Texas Society of
CPA Certified Public Accountants

Emailed to: Notice.Comments@irscounsel.treas.gov

November 2, 2016

The Honorable Jacob J. Lew
Secretary of the Treasury
CC:PA:LPD:PR (REG-163113-02)
Room 5203
Internal Revenue Service
POB 7604, Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Section 2704 Regulations Concerning Estate, Gift and Generation-skipping Transfer Taxes; Restrictions on Liquidation of an Interest

Dear Treasury Secretary Lew:

The Texas Society of Certified Public Accountants (TSCPA) is a nonprofit, voluntary professional organization representing more than 25,000 members. One of the expressed goals of the TSCPA is to speak on behalf of its members when such action is in the best interest of its constituency and serves the cause of CPAs in Texas, as well as the public interest. TSCPA has established the Federal Tax Policy Committee to represent those interests on tax-related matters. TSCPA has also established the Business Valuations, Forensic and Litigation Services Committee. These committees have been authorized by TSCPA's Board of Directors to submit comments on such matters of interest to committee membership. The views expressed herein have not been approved by the Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policies of the TSCPA.

We appreciate the opportunity to issue comments with respect to REG-163113-02 published Aug. 4, 2016. We wish to raise several issues regarding these proposed regulations under Internal Revenue Code Section 2704 that would dramatically restrict, if not eliminate, valuation discounts on intra-family transfers of certain family-owned entity interests. For decades, Texas families have followed the law and taken legitimate valuation discounts to help preserve family ranches, farms, oil and mineral interests, and other businesses. In many cases, these properties have remained in the family for generations and are part of our rich Texas history and heritage. We question whether the Treasury Department has authority to propose these regulations in their current form, and we believe the proposed regulations are inconsistent with long-standing case law and economic reality. We provide specific examples of potentially unintended adverse effects of the proposed regulations and propose some improvements and clarifications.

Treasury's Authority to Issue the Regulations

The broad proposed regulations Treasury has issued conflict with a large body of existing case law and interfere with states' rights and rights of property owners. When Congress enacted Section 2704 in 1990, it offered restrictions on the regulatory authority granted and provided for exceptions taxpayers have appropriately applied to reduce valuations. These valuation adjustments have been

approved by case law, much of which originated in Texas and the Fifth Circuit. Section 2704(b)(4) provides that:

> "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.*" (emphasis added)

To the extent the proposed regulations add disregarded restrictions that create assumed "put" rights,[1] mandate the use of minimum value, assume cash redemptions within six months and ignore certain unrelated parties unless their percentage ownership exceeds a given percentage, they are creating a fiction rather than disregarding existing restrictions as authorized under Section 2704(b)(4). Moreover, these valuation adjustments ignore economic realities. The Internal Revenue Service has repeatedly championed legislation to overturn this long-standing body of case law, but Congress has declined to enact additional restrictions. In the absence of legislation, Treasury should not promulgate regulations conflicting with well-established case law. The Tax Court's opinion in *Pierre v. Commissioner*, 133 T.C. 24, (2009) stated:

> "In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner's transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC."

In general, state law, not federal tax law, determines the nature of a taxpayer's interest in property and the property owner's legal rights. This has been particularly true with respect to estate and gift taxes. The proposed regulations disregard states' rights and those of property owners; if Treasury can just rewrite the law, it would create a situation that could undermine taxpayer confidence in estate planning and in the fairness of tax administration in general.

Three-Year Rule

The final regulations should clarify that the effective date of the regulations is not earlier than when the regulations are made final. The final regulations should "grandfather" transactions that have taken place with a good-faith reliance on then-existing law. To apply the new final regulations to past transactions, such as application of the new three-year rule to transactions that were in place before the three-year rule became effective, at minimum would be unfair. Section 2035 provides for a three-year rule where the value of the asset would have been included in the decedent's gross estate under Section 2036, 2037, 2038 or 2042. We believe the statutory authority granted under Section 2704 to issue regulations provides authority to disregard certain restrictions, but does not grant authority to add provisions that do not in fact exist, such as the expansion of the three-year rule provided for in Section 2035. We understand Treasury's desire to have a bright-line test for the

[1] The right to cash in his or her interest on demand and be paid out in a relatively short period (with exceptions).

application of Section 2704(a), but case law has provided a "facts and circumstances" test.[2] Case law has also recognized the impact of ownership by unrelated parties based on facts and circumstances without the imposition of a three-year ownership requirement.[3] Moreover, to the extent that the proposed regulations attempt to restrict the discount applicable by reason of state community property laws, they exceed the authority supplied by Section 2704 to disregard discounts created by "restriction;" clearly Congress did not intend to disregard a situation created by operation of state law.

Economic Reality

The proposed regulations ignore the economic reality of discounts for minority interests, lack of control, lack of marketability and other valuation concepts that legitimately reduce the value of an asset. The courts have long respected and accepted these discounts as reflecting economic reality. The proposed regulations discard concepts of fair market value and a willing buyer and seller, and disregard restrictions that have true economic meaning in terms of valuation. It seems particularly unfair to force the sale of a family business because legitimate discounts in value are disregarded.

There is true economic reduction in value where a person has a non-controlling interest in an illiquid asset, such as an operating business. Economic realities and not tax fictions dictate that minority interests often cannot be sold without a discount that, depending on the circumstances, can be substantial. An owner of an interest in a family-limited partnership that holds, for example, royalty interests, a ranch operation, private equity investments and other such assets does not hold an undivided interest in the underlying assets. Often a family-limited partnership is used for real economic purposes and generational planning rather than merely estate and gift tax valuations, such as protecting the family's interest from an individual member's imprudence or disagreements with other family members; providing creditor protection; providing unity of management overall rather than having separate owners each having to agree on day-to-day business decisions; preventing minority interest holders from interfering with management; or keeping the property together and in the hands of the family or at least susceptible for sale at a fair value rather than at the values that would be imposed by the marketplace on a property with fragmented ownership interests. The transferred asset is the partnership interest with all its restrictions, not the underlying property. Indeed, a frequent concern is the adverse effect of the disconnect of inside and outside basis, and particularly the impact of high income tax rates on disposition of that low-basis property.

The proposed regulations ignore genuine relationships among family members who often have divergent interests in timing of cash needs, varying levels of passion for the business itself and so forth. This is particularly true for those family members who are more remote under the broad attribution rules used. Families frequently may not get along well, particularly more distant generations' members—with some family members suing others in an effort to get their money out of the business or having to accept a buyout at a substantial discount. The value of the business entity is truly less when there is discord in the family as to whether to keep the property together. As a result, contentious estate and probate litigation has become increasingly common, particularly in recent years. Frequently, even family members cannot generally buy out another family member's interest for their percentage share of the value of the underlying assets. We anticipate that requiring a highest and best-use valuation based on the value of the underlying assets will result in forced

---

[2] See, e.g., *Estate of Murphy v. Commissioner*, T.C. Memo.1990-472.

[3] See *Kerr v. Commissioner*, 292 F.3d 490, 494 (5th Cir.2002).

sales of family businesses and farms to pay estate taxes, causing subdivisions and shopping centers to replace our open space and deplete our Texas heritage.

Section 2704(a) provides that a lapse of liquidation or voting rights, where members of the family hold control both before and after the lapse, will result in a gift or inclusion in gross estate. The existing regulations under Section 25.2704-1(c)(2) provide for exceptions where the holder, the holder's estate and members of the holder's family cannot immediately liquidate the interest the holder could have liquidated prior to the lapse; where necessary to prevent double taxation; or if the lapse of the liquidation right that results solely from a change in state law. The proposed regulations limit or eliminate these exceptions by requiring the inclusion of the value of the lapsed liquidation right in gross estate where death occurs within three years of the transfer. This results in the inclusion in gross estate of a phantom value which could result in a valuation of the interest in excess of what the valuation would have been without any valuation discounts. This phantom value cannot be offset by a marital or charitable deduction.[4] We understand Treasury's concern about a transfer in contemplation of death by a terminally ill or elderly transferor, but it is not appropriate in circumstances where there is an unanticipated death. If the three-year rule is retained in the final regulations, there should be an exception for accidental or other unanticipated deaths.

Section 2704(b) provides that certain restrictions on liquidation be disregarded in determining the value of a transferred interest where there is a transfer of an interest to a family member, and the transferor and members of the transferor's family hold control immediately before the transfer. There are exceptions for commercially reasonable restrictions that arise as a part of third-party financing or restrictions imposed by federal or state law. The proposed regulations add disregarded restrictions. These disregarded restrictions may result in the elimination of a valuation discount. While we understand the objective of preventing abuse, the additional disregarded restrictions are overreaching and extend well beyond abusive situations.[5] Ignoring the reality of the lack of control of a partnership interest is an attack on the business purpose of family asset-holding entities. Creating a hypothetical world for families that are expected to work together is not a real-world assumption. Families are often in court disputing family business issues. These restrictions assume conditions contradictory to the real world and eliminate facts that determine a fair market value for an ownership interest.

The Fifth Circuit Court of Appeals dismissed the IRS' position that families will always work in concert and always agree on business and financial matters.[6] This caused the IRS to issue Revenue Ruling 93-12, which makes clear that discounts for lack of control cannot be denied simply because the interests are passed from one family member to another. Citing the *Bright* case and Revenue Ruling 93-12, numerous tax court cases and opinions of federal courts of appeal affirm that "fair market value" is the one and only definition of value for federal estate and gift tax purposes. The proposed regulations conflict with established precedent when the business is controlled by the family. Most partnership agreements contain standard language providing that members cannot liquidate their interests unless it is approved by all partners. The proposed regulations would not recognize an appropriate discount in spite of the fact that the partnership may not be liquidated for many years.

---

[4] See previous subhead Three-Year Rule for our view that Treasury does not have the authority to add this bright-line test.

[5] See previous subhead Treasury's Authority to Issue the Regulations.

[6] See *Estate of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981).

The proposed regulations define a controlling interest as family-owned interests of 50 percent or more or any family ownership of an interest such as a general partner that can cause the liquidation of the entity. A 50 percent interest is super minority interest that cannot do anything without the unity and approval of the other 50 percent interest. As a result, a 50 percent interest does not have the prerogatives of control for a controlling interest. The definition of control of 50 percent or more disregard the fact that interests less than a super majority do not have the full operational control such as making major decisions in the business.

Income Tax Basis

One commentator has expressed concern that the valuation methodology under the proposed Section 2704 regulations may not be the same valuation methodology used for Section 1014(f). Steve Akers, a noted commentator, has written:

> "Section 2704 applies only 'for purposes of this subtitle' [i.e., Subtitle B-Estate and Gift Taxes] and the basis consistency provisions in §1014(f) state that the fair market value (for purposes of the basis adjustment under §1014(a)) 'shall not exceed' the finally determined estate tax value. The IRS might argue that the fair market value that applies for basis purposes is not augmented as a result of ignoring certain liquidation restrictions under §2704."[7]

The final regulations should make it clear that if an asset is valued for estate and gift tax purposes under Section 2704, the basis for the beneficiary or gift recipient should be the same for income tax purposes under Section 1014(f).

Minimum Value

The proposed regulations replace the traditional fair market value definition with a new and previously unknown definition of value: minimum value. Revenue Ruling 59-60 sets forth the fair market value definition, approaches, methods and factors to consider in ascertaining an entity's value. This ruling defines fair market value as the price at which a hypothetical willing buyer and seller at arm's length would agree to buy/sell an interest in the entity. Considering the realities of the marketplace, the fair market value of a minority interest is not worth as much as that interest's pro-rata share of the whole entity. Minority interests do not enjoy control or marketability. Ignoring the true fair market value of these property interests could result in effective estate tax rates well in excess of the statutory 40 percent rate up to the complete government confiscation of the entire interest being transferred.

The proposed regulations advance a new valuation theory for valuing intra-family estate and gift transfers. The proposed regulations do not clearly state how this new standard is to be applied; applying the proposed regulations appears to substantially reduce or altogether disregard valuation discounts. This ignores the precedent of decades of court cases, appraisal education, and experience, academic research and economic realities.

---

[7] Steve R. Akers, "Section 2704 Proposed Regulations Impose Far-Reaching Limitations on Valuation Discounts for Transfers of Interests in Family-Controlled Entities" (August 2016) Bessemer Trust.

Put Right

The proposed regulations provide an unrealistic put right to every interest holder. The assumption that each member of the family or entity would have unlimited put rights to the entity is a fictional assumption that contradicts reality. It would not be negotiated in an arm's length transaction. This assumption is an impossible scenario in the real world that conflicts with the business purposes of family entities. Business owners may decide to sell or liquidate the business rather than continue as a family-owned entity going concern. The last outcome is highly destructive, especially of smaller businesses.

We ask that Treasury withdraw or significantly revise the proposed regulations to prevent harsh effects that are contrary to a long-standing body of existing case law.

We appreciate this opportunity to present our comments. We would be happy to discuss this further with you. Please contact me at 972-419-8383 or kmh@gpm-law.com if you would like to discuss our comments.

Sincerely,

Kenneth M. Horwitz, JD, LLM, CPA
Chair, Federal Tax Policy Committee
Texas Society of Certified Public Accountants

Baria Jaroudi, CPA, ABV, CBA, CVA
Chair, Business Valuations, Forensic and
Litigation Services Committee
Texas Society of Certified Public Accountants

Principal responsibility for drafting these comments was exercised by Kenneth M. Horwitz, JD, LLM, CPA; Christina A. Mondrik, JD, CPA; Carol Warley, JD, CPA; and Baria Jaroudi, CPA, ABV, CBA, CVA.

cc: The Honorable John A. Koskinen, Commissioner, Internal Revenue Service
The Honorable Mark J. Mazur, Assistant Treasury Secretary for Tax Policy
John D. MacEachen, Office of the Associate Chief Counsel (Passthroughs & Special Industries)
Nina E. Olson, National Taxpayer Advocate
Texas Members of U.S. Congress