Oral Testimony of Brian Reardon
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Proposed Rules under Section 2704
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My name is Brian Reardon. I am a former Special Assistant to the President of the United States, serving on the National Economic Council. During my time at the NEC, I oversaw the tax portfolio and helped to craft and then get enacted into law the 2003 Jobs and Growth Act as well as the 2004 American Jobs Creation Act.

I am here today as the President of the S Corporation Association, a trade association representing the interests of America's 4.5 million S corporations. S corporations are in every state and they are in every industry. They employ one in four private sector workers and they form the economic cornerstone of thousands of communities across the country.

They also tend to be family-owned and operated businesses, which puts them right in the crosshairs of the proposed rules put forward under Section 2704.

S-Corp submitted extensive comments opposing these rules back on October 17th. Key points raised by those comments include the following:

1. The proposed rules are an attempt to broadly apply a general family attribution rule to family businesses that are passed from one generation to the next.
2. In doing so, they would largely eliminate the consideration of control and, perhaps to a lesser degree, marketability when valuing the businesses for estate tax purposes.
3. This would result in a tax increase on family owned businesses of 30 percent or more over what an identical non-family business would pay.
4. This broad application of family attribution is wholly inconsistent with Congressional intent when enacting 2704. Chapter 14 was intended to be a series of targeted provisions aimed at particular perceived abuses. It was not intended to be a general family attribution rule.

Since we submitted these comments, there has been a lively debate as to the true scope of the proposed rules.

With few exceptions, the tax community is adamant that the rules are broad and would largely eliminate discounts for control and marketability for family controlled businesses.

Treasury is just as adamant that the rules are narrow and leave most of those discounts intact.

I am not sure I have ever witnessed a wider divergence of views, and I think it's important to review exactly why the business community is so alarmed.

I see three underlying sources of our concern --- the breadth and aggressive nature of the enforcing provisions; the limited usefulness of the mitigating provisions; and, finally, the failure of the inherent logic of the regulations if you read them with the narrow view in mind.

In terms of aggressiveness, we make clear in our comments that the proposed rules go well beyond the underlying statute in several instances:

1. The rules disregard all transfers made within 3 years of the death of the business owner;
2. The rules ignore the plain language of 2704 creating a safe harbor for non-mandatory default state law restrictions; and
3. And the rules disregard interests held by nonrelated parties when determining whether a family controls the business.

None of these provisions are authorized under 2704, yet here they are. Their aggressive nature is consistent with a broad interpretation of the rules, not a narrow one.

The second flag is what I consider to be the lack of "usefulness" of some of the rules' mitigating provisions. For example, the rules provide that non-family interests *can* be considered for purposes of determining control, but only if their ownership rights meet the following criteria:

a. They have to have been held for at least three years;
b. The interest must represent at least 10 percent of the business;
c. All non-family interests must total at least 20 percent of the business; and
d. Each non-family interest has to have a "put right".

No business is going to give a minority owner these rights, particularly the “put right”, which means no non-family interest will count towards determining control. The provision is effectively useless.

That same analysis applies to another “safe harbor” in the rules.   Under the proposed rules, a family business can avoid having any “disregarded restrictions” if every interest holder in the business has a “put right” to receive from the business, within six months of notification, cash or cash equivalents equal to the “minimum value” of the interest.

No business could possibly operate under such an ownership structure, so the safe harbor is simply not useful.

Including provisions which purport to provide relief from the rules, but that are in fact not useful suggests an aggressive approach on the part of Treasury.

And finally, there’s the implied put right. The private sector argues that the rules only make sense if Treasury assumes that every minority interest in a family business has an implied put right, as defined above, and any effort to limit or remove that put right would be a disregarded restriction that should be ignored for valuation purposes.

Treasury is adamant that no put right exists, but really, the rules make little sense without it. Consider the first example.

In that example, minority stakes in a partnership are passed on from a parent to two children. The partnership agreement prohibits withdrawal by a limited partner, but that limitation could be removed by the approval of all partners.

So under the proposed rules, the limitation on withdrawal is a disregarded restriction and therefore the minority interests should be valued as if the limitation doesn’t exist. The example goes to great length to describe how the interest should be valued.

But if no put right exists, even without the limitation on withdrawal, you would still have a minority interest in a partnership that would be valued taking lack of control and lack of marketability into account. The value of the interests would therefore be the same, with or without the limitation.

So if there's no implied put right, what's the point? Why go through this entire exercise, just to come up with the same valuation?

This is why the business community is so confused.

Looking forward, it is clear these rules need to be withdrawn. Over 28,000 comments have been received by Treasury during the comment period, and with few exceptions, they all were opposed. That is an extraordinary outpouring of opposition by the business community and Treasury needs to be responsive.

It is also clear that Congress needs to rewrite section 2704. Family attribution is a fatally flawed concept, whether it's applied broadly, per our reading of these rules, or narrowly, as written into the underlying 2704 statute.

The S Corporation Association intends to continue to work with stakeholders and tax writers to achieve both of these goals, and we appreciate the willingness of both Treasury and the Congressional tax writers to listen to our concerns.

Thank you very much for this opportunity to address this important issue and I'm happy to answer any questions you might have.