October 17, 2016

VIA E-MAIL

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

RE: Comments to Proposed Regulations on Estate, Gift, and Generation Skipping Transfer Taxes; Restrictions on Liquidation of an Interest (REG-163113-02)

Dear Mr. MacEachen:

The S Corporation Association ("**S-Corp**") respectfully submits the following comments to REG-163113-02, Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest, 81 Fed. Reg. 51413 (proposed Aug. 4, 2016) (the "**Proposed Regulations**" or "**Prop. Treas. Reg.**").[1]

S-Corp is an organization devoted to promoting and protecting the interests of America's more than 4.5 million S corporations. The S corporation is the most common corporate structure in the U.S. and typically is used by family-controlled businesses. It is our mission to protect these businesses while working to ensure that America's most popular corporate structure remains competitive in the 21st Century. Based on an extensive analysis, we believe the Proposed Regulations put many of these family businesses in jeopardy and should be withdrawn.

The Proposed Regulations would result in a 30% (or greater) increase on the tax burden already imposed on the transfer of family business interests to each successive generation. The tax increase is based on the generalized (and erroneous) assumption that any interest in a family-controlled business has a greater value than an otherwise identical interest in a business controlled by non-family members, regardless of the particular facts and circumstances presented in the valuation analysis. The Proposed Regulations would discriminatorily result in the estate of an owner of an interest in a family business paying a higher estate tax than the estate of an owner of an identical interest in a non-family business.

[1] All "**Treasury Regulation**" or "**Treas. Reg.**" references are to the regulations promulgated under the Internal Revenue Code of 1986, as amended (the "**I.R.C.**"), by the Department of Treasury ("**Treasury**"), unless otherwise stated. The Internal Revenue Service is referred to as the "**Commissioner**" or the "**IRS**," unless otherwise stated. All "**Section**" or "**§**" references are to one or more sections of I.R.C., unless otherwise stated.

The Proposed Regulations undermine the settled principle that property is valued for transfer tax purposes at its "fair market value" by ignoring restrictions on liquidation and withdrawal that commonly exist in closely-held businesses, whether or not family controlled. The Proposed Regulations impermissibly expand the scope of § 2704(b) to impose a tax on "phantom assets" and "phantom value" associated with the transfer of interests in family-controlled entities, including S corporations. The Proposed Regulations also attempt to resurrect the family attribution rules the IRS unsuccessfully sought to impose during the 1980's.

The business, estate planning, and valuation communities have raised numerous concerns about the harm the Proposed Regulations will have on family-controlled entities, the limitations of Treasury's rulemaking authority, and the costly confusion that will result from Treasury adopting the Proposed Regulations. S-Corp shares these concerns. For the reasons discussed below, S-Corp requests that Treasury not adopt the Proposed Regulations (either in their current form or as modified) because of the significant harm they will cause to family businesses organized as S corporations or otherwise.[2]

I. Congress did not intend for § 2704 to be a general family attribution provision that abolishes or substantially reduces lack of control and lack of marketability discounts in all family-controlled entities.

The Proposed Regulations are contrary to the intent Congress expressed in § 2704, irreconcilable with the legislative history of Chapter 14 of the I.R.C. ("**Chapter 14**"), and beyond the authority Congress granted to Treasury to promulgate regulations under § 2704.

A. Application of a general family attribution rule is antithetical to the fair market value standard.

"Fair market value" is the bedrock of the transfer tax system. In determining fair market value, the legal rights and interests inherent in the transferred property must first be determined under state law (unless federal law supersedes state law). After that determination is made, federal tax law takes over to determine how such rights and interests will be taxed. *United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Comm'r*, 309 U.S. 78 (1940).

Fair market value is the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b); Treas. Reg. § 20.2512-1. "The standard is an objective test using ***hypothetical buyers and sellers*** in the marketplace, and is a not personalized one which envisions a particular buyer and seller." *LeFrak v. Comm'r*, 66 T.C.M. 1297, 1299 (1993) (emphasis added). "All relevant facts and elements of value as of the applicable valuation date shall be considered in every case." Treas. Reg. § 20.2031-1(b).

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[2] These comments are not intended to be an exhaustive list of all of S-Corp's concerns with the Proposed Regulations. S-Corp anticipates that practitioners, legal scholars, and other groups commenting on these regulations will address the numerous practical and technical problems associated with the Proposed Regulations.

Valuation adjustments (or discounts) for lack of control and lack of marketability reflect the fact that non-controlling interests in privately-held entities are worth much less than their proportionate share of the overall business value. That is because the interest owner has no unilateral right to control the operations of the entity (including decisions regarding liquidation, distributions, investments, and the like) and no ready ability to convert the interest to cash. These adjustments commonly are applied by courts in determining the fair market value of property. *See, e.g.*, *Estate of Andrews v. Comm'r*, 79 T.C. 938 (1982).

In 1981, the IRS took the position that "no minority discount will be allowed with respect to transfers of shares of stock among family members where, at the time of the transfer, control . . . of the corporation exists in the family." Rev. Rul. 81-253, 1981-2 C.B. 187 (1981). The IRS issued Rev. Rul. 81-253 in response to the Fifth Circuit's decision in *Estate of Bright*, which had rejected the IRS's family attribution theory. *Estate of Bright v. United States*, 658 F.2d 999, 1001 (5th Cir. 1981) (en banc). Following *Estate of Bright*, numerous other courts rejected the family attribution theory of Revenue Ruling 81-253. *See Propstra v. United States*, 680 F.2d 1248, 1250 (9th Cir. 1982); *Estate of Andrews*, 79 T.C. at 951–56. After numerous losses in the courts, the IRS ultimately abandoned its family attribution position in Rev. Rul. 93-12, 1993-1, C.B. 2002 (1993).

The Proposed Regulations violate the fair market value standard by ignoring the legal and economic reality of liquidation and withdrawal restrictions. Moreover, the Proposed Regulations artificially limit the hypothetical buyer and seller test to non-family transfers by impermissibly imposing a general family attribution rule.

B. The legislative history of Chapter 14 demonstrates that a broad family attribution rule was not intended by Congress.

In 1987, Congress passed § 2036(c) as part of the Omnibus Budget Reconciliation Act of 1987. Congress sought to target perceived abusive estate tax valuation freezes with § 2036(c), not entity-level discounts. H.R. REP. NO. 100-495, at 995 (1987). Section 2036(c) generally provided that if a taxpayer transfers a disproportionately large share of the potential appreciation in an enterprise while retaining an interest or a right in that enterprise, then the transferred property would be included in the taxpayer's gross estate. *Id.* In enacting this statute, the Senate rejected a proposal by the House of Representative that would have overturned existing case law that allowed lack of control and lack of marketability discounts and would have eliminated such discounts (in part, because of family attribution rules) for the purposes of valuing interests in closely-held entities. *See* H.R. REP. NO. 100-3545, at 1041–44 (1987).

It did not take long for § 2036(c) to prove unworkable. Practitioners found that the sweeping language of § 2036(c) meant that it applied to a wide variety of transactions beyond the estate freeze. BNA Portfolio 835-4th, *Transfers of Interests in Family Entities Under Chapter 14: Sections 2701, 2703, and 2704 Detailed Analysis* at I.A.3. This potential broad applicability prevented many taxpayers from undertaking legitimate intra-family transactions. *Id.* At the same time, § 2036(c)'s lack of precision allowed unfavored transactions to escape taxation.

In 1990, a bipartisan Congress decided to repeal § 2036(c) because "the statute's complexity, breadth, and vagueness posed an unreasonable impediment to the transfer of family businesses." Informal S. Rept. on S. 3209, 136 CONG. REC. S15629, S15679–80 (daily ed. Oct. 18,

1990). Congress repealed § 2036(c) in its entirety as it determined that the statute's "across-the-board inclusion rule [was] inappropriate . . . ." *Id.* at S15680. Instead of an across-the-board rule, Congress "substitute[d] for section 2036(c) a series of targeted rules generally designed to assure a more accurate determination of . . . value" now found in Chapter 14. *Id*.

In enacting Chapter 14, the Senate made it clear that its goals were, in part, "(1) to provide a well[-]defined and administrable set of rules" and "(2) to allow business owners who are not abusing the transfer tax system ***to freely engage in standard intra-family transactions without being subject to severe transfer tax consequences***." Informal S. Rept. on S. 3209, 136 CONG. REC. at 15679–81 (emphasis added). Further, the Senate Report stated that "[t]he bill ***does not affect minority discounts or other discounts available under present law***." *Id*. (emphasis added).

Legislative history provides that Congress did not intend for Chapter 14 to be a general family attribution provision or otherwise change the established rule that the first step in establishing fair market value for tax purposes is to determine the state law property rights transferred and then apply federal tax law. Although Chapter 14 admittedly has an impact on certain family transactions, the rules target transactions specifically defined in the statute. In other words, 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.

Section 2704 was enacted as a part of Chapter 14. As stated in the Senate Report, Congress did not intend for § 2704 to abolish lack of control or lack of marketability discounts available under the present law. *Id.* Instead, § 2704(a) addressed lapsing voting and liquidation rights that had no effect on the value of property in the hands of the transferor, but reduced value for transfer tax purposes. Likewise, § 2704(b) addressed liquidation restrictions contained in an entity's governing documents that were more onerous than those that would otherwise apply under the applicable state law default rules.

The Proposed Regulations ignore the legislative history of Chapter 14 by impermissibly imposing a general family attribution rule that results in the abolition of lack of control and lack of marketability discounts in intra-family transactions.

C. The rulemaking authority granted in § 2704(b)(4) does not permit Treasury to promulgate regulations that impose a general family attribution rule.

Congress granted Treasury a limited power to promulgate regulations addressing additional restrictions under § 2704(b). Congress specifically provided as follows:

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

I.R.C. § 2704(b)(4) (emphasis added). In other words, Treasury only has the authority to adopt regulations that disregard restrictions that reduce value for transfer tax purposes but do not reduce

the value of such interest in the hands of the transferee. Because the terms "transferor" and "transferee" in § 2704(b) refer to the specific individuals involved in the transaction subject to tax, the value comparison required by the statute necessitates an analysis of the effect of the restriction on the value of the interest in the hands of the transferee before a restriction may be disregarded. The general family attribution approach applied in the Proposed Regulations provides for no such analysis.

A comparison of the broad rulemaking authority granted to Treasury regarding lapsed voting and liquidation rights under § 2704(a) demonstrates the necessity for such a valuation comparison. Section 2704(a)(3) provides that "[t]he Secretary may by regulations apply this subsection to rights similar to voting and liquidation rights." Unlike § 2704(b)(4), the grant of authority contains no requirement for a valuation analysis of the interest in the hands of the transferee. Had Congress intended to allow Treasury to promulgate regulations that ignore any restriction without regard to whether "such restriction has the effect of reducing the value of the transferred interest for [transfer tax] purposes . . . but does not ultimately reduce the value of such interest to the transferee," it could have easily done so by omitting the quoted language.[3]

The analysis required by § 2704(b)(4) is similar to the application of the device test adopted by Congress in § 2703(b)(2) based on the court's decision in *St. Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982). In *St. Louis County Bank*, the court held that a stock-purchase agreement could be ignored for estate tax purposes under the theory that the agreement was a testamentary device to avoid estate taxes. The court opined that the decedent was in poor health when the agreement was entered into, it was not used at the death of another shareholder, and the property had a zero value under the formula contained in the agreement. *Id.* at 1211. As noted, Congress incorporated the case-by-case device test in § 2703(b)(2) in determining whether restrictions on the right to sell or use property should be respected for transfer tax purposes by requiring a taxpayer to demonstrate that any "option, agreement, right or restriction . . . [i]s not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth." I.R.C. § 2703(b). Congress specifically cited *St. Louis County Bank* in the Chapter 14 legislative history. *See also Estate of Lauder v. Comm'r*, 60 T.C.M. (CCH) 997, 982 (1990) (holding that the focus is on the "intent of the parties . . . i.e., whether they knew at the time the agreements would or would not be enforced as an element of testamentary intent to pass" stock to children "under an artificial and arbitrary advantage"); *Estate of True v. Comm'r*, 390 F.3d 1210, 1220–26 (10th Cir. 2004).

The invalid assumption underlying the § 2704(b) Proposed Regulations is that restrictions on withdrawal or liquidation in any family-controlled entity do not affect the value of an interest owned by a family member. In other words, Treasury erroneously assumes that

[3] The analysis is required for the promulgation of regulations under § 2704(b) addressing restrictions under the broad approach taken by the Proposed Regulations as well as under a more narrow approach addressing "passive investment companies" contained in the Obama Administration's 2013 Green Book Proposal that many practitioners thought Treasury would adopt. There are, of course, numerous practical problems with a focus solely on passive investment companies, including distinguishing between companies that passively hold marketable securities from those that, for example, (1) own active businesses through a corporate holding company, (2) maintain control over the publicly traded stock they own through special voting rights or positions on the board of directors, or (3) were long-term operating business owners who contributed business assets into a larger, publicly traded entity as market conditions evolved. We would submit that attempting to address these distinctions is impossible, which is why the case-by-case approach for addressing "other" restrictions required by § 2704(b)(4) should be followed.

withdrawal and liquidation restrictions in all family-controlled entities are routinely ignored, regardless of the purpose for their existence, and that any family member would have *carte blanche* to withdraw at proportionate net asset value. The value comparison required by § 2704(b)(4) prohibits the promulgation of a regulation based on such a generalized assumption.

Treasury's assumption also ignores reality. Restrictions on withdrawal and liquidation have a substantial impact on value in the real world, even when (and sometimes especially when) the entity is family-controlled. Such restrictions in family and non-family entities exist for a variety of non-tax reasons, including the desire to continue the business without being forced to liquidate assets or incur borrowing costs to pay the exiting owner. Whether and under what terms a non-controlling interest owner has the ability to withdraw or liquidate depends on the purposes for which the entity was created, the proclivities of the organizing shareholders, the continuity needs and liquidity constraints of the company, and numerous other business reasons that are different in every case. Consequently, the common restrictions on the ability to withdraw from the entity, liquidate the entity or redeem interests are necessary to realize underlying entity objectives and sustain the continuity of the entity. Treasury's assumption of "across-the-board" family unity also ignores the reality that many family members do not act in concert with one another. Casebooks are filled with decisions addressing family business disputes in numerous contexts, including shareholder oppression, breach of fiduciary duty, and the like. Any experienced litigator can attest that family business disputes tend to be ugly, protracted, and costly.

Because the general family attribution approach applied in the Proposed Regulations exceeds the limited power Congress granted to Treasury to promulgate regulations addressing additional restrictions under § 2704(b), this approach should be abandoned and replaced with a rule that requires an analysis of the valuation effect of the restriction in the hands of the transferee.

II. Substantial portions of the Proposed Regulations cannot be harmonized with the language of § 2704 and its legislative history.

A. To be granted judicial deference, Treasury must demonstrate that the Proposed Regulations are consistent with § 2704 and Congressional intent.

The determination of whether the Proposed Regulations are entitled to judicial deference is based on a two-step analysis. *Mayo Found. for Educ. & Research v. United States*, 562 U.S. 44 (2011) (holding that *Chevron* governs the judicial review of a Treasury Regulation); *United States v. Mead Corp.*, 533 U.S. 218 (2001); *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) ("***Chevron***"). First, if the intent of Congress is clear, based on traditional rules of statutory construction, "that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Chevron*, 467 U.S. at 842–843. Second, if the statute is silent or ambiguous with respect to the specific issue, the question is "whether the agency's answer is based on a permissible construction of the statute." *Id.* "A challenged regulation is not considered such a permissible construction or reasonable interpretation ***unless it harmonizes with the statutory language and with the statute's origin and purpose***." *Walton v. Comm'r*, 115 T.C. 589, 598 (2000) (emphasis added). We submit that the Proposed Regulations do not satisfy the *Chevron* standards.

B. The Proposed Regulations' disregard of state and federal default restrictions is inconsistent with § 2704(b) and its legislative history.

Section 2704(b) excludes from the definition of an applicable restriction "any restriction imposed, or required to be imposed, by any Federal or State law." I.R.C. § 2704(b)(2)(B). However, the Proposed Regulations addressing both (1) applicable restrictions, and (2) other restrictions would disregard ***all*** non-mandatory restrictions on liquidation or withdrawal, including the state or federal default statutes that govern the operation of an entity in the absence of a provision contained in the entity's governing documents. The preamble to the Proposed Regulations provide as follows:

> A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. . . . In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise.

Prop. Treas. Reg. § 25.2704-2(b)(4)(ii); *see* Prop. Treas. Reg. § 25.2704-3(b)(5)(iii) (substantially similar rule). The Proposed Regulations identify the source of a limitation as being "a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise." Prop. Treas. Reg. § 25.2704-2(b)(2); Prop. Treas. Reg. § 25.2704-3(b)(2) (substantially similar rule).

Treasury's proposed disregard of default restrictions under federal and state law is in conflict with the clear intent of Congress contained in § 2704(b)(2)(B) and legislative history of § 2704(b). Treasury interprets the multi-part phrase "imposed, or required to be imposed by Federal or State law" to singularly mean a restriction that is required to be imposed (i.e., cannot be overridden in the governing documents). That interpretation creates surplusage in that provision by giving "imposed" and "required to be imposed" the same meaning (i.e., both mean mandatory), defying a principal tenet of statutory construction that requires statutes to be interpreted in a manner that avoids surplusage. On the other hand, surplusage is avoided by construing § 2704(b)(3)(A) as applying to restrictions imposed under default ***or*** mandatory federal or state law. *See* I.R.C. § 2704(b)(3)(A) (using the term "or" too). This interpretation is in accord

with the legislative history of § 2704(b) because Congress intended to perpetuate in Chapter 14 the basic requirement that state law defines the interests in property subject to transfer tax.

In addition to being inconsistent with § 2704(b) and its legislative history, Treasury's interpretation creates numerous practical problems, including the following:

(1) The interpretation ignores the fact that default restrictions imposed under federal or state law have a real-world impact on the value of an interest and limit the holder's rights, regardless of whether the interest is held by a family member or a third party.

(2) It is unclear whether and the extent to which the Proposed Regulations apply to restrictions imposed by federal or state laws made effective before October 8, 1990, which creates uncertainty regarding whether the valuation of an interest subject to the Proposed Regulations should consider restrictions imposed by pre-October 8, 1990 law.

(3) A valuation vacuum exists under the Proposed Regulations, as the Proposed Regulations do not clearly articulate the assumptions that are required to be made in valuing an interest if liquidation or withdrawal restrictions contained in the governing documents and state law do not apply. *See* Proposed Regulations, 81 Fed. Reg. at 51417 ("[T]he fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction does not exist (that is, ***as if the governing documents and the local law are silent on the question***) . . . ." (emphasis added)). For example, the corporate default rules for most states contain no provision allowing for a shareholder's withdrawal. In that case, where there is no restriction on withdrawal to be ignored, does the valuation analysis assume a right to withdraw exists? If so, under what terms?

Because these provisions are manifestly inconsistent with § 2704(b) and its legislative history and create substantial uncertainty and confusion, they should be removed from the final version of the Proposed Regulations if Treasury is still inclined to promulgate them.

C. The proposed definition of a "disregarded restriction" is inconsistent with § 2704(b)(4).

As discussed above, Treasury may only promulgate regulations addressing "other" restrictions if the restriction to be addressed "***has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee***." I.R.C. § 2704(b)(4) (emphasis added). Thus, a regulation capturing a restriction that reduces the value of the transferred interest for both Chapter 14 ***and*** reduces the value of such interest to the transferee conflicts with the plain meaning of § 2704. We submit that restrictions on an owner's ability to withdraw, liquidate, or redeem impacts both the value for Chapter 14 purposes and the commercial value of the interest in the transferee's hands.

The Proposed Regulations create a new category of "disregarded restrictions" that would not be considered when valuing an intra-family transfer of an interest. Put simply, a

"disregarded restriction" is a restriction that: (1) limits the ability of a holder of the interest to liquidate the interest;[4] (2) limits the liquidation proceeds to an amount that is less than a minimum value;[5] (3) defers the payment of the liquidation proceeds for more than six months; or (4) permits the payment of the liquidation proceeds in any manner other than cash or property, other than certain notes of an entity engaged in active trade or business.[6] Prop. Treas. Reg. § 25.2704-3(b)(1).

Each of these restrictions conflicts with the plain meaning of § 2704(b)(4) because the restrictions ***do*** reduce the actual value of the interest to the transferee due to the relevant lack of control and lack of marketability discounts to be applied when valuing the interest in the commercial context. If Treasury is simply assuming that the restrictions will never be enforced in any family-controlled entity (or that a family owner would assume the right to be liquidated for cash at pro-rata value), then Treasury's assumptions ignore reality as discussed above. If not, then the restrictions do in fact reduce the value of the interest to the transferee.

The conundrum presented by this valuation issue underscores our point in Part I above; that is, § 2704(b)(4) requires a case-by-case analysis to determine the valuation effect of the restriction in the hands of the transferee. Any other reading is inconsistent with the plain language of § 2704(b)(4).

From a practical standpoint, the definition of minimum value has several issues:

(1) It will create phantom assets or value subject to transfer taxes by effectively requiring a liquidation or redemption right for pro-rata net asset value of the family-controlled business. *See* Matthew E. Rappaport, *Extended Thoughts on the IRC 2704 Proposed Regulations*, SIGMA VALUATION CONSULTING, INC. (Aug. 5, 2016), http://www.sigmavaluation.com/2704-proposed-regs/ ("***[T]he Service is trying to reverse-engineer an undiscounted or lightly discounted transfer tax value for all such interests***. . . . By my count, this 'minimum value' would effectively control the way valuation professionals would calculate the fair market value of a fractional interest in a family-controlled

[4] Specifically, a "provision [that] limits or permits the limitation of the ability of the holder of interest to compel liquation or redemption of the interest." Prop. Treas. Reg. § 25.2704-3(b)(i). Presumably, Treasury has elected to interpret the phrase "limits or permits the limitation of" to include mandatory and non-mandatory limitations under the entity's governing documents, federal law, or state law. *See* Part II.B, *supra*, (arguing for a similar interpretation for the phrase "imposed or required to be imposed").

[5] The term "minimum value" means "the interest's share of the net value of the entity determined on the date of liquidation or redemption." *Id.* The "net value of the entity" is "the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity." *Id.* The only obligations taken into account are those that "would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate." *Id.*

[6] One requirement of such notes is that they be issued at "market interest rates." Prop. Treas. Reg. § 25.2704-3(b)(1)(iv). The Proposed Regulations provide no guidance on what the phrase "market interest rates" means and whether normal rate of return enhancement for lack of marketability should be taken into account. William H. Frazier, *Implications of Proposed Section 2704 – Taxation Based on Theoretical Value vs. Actual Value*, STOUT RISIUS ROSS, INC. (Aug. 15, 2016), http://blog.srr.com/estate-and-gift-tax/implications-of-proposed-section-2704-taxation-based-on-theoretical-value-vs-actual-value/ ("Ironically, a proper valuation of the notes would include an additional rate of return enhancement for lack of marketability. The net effect of the additional borrowing is that the cost of debt rises as well as the cost of equity."). The same issues exists for notes permitted under Prop. Treas. Reg. § 25.2704-3(b)(6).

entity, ***leaving little or no flexibility to account for legitimate economic factors affecting transfer tax value***." (emphasis added)).

(2) Equating "minimum value" with the pro-rata net asset value of the family-controlled business erroneously assumes that every family-controlled business has sufficient liquidity, can readily access liquidity in the case of insufficient liquidity, and can distribute to a minority owner a pro-rata portion of the entity's net assets without consequences to the entity or remaining owners.

(3) It is unclear whether the fair market value of the property owned by the entity includes unidentifiable intangible assets implied by a capitalization of earnings, unallowable personal goodwill, or self-created intangibles.

(4) It is unclear whether contingent obligations (including built-in capital gains, environmental liabilities, claims against the company, etc.) are taken into account when determining fair market value because, among other things, the Proposed Regulations use the phrase "(if paid)" while referencing § 2053. *See* STEVE R. AKERS, SECTION 2704 PROPOSED REGULATIONS 7–8 (2016) ("In valuing a business that sells goods and services, business analysts routinely incorporate estimates of the impact of risks and other unbooked obligations and exposures. Are these to be ignored?").

D. The proposal to disregard certain interests held by non-family members is inconsistent with § 2704(b)(4) and § 2704(b)(2)(B).

In determining whether the transferor's family would have the ability to remove a restriction, the Proposed Regulations would disregard the interest held by a non-family member that has been held less than three years before the date of the transfer, that constitutes less than 10% of the value of all of the equity interests, that when combined with the interests of other non-family members constitutes less than 20% of the value of all of the equity interests, or that lacks a right to put the interest to the entity and receive a minimum value. Proposed Regulations, 81 Fed. Reg. at 51415; Prop. Treas. Reg. § 25.2704-3(b)(4).

The preamble to the Proposed Regulations makes the following argument in support of this proposed bright-line rule:

> [T]he Treasury Department and the IRS have concluded that the grant of an insubstantial interest in the entity to a nonfamily member should not preclude the application of section 2704(b) because, in reality, such nonfamily member interest generally does not constrain the family's ability to remove a restriction on the liquidation of an individual interest. . . . The Treasury Department and the IRS have concluded that the presence of a nonfamily-member interest should be recognized only where the interest is an economically substantial and longstanding one that is likely to have a more substantive effect.

Proposed Regulations, 81 Fed. Reg. at 51415.

Here again, Treasury is making another broad, non-particularized assumption that is unrelated to how the interest affects value in the hands of a specific transferee. This time, the assumption is that ***any*** non-family owner in a family-controlled business below a certain equity threshold or who has held the interest for less than three years will accede to a family's request to remove a liquidation restriction, regardless of the size of the interest, the amount of time the interest has been held, the relationship of the third party to the family, the leverage that might exist for the third party, or the benefits the third party is receiving from the entity. But, interests held by non-family members in family-controlled entities do affect the value of an interest in the hands of a transferee. As discussed above, the effect of any restriction must be analyzed based on how it affects value in the hands of the transferee. The broad assumption underlying Prop. Treas. Reg. § 25.2704-3(b)(4) conflicts with that requirement.

In addition, the court's decision in *Kerr v. Commissioner* demonstrates that the proposed bright-line rule conflicts with the plain meaning of § 2704(b)(2)(B). *See Kerr v. Comm'r*., 292 F.3d 490, 494 (5th Cir. 2002) ("For a restriction to be considered removable by the family, the Code specifies that "***[t]he transferor or any member of the transferor's family, either alone or collectively***," must have the right to remove the restriction. I.R.C. § 2704(b)(2)(B)(ii). ***The Code provides no exception allowing us to disregard non-family partners who have stipulated their probable consent to a removal of the restriction. The probable consent of UT, a non-family partner, cannot fulfill the requirement that the family be able to remove the restrictions on its own***." (emphasis added)).

Treasury also should reconsider this bright-line rule for several practical reasons:

(1) A business (even a publicly-traded company) that satisfies this bright-line rule has yet to be identified and likely cannot be identified.

(2) The proposed bright-line rule is especially punitive for businesses that have existed for fewer than three years because it would be impossible for such businesses to satisfy the three-year ownership requirement.

(3) It is unclear whether Treasury will accept the consequence that the impact of eliminating minority discounts for family-controlled entities under the proposed bright-line is that valuation experts will then be justified in applying lack of continuity discounts.

E. The proposed three-year claw-back rule in Prop. Treas. Reg. § 25.2704-1 is inconsistent with § 2704(a), creates phantom assets subject to transfer tax, and is punitive.

Congress circumscribed Treasury's authority to promulgate regulations interpreting § 2704(a) "to ***rights*** similar to voting and liquidation rights." I.R.C. § 2704(a) (emphasis added). The proposed three-year claw-back rule seeks to treat any transfer within three years of death, which results in the transferor losing a liquidation or voting right, as a deemed transfer of the value of the "lapsed" voting or liquidation right at the transferor's death. Prop. Treas. Reg. § 25.2704-1(c)(1). Even though the rights associated with the ownership of the transferred interest do not lapse, this claw-back rule will result in a phantom asset equal to the

value attributable to the so-called "lapsed" right being included in the transferor's gross estate at death. *Id.*

The proposed three-year claw-back rule creates a minimum holding period for interests transferred among family members, even if the rights inuring to the holders of the interests are identical. Congress did not intend for Treasury to regulate holding periods when it granted rulemaking authority in § 2704(a)(3), only the lapsing (i.e., disappearing) of rights similar to voting or liquidation rights. This focus on the continued existence of certain rights attendant to an interest in a family-controlled business should be no surprise to Treasury, as the complete lapse of such rights was the focus of *Estate of Harrison v. Comm'r*, 52 T.C.M. 1306 (1987), the case on which Treasury relies to justify the Proposed Regulations. In fact, Treasury has recognized this focus in its longstanding regulations, which provide that "a transfer of an interest that results in the lapse of a liquidation right is not subject to [Treas. Reg. § 25.2704-1] if the ***rights*** with respect to the transferred interest are not restricted or eliminated." Treas. Reg. § 25.2704-1(c)(1) (emphasis added).

The three-year claw-back rule results in phantom assets being included in a decedent's estate. This result is especially punitive considering that transfer taxes would have been already assessed and paid with respect to the underlying transfer, clearly violating Congress's intent to allow "business owners . . . to freely engage in standard intra-family transactions without being subject to severe transfer tax consequences." Informal S. Rept. on S. 3209, 136 CONG. REC. at 15679–81. The punitive nature of this provision is highlighted by the inability for the decedent's estate to take marital or charitable deductions with respect to the phantom assets. AKERS, *supra*, at 4 ("This 'phantom asset' value would be included in the transferor's gross estate and would not qualify for a marital or charitable deduction.").

Treasury should also abandon this proposed three-year claw-back rule for several practical reasons:

(1) It is unclear whether the value of the phantom asset is determined using values on the date of the gift or on the death of the decedent's death.

(2) The Proposed Regulations lack a coordination provision that would prevent the phantom asset from being subject to tax under the proposed rules regarding applicable restrictions and disregarded restrictions as well as under the three-year claw-back rule.

(3) The disregard of certain interests held by non-family members may very well capture transfers otherwise falling outside of § 2704(a)'s scope.

(4) It is unclear whether transfers occurring before the effective date of the Proposed Regulations are subject to the three-year claw-back rule.

III. Treasury should not adopt the Proposed Regulations for practical and economic reasons.

As discussed in other parts of this letter, there are practical and economic reasons for Treasury to not adopt the Proposed Regulations. *See Altera Corp. & Subsidiaries v. Comm'r*,

145 T.C. 91 (2015) (invalidating a Treasury Regulation that did not adequately address such comments).

A. Effect on family-controlled businesses and the U.S. economy

Treasury certified that the Proposed Regulations "will not have a significant economic impact on a substantial number of entities." Proposed Regulations, 81 Fed. Reg. at 51418. That certification illustrates that Treasury failed to consider the effects of the Proposed Regulations carefully.

1. Deep economic impacts

The Proposed Regulations will have a severe impact on family-controlled businesses, including those operating as S corporations. Family-controlled businesses account for a majority of U.S. gross domestic product and employment in the United States. *Family Business Facts*, CONWAY CENTER FOR FAMILY BUSINESS, http://www.familybusinesscenter.com/resources/family-business-facts/ (last visited Sept. 16, 2016); *see* Allyson Versprille, *Practitioners Have Mixed Reaction to Valuation Discount Bill*, BLOOMBERG BNA (Sept. 16, 2016), http://taxandaccounting.bna.com/btac/T11100/split_display.adp?fedfid=97285357&vname=dtrnot&split=0.

The Proposed Regulations will increase the transfer tax burden of owners of interests in family-controlled businesses based on artificial values that have no connection to the real world. AKERS, *supra*, at 10 ("[I]n reality, if the Proposed Regs are finalized as produced, valuation for tax purposes will have no connection to the reality of values in the marketplace. ***Taxpayers will be taxed on a theoretical value that is impossible even in the theoretical world***." (emphasis added) (quoting WILLIAM H. FRAIZER, MUSINGS ON THE THEORETICAL REDEMPTION RIGHTS IN PROPOSED REGULATION 163113-02 (2016)).

The increased tax burden will be particularly harsh upon the death of a family member. The increased tax burden will require families to secure additional liquidity to pay estate taxes, likely through a combination of costly loans and taxable asset sales. The proceeds of these sales will naturally be determined by actual market prices, while the estate tax will be levied based on a much higher artificial value. The phantom tax imposed by the Proposed Regulations is an unjust confiscation of the family business equity built by the family, often over generations. The practical effect is an impermissible, discriminatory, and indirect tax rate increase on family-controlled businesses and their owners by regulatory fiat. Thus, Treasury must not adopt the Proposed Regulations.

2. Two sets of valuations

The Proposed Regulations will also result in family-controlled businesses "requir[ing] two valuations: one for intra-family ownership transactions and one for others not covered by the new § 2704." AKERS, *supra*, at 14. Such a result contravenes fundamental valuation principles by requiring valuation experts to account for the identities of those involved in an intra-family transfer subject to the Proposed Regulations. The dual-valuation system that will result from the Proposed Regulations is costly, unworkable, and undermines Congress's intent by penalizing family-controlled businesses.

B. Uncertain treatment under § 1014

The Proposed Regulations purport to eliminate or severely limit lack of control and lack of marketability discounts for intra-family transfers of interests in family-controlled entities. If such a transfer occurred because of the holder's death, the recipient should receive a basis adjustment for income tax purposes to the interest's (inflated) fair market value pursuant to § 1014, although the Proposed Regulations are silent regarding the coordination of valuation principles with § 1014. I.R.C. § 1014(a). This basis adjustment will lead to lost income tax revenue in an amount proportionate to the value of the foregone lack of control and lack of marketability discounts. *See* Kathleen Adcock, *IRS Proposes New Regulations for § 2704*, BLOOMBERG BNA (Aug. 19, 2016), http://www.bna.com/irs-proposes-new-b73014446640/; Kein Matz, *The IRS Issues Proposed Regulations Under Section 2704 That Would Significantly Curtail Discounts for Family-Controlled Entities (PART ONE)*, LINKEDIN (Aug. 15, 2016), https://www.linkedin.com/pulse/irs-proposes-regulations-under-section-2704-would-curtail-kevin-matz. Further, the lost income tax revenue may not be fully offset by increased estate tax collections because many estates are below the § 2010(c) exemption amount.

The Proposed Regulations' silence regarding the coordination of valuation principles with § 1014 generates uncertainty and suggests that Treasury has not considered this issue. Ensuring valuation alignment for transfer tax and § 1014 purposes is not only appropriate from a policy standpoint, but also necessary to avoid further inequitable treatment of family-controlled businesses.

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The Proposed Regulations resurrect the family attribution battle that had been put to rest decades ago. While there are many uncertainties related to the Proposed Regulations, two things are certain if Treasury moves forward and adopts the Proposed Regulations as drafted:

(1) Economic harm will occur as family-controlled businesses are sold or heavily leveraged to pay the additional estate, gift, and generation-skipping transfer taxes associated with the transfers of interests improperly subjected to the Proposed Regulations; and

(2) Courts will scrutinize and invalidate all (or at least substantial parts) of the Proposed Regulations (as they have done in the past with respect to other pronouncements by Treasury and the Commissioner addressing Chapter 14[7]), at great expense to Treasury, the Commissioner, and taxpayers.

Promulgation of the Proposed Regulations in their current form and scope will generate significant uncertainty and constitute a significant impediment for the continuity of family-controlled businesses. The Proposed Regulations inappropriately and illegally discriminate against family-controlled businesses in form and effect. If Treasury is inclined to promulgate regulations to address perceived abuse, those regulations should be targeted in scope, capable of

[7] *See Kerr v. Comm'r*, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002) (rejecting IRS attempt to apply § 2704(b) to withdrawal rights); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000) (denying overbroad interpretation of § 2703); *Walton v. Comm'r*, 115 T.C. 589, 597 (2000) (partially invalidating regulation under § 2702).

reasonable application and administration, and consistent with Congress's intent, as set forth in § 2704 and the legislative history of Chapter 14. The Proposed Regulations do not satisfy any of those conditions.

Thank you for the opportunity to comment on the Proposed Regulations. We welcome the opportunity to meet with Treasury or the Commissioner to discuss these comments in detail or to answer any questions about these comments. We also look forward to the opportunity to comment on any revised version of the Proposed Regulations that address these and other comments to the Proposed Regulations.[8]

Very truly yours,

Brian Reardon
President
S Corporation Association

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[8] S-Corp anticipates that Treasury may attempt to salvage the Proposed Regulations through revisions based on comments it receives. If Treasury goes down this path, an opportunity to comment on those revisions is necessary to comply with the Administrative Procedure Act because (1) those revisions will affect the rights and liabilities of taxpayers and family-controlled businesses and (2) it is impossible to predict which of the innumerable permutations of revisions Treasury will select for the final regulations, depriving the public of its right to meaningfully comment and to notice of Treasury's final regulations. *See Ass'n of Private Sector Coll.s & Univs. Duncan*, 681 F.3d 427, 461–63 (D.C. Cir. 2012).