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The Real Estate Roundtable

November 1, 2016

The Honorable Mark J. Mazur
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William J. Wilkins
Chief Counsel, Internal Revenue Service
U.S. Department of the Treasury
1111 Constitution Ave., NW
Washington, DC 20224

RE: <u>REG-163113-02 – Comments on Proposed Regulations for Restrictions on Liquidation of an Interest</u>

Dear Assistant Secretary Mazur and Chief Counsel Wilkins:

On behalf of the members of The Real Estate Roundtable, I write to express deep concerns with the Treasury Department's and Internal Revenue Service's Proposed Regulations regarding the valuation of interests in family-controlled businesses for estate, gift, and generation-skipping tax purposes.

At a time when the economy is fragile and job creation is a top priority of the Administration, the Proposed Regulations are a step in the wrong direction—neither helpful nor appropriate. The rules would prevent family businesses from successfully transitioning from one generation to the next. Artificially imposing higher valuations for restricted interests will create a tax burden that threatens the viability and continuity of the family-owned business. In short, the Proposed Regulations are counter-intuitive to the job-creating policies the country needs.

Family businesses, including family-owned real estate businesses, are a driving force supporting job creation, economic growth, and thereby strong communities in the United States. According to the best data available, which comes from the U.S. Census Bureau, there were 5.33 million family-owned businesses in the United States in 2012, including more than one million family-owned real estate and construction companies.[1] Family-owned businesses represent over 29 percent of all U.S. businesses with paid employees, and those family-owned businesses employed nearly 22 million workers with a total payroll in excess of $784 billion.

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[1] U.S. Census Bureau, *2012 Survey of Business Owners* (Sept. 2015), *available at:* http://census.gov/data/developers/data-sets/business-owners.html (here, a family-owned business is one in which two or more members of one family—spouses, parents/guardians, children, siblings, or other close relatives—own the majority of the business).

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The owners of family businesses are deeply involved in the civic life and economic development of their communities, large and small. They are often the first to respond to critical local needs. Successful entrepreneurs and the owners of family businesses are embodiments of the American Dream, highly regarded for both their business acumen and their support of institutions and causes that enhance the lives of others. Academic research has shown that family businesses are more likely to embrace responsible labor and environmental practices, adopt social responsibility as a key objective, maintain strong relationships with suppliers and customers, and support the local community.[2]

The Proposed Regulations go beyond egregious abuses and capture ordinary situations that arise in active, family-owned real estate businesses. For example, a family member may inherit a real estate interest that has no discernable value in the secondary market and cannot be liquidated on demand. At the same time, the family member is not in a position to dictate to the person controlling the business what actions to take to ensure the tax can be paid. The Proposed Regulations unfairly and incorrectly assume coordination/collusion on the part of all surviving family members, when, in reality, there is often little, if any, agreement between the parties, and thus no real alignment of interests. The Proposed Regulations turn a blind eye to the real world practicalities of intergenerational transfers of property interests.

By extending the new rules to operating companies and illiquid assets, such as real estate, the Proposed Regulations will cause immense harm and disruption to active businesses that employ hundreds of thousands of workers. The Proposed Regulations disregard the economics of holding a noncontrolling interest in a property business where capital is typically reinvested, distributions are infrequent, and liquidation is not guaranteed. Here, restrictions on liquidation and control serve an important non-tax purpose—the preservation of the business as an ongoing concern.

According to press reports, Treasury officials have justified the broad application of the new rules to active businesses on the grounds that it is difficult: to identify an active business; to distinguish an active business from personal investment; or to address situations in which the active business entity "has been stuffed with additional assets, like portfolio assets, not needed or used in the business."[3] Differentiating between active and passive businesses is a deeply ingrained and important feature of the tax system with well-settled law, particularly in real estate. The theoretical potential for abuse does not justify a punitive regime that disregards economically sound valuation principles.

In addition to causing unnecessary harm to a critically important segment of the economy—family-owned businesses—the Proposed Regulations go well beyond the original intent of Sections 2701 and 2704. As described in greater detail below, we believe many of the provisions, as written, are without statutory authority. For these reasons, we respectfully request that you withdraw the Proposed Regulations.

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[2] Thomas Zellweger et al, *Why Do Family Firms Strive for Nonfinancial Goals? An Organizational Identity Perspective*. 37 ENTREPRENEURSHIP THEORY & PRACTICE 229 (2013).
[3] Lee A. Sheppard, *News Analysis: The New Fashion in Family Limited Partnership Valuation*, 153 TAX NOTES 199 (Oct. 10, 2016).

BACKGROUND

On August 4, 2016, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") published in the Federal Register Proposed Regulations under Section 2704 of the Internal Revenue Code and, as a concomitant thereto, Section 2701. [All references to "Sections" are to the Internal Revenue Code of 1986, as amended.]

Although some provisions of the Proposed Regulations may be appropriate to clarify the context and reach of Section 2704 (and particularly Section 2704(b)), several provisions of the Proposed Regulations go well beyond the original intent of Sections 2704 and 2701.

Section 2704(b)(4) provides authority 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 [that is, Subtitle B -- Estate and Gift Taxes] but does not ultimately reduce the value of such interest to the transferee."

However, this language does not grant the authority to promulgate legislative regulations, and, as noted below, it is clear that in these Proposed Regulations there are instances reflecting an attempt to do so.

Rather than critique the specific language of the Proposed Regulations, this submission addresses the particular Proposed Regulations that we believe are: (1) "legislative regulations" and thus well beyond the regulatory authority of the Secretary under Section 2704(b)(4); (2) overly broad and therefore overreaching; (3) ambiguous, which will lead to unnecessary litigation, costly to both taxpayers and the IRS; and/or (4) failing to account for how businesses operate in the real world of commerce.

SUBSTANTIVE CONCERNS

1. The Bright-Line Test of Prop. Reg. § 25.2704-1(c)(1)

We believe that the "bright-line test" of Prop. Reg. § 25.2704-1(c)(1), treating transfers within three years of death that result in the lapse of a liquidation right as transfers occurring at death for purposes of Section 2704(a), is clearly beyond the scope of current Section 2704, or, for that matter, any part of the Special Valuation Rules of Chapter 14 of Subtitle B.

We do not disagree with the Treasury/IRS observation that Section 2035 replaced the contemplation of death concept with a bright-line, three-year test. However, the modification of Section 2035 was an act of Congress, signed into law by the President. Contrast the same with this bright-line test, which is an attempt to promulgate a legislative regulation without the express authority of Congress to do so in the Code. Thus, this bright-line test must be deleted from the Proposed Regulations.

2. <u>The Extension of Sections 2701 and 2704(b) under Prop. Regs. §§ 25.2701-2(b)(5)(i) and (iv) to Cover Other Than a Corporation or Partnership</u>

Chapter 14 (Special Valuation Rules) of Subtitle B of the Code was, by the express language of Congress in Sections 2701 and 2704, intended to apply only to a corporation or a partnership. The Treasury/IRS was not given the authority under Section 2701 or Section 2704 to broaden this scope to "any other entity or arrangement that is a business entity within the meaning of § 301.7701-2(a)" of the Regulations.

We understand that the term "business entity" is broadly defined in Reg. § 301.7701-2(a). Nonetheless, there is no authority granted in Chapter 14 to wedge that term into the Proposed Regulations.

Accordingly, this concept, which again is an attempt to promulgate a legislative regulation without authority to do so, needs to be deleted from the Proposed Regulations.

3. <u>Transfers Subject to Disregarded Restrictions under Prop. Regs. §§ 25.2704-3(b)(4) and 25.2704-3(f) (and 25.2704-2(f))</u>

Prop. Reg. § 25.2704-3(f) (as well as Prop. Reg. § 25.2704-2(f)) states that transfers of "a part of a decedent's interest in an entity includible in the gross estate… to one or more members of the decedent's family" are treated as a transfer of a single property interest. We believe that this provision does not recognize the differing relationships existing between those family members in control of a corporation or a partnership and the shareholders or partners who are not in control -- whether such persons are family members, trustees or beneficiary of trusts for the benefit of family members, non-family members, charitable organizations or others.

Studies have shown that only about 50 percent of family business entities survive to the second generation and only about 5 to 10 percent survive to the third generation or beyond [*add cite*]. This phenomenon is in large part due to conflicts, disagreements and perceived disregard or disdain of one or more family members for some or all of the other family members. In this context, we would note that Cain and Abel were brothers; and, by this reminder, we would emphasize that aggregating either family members, on the one hand, or non-family members, on the other hand, does not take into account the separate and distinct interests of each shareholder or partner, as the case may be.

The Proposed Regulations seek to overturn the long-standing judicial approach, based in part on Rev. Rul. 93-12, 1993-1 C.B. 202, that transfers of different parts of a transferor's stockholdings or partnership interest are treated as separate and distinct transfers, irrespective of the relationships of the transferees to the transferor. Likewise, the Proposed Regulations would eviscerate the concept articulated very clearly in Regs. §§ 20.2031-1(b) and 25.2512-1 that fair market value is the price at which 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. Accordingly, this language needs to be deleted in both places in the Proposed Regulations as contrary to long-standing authority.

In addition to the failure to recognize the aforesaid reality among family members, Prop. Reg. § 25.2704-3(b)(4) seeks to forge an even more unnatural connection among non-family members, stating in Prop. Reg. § 25.2704-3(b)(4)(C) that interests held by non-family members will be disregarded unless those shareholders or entity members who are not members of the transferor's family constitute at least 20 percent of the value of the equity interests in the corporation or at least 20 percent of all the interests in the entity. This amalgamation of disparate interests into a single vote is inappropriate.

Furthermore, the three-year test of Prop. Reg. § 25.2701-3(b)(4)(A) appears to be wholly unrelated to whether the restriction which may lapse or be removed by family members is a restriction imposed on only a member or members of the same family or all shareholders or partners. Illustratively, the entity may be a business the cash resources of which are limited and needed for capital expenditures, reserves against business losses or the like, so that all shareholders and entity interest holders are subject to the restriction until it is lifted. And, if family members are the key persons in the operations of the business, they are the ones, subject to their fiduciary responsibilities, tasked with determining if and when such restrictions should lapse or be lifted.

Moreover, the proposed de minimis rule that at least 10 percent of the value of all the equity interests in the corporation or at least a 10-percent interest in the business entity must be held by a non-family member or such interest will be disregarded, as specified in Prop. Reg. § 25.2704-3(b)(4)(B), cannot be the determinant of "where the interest is an economically substantial and longstanding one that is likely to have a more substantive effect", as stated in the Background section of the Preamble to the Proposed Regulations. By way of example, if the fair market value of a corporation is $10 million, how can it be argued that an interest of 9 percent, worth $900,000, is not "economically substantial", or, even more vividly, if the fair market value of a partnership is $50 million, that an interest of 8 percent, worth $4 million, is not "economically substantial".

Accordingly, for all of these reasons, Prop. Regs. §§ 25.2704-3(f) (and 25.2704-2(f)) and 25.2704-3(b)(4) need to be substantially revised.

4. Transfers Resulting in the Loss of Power to Liquidate an Entity under Prop. Reg. § 25.2704-1(c)(1)

Even if Prop. Reg. § 25.2704-1(c)(1) were not considered an invalid legislative regulation, it does not reflect the real world situation that often arises when a new generation takes control of a business inherited from an earlier generation. Assume that parent has a 60 percent shareholding in a corporation which, in the absence of documentation to the contrary, is governed by a majority in shareholding interests, with parent's two children each owning 20 percent. Parent leaves 30 percent to each child, with a prohibition on liquidation because parent desires that his children continue the business. Children decide that, without parent there to guide the business, they ought to liquidate, and such decision is rational. Why should this be deemed to make the prohibition on liquidation non-applicable ab initio?

Finally, the Proposed Regulation does not appear to recognize that, inasmuch as the donee of a gift of an interest in a corporation or partnership takes the donor's basis under Section 1015, I.R.C., while the recipient of a bequest from a decedent receives a basis equal to the fair market value at death under Section 1014, I.R.C. (which is often a stepped-up basis on death), the Federal tax cost of a gift (including both gift tax and income tax) is often far greater than the tax cost of a bequest (which may be only the estate tax, but no income tax due to the stepped-up basis). Thus, in many situations there is a real disincentive to gift shares or a partnership interest rather than to hold until death.

5. Exceptions to "Applicable Restriction" under Prop. Reg. § 25.2704-2(b)(4)

First, we believe that an error has been made in inserting the qualification in Prop. Reg. § 25.2704-2(b)(4)(i) that a "fiduciary of a trust" under Section 267(b), I.R.C. does not include a "bank", as defined in Section 581, I.R.C., that is "publicly held", thereby excluding privately owned banks and trust companies. There are a number of private banks and trust companies that are highly qualified and have impeccable reputations, but are not publicly traded. These entities are governed by state law and the applicable provisions of Federal law, and that should be sufficient under the Proposed Regulations.

Next, it is understood that any restriction imposed, or required to be imposed, under Federal or state law is not, under Section 2704(b)(3)(A), an "applicable restriction". We are puzzled by the statement in Prop. Reg. § 25.2704-2(b)(4)(ii) that a "provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with respect to a particular entity…is not a restriction that is imposed or required to be imposed by federal or state law." It is clear that the words "required to be imposed" do not mandate that the provision(s) be engrafted into the governing documentation.

We are further puzzled by the language in Prop. Reg. § 25.2704-2(b)(4)(ii) that "a restriction is not imposed or required to be imposed by federal or state law if that law also provides…an optional provision that does not include the restriction or that allows it to be removed or overridden…or permits the restriction to be overridden…." Why was the concept that a more restrictive provision than "Federal or State law" dismissed? Illustratively, assume a corporation with 2 families each owning 50 percent of its stock and a stockholders agreement that imposes a right of first refusal on either side's desire to sell, and that right of first refusal provides for a fair market value determination accompanied by a 25 percent discount attributable to the purchasing family's need to obtain cash for the purchase. That concept is more stringent that Federal or State law, and yet it would be considered an "applicable restriction" if both families later modified the provision (which could be deemed a "lapse" under Section 2704(b)(2)(B)(i)).

6. Transfers Subject to Disregarded Restrictions under Prop. Reg. § 25.2704-3

First, we note that all of the issues that we have raised with respect to an "applicable restriction" under Prop. Reg. § 25.2704-2 are likewise raised with respect to "disregarded restrictions" under Prop. Reg. § 25.2704-3.

Next, we disagree with the statement in Prop. Reg. § 25.2704-3(b)(1)(ii) that "The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity." This statement is contrary to the statement in the Preamble that "Fair market value [of an interest in the entity] is determined under generally acceptable valuation principles, including any appropriate discounts or premiums." It is also contradicted by language in certain Examples, such as the first sentence in paragraph (ii) of Example 4.

We acknowledge statements by Treasury personnel that Treasury does not think the Proposed Regulations provide for valuation on a put right/minimum value basis. However, we do not understand how "generally accepted valuation principles" may logically be applied if all restrictions on withdrawal are disregarded.

Further, in Prop. Regs. §§ 25.2704-3(b)(1)(iv) and 25.2704-3(b)(6), it is not clear as to what is intended by providing that a note or obligation may be included in liquidation proceeds so long as such note is "adequately secured" and "requires periodic payments on a non-deferred basis". Does this mean that the note may not be subordinated to bona fide third-party financing for the entity? Does this mean that in a downturn of the business the note must continue to be paid on the same periodic basis? Does the term "periodic payments" include both principal and interest, or are periodic payments of interest acceptable where the entire principal of the note is payable at the end of the term of the note?

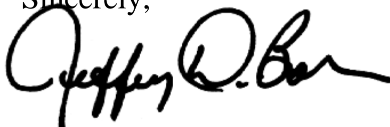
Finally, in Prop. Regs. §§ 25.2704-3(b)(1)(iv) and 25.2704-3(b)(6), the term "active trade or business" is not defined. There is no uniform definition in the Code for "trade or business", which term is found but not defined in Sections 162, 469, 1411, and 6166. The term "active trade or business" is utilized in Section 469, but not elsewhere. Because the definition of the term is crucial in the Proposed Regulations, it must either be defined or cross-referenced to Section 469.

CONCLUSION

For all of these reasons, The Real Estate Roundtable respectfully requests that the Proposed Regulations be withdrawn and rewritten to take into account our comments. The Roundtable also requests the opportunity to testify at the public hearing on the Proposed Regulations scheduled for December 1, 2016, and we are submitting, separately, an outline of topics to be discussed.

We have not set forth herein all of our thoughts, but would be pleased to commit our resources to working with the Treasury and IRS representatives in order to ensure that the Regulations which are ultimately finalized address the legitimate concerns of Treasury/IRS while also recognizing the economic realities associated with the transition of a business from one generation to another.

Sincerely,



Jeffrey D. DeBoer
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