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Via Regulations.gov

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 regarding Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest (REG-163113-02)

Dear Mr. MacEachen:

On behalf of the Family Business Coalition, I write to request that the Internal Revenue Service withdraw the proposed regulations concerning Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest.[1]For the reasons set forth below, the proposed regulations will be detrimental to family businesses across the country and undermine their economically viability.

The Family Business Coalition is a diverse collection of organizations and industry groups united for the common purpose of protecting America's family businesses across the country. Our group has the important task of monitoring and acting on legislation and regulations that affects family businesses. We are the voice of America's main economic engine – family businesses – working together towards a better business climate that promotes private business expansion and job growth.

1. Valuation discounts for family-owned businesses serve a legitimate economic purpose

It is economic reality that a minority interest in a family enterprise is worth less than that interest's pro-rata share of the business as a whole because the minority interest does not have control of the business or marketability. Although an adjustment in the valuation of an interest to reflect this lack of control or marketability is often called a "discount," that adjustment recognizes the true fair market value of the interest.

The proposed regulations target closely held family businesses. The regulations will increase estate tax liability by removing legitimate valuation discounts relating to treatment of certain lapsing rights and restrictions on liquidation. Assistant Secretary of the Treasury Mark Mazur, in

[1] Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest, 81 Fed. Reg. 51,413 (Aug. 4, 2016) (to be codified at 26 C.F.R. pt. 25).

a blog post defending the proposed regulations, disingenuously called these legitimate discounts a "loophole," further claiming that valuation discounts allow business owners to pay less in taxes than they should. Mazur said:

> It is common for wealthy taxpayers and their advisors to use certain aggressive tax planning tactics to artificially lower the taxable value of their transferred assets. By taking advantage of these tactics, certain taxpayers or their estates owning closely held businesses or other entities can end up paying less than they should in estate or gift taxes. Treasury's action will significantly reduce the ability of these taxpayers and their estates to use such techniques solely for the purpose of lowering their estate and gift taxes.[2]

Valuation discounts based on restrictions and lapsing rights for family businesses are not "aggressive tax planning tactics" and are not used "solely" to lower estate and gift taxes. Instead, they reflect the true fair market value of an interest in a family business, just as it would for a non-family business. In this respect, it should be remembered that the proposed regulations are being promulgated under Section 2704(b)(4), which provides that IRS may not disregard restrictions on a business interest if such restrictions affect the ultimate value of the interest after transfer:

> 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*.[3]

Lack of control discounts (also referred to as minority discounts) and lack of marketability discounts are not an artificial reduction in value of that interest that applies only on transfer; instead, they reflect the genuine fair market value of a business interest in the hands of the transferee. By creating a new class of disregarded restrictions, the proposed regulations – especially when combined with supporting statements released by the Department of the Treasury[4] – do not ensure that disregarded restrictions will be only those that affect the transfer value of the interest.

The proposed regulations are based on a false assumption that an interest in a family business is worth more than an interest in a non-family business. The effect of the proposed regulations will be to increase the value of an interest in a family business, which in turn will effectively increase estate or gift taxes. The increase in the tax burden on a family business could easily be 25 to 50 percent higher than current regulations. This increase in tax liability will require businesses to spend more on estate planning, as they will be required to redo current plans and require an increase in the amount of life insurance to offset the higher tax liability.

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[2] Mark J. Mazur, Dep't of the Treasury, Treasury Notes: *Treasury Issues Proposed Regulations to Close Estate and Gift Tax Loophole*, Aug. 2, 2016, http://bit.ly/2eLuSlr.
[3] I.R.C. § 2704(b) (emphasis added).
[4] See e.g., Mark J. Mazur, Dep't of the Treasury, Treasury Notes: *Treasury Issues Proposed Regulations to Close Estate and Gift Tax Loophole*, Aug. 2, 2016, http://bit.ly/2eLuSlr, Department of Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals,* February 2012, http://bit.ly/2eP2v7K.

2. The proposed regulations improperly revive the abandoned family attribution standard for valuation

In addition to increasing the tax burden on an interest in a family business, the proposed regulations will change the standard for valuation from the "willing seller, willing buyer at arm's length" test to the outdated and disregarded use of "family attribution." The Internal Revenue Service, in Revenue Ruling 81-253, determined that family control disallowed lack of control discounts:

> It is the position of the Service that ordinarily 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 (either majority voting control or de facto control) of the corporation exists in the family.[5]

Similarly, the proposed regulations remove a minority interest's lack of control from being considered when applying restrictions to the value of the interest if the family collectively has control:

> The term disregarded restriction means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or *any member of the transferor's family* (subject to paragraph (b)(4) of this section), *either alone or collectively*.[6]

Family attribution was withdrawn as a method for determining the value of minority interests after several court rulings showed that family attribution was not in line with previous court decisions.[7] These cases instruct that a decedent's property could not be attributed to family control and that the IRS valuation did not meet the "willing buyer, willing seller" test set out in Revenue Ruling 59-60. Further, Revenue Ruling 93-12 ensures lack-of-control discounts can be applied when passing an interest in a business from one family member to another:

> For estate and gift tax valuation purposes, the Service will follow *Bright, Propstra, Andrews,* and *Lee* in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest. Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest.[8]

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[5] Rev. Rul. 81-253, 1981-1 C.B. 187.

[6] Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest, 81 Fed. Reg. 51,413 (Aug. 4, 2016) (to be codified at 26 C.F.R. pt. 25) (emphasis added).

[7] *See, e.g.*, *Estate of Lee v. Comm'r*, 69 T.C. 860 (1978); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981).

[8] Rev. Rul. 93-12, 1993-1 C.B. 202.

Realizing that family attribution had been rejected by the courts, the Senate Report on the legislation creating Section 2704 explained that fair market value should be based on the "willing buyer, willing seller" test:

> The value of property transferred by gift or includible in the decedent's gross estate generally is its fair market value at the time of the gift or death. *Fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts* (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer.
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> *Accordingly, courts generally have refused to consider familial relationships among co-owners in valuing property*. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.[9]

The legislative history of Section 2704 thus shows that family attribution should not be used and that the "willing buyer, willing seller" test should be maintained.

The proposed regulations also change the method of valuation by allowing the buyer and seller to be known parties in the case of intra-family transfers. This change in the valuation standard and the abandonment of the "willing buyer, willing seller" test will completely change the methods appraisers must use and will render previous tax court precedent, academic research, and appraisal education moot. The new standard will require years of litigation between estates and the IRS to recreate this level of understanding that the current system enjoys, costs that will be borne by families trying to maintain their family businesses.

3. Several parts of the proposed regulations go beyond the authority granted in Section 2704(b)(4)

The creation of a new class of "disregarded restrictions" within the proposed regulations is perhaps the most questionable part of the IRS rulemaking because the vagueness with which the rules are written will allow the IRS to exceed its authority under Section 2704(b)(4). The proposed regulations, as written, will allow IRS appraisers to ignore restrictions created by family business by-laws, private party contractual agreements, and applicable state laws that affect the marketability of the interest, and hence the genuine fair market value of that interest. As noted above, any restriction that is disregarded for the purposes of increasing the tax liability but also affects the value of the interest in the hands of the ultimate owner violates the authority to disregard those restrictions granted by Section 2704(b)(4).

Under current regulations, the value of lapses in voting rights or liquidations that were available immediately prior to death are included in the estate valuation. The proposed regulations change that timeframe to three years prior to death. The principal problem with this bright line rule is that no one knows when they will die. The new rule therefore could undue legitimate transfers unrelated to estate tax planning whenever there is an untimely death within three years.

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[9] S. Rept. on S. 3209, 136 CONG. REC. S15629, S15679 (daily ed. Oct. 18, 1990) (emphasis added).

Untimely deaths that result in an unexpected estate tax payment are not uncommon. Congresswoman Kristi Noem (SD-AL) has explained the dire and unexpected effects of her father's untimely death on multiple occasions, including in the following op-ed:

> You don't forget moments like this – the ones that come so unexpectedly, shoving a pit into your stomach. I was 21-years-old and nearing the due date for my husband Bryon and my first baby. That's when the phone call came: "Kristi, your dad is stuck in a grain bin." I knew instantly what it meant.
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> By the time I got to the farm, neighbors and friends had taken payloaders and ripped down the grain bin trying to find my dad. When they finally did, our neighbors started doing CPR until the EMTs took over. I followed the ambulance to the hospital with my family and the doctors fought to save him for hours. Nothing worked. That night, we lost my dad – this man who had seemed invincible to me.
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> Not too long after the accident, while we were still trying to pick up the pieces, our family received a letter from the IRS. Because of this tragedy, one that undermined our sense of security, the death tax was now about to undermine our financial security.[10]

Under the proposed regulations, any transfer to a family member that Congresswoman Noem's father might have made during the three years prior to his unexpected and untimely death would have to be undone for the purpose of the estate tax. Clawing back interests in a family business that were legitimately transferred simply to increase an estate tax bill is one of the most egregious parts of the proposed regulations.

4. The IRS did not comply with the Regulatory Flexibility Act and ignored the costs family businesses will incur to comply with the new regulations

The IRS did not conduct an initial regulatory flexibility analysis as required by the Regulatory Flexibility Act.[11] The IRS claims that it is exempt from this requirement because the proposed:

> Regulation will not have a significant economic impact on a substantial number of small entities. The proposed regulations affect the transfer tax liability of individuals who transfer an interest in certain closely held entities and not the entities themselves. In addition, any economic impact on entities affected by section 2704, large or small, is derived from the operation of the statute, or its intended application, and not from the proposed regulations in this notice of proposed rulemaking.[12]

This no-impact certification is improper for at least three reasons.

First, agencies are required to provide a "factual basis" to support their certification that regulations will not have an impact on businesses.[13] The IRS has made two statements to support

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[10] Rep. Kristi Noem, *My father's tragic death and Hillary Clinton's tax plan*, FOXNEWS.COM, Oct. 2, 2016, http://fxn.ws/2eaKNZ2.
[11] 5 U.S.C ch. 6.
[12] 81 Fed. Reg. at 51,418.
[13] 5 U.S.C. § 605(b).

its certification, neither of which is a "factual basis." The IRS claims that the transfer tax liability falls on individuals who own an interest in a small business and therefore the business itself will not be affected. That is a conclusory statement without factual support and is belied by the economic realities of closely held, owner-operated family businesses, as discussed below. The IRS also claims that any impact of the proposed rule flows from the statute and not the regulation. That is an unsupported legal argument that ignores decades of reliance on the existing valuation process and IRS rules. The IRS is not responding to any statutory change with the proposed new regulations. Rather, it has taken upon itself the decision to change longstanding rules, regulations, and practice in this area. It is incorrect to conclude that the impact of the rule flows solely from the statute, especially where, as noted above, the rules as written permit the IRS to exceed its authority under Section 2074(b)(4).

Second, this proposed rule will have "a significant economic impact on a substantial number of small entities."[14] This impact will be felt in at least two ways.

It is widely understood that, for pass-through entities such as partnerships, the taxes of the business are paid by individuals because there is no separation between the two. For purposes of taxation, the business is the individual and IRS regulations codify as much:

> In general, an affected investor . . . in a pass-through entity shall separately take into account as an item of income and as an item of expense an amount equal to his or her allocable share of the affected expenses . . . of the pass-through entity for purposes of determining his or her taxable income. . . . [T]he expenses so taken into account shall be treated as paid or incurred by the affected investor in the same manner as paid or incurred by the pass-through entity.[15]

For a business to be treated as identical to the individual in one part of the tax code but then treated as separate entities to justify the failure to conduct a regulatory flexibility analysis is improper.

In addition, the economic reality is that the burden of preparing for and adjusting to the proposed regulations will fall on the business, which includes the owners, employees, customers, vendors and other stakeholders. Small businesses that have affected restrictions in their current partnership agreements, corporate bylaws, incorporation documents, or contractual agreements will bear the cost of redoing those critical documents and agreements to account for the proposed rules. That impact alone is enough to warrant a regulatory flexibility analysis. Many businesses also are likely to delay investing in expansion, including investments in capital equipment, hiring of workers, and increases in wages for existing workers, while the inevitable litigation and revenue rulings construing and interpreting the new rules plays out.

Third, the IRS should conduct a regulatory flexibility analysis to study whether it is possible to exempt small, family-controlled, owner-operated businesses from the proposed rulemaking.[16] This exemption could include any interests containing closely held stock in a family operated

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[14] *Id*. § 602(a)(1).
[15] 26 C.F.R. § 1.67-2T.
[16] *See* 5 U.S.C. § 603(c), (c)(4) (requiring agencies to study whether "an exemption from coverage of the rule" will lessen the impact on small entities but still allow the agency to "accomplish the stated objectives of applicable statutes").

business or any other exemptions the IRS deems suitable to ensure small entities are not unfairly burdened by the regulation. This exemption would ease the burden on small entities while still allowing the IRS to combat abuses, real or perceived, in this area and accomplish the objectives of the statute.

The Family Business Coalition hereby petitions the IRS to conduct an initial regulatory flexibility analysis, publish the results in the *Federal Register*, accept comments on that analysis and, to the extent it does not withdraw the proposed regulations in full, include a final regulatory flexibility analysis with the final rules.[17]

5. The proposed regulations may go beyond the authority of the IRS to promulgate them

Similar policy proposals to remove valuation discounts to increase tax revenues have been previously proposed by Members of Congress, but Congress has failed to enact them. If the purpose of eliminating valuation discounts is to raise tax revenues, it would be inappropriate for the IRS to make an end run around Congress and achieve through regulation what Congress has failed to enact into statutory law. Article I, Section 8 of the U.S. Constitution states "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises."[18] Additionally, as has been previously noted, Section 2704(b)(4) only gives IRS the ability to collect revenue it should be owed,[19] if the purpose of the proposed regulations is to raise additional revenue, such action exceeds the agency's rulemaking authority.

6. The proposed regulations go in the opposite direction of legislative history on the estate tax

The proposed regulations are in conflict with 15 years of action by Congress on the estate tax designed to lessen the tax burden on family businesses. Beginning with passage of the Economic Growth and Tax Reconciliation Act of 2001,[20] the estate tax exemption and tax rate have been increased and decreased, respectively, including one year of full repeal in 2010. As part of a bipartisan agreement in the American Taxpayer Relief Act of 2012,[21] the estate tax exemption was set at $5 million with an annual adjustment for inflation and a 40 percent tax rate. Most recently the House of Representatives passed the Death Tax Repeal Act of 2015 with bipartisan support.[22] These actions show a pattern of Congress seeking to reduce the burden the estate tax puts on family businesses; however, the proposed regulations undermine that congressional intent by increasing the tax burden.

7. The proposed regulations are too vague to be implemented

Finally, as previously noted in several parts of these comments, the proposed regulations are vaguely written. Interpretations by estate-planning attorneys and descriptions from the IRS vary widely. The vagueness of the regulations could lead to future abuses that go well beyond the

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[17] 5 U.S.C.
[18] U.S. Const. art. I. sec. 8. cl. 1.
[19] I.R.C. § 2704(b)
[20] Pub. L. No. 107–16, 115 Stat. 38.
[21] Pub. L. No. 112–240, 126 Stat. 2313 (enacted January 2, 2013).
[22] H.R. 1105, 114th Cong. (passed by House, Apr. 16, 2015).

intentions of the current rule makers. For this reason alone the current proposed regulations should be withdrawn.

8. Conclusion

Thank you for taking the time to read these comments on this proposed rulemaking. On behalf of the Family Business Coalition, jointly representing over a million family businesses across the country, I urge you to withdraw the proposed rule changes under Section 2704 of the Internal Revenue Code.

In addition to these comments, I would like to speak at the public hearing on December 1, 2016. I will be speaking on the following topics:

1. How the estate tax affects multi-generational family businesses, jobs, and wages (4 minutes)
2. Valuation discounts and how they fairly value family businesses (3 minutes)
3. Potential harm caused by this proposed regulation (3 minutes)

Sincerely,

Palmer Schoening
Chairman
Family Business Coalition