October 31, 2016

Mr. John Koskinen
Commissioner, Internal Revenue Service
1099 14th St. NW, Suite 4200w
Washington, DC 20005

RE: Estate, Gift, and Generation-skipping Transfer Taxes: Restrictions of Liquidation of an Interest (RIN 1545-BB71)

Commissioner Koskinen:

On behalf of our over 7,000 members, the American Society of Appraisers (ASA)[1] and the American Society of Farm Managers and Rural Appraisers (ASFMRA)[2] are pleased to provide our views in connection with the above captioned proposal. As written – and based on the interpretation of our members – the proposal would significantly alter the way that business interests that pass via estate, gift, or generation-skipping transfer would be valued where the interest is passed from one family member to another. More specifically, the proposal would virtually eliminate the use of valuation discounts from all but a sliver of transactions, leading to artificially inflated taxable values on the interest.

Such an outcome runs counter to existing Tax Court rulings, IRS Revenue Ruling decisions, established valuation theory and practice, and the economic reality under which many of these transfers occur. For these reasons – discussed in detail below – ASA opposes the Service's proposal and would strongly urge the Service to withdraw its proposal, or consider issuing a further notice of proposed rulemaking to afford stakeholders an opportunity to review and comment on any changes to the proposal before they are finalized

DISCUSSION

1. The Service's proposal is contrary to accepted, well developed valuation theory and practice.

   Underpinning much of our concern is the perception of what valuation discounts are – and more specifically, what they are not. Discounts are not, as some would contend, a means for certain taxpayers to avoid paying taxes that would otherwise be owed on a business interest that was passed as a gift or through an estate to a family member. Instead, it might be more helpful for the Service and others to think of discounts as adjustments to account for specific economic conditions, used to take a value developed using available public company data to ensure the final value reflects what that interest is worth in private markets.

   These adjustments are often applied in two common circumstances: One, where the interest does not have control over the business; and the other, where the interest cannot be readily sold or liquidated due to restrictions imposed on the interest. In situations where an interest is impacted by one of these factors, it is economically reasonable to conclude that a hypothetical buyer would not be willing to pay as much for the interest. Because of this, appraisers must adjust the value to reach a final conclusion, which can then be relied upon to determine the tax liability incurred in the transfer.

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[1] The American Society of Appraisers (ASA) began in 1939 as a multidisciplinary professional appraisal organization to teach, test, and credential individual professional appraisers – including business valuation professionals.
[2] Founded in 1929, the American Society of Farm Managers and Rural Appraisers® (ASFMRA®) is the largest professional Society for rural property experts in the United States. Members of ASFMRA provide management, consultation and valuation services, as well as real estate services, on rural and agricultural assets.

This is also essential because the values developed by the appraiser rely often on data collected from publically traded company activity. While this data provides a reliable, readily available source of transactional information, it is nevertheless coming from a market where interests are generally salable and where many transactions involve the purchase of a controlling interest. Without the use of discounts as an adjustment for these realities, there would be no clear distinction between interests that change hands in public or private markets. Appraisers must use their expertise to determine where the use of an adjustment is required, and to what degree the adjustment must be made. Absent a clear and compelling rationale for such a marked departure from decades of established valuation practice, we cannot understand why the Service would compel valuation practitioners to ignore the economic realities which require the use of discounts.

2. The Service's proposal appears to reintroduce "family attribution" to valuation – a concept that had been roundly discarded.

Prior to 1981 the Service had required that any business interest held by a family member, where another family member was in control of the business, had to be valued as though that interest (no matter the size) also had control. This idea, called "family attribution", works off the assumption that families will always agree when it comes to issues involving business or monetary decisions and that all family members share a common interest in the direction of the business.

As discussed in *Estate of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981), an *en banc* Fifth Circuit rejected this notion, saying the court "reject[s] the heart of the government's arguments", while also pointing out that "as early as 1940, the Tax Court has uniformly valued a decedent's stock for estate tax purposes as a minority interest when the decedent himself owned less than 50%, and despite the fact that control of the corporation was within the decedent's family." Under the current proposal, the Service would effort to do by regulatory fiat that which clear legal precedent says cannot be done and impose a family attribution regime. Moreover, the Service itself acceded this argument in Revenue Ruling 93-12, where it stated that discounts for lack of control cannot be denied simply because the interests are passed from one family member to another.

Even without these two critical decisions, one does not have to think long to understand why the Service's position that families will work in concert at all times is deeply flawed. Many bitter familial disagreements stem from the exact kinds of decisions the Service considers here to be easy and uniform. Indeed, family businesses – like all well-run businesses – create partnership agreements that dictate how such disagreements will be handled preemptively, assuming at formation that these disagreements are inherent to any business, let alone ones helmed by family members. As a final point, it seems that there is little precision to what constitutes a family member for the purposes of this proposal. Without clear contours, one can imagine in our current society many families that would not be covered by this proposal, and others that would be. Such disparate treatment appears on its face to disadvantage certain business owners over others in the same class.

3. The proposal violates the seminal Revenue Ruling 59-60, and its definition of Fair Market Value.

For more than half a century, taxpayers, the Service, and the Tax Court have operated under a well-defined and well-understand standard of value – Fair Market Value. One of the key principles of fair market value is that the buyer and the seller are deemed to be hypothetical (i.e., unidentified) parties. In contrast, the proposed regulations will force appraisers to assume a cordial and cooperative family relationship -- one which may not exist.

Revenue Ruling 59-60 has been the basis for Fair Market Value since 1959, and the proposal would change that basis for family-owned businesses. Consequently, this will result in the same asset having different value to different parties depending on the noneconomic factors. This violates the financial and economic principle of "no arbitrage" (single price rule) — that an asset has the same value to all parties (or, that an asset's value is a function of its expected cash flows rather than who owns the asset). This proposed regulation essentially introduces the concept of "investment value" into tax valuation, and abandons the very cornerstone of business valuation for tax purposes.

4. The proposal describes the liquidation of an interest, while Fair Market Value contemplates a sale.

The biggest challenge we see to the understanding and interpretation of the proposal is the use of the term "Fair Market Value." This definition of value is intended to represent the value that arises in a sale transaction in a free and open market between two unrelated parties whose only motivation is financial gain. For Fair Market Value purposes, every transfer is viewed in the context of a hypothetical sale transaction. The wording of the proposal makes it is clear that the transfer is viewed from the standpoint of a liquidation. In fact, the proposal uses the term "liquidate" or "liquidation" over 120 times and the terms "sell" or sale" only four times.

In a transfer for gift or estate tax purposes, the proposal would instruct us to ignore the restrictive provisions of the partnership agreement that prohibit a limited partner from withdrawing. Under the law of some states (e.g., Delaware and Texas), the limited partner may withdraw only if the partnership agreement specifically permits withdrawal. Under the proposal, this would be a "disregarded restriction" and is ignored. By ignoring both the partnership agreement and state law, the proposal would have us view the limited partnership interest (the subject of the valuation) as possessing withdrawal rights. The business laws of some (and perhaps many) states hold that, on withdrawal, a limited partner is entitled to receive "Fair Value." Note the drafters of these provisions did not use Fair Market Value, even though they easily could have. Varying by state, Fair Value is often synonymous with the "Minimum Value" found in the proposed regs. However, this is not always the case. The fair value provision of state law does not appear to be a disregarded restriction and, if so, would now become part of the valuation analysis. In other words, in order to determine Fair Market Value, an appraiser must also determine Fair Value in the state in which the partnership is domiciled. The complexity of the assignment has just increased by an order of magnitude.

Page 12 of the proposal states: "…for purposes of determining control, under the attribution rules of existing §25.2701-6, an individual, the individual's estate, and members of the individual's family are treated as holding interests held indirectly through a corporation, partnership, trust, or other entity." Does the term "control" here relate to a test to determine if a transfer falls under §2704 or is this the generic meaning of control used to determine if a minority interest or lack of control discount applies? If it is the latter, then the proposal seems to be saying that if a person owns any part of the general partnership interests, it is as if that person controls all of the general partnership interest. If this is the case, then it would appear no discount for lack of control would be appropriate.

It is hard to imagine how the concept of a willing buyer can be interposed into the fanciful fact construct suggested by the proposal. Currently, we are able to bridge the factual gap created by the special rules of 2704 which have us ignore applicable restrictions but default to state law. This is because there is a frame of reference for the state mandated restriction and, from market evidence and valuation and finance theory we can assess the magnitude of the hypothetical investor's risk and the valuation adjustment required.

A partnership interest being transferred is viewed as the "willing seller" in the Fair Market Value equation. According to the proposal, the willing seller is part of the control group and thus has the ability to liquidate his or her interest. The willing buyer, on the other hand, is not part of the control group and would be acquiring an illiquid, minority interest. There is no way to bridge this economic gap. Either the buyer pays too high a price or the seller accepts too low of a price. No transaction would occur.

This takes us back to the term "liquidation", which is what the proposal implies is happening when a member of the control group transfers an interest. When liquidations occur they are usually auctions or surrenders of property for a pre-set price. Fair Market Value assumes a negotiated transaction occurring in a marketplace. Thus, while value for estate or gift tax purposes is supposed to be governed by Fair Market Value, the proposal changes the structure of the transfer such that even an altered definition of Fair Market Value is no longer possible.

Since we cannot assume even hypothetically a willing buyer, the only remaining party to the liquidation is the partnership. What we are now contemplating is the value at which the partnership might redeem the interest being transferred. Thus, another central tenet of the Fair Market Value definition is violated—the "willing buyer" is not the unrelated, hypothetical, third party the definition requires but is the family of the "willing seller".

The proposal, by reinstituting family attribution, assumes the partners act in concert and that they, in effect, are one person. How then can a withdrawing partner negotiate with the partnership over the value of the interest since he or she is an indistinguishable part of the partnership? One cannot negotiate with one's self. There is either family attribution of there is not.

5. The Service, in its proposal, elects to ignore numerous otherwise reasonable marketability restrictions – including those imposed as a matter of state law.

The proposal ignores the fact that many restrictions on closely held stock have valid business reasons—even among and between family members. These restrictions may be imposed to keep capital from leaving during early stage periods, to provide for stable ownership and leadership structures over a period of years, or simply to avoid interest holders "cashing out" at inopportune moments. The regulations do not address certain situations, and may cause a block of stock to have a higher value for tax purposes than the block could achieve in an arm's length transaction because these restrictions would be entirely ignored.

Numerous studies, including studies by the Securities and Exchange Commission of restricted stock discounts, illustrate that investors pay less for an investment when they do not control it or it is illiquid. This proposal ignores economic reality. The Service proposes—by regulatory fiat—to overturn both existing private party contractual agreements and various state laws by ignoring the marketability restrictions placed on interests when valuing them for taxation purposes.

6. While the Service may have legitimate concerns relating to the abuse of discounts with some corporate structures, the proposal's construction and breadth will lead to widespread confusion and go well beyond the perceived problems the Service wishes to address here.

While there may be abuses of discounts, particularly in connection with the valuation of interests in asset holding family limited partnerships, this proposal throws the kitchen sink at the problem. This will result in capturing scores of otherwise legitimate, productive businesses in a goal to head off a (likely small) amount of abuse. The Service can, and should, develop a more tailored response to its concerns, and ASA and ASFMRA stand ready to provide our valuation expertise to assist in such an effort.

The proposed regulations are unnecessarily complicated rules that will require complex legal analyses of otherwise simple economic issues. Since the new rules circumvent and invalidate a long history of case precedent and Revenue Rulings, this will cause uncertainty and confusion in the appraisal of businesses and business interests. When written, IRC 2704 was meant to cover partnership and corporations, but this proposal would extend coverage to all business relationships. The proposal is vaguely written and could be applied to numerous situations, including trusts and joint venture agreements. This could be expanded to include real estate and other investments, causing confusion for how to value tenant-in-common and partial interests in real estate and mineral interests. The proposal introduces new terms, such as minimum value, which are not defined and not reflective of economic reality.

7. The practical impacts of this proposal would be destructive to family-owned businesses.

Taken on its face, the proposal's effects on family owned businesses who wish to transfer interests via gift or estate will be devastating. A short list of these impacts includes the following:

a. The proposal would create a two-tiered tax system where owners of family businesses would pay transfer taxes at a far higher rate than the owners of non-family businesses. The Service has failed to provide any compelling reason why family owned businesses should be disadvantaged in this way, and the proposal would have a chilling effect on the formation or continuation of family owned businesses.
b. The change would impose a tax increase on the transfer of family-owned business interests. With 62% of the jobs in the US are created by family-owned businesses, this would decrease economic growth, reduce job growth, and hinder capital investment as profits are not reinvested into the business, but instead diverted to pay an artificially inflated tax bill.
c. Business continuity for the transfer of ownership to future generations would be threatened. Instead of using sound, tested planning mechanisms to ensure orderly transitions from generation to generation,

family owned businesses may instead be forced to pursue more exotic or risky means of transferring interests from one generation to the next.

While legal and tax professionals can provide additional detailed examples of just what impact this proposal would have, it is safe to assume that even in best case scenarios the diversion of capital from reinvestment to payment of tax bills will slow the growth of otherwise healthy businesses. And in the worst case scenarios, businesses may be forced to take on more debt to pay these bills, or decide to sell to a third party or liquidate outright rather than continue on as a family-owned business.

For all of the foregoing reasons, ASA and ASFMRA oppose the Service's proposal, and would strongly urge that the Service withdraw its proposal and work with ASA, ASFMRA, and other stakeholder groups to address specific issues the Service may have with valuation issues. Should the Service prefer, providing stakeholders an opportunity to provide feedback on changes to this proposal through a further notice of proposed rulemaking would allow for a similar dialogue to occur. If you have questions regarding our views, or wish to discuss them further, please contact John D. Russell, JD, Senior Director of Government Relations and Chief Lobbyist for ASA at jrussell@appraisers.org, or by phone at 703-733-2103.

Sincerely,
American Society of Appraisers
American Society of Farm Managers and Rural Appraisers