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The American College of Trust and Estate Counsel

Please Address Reply to:

Executive Director
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Internal Revenue Service
CC:PA:LPD:PR (Notice 2017-38)
Room 5205
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Via Email (Notice.Comments@irscounsel.treas.gov)

Comments in Response to Notice 2017-38

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel ("ACTEC") is pleased to comment, in response to Notice 2017-38, 2017-30 I.R.B. 147, on the regulatory burdens and complexity that are, and would be, imposed by Proposed Regulations under section 2704.

ACTEC is a professional organization of approximately 2,600 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift, and generation-skipping transfer tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

Executive Order 13789 of April 21, 2017, directed the identification of tax regulations issued on or after January 1, 2016, that (i) impose an undue financial burden on United States taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the Internal Revenue Service, and the recommendation of specific actions to mitigate the burdens identified.

Notice 2017-38 identified eight regulations that meet at least one of the first two criteria specified by the Executive Order and requested comments on whether those regulations should be rescinded or modified and, in the latter case, how they should be modified in order to reduce burdens and complexity. This letter addresses the fourth of those eight regulations, described in the Notice as "Proposed Regulations under Section 2704 on Restrictions on Liquidation of an Interest for Estate, Gift and Generation-Skipping Transfer Taxes (REG-163113-02; 81 F.R. 51413)" ("the Proposed Regulations").

The Notice said the following about the Proposed Regulations:

> Section 2704(b) of the Internal Revenue Code provides that certain non-commercial restrictions on the ability to dispose of or liquidate family-controlled entities should be disregarded in determining the fair market value of an interest in that entity for estate and gift tax purposes. These proposed regulations would create an additional category of restrictions that also would be disregarded in assessing the fair market value of an interest. Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens. Commenters were also concerned that the proposed regulations would make valuations more difficult and that the proposed narrowing of existing regulatory exceptions was arbitrary and capricious.

ACTEC submitted Comments on the Proposed Regulations dated October 27, 2016 ("ACTEC's Comments on Proposed Regulations Under Section 2704"), and representatives of ACTEC participated in the public hearing on December 1, 2016. Those Comments identified and discussed many burdens that would be imposed by the Proposed Regulations. ACTEC reaffirms all of the analysis and recommendations in those Comments. The following is a summary of some of the most serious and avoidable burdens that the Proposed Regulations impose, selected and analyzed in the context of Executive Order 13789 and Notice 2017-38 and in light of the December 1 hearing and other developments. **ACTEC concludes that these burdens are so severe, and the fundamental problems with the Proposed Regulations have proven to be so intractable, that the only feasible remedy is to withdraw the**

Proposed Regulations without further delay, with the possibility of re-proposing them for further public comment when they can be redrafted with the substantial modifications and clarifications they need.

1. STANDARD OF VALUE

(See Part 15 on pages 20-23 of ACTEC's Comments.)

Issue. The Proposed Regulations prescribe a set of "disregarded restrictions" that may not be taken into account in determining the value of an interest in an entity when that interest is transferred to or for the benefit of a member of the transferor's family. A disregarded restriction is defined to include a restriction that can be removed by any member of the transferor's family and that limits the transferee's ability to compel the entity to redeem the interest. The Proposed Regulations treat as a disregarded restriction a limitation on the amount the transferee may receive on liquidation or redemption of the interest to less than the interest's share of the net value of the entity, which the Proposed Regulations refer to as "minimum value."

For more than 50 years the Treasury Regulations have valued property for estate and gift tax purposes at its fair market value, defined as "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." Reg. §20.2031-1(b); *see* Reg. §25.2512-1. The introduction of the "minimum value" concept has suggested to many that the Proposed Regulations would create a new standard of value to replace this long-standing willing-buyer-willing-seller standard, and would value interests in family-owned entities for estate, gift, or generation-skipping transfer tax purposes as if the transferee had a put right at the interest's share of the net value of the entity. That new standard has sometimes been described as creating a "deemed put right."

The statutory authority for the new proposed disregarded restrictions is section 2704(b)(4) of the Internal Revenue Code, which states:

> 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.

A valuation standard that requires the value of an interest to be determined as if there were no restrictions on the transferee's ability to redeem the transferred interest at its minimum value when those restrictions actually exist would require disregarding a restriction even if that restriction *does* "ultimately reduce the value of such interest to the transferee." A regulation imposing such a requirement would clearly exceed the statutory authority of section 2704(b)(4). Not only would that offend the third criterion in Executive Order 13789, but it would make it impossible to expect reasonable compliance and would provoke endless litigation that might prove to be the greatest burden of all.

In public comments and at the December 1 hearing, representatives of the appraisal community made the point, as acknowledged in Notice 2017-38, that the Proposed Regulations would make valuations more difficult, if not impossible. The Government representatives at the December 1 hearing offered reassurances that no deemed put right was intended. But, as drafted, the Proposed Regulations created that concern, and those reassurances did not discuss any alternative construction of the Proposed Regulations that would allay that concern.

Meanwhile, although the Proposed Regulations are not in effect, their continued existence even in proposed form has created an unnecessary compliance burden for taxpayers and tax return preparers. Under Reg. §301.6501(c)-1(f)(2)(v), to obtain assurance that the filing of a gift tax return will start the statute of limitations running on assessment of gift tax with respect to gifts reported on that return, taxpayers are obliged to include with the return a statement that describes any position taken that is contrary to any proposed regulations published at the time of the transfer. Therefore, because of the observed impossibility to understand what the Proposed Regulations mean, almost every gift tax return reporting a gift or other transfer of a non-controlling interest in a family-controlled entity to a family member made after August 2, 2016, will need to contain this statement, even though the Proposed Regulations are not, and may never be, in effect.

Modification Needed. Because even in proposed form the Proposed Regulations have, since August 2, 2016, imposed a widespread burden of uncertainty and concern, as well as the very real burden of additional, otherwise meaningless, statements on gift tax returns, ACTEC sees no alternative but to recommend that the Proposed Regulations be withdrawn without delay.

Going forward, any re-proposed regulations (and not just the Preamble) should explicitly repudiate the "deemed put right" interpretation and "minimum value" as a new standard of transfer tax value. Ideally, the confusing term "minimum value" would be abandoned altogether and replaced with a term that clearly reveals its hypothetical nature and its specific use solely to identify a "disregarded restriction." In addition, such regulations should provide guidance as to what impact disregarding the restriction would have on the valuation of an interest in an entity, and that guidance should be consistent with the mandate of section 2704(b)(4) that a restriction should be disregarded only if it does not ultimately reduce the value of the interest in the hands of the transferee.

2. IGNORING NONFAMILY MEMBERS

(See Part 22 on pages 31-34 of ACTEC's Comments.)

Issue. As noted in the previous section, the Proposed Regulations ostensibly limit "disregarded restrictions" to restrictions that can be removed by the transferor's family. Such a limitation is necessary to ensure that the disregarded restriction "does not ultimately reduce the value of such interest to the [family member] transferee" within the meaning of the statutory authority in section 2704(b)(4). But, astonishingly, the Proposed Regulations require that nearly all bona fide interests held by nonfamily members be ignored in making this determination. The Preamble to the Proposed Regulations states that this feature is aimed at tax-avoidance techniques that rely on nominal interests held by nonfamily members. While that objective is understandable, the Proposed Regulations would ignore even very substantial nonfamily interests that have not been held for three years or more and would ignore even substantial interests held for three years or more unless *all* of the nonfamily members who own interests in the entity have a unilateral right of redemption (or put right) entitling them to redeem their interests for those interests' shares of the net value of the entity.

To avoid the harsh application of the Proposed Regulations in settings where there is no reason for them to apply, a transferor, for example, would have to wait three years after forming an entity or welcoming nonfamily owners to the entity before transferring interests to members of the transferor's family. ACTEC views that restraint on transfer as an undue burden on the involvement of family members, especially younger-generation family members, in the stewardship and benefits of the family wealth. Moreover, the entity would have to give all of its nonfamily owners a redemption right that could favor nonfamily owners over the family that nurtured that wealth and created that entity, which ACTEC also regards as an undue burden on that family.

The combination of features the Proposed Regulations would require in a nonfamily owner's interest before respecting that interest is totally unrealistic. It is simply not found in the real world of either family-owned or widely-held entities. Thus, the Proposed Regulations create an impression of a lack of understanding that has aggravated the public exasperation with the Proposed Regulations. By ignoring all or nearly all nonfamily owners, the Proposed Regulations ignore the important limitation of the statutory authority to restrictions that do not reduce the value of interests to the transferor's family.

<u>Modifications Needed</u>. The treatment of interests held by nonfamily members should be tailored to the presumed target of the rules, should make practical real-world sense, and should fit within the limits of the statutory authority.

3. APPLICATION TO FAMILY-OWNED OPERATING BUSINESSES
(See Part 20 on pages 30-31 of ACTEC's Comments.)

<u>Issue</u>. By far the most intense public reaction to the Proposed Regulations is that they would unduly burden, if not destroy, family-owned operating businesses. That was conspicuous at the December 1 hearing. And the outcry has evidently reached the ears of Congress, where, for example, bills to prevent the finalization of the Proposed

Regulations have been titled the "Protect Family Farms and Businesses Act" (H.R. 6100 and S. 3436 in the 114th Congress and H.R. 308 and S. 47 in the current 115th Congress).

As was evident at the hearing, family businesses have a very significant place in the American economy. They are created and maintained by sacrificial investment and hard work, not merely by the provisions on the printed page of an entity's governing documents that seem to be the target of the Proposed Regulations. As a result, discounts that are commonly encountered in the valuation of interests in businesses may be more likely to reflect real market forces than discounts that reflect restrictions imposed solely for transfer tax purposes. Thus, requiring appraisers to disregard the real market environment would also exceed the statutory authority in section 2704(b)(4).

The Government representatives at the December 1 hearing offered reassurances that the Proposed Regulations are not intended to eliminate all discounts, implying that in fact the market-driven discounts commonly encountered in the case of operating businesses were not the target of the Proposed Regulations, and the Proposed Regulations would, therefore, have little or no effect on operating businesses. Even so, as acknowledged in Notice 2017-38, the Proposed Regulations as drafted created the concern that such common discounts would be eliminated or restricted. If the reassurances offered by the Government representatives are justified and little or no impact on operating businesses is intended or anticipated, then there will be nothing of substance to be lost – and very much calming of public outcry to be gained – by simply making an exception for family-owned operating businesses explicit.

Modification Needed. The regulations (and not just the Preamble) should contain an explicit exception for family-owned entities engaged in one or more active trades or businesses. The definition of such an entity need not be borrowed from existing rules, such as those in section 6166 of the Internal Revenue Code, which have grown up over time in a somewhat unstructured manner. A definition tailored to the context of section 2704 and the public concerns that have been heard might work better.

4. ORIGIN OF THE RESTRICTION

(See Part 18 on page 26 of ACTEC's Comments.)

Issue. As proposed, it appears that the "disregarded restriction" rules would apply to individuals who never had control of an entity and who therefore never had the motive or the occasion to make transfers or take other estate planning action to avoid the tax treatment a controlling interest might otherwise receive. This burden would clearly be unfair, particularly in light of what appears to be the focus of the statutory authority in section 2704(b)(4) on transitory artificial restrictions.

Modification Needed. The application of the regulations should be limited to those individuals who at one time had the power to remove the restrictions and gave up that power as a result of their own transfers or modifications of interests in the family-controlled entity.

5. THREE-YEAR RULE

(See Part 6 on pages 9-12 of ACTEC's Comments.)

Issue. Section 2704(a) treats a loss or lapse of a right to liquidate a family-controlled entity, resulting from a transfer of an interest in the entity, as a deemed gift equal to the resulting loss of value. When the lapse occurs at death, the loss of value is treated as an amount includable in the decedent's gross estate. Current Reg. §25.2704-1(c)(1) provides that a transfer of an interest in a family-controlled entity that results in the loss of the transferor's ability to liquidate the entity is not a taxable lapse for purposes of section 2704(a) if the rights with respect to the transferred interest are not restricted or eliminated.

The Proposed Regulations would deny that exception for transfers occurring within three years before the transferor's death. The desire for a "bright-line" rule to discourage "death-bed planning" is understandable. But this three-year rule would mean that any transferor who complies with all the known rules under section 2704 would still have the unfair burden of anxiety that the rules might retroactively change if the transferor dies within three years, no matter how unexpected that death is or how unrelated the transfer was to the timing of the transferor's death.

Modification Needed. The three-year rule should be abandoned in favor of something like the regulations under section 7520, which is a more appropriate model for a regulatory bright-line test regarding mortality.

6. THIRTY-DAY DISCONTINUITY IN THE PROPOSED EFFECTIVE DATE

(See Part 27 on pages 35-36 of ACTEC's Comments.)

Issue. Various provisions of the Proposed Regulations have two different effective dates, 30 days apart, apparently in an effort to comply with the 30-day delay required by the Administrative Procedure Act (5 U.S.C. §553(d)) in the case of what are considered "substantive" regulations. This would have the effect of requiring transferors and advisors, perhaps for several generations, to assume the burden of determining which category a particular transfer falls into. It could also have the effect of imposing on the Internal Revenue Service the burden of devoting litigation resources to resolve disputes over which of the provisions of the Proposed Regulations are "substantive" for this purpose. And all this is imposed for the sake of just 30 days.

Modification Needed. All provisions of these regulations should have the same effective date, with the 30-day delay included.

THE BROADER CONTEXT

Valuation of assets transferred by gift or at death or in a generation-skipping transfer, whether for transfer tax purposes or for income tax purposes, creates burdensome complexities and uncertainties for taxpayers, tax advisors, the Internal Revenue Service, and courts. Those complexities and uncertainties often encourage audit lotteries, forum shopping, and fact-specific case law. Comprehensive updating and reform of those valuation rules may be needed, and ACTEC would support that effort and would be willing to assist it.

Meanwhile, new regulations under section 2704 could offer an opportunity to provide significant clarity and thus simplification in one area, and thereby could actually *reduce* the burden of compliance and enforcement. But that would require a different focus and different approach than the Proposed Regulations reflect.

In addition, new regulations like this may best align with the objective of avoiding undue financial burdens on taxpayers if they could be truly holistic and explicitly be the exclusive source of remedies for the abuses and other problems they are intended to address. If the regulations could truly achieve fairness in valuing non-controlling interests in family-controlled entities, then they might, for example, include a prohibition on novel, aggressive, or controversial invocations of other Code provisions such as section 2036 in addressing the Internal Revenue Service's compliance concerns within the scope of those regulations.

CONCLUSION

As the public reaction has shown, it has been simply impossible to understand the Proposed Regulations, to understand what motivated them, to understand what they were aimed at, and to understand what effect they are meant to have. ACTEC believes that those fundamental failures cannot be appropriately addressed by mere revisions in the final version of the regulations.

Moreover, even in proposed form the Proposed Regulations have imposed widespread burdens of uncertainty, concern, and exasperation, and burdens in the preparation of gift tax returns. ACTEC believes that those burdens can be relieved only by the prompt withdrawal of the Proposed Regulations.

ACTEC therefore recommends that the Proposed Regulations be withdrawn without further delay. If and when they can be redrafted in a form that corrects their fundamental failures and makes the modifications proposed in ACTEC's Comments and this letter, they can be re-proposed for public comment.

The principal draftsman of these comments was Ronald D. Aucutt. Substantial contributions were made by Carlyn S. McCaffrey. If you would like to discuss the recommendations in ACTEC's Comments and in this letter, please contact Beth Kaufman, chair of ACTEC's Washington Affairs Committee, at (202) 862-5062 or by email at bkaufman@capdale.com, or Daniel H. Markstein, III, who chaired the task force that prepared this letter, at (205) 254-1043 or by email at dmarkstein@maynardcooper.com.

Respectfully submitted,

Susan T. House, President