interest in the ordinary course, one would not describe that partnership as in partial liquidation. Rather, one would say a partner had withdrawn. The concepts are distinct. Similarly, nothing in the statute provides for the 'straw man' rule. From a revenue-raising perspective, it would be helpful if the statute included that rule, but courts cannot legislate that concept into the statute by judicial fiat. The simple fact is that, given the ease of avoidance, § 2704(b) was dead letter on arrival. For neither the first nor the last time, Congress wrote a bad law.

IV. The Weakness of § 2704(b): § 2703 Impact and Potential Policy Responses

Section § 2704(b)'s weakness creates interesting problems, from the interpretive impact on § 2703 to possible policy responses. This Part considers the ability (or inability) of § 2703 to apply where § 2704(b) is potentially applicable. It also reviews regulation revisions that the IRS could implement to strengthen § 2704(b). Lastly, this Part considers proposed legislative changes to § 2704(b) and offers a different approach to that reparative legislation.

When considered in relation to § 2703, § 2704(b) is effectively a limit on the IRS's § 2703 power rather than an additional grant of authority. It is doubtful that is what Congress intended, but it is hard to read the statutes any other way. Absent § 2704(b), § 2703 would cover liquidation restrictions, since they are certainly, like *Holman* limits on transfer,[212] value-depressing restrictions on sale and use.[213] Under § 2703(a), it is irrelevant that a restriction results from inaction—a failure to elect more liberal liquidation rules than the default—as opposed to action. It also should not matter if an entity-level restriction is required by law for that entity. The only question is whether the restriction qualifies for the § 2703(b) safe harbor.

However, proper statutory interpretation precludes reading § 2703(a) to cover liquidation restrictions. If § 2703(a) is read that way, it renders § 2704(b) meaningless. That violates the interpretive norm that statutes "should be read to avoid rendering superfluous any parts thereof."[214] Especially since these sections were enacted simultaneously, the heavy presumption is to construe them together so that both are meaningful. Since § 2703 can be reasonably read not to encroach on § 2704(b)—by excluding liquidation restrictions from § 2703—it must be read that way. The regulations buttress this view. They state, "An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction" under § 2704(b).[215] Rephrased in the inverse, a § 2704(b) applicable restriction cannot also be subject to § 2703.

A last-gasp interpretive attempt to apply § 2703 would argue that § 2703 can apply to liquidation restrictions that are not applicable restrictions under § 2704(b). As the *Kerr* case demonstrated,[216] plenty of suspect liquidation restrictions can escape § 2704(b) by avoiding the 'applicable restriction' label. If, by its terms, § 2704(b) is unconcerned with these restrictions, why should § 2703 be precluded from covering them? The answer is twofold. First, the title of §2704(b)—"Certain Restrictions on Liquidation Disregarded"[217]—counsels against that interpretation. That only "[c]ertain" restrictions are disregarded implies that the section is not just meant to define a group of disregarded restrictions, but also a group that is *not* disregarded.[218] If § 2703(a) covers all liquidation restrictions that are not applicable restrictions, then § 2704(b) loses its implied role as the delineator between certain disregarded and regarded liquidation restrictions. Second, an interpretation that allows § 2703 to cover liquidation restrictions that are not applicable restrictions leads to a perverse result. In this construction, § 2704(b) essentially becomes a safe harbor against § 2703. Since § 2704(b) is so much weaker than § 2703, a tax-conscious taxpayer would want a liquidation restriction to be an applicable restriction rather than face § 2703. That result is nonsensical. The best holistic interpretation is that § 2704(b) covers liquidation restrictions while § 2703 covers everything else.

Moving from statutory interpretation to regulatory authority, another compelling question is whether the IRS has any rulemaking power to strengthen § 2704(b). There are two paths the IRS could follow. The first is a dead end. The second, while not a full fix, would stiffen § 2704(b) somewhat (and would better harmonize the text of § 2704(b) with the regulations). In terms of the dead end, the IRS could argue that it has authority pursuant to § 2704(b)(4) to issue regulations strengthening § 2704(b) by, for instance, circumscribing the state-law safe harbor under § 2704(b)(3)(B). Under § 2704(b)(4), the IRS can issue regulations to "provide that other restrictions shall be disregarded….if such restriction has the effect of reducing the value of the transferred interest" artificially.[219] The *Kerr* Tax Court noted this provision was a grant of "broad regulatory authority."[220] Arguably, the IRS could take the position that it can use this provision to pass regulations allowing it to disregard *any* restrictions, including liquidation restrictions that are not disregarded under the rest of §2704(b). However, that position is untenable. The reference to "other" restrictions most naturally reads to mean restrictions other than liquidation restrictions.[221] If that were not the case, then the marginal regulatory discretion in § 2704(b)(4) would be able to re-write the other express terms of the statute. If Congress intended § 2704(b)(4) to be that broad, it would not have bothered to include the rest of § 2704(b). Even for restrictions "other" than liquidation restrictions,[222] this regulation-writing grant cannot be used especially broadly. In its context, section § 2704(b)(4) is most naturally read to mean that the IRS can subject restrictions (other than restrictions on liquidation) to the terms of § 2704(b). To contend otherwise makes § 2704(b)(4) impossibly powerful. If §2704(b)(4) allows the IRS to disregard restrictions in any manner (rather than just subjecting them to §2704(b)), the IRS could issue regulations stating, for example, that all restrictions on transfer are disregarded. It could apply that rule to entities whether or not family-owned and whether or not safe-harbored under § 2703(b). That cannot be so, and contextual interpretation counsels against such a broad reading.

However, the IRS is not bereft of regulatory tools to strengthen § 2704(b). The *Kerr* court alluded to another regulatory change the IRS could make. When the *Kerr* court compared the required-by-law safe harbor of § 2704(b)(3)(B) with the regulations, it noted the regulations were "an expansion of the [statutory safe harbor] exception."[223] The Tax Court provided no explanation for this comment. However, the court had seemingly recognized that the statute itself only references restrictions "imposed, or required to be imposed" by law.[224] The statute does not reference defaults. It is the regulations that introduce the default concept.[225] Per the *Kerr* court's observation, the statutory safe harbor is most sensibly read to refer, not to default rules, but *required* rules that cannot be contracted away. Only the latter are truly "imposed."[226] The legislative history supports this reading.[227] To be true to the statute, the regulations should be amended so that the § 2704(b)(3)(B) safe harbor only covers required (and not default) restrictions. This revision has the added benefit of making § 2704(b) somewhat more effective. To appeal to taxpayers attempting to use the § 2704(b)(3)(B) safe harbor, it is easy for states to make classes of entities that have exceedingly restrictive default liquidation rules, since owners can contract out of those rules. The default is set at the maximum level of restriction, and owners modify as needed. That easy contractual control disappears for entities that include required, unalterable restrictive liquidation provisions. Thus, § 2704(b) will become harder to avoid. However, this change, while ameliorative, will not fix the statute. In response, states will undoubtedly create menus of entity types with an array of required restrictive liquidation terms. These entities will be separate from standard partnerships, LLCs, corporations, etc., and only the transfer-tax conscious will opt to create them.[228] Taxpayers will no longer be able to custom-tailor their own entities, so states will respond by offering more tailored entity options up front. Even so, required restrictions are less user-friendly than default ones, so the rule change will make § 2704(b) harder to avoid. This strengthening of § 2704(b) is material but still marginal.

After defining the limits of regulatory change, the natural next question is what could be done through legislation. Notwithstanding the rule change proposed above, § 2704(b) requires reparative legislation. Aside from the issues already discussed, the statute remains otherwise flawed and too easily avoidable due to, for instance, its narrow definition of family and the related straw-man problem.[229] As with most any issue in the current political climate—much less one related to the transfer tax system—federal legislative action appears unlikely. However, it is worth noting that this twin consideration of § 2703 and § 2704(b) shows the best approach to take if and when reparative legislation becomes viable.

Current reform proposals are complicated. The Treasury Department has put forward a plan to, in essence, undo *Kerr*.[230] Under its proposal, rather than allude to other state and federal law for the § 2704(b)(3)(B) safe harbor, liquidation restrictions would be disregarded if they are "more restrictive than a standard to be identified in regulations."[231] To fix the straw man problem, "certain interests…held by charities or others who are not family members of the transferor would be deemed to be held by the family," and § 2704(b) would also be expanded to cover "an additional category of restrictions" including transfer restrictions.[232] To help taxpayers cope with this expanded § 2704(b), the IRS would be given the authority to create safe harbors "so as to avoid the application of section 2704 if certain standards are met."[233]

This proposal is too complex. It just drives more cars into the pileup that is § 2704(b). Specific safe-harbor standards hardwired into the statute will either be too general or so specific as to require volumes of explanation. What should be the minimum acceptable liquidation restriction for an Oregon partnership that holds a family's plumbing supply business? How about a single-member Delaware LLC that holds farmland? The statute could not possibly be long enough to satisfactorily cover every such business context. The same problem arises in delineating who is or is not a straw man for purposes of the deemed-control analysis. Moreover, that new safe-harbor power would turn into a succession of whack-a-mole regulatory revisions as the IRS tries to curb the avoidance that blossoms with each new safe harbor.

There is an easier way, one that will shorten and streamline the Code rather than expand it. Section 2704(b) should be repealed, with a stipulation that § 2703 covers liquidation restrictions. Section 2703 is a balanced, battled-tested method for evaluating valuation discounts. It makes sense for that provision to occupy the field. While Treasury's proposed § 2704(b) revisions would require pages upon pages of complex new regulations, this § 2703 approach piggybacks on existing law and standards. Since § 2703 builds on decades of regulations and case law, its general concepts have been well fleshed out in their application. Through that precedent, practitioners have learned what to expect from § 2703, so the transition out of § 2704(b) would be a smooth one. The ABA has already gestured toward this idea, proposing that a § 2703-style arm's-length standard should be imported into § 2704(b).[234] It is just a few steps further from that proposal to entirely replacing § 2704(b) with § 2703.

Conclusion

This analysis has painted a tale of two statutes—§ 2703, which has been largely successful in implementation, and § 2704(b), which has largely failed. These divergent statutory fates demonstrate the importance of thoughtful, iterative drafting with the benefit of expert input. Indeed, the final form of § 2703 can be traced to practitioner comments.[235] While § 2703 also demonstrates the benefits of building on existing standards, it shows the potential for confusion and complexity in partial codification of a larger body of tax law. This analysis concluded with proposals to improve the interrelated operation of these statutes, but these object lessons are generalizable beyond these two Code sections. However difficult transfer tax valuation may be, § 2703 shows the benefit of incorporating prior experience into current rules.

[1] *E.g.*, Treas. Reg. § 20.2031-2(b)-(d) (as amended 2006); Treas. Reg. § 25.2512-2(b)-(d) (as amended 1976).
[2] Treas. Reg. § 20.2031-1(b) (as amended 1965).
[3] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended.
[4] I.R.C. § 2704(b)(1)(B) (2012); Treas. Reg. §25.2703-1(b)(3) (1992).
[5] I.R.C. § 2703(a)(1)-(2).
[6] I.R.C. § 2703(b).
[7] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388, 1498-99 (1990) (codified as amended at I.R.C. §§ 2703, 2704(b) (2012)).
[8] *See* Richard L. Dees, *Section 2036(c): The Monster That Ate Estate Planning and Installment Sales, Buy-Sells, Options, Employment Contracts and Leases*, 68 TAXES 876 (1988).
[9] 136 CONG. REC. 30,538 (1990). A franker ACTEC representative deemed § 2036(c) a “disaster.” *‘Discussion Draft’ Relating to Estate Valuation Freezes*: *Hearing Before the H. Comm. on Ways and Means*, 101st Cong. 92 (1990) [hereinafter *Hearing*] (statement of E. James Gamble, Chairman, Estate and Gift Tax Committee of the American College Of Trust and Estate Counsel).
[10] 136 CONG. REC. 30,538.
[11] *Id.*
[12] *Id.* at 539.
[13] 601 F.3d 763, 776-84 (8th Cir. 2010) (Beam, J., dissenting).
[14] STAFF OF H. COMM. ON WAYS AND MEANS, 101ST CONG., DISCUSSION DRAFT OF PROVISIONS RELATING TO ESTATE FREEZES 17-18 (Comm. Print 1990).
[15] *Id.*
[16] *Id.* at 17.
[17] I.R.C. § 2703(a)(1) (2012).
[18] *Id.* § 2703(a)(2).
[19] STAFF OF H. COMM. ON WAYS AND MEANS, 101ST CONG., DISCUSSION DRAFT OF PROVISIONS RELATING TO ESTATE FREEZES 17 (Comm. Print 1990).
[20] *Id.*
[21] *Id.*
[22] *Hearing*, *supra* note 9, at 98.
[23] H.R. 5425, 101st Cong. § 2703 (1990).
[24] S. 3113, 101st Cong. § 3(e) (1990).
[25] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388, 1498 (1990) (codified at I.R.C. § 2703 (2012)).
[26] I.R.C. §§ 2703(b)(1)-(2); S. 3113 § 3(e).
[27] Treas. Reg. § 20.2031-2(h) (1958) (as amended 1992); Treas. Reg. § 20.2031-3(c) (1958) (as amended 1992); *e.g.*, St. Louis Cnty. Bank v. United States, 674 F.2d 1207, 1210 (8th Cir. 1982).
[28] I.R.C. § 2703(b)(3); S. 3113 § 3(e).
[29] 136 CONG. REC. 30,541 (1990).

[30] Estate of True v. Comm'r, 82 T.C.M. 27, 48 (2001), *aff'd*, 390 F.3d 1210 (10th Cir. 2004).
[31] *Hearing*, *supra* note 9, at 98.
[32] *E.g.*, Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017, 1026-27 (2006); *see also* JOHN A. BOGDANSKI, FEDERAL TAX VALUATION, § 604(2)(a) n.241 (2014).
[33] *See* Jerold I. Horn, *Buy-Sell Agreements Under Chapter 14, Including Amendment/Modification of Grandfathered Agreements, and Drafting New Agreements*, 21 ACTEC NOTES 37, 38 (1995).
[34] *E.g.*, Treas. Reg. § 20.2031-2(h) (1958) (as amended 1992).
[35] H.R. 5425, 101st Cong. § 2703(a)(1)-(3) (1990).
[36] Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017, 1024 (2006).
[37] 136 CONG. REC. 30,541 (1990). The record refers to buy-sell agreements synecdochically for all § 2703-covered restrictions, so this quote can be read to refer to all such restrictions. *See* H.R. REP. NO. 101-964, at 1137 (1990) (Conf. Rep.) ("Buy-sell agreements and options" used to discuss all § 2703-covered restrictions).
[38] I.R.C. §2703(a) (2012).
[39] *Id.*
[40] 136 CONG. REC. 30,538.
[41] Treas. Reg. § 25.2703-1(b)(3) (1992).
[42] *Id*.
[43] Treas. Reg. § 25.2703-1(b)(3).
[44] *E.g.*, Treas. Reg. § 20.2031-2(h) (as amended 1992); Treas. Reg. § 20.2031-3(c) (as amended 1992).
[45] Treas. Reg. § 20.2031-2(h).
[46] Estate of True v. Comm'r, 82 T.C.M. (CCH) 27, 48 (2001), *aff'd*, 390 F.3d 1210 (10th Cir. 2004).
[47] *Id.*
[48] *E.g.*, Bommer Revocable Trust v. Comm'r, 74 T.C.M. (CCH) 346, 353 (1997).
[49] *E.g.*, Estate of Blount v. Comm'r, 87 T.C.M. (CCH) 1303, 1312 (2004), *aff'd on this issue*, 428 F.3d 1338 (11th Cir. 2005).
[50] *See* Steven M. Fast et al., *Context Matters: Rules for Reducing Taxable Value*, 120 YALE L.J. ONLINE 141, 143 (2010).
[51] Fast et al., *supra* note 50, at 145-46.
[52] No. SA-97-CA-0774-OG, 2000 WL 206374 (W.D. Tex. Jan. 18, 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001).
[53] *Id.* at *8.
[54] H.R. 5425, 101st Cong. § 2703(a)(1)-(3).
[55] Smith v. United States, No. C.A. 02-264 ERIE, 2004 WL 1879212, at *4 (W.D. Pa. June 30, 2004), *report and recommendation adopted*, No. C.A. 02-264 ERIE, 2004 WL 2051218 (W.D. Pa. July 23, 2004).
[56] Holman v. Comm'r, 601 F.3d 763 (8th Cir. 2010); Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017 (2006).
[57] I.R.C. § 2703(b)(1) (2012).
[58] Estate of Bischoff v. Comm'r, 69 T.C. 32, 39 (1977).
[59] *See* Treas. Reg. § 25.2703-1(b)(3) (1992).
[60] *See* HENRY B. HANSMANN, THE OWNERSHIP OF ENTERPRISE 39-44 (1996).
[61] Holman v. Comm'r, 601 F.3d 763, 770 (8th Cir. 2010) ("[F]amily ownership…of [a] business may be a bona fide business purpose…We have not so held…in the absence of a business." (citations omitted)).
[62] *Id.* at 765.
[63] *Id.* at 767.
[64] *Id.* at 770.
[65] *Id.* at 771.
[66] *Id.* at 772 (citation omitted).
[67] *See* Louis A. Mezzullo, *Holman Sheds Light on the Reach of § 2703*, 35 EST., GIFTS AND TR. J. 249, 252 (2010).
[68] *Holman*, 601 F.3d at 771.
[69] *Id.*
[70] Estate of Murphy v. United States, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009); Estate of Black v. Comm'r, 133 T.C. 340 (2009).

[71] *Estate of Murphy*, 2009 WL 3366099, at *9; *Estate of Black*, 133 T.C. at 363.

[72] Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353 (2005).

[73] *Id.* at 1361.

[74] *Id.*

[75] *Holman*, 601 F.3d at 771.

[76] *Id.*

[77] *Estate of Schutt*, 89 T.C.M. at 1354.

[78] *Holman*, 601 F.3d at 771.

[79] Mezzullo, *supra* note 67, at 252.

[80] *See* Brent B. Nicholson, Holman v. Commissioner*: A Death Knell for the Tax Value of Transfer Restrictions in Family Limited Partnerships?*, 2 WM. & MARY BUS. L. REV. 291, 319-20 (2011).

[81] Fisher v. United States, No. 1:08-CV-0908-LJM-TAB, 2010 WL 3522952, at *1 (S.D. Ind. Sept. 1, 2010).

[82] *Holman*, 601 F.3d at 772 (citation omitted).

[83] *Fisher*, 2010 WL 3522952, at *4-5.

[84] Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017 (2006).

[85] I.R.C. § 2703(b)(1) (2012).

[86] *Estate of Amlie*, 91 T.C.M. at 1019.

[87] *Id.* at 1026.

[88] *Id.* at 1020.

[89] *Id.*

[90] *Id.*

[91] *Id.* at 1021-22.

[92] *Id.* at 1022.

[93] *Id.* at 1026-27.

[94] Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 699 (1993).

[95] Family control and minority risk are not the only relevant justifications, but they are the most relevant. *See* Anthony J. Testa Jr., *Buy-Sell Agreements and the Web of Federal Estate and Gift Tax Exposure*, 27 DEL. J. CORP. L. 181, 198 (2002).

[96] I.R.C. §2703(b)(2) (2012).

[97] BOGDANSKI, *supra* note 32, at § 6.04(2)(c)(ii).

[98] *Id.*

[99] Estate of True v. Comm'r, 82 T.C.M. (CCH) 27, 51 (2001), *aff'd,* 390 F.3d 1210 (10th Cir. 2004) (citations omitted).

[100] Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017, 1026 (2006).

[101] *Id.* at 1026-27.

[102] *Id.*

[103] *Id.*

[104] *Id.* at 1019, 1022.

[105] *Id.* at 1026-27.

[106] Holman v. Comm'r, 130 T.C. 170, 179 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).

[107] *Id.* at 195-97.

[108] *Id.*

[109] *Id.*

[110] *Id.*

[111] *Cf.* Pevsner v. Commissioner, 628 F.2d 467, 470 (5th Cir. Unit A 1980) (choosing an objective test for the same reason).

[112] Palmer v. City of Chicago, 806 F.2d 1316, 1318 (7th Cir. 1986).

[113] *E.g.*, Mathews v. Eldridge, 424 U.S. 319, 339-49 (1976).

[114] I.R.C. § 2703(b)(3) (2012).

[115] BOGDANSKI, *supra* note 32, at § 6.04(2)(c)(iii).

[116] Francis X. Burns et al., *Valuing Limited Partnership Interests*, TR. & EST., Oct. 2010, at 33.

[117] *Id.* at 38.

[118] Estate of Blount v. Comm'r, 87 T.C.M. (CCH) 1303, 1315 (2004), *aff'd on this issue*, 428 F.3d 1338 (11th Cir. 2005).

[119] Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017, 1027 (2006).

[120] Mezzullo, *supra* note 67, at 250.

[121] H.R. REP. NO. 101-964, at 1137 (1990) (Conf. Rep.).

[122] *E.g.*, Dorn v. United States, 828 F.2d 177, 182 (3d Cir. 1987).

[123] *Cf.* Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838 (7th Cir. 1999) (observing, analogously, that judges are ill-suited to determine a market-rate salary).

[124] Estate of Amlie v. Commissioner, 91 T.C.M. (CCH) 1017, 1027-28 (2006).
[125] *Id.*
[126] *See supra* Part I.A.
[127] H.R. REP. NO. 101-964, at 1137 (1990) (Conf. Rep.).
[128] Testa, *supra* note 95, at 205.
[129] Calvin H. Johnson and Joseph M. Dodge, *Passing Estate Tax Values Through the Eye of the Needle*, 132 TAX NOTES 939, 941-42 (2011) (finding §§ 2703-04 too weak); Mark R. Siegel, *The Internal Revenue Code's Assault on Buy-Sell Agreements*, 54 LA. L. REV. 149, 168 (1993) (deeming § 2703 an overly-aggressive "legislative intrusion").
[130] Holman v. Comm'r, 601 F.3d 763, 780-81 (8th Cir. 2010) (Beam, J., dissenting).
[131] I.R.C. § 2703(b)(2) (2012) (emphasis added).
[132] *Holman*, 601 F.3d at 781.
[133] *Id.*
[134] Treas. Reg. § 25.2703-1(b)(1)(ii) (1992).
[135] I.R.C. § 2703(b)(2).
[136] *Holman*, 601 F.3d at 781.
[137] I.R.C. § 2703(b)(2) (emphasis added).
[138] Treas. Reg. § 25.2703-1(b)(1)(ii) (1992).
[139] I.R.C. § 2703(a).
[140] Brief for Appellee at 38, Holman, 601 F.3d 763 (No. 08-03774).
[141] I.R.C. § 2703(a).
[142] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 844 (1984); Brief for Appellee, *supra* note 140, at 35-37.
[143] *Chevron*, 467 U.S. at 844.
[144] Brief for Appellee, *supra* note 140, at 34-39.
[145] United States Nat'l Bank of Oregon v. Independent Ins. Agents of Am., Inc., 508 U.S. 439, 455 (1993) (citations omitted); Brief for Appellee, *supra* note 140, at 37.
[146] *E.g.*, JOSEPH M. DODGE, WENDY C. GERZOG & BRIDGET J. CRAWFORD, FEDERAL TAXES ON GRATUITOUS TRANSFERS: LAW AND PLANNING 193-94 (2011).
[147] *Chevron*, 467 U.S. at 842-43 (1984).
[148] *E.g.*, Treas. Reg. § 20.2031-2(h) (1958) (as amended 2006); *see also* Jerold I. Horn, *supra* note 33, at 37-38.
[149] 136 CONG. REC. 30,541 (1990).
[150] Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017, 1024 (2006).
[151] 136 CONG. REC. 30,541.
[152] Estate of True v. Comm'r, 82 T.C.M. (CCH) 27, 71 (2001) (emphasis added), *aff'd*, 390 F.3d 1210 (10th Cir. 2004).
[153] Rev. Rul. 59-60, 1959-1 C.B. 237 ("[T]he option price *is not* determinative… for gift tax…such agreement *may or may not*…fix the value for estate tax." (emphasis added)); Rev. Rul. 189, 1953-2 C.B. 294.
[154] *Estate of True*, 82 T.C.M. at 72.
[155] Spitzer v. Comm'r, 153 F.2d 967, 971 (8th Cir. 1946).
[156] I.R.C. § 2703(b)(2) (2012).
[157] Harris v. Comm'r, 340 U.S. 106, 107 (1950) (citations omitted).
[158] E. James Gamble, *Buy-Sell Agreements, Section 2703, and the Final Regulations*, 18 ACTEC NOTES 16, 17 (1992).
[159] I.R.C. §§ 2701(e), 2702(e), 2704(c)(2) (2012).
[160] Treas. Reg. § 25.2703-1(b)(3) (1992).
[161] I.R.C. § 2703(a) (2012).
[162] *See infra* Part IV.
[163] *Holman*, 601 F.3d at 765.
[164] Steve R. Akers, *Musings on Current Events:* Holman v. Comm'r, ACTEC. ORG (Mar. 11, 2015, 9:37pm), http://www actec.org/public/AkersHolman8thCircuit .asp ("The case overall is still a taxpayer victory.").
[165] *See* Holman v. Comm'r, 130 T.C. 170, 216 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).
[166] *Id.*
[167] *Holman*, 601 F.3d at 768.
[168] *Holman*, 130 T.C. at 176.
[169] *See* J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW &

PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 21:6 (2014).
[170] *E.g.*, Deborah M. Beers, Fisher v. U.S.*: District Court Ignores Transfer Restrictions in LLC Operating Agreement for Valuation Under § 2703*, 35 EST., GIFTS AND TR. J. 288, 289 (2010).
[171] I.R.C. § 2703(a).
[172] Estate of Blount v. Comm'r, 87 T.C.M. (CCH) 1303 (2004), *aff'd in part and rev'd in part*, 428 F.3d 1338 (11th Cir. 2005).
[173] *Estate of Blount*, 428 F.3d at 1344-45.
[174] *Id.*
[175] I.R.C. § 2703(a) (2012); *see also* John A. Bogdanski, *Stock Buyouts Funded by Life Insurance: The* Blount *Conundrum*, EST. PLAN., June 2006, at 40.
[176] I.R.C. § 2704(b)(1)(A).
[177] *Id.* § 2704(b)(1)(B).
[178] *Id.* § 2704(b)(1).
[179] *Id.* § 2704(b)(2)(A).
[180] *Id.* § 2704(b)(2)(B).
[181] *Id.* § 2704(b)(3)(A).
[182] *Id.* § 2704(b)(3)(B).
[183] *Id.* § 2704(b)(3)(A).
[184] Treas. Reg. § 25.2704-2(b) (1992).
[185] Kenneth P. Brier, *Family Limited Partnerships and Chapter 14: Some Estate Planning Perspectives*, 21 ACTEC NOTES 297, 300 (1996) (emphasis added).
[186] *Id.* (citations omitted).
[187] *Id.*
[188] U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS 79 (Feb. 2012); DODGE, *supra* note 146, at 509; *e.g.*, S.B. 350, 2009 Leg., 75th Sess. § 25-27 (Nev. 2009).
[189] Richard L. Dees, *The Slaying of Frankenstein's Monster: The Repeal and Replacement of Section 2036(c)*, 69 TAXES 151, 166 (1991).
[190] *Id.* at 153.
[191] H.R. REP. NO. 101-964, at 1138 (1990) (Conf. Rep.).
[192] Brier, *supra* note 185, at 300.
[193] I.R.S. Tech. Adv. Mem. 97-30-004 (July 25, 1997); I.R.S. Tech. Adv. Mem. 97-25-002 (June 20, 1997); I.R.S. Tech. Adv. Mem. 97-23-009 (June 6, 1997).
[194] Brier, *supra* note 185, at 300.
[195] Treas. Reg. § 25.2704-2(b) (1992).
[196] *See* sources cited *supra* note 193.
[197] *See* CALLISON, *supra* note 169, at § 21:6.
[198] I.R.C. § 2704(b)(2)(B)(ii) (2012).
[199] *E.g.*, I.R.S. Tech. Adv. Mem. 97-23-009 (June 6, 1997).
[200] 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002).
[201] *Id.* at 471.
[202] *Id.* at 472.
[203] *Id.* at 473.
[204] *Id.* at 473-74; Treas. Reg. § 25.2704-2(d) (1992).
[205] I.R.C. § 2704(b)(3)(B) (2012).
[206] *Kerr*, 292 F.3d at 491.
[207] *Id.* at 494.
[208] *Kerr*, 113 T.C. at 456.
[209] *Kerr*, 292 F.3d at 494.
[210] *Id.*
[211] Estate of Jones v. Commissioner, 116 T.C. 121, 130 (2001); Knight v. Commissioner, 115 T.C. 506, 520 (2000); Estate of Harper v. Commissioner, 79 T.C.M. (CCH) 2232, 2234 (2000).
[212] *See supra* Part II.B.1
[213] I.R.C. § 2703(a) (2012).
[214] Astoria Fed. Sav. & Loan Ass'n v. Solimino, 501 U.S. 104, 112 (1991); *see also* Marbury v. Madison, 5 U.S. (1 Cranch) 137, 174 (1803).
[215] Treas. Reg. § 25.2704-2(b) (1992).
[216] Kerr v. Commissioner, 292 F.3d 490 (5th Cir. 2002).
[217] I.R.C. § 2704(b) (2012).
[218] *Id.*
[219] *Id.* § 2704(b)(4).
[220] Kerr v. Commissioner, 113 T.C. 449, 474 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002).
[221] I.R.C. § 2704(b)(4).

[222] *Id.*
[223] *Kerr*, 113 T.C. at 472.
[224] I.R.C. § 2704(b)(3)(B) (2012).
[225] Treas. Reg. § 25.2704-2(b) (1992).
[226] I.R.C. § 2704(b)(3)(B) (2012).
[227] H.R. REP. NO. 101-964, at 1138 (1990) (Conf. Rep.).
[228] *E.g.*, S.B. 350, 2009 Leg., 75th Sess. § 25-27 (Nev. 2009).
[229] *See* Brier, *supra* note 185, at 299-300.
[230] U.S. DEP'T OF THE TREASURY, *supra* note 188, at 79.
[231] *Id.*
[232] *Id.*
[233] *Id.*
[234] AMERICAN BAR ASS'N SECTION OF TAXATION, OPTIONS FOR TAX REFORM AND SIMPLIFICATION WITH RESPECT TO FEDERAL ESTATE, GIFT AND GST TAXES 3 (2012).
[235] *Hearing*, *supra* note 9, at 97-98.