

**Comments of the Family Business Estate Tax Coalition on the Department of the Treasury and Internal Revenue Service's Proposed Regulations on "Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest," 81 Fed. Reg. 51,413 (Aug. 4, 2016).**

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## Executive Summary

The Family Business Estate Tax Coalition is a grassroots coalition of over 50 national organizations representing family-owned business organizations dedicated to protecting all family-owned businesses from the estate tax.<sup>1</sup> The Coalition opposes the Treasury's proposal to deny family-owned businesses ordinary valuation discounts for lack of control and lack of marketability when calculating gift and estate tax liability. The proposed regulations will discourage families from continuing to operate and build their family businesses and passing them on to future generations, undermining economic growth and job creation. The Treasury proposal is not only bad policy, but also unlawful. It should be withdrawn.

**Background.** How assets are valued makes a dramatic difference for gift and estate tax purposes. For closely held businesses, there are few if any comparable sales and no ready markets, so their value must be determined by estimating the likely sale price between two willing and unrelated parties. A variety of factors are considered, but three key discounts often apply: (i) Lack of Control – If the interest being transferred is not a controlling interest, it is worth less; (ii) Lack of Marketability – If there no ready market for the interest, finding a willing buyer may be difficult and the asset is worth less; and (iii) Restrictions on Control or Liquidation (Sale) Rights – When passing on businesses to the next generation, families often limit the rights associated with those shares so as to keep a business within the family or reduce potential sources of family friction, reducing the value of those shares.

Under current law and established legal precedent, these discounts can amount to 30 percent or more of the asset value and reflect the underlying economic reality that non-

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<sup>1</sup> A full listing of the Coalition's members is available on its website, <http://www.estatetaxrelief.org>.

controlling ownership interests, assets without ready markets, and assets encumbered by restrictions have lower values.

The proposed regulations would deny these discounts in many or even most circumstances, through several changes to tax law. The first retroactively imposes additional tax liability on the transfer of shares subject to restrictions on voting or liquidation if the giver dies within three years of the transfer, deeming those restrictions to be “lapsed.” The second denies a discount for transferred shares that are subject to restrictions on liquidation. The third denies a discount for restrictions on liquidation under state law. And the fourth denies a discount for restrictions that may turn on ownership stakes of non-family members. In short, the proposal adopts the assumption that family members who own a business will inevitably collude with one another to defeat nearly any restriction or other limitation on the control or liquidation of a family-owned business, such that those limitations must be disregarded when calculating gift and estate tax liability. If finalized, the regulations could increase estate and gift tax liabilities by 30 percent or more on family-owned businesses, resulting in fewer family businesses surviving from one generation to the next.

**The Proposal Exceeds Treasury’s Legal Authority.** The reason that Treasury has for years asked Congress to implement through legislation the same policies contained in its proposal is that it lacks the legal authority to carry them out on its own. Each of the proposed regulations conflicts with governing statutory authority:

- The three-year lookback regulation relies on a statutory provision that is limited to actual (not “deemed”) lapses and improperly intrudes on the regulatory domain of a separate section of the Code that addresses property transfers made in the years shortly before the transferor’s death.

- The regulation denying discounts for restrictions on an individual's stake in a business relies on statutory authority that is limited to the restrictions that apply to the business as a whole; it also impermissibly intrudes on the regulatory domain of a separate section of the Code that addresses restrictions on an individual equity holder's ability to liquidate his or her stake.
- The regulation denying discounts for state-law restrictions conflicts with statutory text that explicitly permits discounts for restrictions "imposed...by any Federal or State law."
- The regulation disregarding the interests and rights of non-family members is unsupported by any statutory authority and clashes with the statutory command that Treasury may not deny discounts for restrictions that "ultimately reduce the value" of transferred assets.

In these respects and others, the proposed regulations amount to an attempt to circumvent the legislative process through unlawful regulatory action.

**The Proposal Is Unreasonable.** The proposed regulations threaten severe injury to family businesses, the employees and communities that depend on family businesses, and the economy as a whole. If finalized, they would impose substantial tax liability on the category of businesses that can least afford it, given that the wealth of family business owners is typically tied up in assets like plants, equipment, or real estate and therefore not available to pay tax bills. The direct result would be to upend succession planning, halt planned expansions and growth so as to conserve cash, require businesses to sell off assets to pay tax liabilities, and even force some to shutter for good. These things would only exacerbate the negative economic consequences of the estate tax, including: reduced savings and investment,

slower economic growth, reduced job creation, and increased compliance costs. Research suggests that additional compliance costs alone could exceed the net tax revenue that the proposal would generate—if, that is, it increases revenue at all, which it may well not.

**Unfair Consequences.** The three case studies provided in Appendix A of these comments illustrate the real-world consequences that the Treasury proposal would have for family-owned businesses, such as forcing the sale of family farms, blocking the expansion of family-owned manufacturers, and preventing parents from gradually turning over the leadership of a family business to their children.

**Arbitrary Policy.** At base, the Treasury proposal is illogical and fails to satisfy the law’s requirement that agencies engage in “reasoned decision making.” The proposal departs from standard valuation principles premised on economic realities without any justification, assumes complete family harmony in business decisions notwithstanding evidence to the contrary, arbitrarily targets family businesses for disparate treatment, reverses course from prior Treasury policy without any explanation, and ignores factors that Congress specifically directed Treasury to consider. Further, Treasury has not even attempted to estimate its proposal’s impact on family businesses, the economy, or even overall tax revenues and has no basis to ascertain whether it passes any form of cost-benefit analysis. These lapses flow from Treasury’s stated purpose in regulating, which is to override Congress’s refusal to entertain Treasury’s requests to adopt these policies by legislation. At the end of the day, that is not a valid basis for regulation.

Treasury’s proposal is legally unsupportable and will, if finalized, injure family-owned businesses across the economy, as well as those who depend on them. The Family Business Estate Tax Coalition requests that the proposal be withdrawn.



## Analysis

### I. The Proposed Regulations Exceed Treasury's Statutory Authority

The proposed regulations exceed the scope of Treasury's statutory authority. Although Code Section 2704 gives IRS authority to disregard certain restrictions when determining the value of certain transfers, that authority does not extend to the restrictions addressed in the proposed regulations. In particular, first, Section 2704 provides no basis for treating the "transfer" of individual voting or liquidation rights within three years of the transferor's death as a "deemed lapse." To the contrary, Section 2704(b)(2)(A) explicitly states that "applicable restrictions" include only entity-level restrictions, i.e., those "which effectively limit[] the ability of the corporation or partnership to liquidate." Second, Section 2704(b)(3)(B)'s exclusion of restrictions "imposed...by any Federal or State law" from the definition of "applicable restriction" unambiguously prohibits the Treasury Department from promulgating a regulation that ignores "default" State law restrictions. And, third, nothing in the text of Section 2704 authorizes the Treasury Department to impose limitations on when non-family member interests may be taken into account.

In our constitutional system "the lawmaking function belongs to Congress," *Loving v. United States*, 517 U.S. 748, 758 (1996), and "an agency literally has no power to act...unless and until Congress confers power upon it," *La. Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374 (1986). Moreover, mere conferral of authority is not enough to justify a regulation, for agencies do not "possess[] *plenary* authority to act within a given area simply because Congress has endowed it with *some* authority to act in that area." *Am. Library Ass'n v. FCC*, 406 F.3d 689, 708 (D.C. Cir. 2005) (quotation marks omitted) (emphasis in original).

The Administrative Procedure Act provides that reviewing courts “shall decide all relevant questions of law...and statutory provisions,” and “hold unlawful and set aside agency action...in excess of statutory jurisdiction, authority, or limitations.” 5 U.S.C. § 706(2)(C). To determine whether an agency has permissibly interpreted a statute it is committed to administer, courts generally undertake the two-step *Chevron* analysis. First “is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter.” *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 842 (1984). But “if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissible construction of the statute.” *Id.* at 843; *see also City of Arlington v. FCC*, 133 S. Ct. 1863, 1868 (2013) (same); *Util. Air Regulatory Grp. v. EPA*, 134 S. Ct. 2427, 2442 (2014) (“Even under *Chevron*’s deferential framework, agencies must operate within the bounds of reasonable interpretation.”) (quotation marks omitted). In evaluating whether an agency’s construction is permissible, a court “must judge the propriety of such action solely by the grounds invoked by the agency.” *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947); *see also Citizens to Pres. Overton Park, Inc. v. Volpe*, 401 U.S. 402, 419 (1971) (“‘post hoc’ rationalizations...have traditionally been found to be an inadequate basis for review”) (citations omitted).<sup>2</sup>

The Treasury Department does not identify any ambiguity in Section 2704 that might justify according its interpretation of that provision *Chevron* deference. Nor is there any. Because the intent of Congress is clear, and that intent precludes Treasury’s proposed actions, the proposed regulations are *ultra vires*. In addition, the proposed regulations far ex-

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<sup>2</sup> “The principles underlying...*Chevron* apply with full force in the tax context.” *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55 (2011)

ceed the bounds of reasonable interpretation, for the reasons stated in this section and elsewhere in these comments. Accordingly, they should be withdrawn.

**A. The New Three-Year “Deemed Lapse” Rule**

Section 25.2704-1(c)(1) of the proposed regulations would introduce the following three-year rule: “The lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor’s death *is treated as a lapse occurring on the transferor’s date of death*, includible in the gross estate pursuant to section 2704(a)” (emphasis added).

Further, the proposed regulations would modify the language of Section 25.2704-1(c)(2)(B) (“Ability to liquidate”) in a manner apparently designed to treat a transfer that relinquishes *personal* voting control of an individual transferor as if such voting control “lapsed” within the meaning of Code Section 2704 if the transfer relinquishing control occurs within three years of the transferor’s death.

The proposed three-year rule would apply in situations where the voting rights have been transferred to other family members but *have not lapsed in any legal or practical sense*. Thus, the proposed regulations introduce a “deemed lapse” rule without any statutory foundation.

1. Code Section 2035 Is the Statutory Three-Year Rule

Although Treasury cites Code Section 2704(b)(4), in Chapter 14, as providing authority for this new three-year rule, Code Section 2035 is the sole statutory authority for estate inclusion with respect to certain property transfers made within three years of the transferor’s death (or gift taxes paid on those transfers). No aspect of Code Section 2035 was amended in connection with the enactment of Chapter 14, and no cross references to any part of Chapter 14 are contained in Code Section 2035. By contrast, Code Section

2704(b)(4) concerns the treatment of “other restrictions” on transferred property that do not, in fact, reduce the value of such property in the hands of the family-member transferees. Effectively “amending” the operation of Code Section 2035 by regulation goes far beyond any rational reading of the scope of regulatory authority provided under Code Section 2704(b)(4) and violates the canon of statutory construction that a statute must be read as whole, so that an interpretation of a single provision “is compatible with the rest of the law.” *United Savings Ass’n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988). Likewise, “[h]owever inclusive may be the general language of a statute, it will not be held to apply to a matter specifically dealt with in another part of the same enactment.” *Fourco Glass Co. v. Transmirra Prods. Corp.*, 353 U.S. 222, 228 (1957) (quotation marks omitted). Here, Code Section 2035 is the more specific provision and precludes Treasury’s proposed application of Code Section 2704(b)(4).

If some new set of transfers is to be subjected to a three-year “look-back” for estate tax purposes, the sole appropriate vehicle for that would be for Congress to amend Code Section 2035. Because the three-year rule of Code Section 2035 “includes” property in the gross estate of a decedent after it has been transferred, Code Section 2035 should be applied and construed narrowly, in recognition of the fact that the “transferred property” is not available in the transferor’s estate to pay any resulting transfer tax liability. In this respect, the “deemed lapse” proposed rule also impermissibly conflicts with Code Section 6166. *See infra* § IV.A.

## 2. A “Deemed Lapse” Is Not a “Lapse” Under the Statute

Code Section 2704 expressly addresses “lapses” of voting or liquidation rights. The “transfer” of voting or liquidation rights to other family members cannot and should not be

treated as a “lapse” under any circumstances if those voting or liquidation rights continue to attach to the transferred equity interests.

There is no basis in the statutory language of Code Section 2704 to support the view that a “transfer” of voting or liquidation rights can or should be treated as a “deemed lapse.” Either a right “lapses” or it does not. If a right does not actually “lapse,” Code Section 2704 can have no effect on valuation. Interpreting Code Section 2704 to treat such transfers as lapsed therefore amounts to an impermissible expansion of the authority conferred by the statute. *Compare Iselin v. United States*, 270 U.S. 245, 250 (1926) (where Congress had set out statutory categories with “particularization and detail,” interpretation that would extend to an additional category was an impermissible “enlargement” of the statute rather than “construction” of it).

This *ultra vires* expansion of the reach of Code Section 2704 is reinforced by the proposed amendments to Examples 4 and 7 at Section 25.2704-1(f). In both of these examples, the transferor (D) transferred to D’s children blocks of corporate shares that enjoyed all of the same voting and liquidation rights, on a per-share basis, both before and after D’s transfer. In both examples, the proposed regulations seek to impose an estate tax on D’s estate if D dies within three years of the transfer by treating D as if D continued to hold the ability to compel the liquidation of the affected corporation immediately prior to D’s death and *as if* that right “lapsed” at D’s death. This kind of “deemed lapse”—which is, in reality, no lapse at all—is simply outside the authority conferred by Code Section 2704.

Because it exceeds the Treasury Department’s statutory authority, Section 25.2704-1(c)(1) of the proposed regulations must be withdrawn.

**B. Disregarding Noncontrolling Equity Holder’s Inability To Liquidate the Entity or the Equity Interest**

As noted in the preamble to the proposed regulations, “courts have concluded that, under current regulations, Code Section 2704(b) applies only to restrictions on the ability to liquidate an entire entity, and not to restrictions on the ability to liquidate a transferred interest in that entity. *Kerr v. Commissioner*, 113 T.C. 449, 473 (1999), *aff’d*, 292 F.3d 490 (5th Cir. 2002).” 81 Fed. Reg. at 51,415. The statutory language of Code Section 2704(b)(2)(A), in defining “applicable restriction,” refers unambiguously to any restriction “which effectively limits the ability *of the corporation or partnership* to liquidate” (emphasis added). Treasury cannot disregard this textual limitation on its authority under the Code.

By its own terms, Code Section 2704 is directed solely at voting and liquidation rights associated with equity interests, as determined with respect to making entity-level decisions. The scope of Code Section 2704 does not extend to the rights of an individual equity holder to liquidate his particular equity interest. Consistent with *Kerr*, Code Section 2704 is therefore limited in its application to restrictions affecting entity-level liquidations, a limitation that only Congress can change by legislation. In this way, the text of the statute unambiguously precludes any interpretation that would reach the rights of individual equity holders to liquidate their own equity interests.

Moreover, such an interpretation must also be rejected as a matter of statutory structure and context. An individual equity holder’s ability to “liquidate” his equity interest, without involving a full liquidation of the entity itself, simply refers to that individual equity holder’s ability to sell or transfer such equity interest for value, either to a third party or by means of a redemption (i.e., where the entity itself is the purchaser of the equity holder’s interest). In the context of family-controlled business entities, sales or redemptions of the in-

terests of an individual equity holder often are governed by buy-sell agreements, option agreements, or other transfer restrictions that are governed by Code Section 2703.

Because Code Section 2703 directly addresses restrictions applicable to an individual equity holder's ability to "liquidate" his individual equity interest in an entity, it is fundamentally wrong to contort Code Section 2704 to confer regulatory authority over such restrictions. *See United Savings Ass'n*, 484 U.S. at 371; *Fourco Glass Co.*, 353 U.S. at 228. Further, because Code Section 2703(b) already provides the statutory test for applying restrictions in connection with the sale or redemption of an individual equity holder's interest, there is no statutory authority to issue new regulations under Code Section 2704 to change the rules for recognition of restrictions in valuing an individual equity holder's interest in an entity.

Nonetheless, Section 25.2704-3 of the proposed regulations would introduce a new, non-statutory set of "disregarded restrictions" intended to apply with respect to an individual equity holder's ability to liquidate his own equity interest in an entity. As described above, Code Section 2703 already *directly* addresses restrictions on the liquidation of an individual equity holder's interest imposed in options or agreements (i.e., typically, options or agreements among equity holders and/or the entity itself), and such restrictions fall outside of the textual authorization of Code Section 2704. Accordingly, Code Section 2704 cannot be read to reach such restrictions, and certainly cannot be read to do so in ways that deviate severely from the clear language of Code Section 2703(b). In these ways, Treasury's interpretation of Code Section 2704 is unwarranted, unworkable, and *ultra vires*. *See Fourco Glass Co.*, *supra*; *Iselin*, *supra*.

Indeed, Treasury recognizes elsewhere in the proposed regulations that Section 2703 properly governs in this context. Thus, proposed regulations Section 25.2704-2(b)(4)(iii) states that “[a]n option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction.” Similarly, proposed regulations Section 2704-3(b)(5)(iv) provides that “[a]n option, right to use property, or agreement that is subject to section 2703 is not a [disregarded] restriction for purposes of this paragraph (b).”

In sum, the Coalition believes that proposed regulations Section 25.2704-3 must be withdrawn in its entirety, because Code Section 2703 and the clear standard of Code Section 2703(b) control with respect to all restrictions on an individual equity holder’s rights to sell or liquidate his own equity interest. Such restrictions cannot be regulated under Code Section 2704.

### **C. Disregarding Liquidation Restrictions Imposed by Federal or State Law**

Proposed regulations Section 25.2704-3(b)(5)(iii) would constitute an improper and *ultra vires* narrowing of the federal and state law exception of Code Section 2704(b)(3)(B).

The proposed regulations would disregard virtually all restrictions on liquidation of an entity that are “default” provisions under applicable state law (i.e., provisions that apply in the absence of an explicit agreement among the equity holders of the enterprise or an explicit term contained in articles of organization, bylaws, or other documents setting forth governance rules for the enterprise). The proposed regulations would *not* permit state law restrictions (such as, for example, a state law rule requiring unanimous approval or a supermajority of equity holders to compel a liquidation of the business entity) unless such restrictions *could not be changed or superseded* by agreement among the equity holders or by the specific governing documents of the enterprise.



Thus, despite that the statutory language of Code Section 2704(b)(3)(B) indicates that restrictions on liquidation “imposed, or required to be imposed, by any Federal or State law” may be taken into account in determining the gift/estate tax value of a transferred interest in a business entity, the proposed regulations would permit consideration only of those state or federal law restrictions “required to be imposed.” This reads out of the statute the words “*imposed, or...*” In this way, the proposed regulatory provision effectively nullifies a portion of the statutory language and thereby exceeds Treasury’s authority. *See, e.g., Astoria Fed. Savings & Loan Ass’n v. Solimino*, 501 U.S. 104, 112 (1991) (statute must be construed “so as to avoid rendering superfluous” any statutory language); *Sprietsma v. Mercury Marine*, 537 U.S. 51, 63 (2002) (rejecting broad interpretation of word “law” because it would render word “regulation” superfluous in preemption clause applicable to a state “law or regulation”).

Such an interpretation of the federal and state law exception under Section 2704 would vitiate the exception, since virtually no “default” restrictions on liquidation under federal or state law are “absolute.” The current interpretation of the state/federal law exception is the only one that is permissible. Thus, if a restriction on liquidation contained in the documents governing liquidation of a particular enterprise is no more restrictive than the “default” provisions of state or federal law, then such restriction may (and should) be taken into account in valuing an equity interest in that enterprise.

#### **D. Limiting When Non-Family Member Interests May Be Taken into Account**

Proposed regulations Section 25.2704-3(b)(4) would establish arbitrary and *ultra vires* limitations under which equity interests held by non-family members would be “disregarded” in determining whether family members, acting collectively, could compel the liquida-

tion or redemption of a family member's equity interest in an entity. Instead of considering the percentage equity interests held by all non-family members in evaluating whether a family has sufficient equity holdings, collectively, to "control" the decision to redeem or liquidate an individual family member's equity holding, the proposed regulations would disregard virtually all non-family equity holders.

As proposed, the interest of a non-family equity holder would be taken into account only if (i) the non-family member has held the equity interest for at least 3 years before the transfer at issue; (ii) on the date of the transfer, the non-family member holds at least a 10 percent equity interest in the enterprise; (iii) on the date of the transfer, non-family members, collectively, hold at least 20 percent of the equity interests in the enterprise; *and* (iv) each non-family member has a "put right" allowing such non-family member to force a redemption of his/her/its equity interest (with six months' notice) in the enterprise at a value at least equal to such non-family member's equity percentage multiplied by the full net asset value of the enterprise (i.e., a redemption at full liquidation value, without any discounts).

None of these proposed "rules" has any statutory foundation. To the contrary, they conflict with the definition of "member of the family" adopted in Code Section 2704(c)(2). Moreover, there is no need or justification for any rules regarding the effect of non-family members' equity interests on the business decisions of an enterprise (including the ability of family members to effectuate redemptions of other family members). Each situation should be evaluated on its facts. Finally, Treasury may not promulgate a rule that would disregard restrictions in circumstances where those restrictions may, in certain instances, "ultimately reduce the value of such interest to the transferee." 26 U.S.C. § 2704(b)(4).

## **II. Legislative History and Statutory Purpose and Structure Confirm Treasury's Limited Authority Under Chapter 14**

The history, purpose, and structure of Chapter 14 confirm Congress's intent to address specific perceived valuation abuses, not to confer plenary power on the Treasury Department to adopt its preferred method of valuation. Each provision of the Chapter is addressed at a particular kind of perceived abuse, such that no individual provision can be read to confer more general authority, particularly where doing so would invade the subject matter of other provisions. In addition, the provisions contain their own limitations. In particular, Section 2704(b)(4), in particular, permits Treasury to disregard a type of restriction on transferred interests in a family corporation or partnership only where it "does not ultimately reduce the value of such interest to the transferee." This and other aspects of Chapter 14, as well as its overall structure, substantially limit Treasury's statutory authority to disregard liquidation and control restrictions.

### **A. Chapter 14 Was Enacted To Address Specific Perceived Valuation Abuses**

When Chapter 14 (Special Valuation Rules) was enacted as part of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, new Code Sections 2701 through 2704 were designed to curb specific perceived abuses in connection with transfers of property and trust interests among family members. Accordingly, each new Code section addresses a specific category of perceived valuation abuse. The history and purpose of these provisions are relevant to understanding Treasury's authority under them.

A brief summary of the specific valuation concerns addressed by each Code section illustrates the narrow, targeted categories of valuation issues intended to fall within the reach of Chapter 14.

## 1. Code Section 2701: Limitations on Preferred Stock Recapitalizations

Prior to the enactment of Chapter 14, taxpayers often recapitalized family-owned companies by creating new classes of preferred stock and allocating virtually all of the net equity to the newly-issued preferred stock. The “junior equity” (the common stock) then was transferred to younger-generation family members with a near-zero value, since the senior-generation family members retained the preferred stock. Such recapitalization transactions commonly are referred to as “preferred stock freeze” transactions, as the goal is to “freeze” the value of the preferred stock retained by the senior generation, while allowing the younger generation family members to enjoy the economic benefits of potential future growth in company value. Basically, if the family enterprise is successful after such a recapitalization, the growth in equity value inures primarily to the benefit of the common shareholders.

Section 2701 was enacted to assure that both the preferred stock retained by the senior generation and the junior equity interests gifted to younger generations were valued realistically for estate and gift tax purposes. For example, (i) Code Section 2701(a)(4) establishes a statutory minimum value for junior equity (generally, 10 percent of net equity value, treating certain family debt as equity); and (ii) Code Sections 2701(a)(3) and 2701(c) generally require that a preferred stock have a cumulative right to its preferred dividends and that no conversion or redemption right may be used to diminish the value of the preferred stock.

## 2. Code Section 2702: Limitations on “Retained Interest” Transfers in Trust

Prior to enactment of Chapter 14, taxpayers routinely established so-called “grantor retained income trusts” or “GRITs.” In valuing the “remainder interest” gifts to younger-generation family members, GRIT grantor-donors used IRS actuarial tables to value the re-

tained “income interest” at a high assumed rate of income return, which diminished the actuarial value of the gifted remainder interest. Further, GRIT donors could have GRIT investments focus on capital growth and low-income yield. Thus, donors could use actuarial tables to determine low actuarial values for remainder interest gifts, while investing GRITs so that substantially higher remainder values actually were passing to the younger generation.

To curb such inconsistencies in the use of actuarial valuations for transfers in trust, Code Section 2702 generally requires “retained interest” trusts (with family members as remainder beneficiaries) funded with investment assets to be structured as “grantor retained annuity trusts” (“GRATs”) or as “grantor retained unitrusts” (“GRUTs”), thereby assuring that the actuarially computed value of the grantor’s “retained interest” has economic reality.

### 3. Code Section 2703: Limitations on Buy-Sell Agreements and Option Agreements Among Family Members

Prior to the enactment of Chapter 14, it was common practice for related-party taxpayers to use so-called “book value” agreements to fix the value of shares to be purchased upon a family member’s death or when a family member left the business. In some instances, such “book value” agreements established an artificially low value for such shares. For instance, “book value” would tend to be lower than fair market value (even in the case of a nonvoting or noncontrolling equity interest) in circumstances where (i) capital assets do not constitute a substantial portion of enterprise value of the business; or (ii) the book value of capital assets is substantially less than the current fair market value of those assets.

To prevent family members from entering into buy-sell agreements or option agreements (entered into after October 8, 1990) that would operate to allow a family member to buy an equity interest in a family-controlled business for less than fair market value, the

general rule of Code Section 2703(a) is to disregard any option, agreement, or other right to acquire the interest at a price less than fair market value.

However, to continue to permit family business owners to utilize buy-sell agreements and options for legitimate business purposes, Code Section 2703(b) established the following standards under which the terms of such a buy-sell or option agreement would be respected:

- a. The agreement must be a bona fide business arrangement;
- b. It must not be “a device to transfer such property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth”; and
- c. Its terms must be “comparable to similar arrangements entered into by persons in an arms’ length transaction.”

Accordingly, when those circumstances apply, Treasury lacks the authority to disregard the economic reality of such agreements.

#### 4. Code Section 2704: Certain Lapsing Rights and Restrictions

In *Estate of Harrison v. Comm’r*, T.C. Memo. 1987-8, the decedent held both a general partner interest and all of the limited partner interests in a partnership. During decedent’s life, as a general partner, he had the right to compel liquidation of the partnership. However, by reason of decedent’s death, his general partner rights lapsed, so that his estate did not have the legal authority to compel liquidation of the partnership. Under those facts, the Tax Court ruled that the decedent’s limited partnership interests were properly valued for federal estate tax purposes *without regard* to the decedent’s ability (immediately prior to his death) to liquidate the partnership. Code Section 2704 was enacted to overrule the result in *Harrison* by treating a lapsing voting or liquidation right as if such a voting or liquidation right re-

mained in effect and was part of the transferred “value” for transfer tax valuation purposes, when a family controls a business entity both before and after a transfer. *See* 81 Fed. Reg. at 51,414 (stating as much).

Section 2704(b) includes a statutory class of so-called “applicable restrictions” to be disregarded in determining the transfer tax value of equity interests transferred to or for the benefit of a family member in a family-controlled entity. Essentially, when family members collectively control a business entity, an “applicable restriction” is defined to be any restriction that effectively limits an equity holder’s right to compel liquidation of the entity and that either (i) lapses after a transfer from one family member to another; or (ii) could be removed after the transfer (as a matter of right) by the transferor or by members of the transferor’s family, acting alone or collectively.

Code Section 2704(b) grants authority to the Treasury Secretary “by regulations [to] 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.” Thus, regulatory authority under Code Section 2704(b) is limited to situations where a restriction “does not ultimately reduce the value” of the transferred interest.

#### **B. Statutory Exceptions to Application of Code Section 2704**

Code Section 2704(b)(3) contains two important statutory exceptions that identify categories of “restrictions” that *shall not* be included within the meaning of “applicable restrictions” under Code Section 2704(b)(2). Thus, restrictions falling within either of the two

2704(b)(3) exceptions may be taken into account in valuing equity interests transferred among family members.

1. Commercially Reasonable Restrictions Imposed by a Lender in Connection with Financing

Under Code Section 2704(b)(3)(A), as long as the lender “is not related to the transferor or transferee, or a member of the family of either,” commercially reasonable restrictions on liquidation of a business entity imposed by the lender in connection with a loan or other financing arrangement with the entity may be taken into account in valuing equity interests in the entity. For example, it is common for a commercial lender to prohibit liquidation of a business entity if such a liquidation might impair or prevent the lender from receiving full payment of the debt owed to such lender.

The proposed regulations do not appear to alter treatment of this exception.

2. Restrictions Imposed, or Required To Be Imposed, by Federal or State Law

Under Code Section 2704(b)(3)(B), valuation of equity interests may (and should) take into account “any restrictions imposed, or required to be imposed, by any Federal or State law.” Accordingly, for example, so-called “default” state law restrictions on liquidation of a business entity widely (and correctly) have been viewed to be “safe harbor” restrictions under this exception.

Because the default restrictions on liquidation imposed by state law cannot be “applicable restrictions,” restrictions by agreement among equity holders (whether embedded in articles of organization or in other documents governing the operation of the entity), that were less restrictive than default provisions under state law have been viewed by taxpayers and their advisers as “per se” permissible restrictions, validly taken into account for transfer tax valuation purposes.



For example, it is common for state law to require unanimity among partners to compel liquidation of a partnership, and a two-thirds vote of shareholders to compel liquidation of a corporation. Partnership agreements permitting liquidation to be approved by a two-thirds vote or corporate articles or bylaws permitting liquidation to be approved by a simple majority have been viewed as restrictions that fall within the “Federal or State law” exception of Code Section 2704(b)(3)(B), because those restrictions are no more restrictive than the default state law rules governing decisions to liquidate a business entity.

**C. Examples of Transfers Not Intended To Be Affected by Chapter 14 or Code Section 2704**

The following three examples illustrate common situations that are properly outside the scope of Chapter 14, but nonetheless appear to fall within the scope of the proposed regulations.

1. Example 1: Rev. Rul. 93-12, 1993-1 C.B. 202

In Revenue Ruling 93-12, issued only a few years after Chapter 14 was enacted, a business owner (P) held 100 percent of the single outstanding class of stock of X corporation. P proceeded to gift equal 20-percent equity blocks to each of P’s five children. In valuing the gifts to children, minority interest discounts were found to be appropriate. This result, consistently reached by courts, was conceded by the IRS. Since this ruling was published shortly after the enactment of Chapter 14 (and has remained undisturbed for over 20 years), it reflects that the IRS interpreted Chapter 14—and Code Section 2704, in particular—as having no effect on the result or proper application of minority-interest discounts in such a case. The ruling cites Tax Court and Ninth Circuit decisions rejecting the contrary position.

2. Example 2: Voting/Nonvoting Recapitalization and Gift of Nonvoting Equity

Consider facts similar to those of Rev. Rul. 93-12. However, instead of giving away 100 percent of the stock of a corporation, the owner (M) of ABC Corporation wishes to retain control but to give 90 percent of the equity to her children. Accordingly, M (sole shareholder of a single class of common stock) recapitalizes ABC by creating two common equity classes (Class A and Class B), identical in all respects except that Class A Common has voting rights and comprises 10 percent of the overall equity interests in ABC, and Class B Common has no voting rights (except as may be required by State law) and comprises the remaining 90 percent of the equity interests in ABC.

Immediately after the recapitalization, M owns all of the Class A and Class B Common shares. M proceeds to gift all of the Class B shares to her children, leaving M with all of the Class A shares (i.e., 10 percent of the equity and 100 percent of the day-to-day voting control). Just as in Rev. Rul. 93-12, the gifts of nonvoting Class B shares to M's children properly are valued to reflect a nonvoting discount.

3. Example 3: Establishing Enterprise with Children in Control

Consider the situation where a parent (F) wants to provide seed capital to his children while granting them control over the new enterprise. Accordingly, a new entity (NewCo) is capitalized with two classes of equity. As in Example 2, the two classes of equity have identical distribution rights, but voting rights are conferred exclusively to Class A. Further, in this Example 3, the voting equity comprises only 1 percent of the total equity interests in NewCo. Thus, the children of F (collectively) contribute 1 percent of the initial capital in exchange for all of the Class A Common (voting) equity of NewCo, with Class A comprising 1 percent of the equity of NewCo and 100 percent of the voting control. F contributes

the remaining 99 percent of the initial capital of NewCo in exchange for all of the Class B (nonvoting) equity, comprising 99 percent of the equity of NewCo without voting rights. Whether gifted later in F's life or at F's death, F's Class B equity interests properly should be valued by taking into account a nonvoting discount.

## **II. The Proposed Regulations Are Bad Policy and Unfairly Target Family-Owned Businesses**

Family businesses are the bedrock of the U.S. economy. They support virtually every sector of the nation's economy, from agriculture in California, to energy extraction in Texas, and manufacturing nationwide. Family businesses are responsible for 62 percent of the country's employment and \$5.9 trillion of the nation's GDP.

The proposed regulations arbitrarily target family businesses, imposing artificially inflated tax burdens that put them at a significant disadvantage to competitors. If finalized, the proposed regulations would upend succession planning, halt planned expansions and growth, and require some businesses to sell off assets, jeopardizing the health of those businesses and impacting workers and communities across the nation. As a matter of policy, the proposed regulations should be rejected. At the least, Treasury is obligated to evaluate the proposed regulations' impacts on family-owned businesses, on particular sectors, and on the economy as a whole.

### **A. Family-Owned Businesses Are Central to Job Creation and Economic Growth**

America's family businesses play a central role in the nation's economy. Together, these firms: generate 62 percent of employment;<sup>3</sup> account for 78 percent of new job crea-

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<sup>3</sup> Joseph H. Astrachan & Melissa Carey Shanker, *Family Businesses' Contribution to the U.S. Economy: A Closer Look*, 14 Fam. Bus. Rev. 211, 217 (2003). The U.S. Census Bureau's 2012 Survey of Business Owners underscores the centrality of family businesses to the U.S. econ-

tion;<sup>4</sup> contribute over \$5.9 trillion to the nation's GDP;<sup>5</sup> make up 35 percent of the S&P 500 Industrials;<sup>6</sup> and achieve 6.07 percent higher returns on assets than non-family businesses.<sup>7</sup>

Family firms make an outsized contribution at every level of the U.S. economy, from their higher rates of revenue growth to their local philanthropic endeavors. They also provide workers with greater job security than non-family firms, and offer enhanced leadership opportunities for women and minorities. It is important for agencies considering regulations that affect family businesses to evaluate the impacts of any contemplated policies on those businesses and on the economy at all levels.

1. Family businesses outperform non-family firms nationally, especially during recessions

Family firms generally outperform their non-family competitors. For example, family firms on the S&P 500,<sup>8</sup> Fortune 500,<sup>9</sup> and Business Week 1000<sup>10</sup> have higher market value

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omy. The Census Bureau uses a narrower definition of "family business": a firm in which *two or more* members of a single family own the majority of the business. Though this definition eliminates sole proprietorships and many family-controlled firms from the category of "family business," the Census Bureau still finds that over 3.2 million family businesses contribute almost \$3.2 trillion to the national economy—approximately 20 percent of GDP. U.S. Census Bureau, *2012 Survey of Business Owners*, [http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=SBO\\_2012\\_00CSCB04&prodType=table](http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=SBO_2012_00CSCB04&prodType=table).

<sup>4</sup> Astrachan & Shanker at 116.

<sup>5</sup> *Id.*

<sup>6</sup> Ronald C. Anderson & David M. Reeb, *Founding Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. of Fin. 1301, 1302 (2003).

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 1324; Jim Lee, *Family Firm Performance: Further Evidence*, 19 Fam. Bus. Rev. 103, 112 (2006).

<sup>9</sup> Belen Villalonga and Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. of Fin. Econ. 385, 414 (2006).

<sup>10</sup> Daniel L. McConaughy et al., *Founding Family Controlled Firms: Efficiency and Value*, 7 Rev. of Fin. Econ. 1 (1998).

to asset ratios than their non-family peers. Family firms also experience higher employment and revenue growth<sup>11</sup> and operate more efficiently.<sup>12</sup> In addition, in times of economic uncertainty, “family firms far outshine their peers.”<sup>13</sup>

According to a *Harvard Business Review* study, family businesses “often invest with a 10- or 20-year horizon, concentrating on what they can do now to benefit the next generation.” This long-term view leads them to take on less debt and be more judicious with capital expenditures than their non-family competitors.<sup>14</sup> While these choices result in lower returns “during good times..., [they] increase their odds of survival during bad times.”<sup>15</sup> Consequently, family businesses dampen the blow of economic recession to the national economy, and lead the country toward economic recovery.<sup>16</sup>

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<sup>11</sup> Jim Lee, *Family Firm Performance: Further Evidence*, 19 *Fam. Bus. Rev.* 103, 112 (2006).

<sup>12</sup> Daniel L. McConaughy, Charles. H. Matthews & Anne S. Fialko, *Founding Family Controlled Firms: Performance, Risk, and Value*, 39 *J. of Small Bus. Mgmt.* 31 (2001); José Castillo & Michael W. Wakefield, *An Exploration of Firm Performance Factors in Family Business: Do Family Value only the “Bottom Line”?*, 17 *J. of Small Bus. Strategy* 37 (2006) (finding a positive relationship between family businesses and return on investment).

<sup>13</sup> Nicholas Kachaner, George Stalk, Jr. & Alain Bloch, *What You Can Learn from Family Business*, *Harv. Bus. Rev.* (Nov. 2012), available at <https://hbr.org/2012/11/what-you-can-learn-from-family-business>.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* See also Harvey James, *Owner as Manager, Extended Horizons and the Family Firm*, 6 *Int’l. J. of the Econ. of Bus.* 41, 53 (1999).

<sup>16</sup> Researchers have also found that “[s]urvivability capital [money that families put into their businesses] can help sustain the business during poor economic times or, for example, after an unsuccessful extension or new market venture. This safety net is less likely to occur in nonfamily firms due to the lack of loyalty, strong ties, or long-term commitments on the part of employees.” David G. Sirmon & Michael A. Hitt, *Managing Resources: Linking Unique Resources, Management and Wealth Creation in Family Firms*, 27 *Entrepreneurship Theory and Prac.* 339, 343 (2003).

## 2. Family businesses are especially important to local economies

Family businesses also provide stability to local economies. They tend to be more rooted in communities, where the family owners live, work, and raise their children. Because of these strong local ties, family businesses are less likely “to move to a more advantageous jurisdiction” for the sake of a tax break or other incentive.<sup>17</sup> As a result, they help maintain stable regional tax bases and facilitate long-term regional planning.

## 3. The unique cultures of family businesses benefit owners and employees

Family businesses generally have corporate cultures that help the firms survive across generations. Studies report that family-firm executives are more likely to be oriented toward the long term and are more likely to reinvest profits into the firm.<sup>18</sup> Moreover, family loyalty and concerns over reputation give family firms incentives to keep profitability high.<sup>19</sup> The cultures at family businesses often lead them to develop longer-lasting connections with customers and suppliers.<sup>20</sup>

Family business cultures also benefit employees. According to one recent study, annual employee retention rates at family businesses are approximately 20 percent higher than

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<sup>17</sup> PwC, *Family Firm: A Resilient Model for the 21st Century* 19 (2012), available at <https://www.pwc.com/gx/en/pwc-family-business-survey/assets/pwc-family-business-survey-2012.pdf>.

<sup>18</sup> Manuel Carlos Vallejo, *Is the Culture of Family Firms Really Different? A Value-based Model for Its Survival Through Generations*, 81 J. of Bus. Ethics 261, 273 (2008).

<sup>19</sup> Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. of Fin. 1301, 1306 (2003).

<sup>20</sup> *Id.*; Katuska Cabrera-Suárez, Petra De Saá-Pérez & Desiderio García-Almeida, *The Succession Process from a Resource- and Knowledge-Based View of the Family Firm*, 14 Fam. Bus. Rev. 37, 38 (2001).

at non-family firms.<sup>21</sup> During temporary market downturns, family firms are less likely to lay off employees.<sup>22</sup> Finally, studies find that family firms have greater levels of organizational harmony and employee involvement, and higher levels of employee commitment to the firms.<sup>23</sup>

#### 4. Family businesses empower women and minorities

Family businesses are particularly empowering to women and minorities. For example, women lead 24 percent of family owned businesses,<sup>24</sup> and 31.3 percent of family businesses report that they plan to have female successors.<sup>25</sup>

In addition, family businesses also represent one of the greatest sources of wealth creation for the Latino community. A Stanford Business School study reports that between 1997 and 2012, the number of Latino-owned businesses increased from 1.2 million to 3.3 million,<sup>26</sup> and 92 percent of these enterprises were family-owned businesses.<sup>27</sup> Further, over

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<sup>21</sup> Nicholas Kachaner, George Stalk, Jr. & Alain Bloch, *What You Can Learn from Family Business*, Harv. Bus. Rev. (Nov. 2012), available at <https://hbr.org/2012/11/what-you-can-learn-from-family-business>.

<sup>22</sup> Jim Lee, *Family Firm Performance: Further Evidence*, 19 Fam. Bus. Rev. 103, 112 (2006).

<sup>23</sup> Manuel Carlos Vallejo, *Is the Culture of Family Firms Really Different? A Value-based Model for Its Survival Through Generations*, 81 J. of Bus. Ethics 261, 273 (2008).

<sup>24</sup> MassMutual Financial Group, *American Family Business Survey 5* (2007), available at <https://www.massmutual.com/mmfg/pdf/afbs.pdf>.

<sup>25</sup> *Id.*

<sup>26</sup> Stanford Latino Entrepreneurship Initiative, *State of Latino Entrepreneurship Research Report 9* (2015).

<sup>27</sup> *Id.* at 6.

half of Latino business owners state that they started their businesses in order to pass something onto their children, and 65 percent report that they employ other family members.<sup>28</sup>

Similarly, the U.S. Census Bureau reports that there are currently 2.5 million African-American businesses.<sup>29</sup> According to a report by the Mass Mutual Financial Group, “African-Americans are far more likely than the general population of business owners to have gone into business to have something tangible to pass on to their children (53 % versus 35 %) and to give back to the community (53 % versus 21 %).”<sup>30</sup>

## **B. The Proposed Regulations Threaten Family-Owned Businesses**

### **1. The proposed regulations target family business**

When families transfer ownership of a family business from one generation to the next, those ownership shares are typically subject to restrictions that limit the new owner’s ability to sell them or to exercise control over the business. For example, when parents transfer shares in a family business to their children, the children may be prohibited from liquidating the shares without the unanimous consent of all other shareholders. Likewise, they may be restricted to receiving liquidation proceeds in a manner other than cash. In addition, their ability to exercise control over the business may be limited, due to the size of their stakes or the allocation of voting rights. While these kinds of restrictions often increase the long-term stability of a family business, as a matter of economic reality they inevitably

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<sup>28</sup> MassMutual Financial Group, *The Pursuit of the American Dream: The Fiscal Practices of Today’s Hispanic Business Owners* 2 (2013), available at [https://www.massmutual.com/mmfg/pdf/execsummary\\_hispanic\\_English.pdf](https://www.massmutual.com/mmfg/pdf/execsummary_hispanic_English.pdf).

<sup>29</sup> U.S. Census Bureau, *2012 Survey of Business Owners*, available at [http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=SBO\\_2012\\_00CSCB04&prodType=table](http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=SBO_2012_00CSCB04&prodType=table).

<sup>30</sup> MassMutual Financial Group, *Building a Legacy: The Fiscal Practices of Today’s African American Business Owners* 5 (2011), available at [https://www.massmutual.com/mmfg/pdf/execsummary\\_africanam.pdf](https://www.massmutual.com/mmfg/pdf/execsummary_africanam.pdf).



decrease the value of the individual shares. Existing Treasury regulations follow commercial valuation standards in recognizing this reality and permitting the value of transferred shares to be appropriately discounted for purposes of calculating gift and estate taxes.

By contrast, the proposed regulations would severely limit the use of valuation discounts for family business transfers. For example, the proposal would apply a three-year “look-back” period to determine if minority share discounts apply. This means that the Internal Revenue Service (IRS) would examine whether shares in a family business were transferred within three years of the death of the transferor. If they were, the minority share discount would be retroactively rescinded. IRS would ignore the value-diminishing restrictions placed on the shares in the family business and impose tax liability based on the value of the shares without the restrictions.

This change will have significant, negative consequences for those heirs of family businesses. Consider the situation where a father wants to pass on his business to his three children to keep the business in the family and so transfers the shares with the restriction that the business cannot be liquidated without the unanimous consent of all three children. Under the proposed regulations, if the father unexpectedly passes away less than three years after the transfers, the value of the shares would be calculated as if the value-diminishing restriction did not exist, imposing a tax burden based on a valuation that significantly exceeds the value of the asset.

It is important to note that the proposed regulations target only family businesses. If the father in the previous example also transferred shares in a separate non-family business at the same time, standard valuation discounts would apply. In other words, the IRS would recognize standard lack-of-control and lack-of-marketability discounts when calculating the

value of those non-family business shares, using different accounting methods to value the family and non-family business shares for gift and estate tax purposes.

2. The proposed regulations undermine family roles in business and family-business succession planning

The proposed regulations distort decision-making and create perverse incentives in the transfer of family businesses. As outlined in more detail below, the proposal incentivizes families to consider either accelerating the transfer of shares in the business; selling or liquidating the firm; or transferring ownership of the firm to a single family member rather than dividing it among multiple family shareholders.

The three-year “look-back” provision in the proposed regulations encourages family business owners to transfer control of the businesses earlier than would otherwise make sound business sense because of the risk that artificially high tax liability will be imposed if the transferor dies earlier than expected. While this risk cannot be eliminated entirely, it can be substantially reduced if the shares are transferred when the transferor is relatively young.

Alternatively, a family business owner could liquidate the family business, or sell it to someone outside of the family, and simply transfer the proceeds to her heirs. As it stands, restricted shares are less valuable specifically because they do not include liquidation or control rights. Valuation discounts partially compensate the holders for this diminution. If minority shareholders in a family business do not receive discounts that reflect the actual value of their shares, there will be greater pressure to simply sell or liquidate the firm. In this way, the proposed regulations may frustrate family ownership of businesses altogether. The natural consequence will be a decline in family businesses, with all the economic consequences that entails.

Another option is for a family business owner to transfer business shares to a single family member, rather than disperse them among multiple individuals. In that case, the heir would receive the same liquidation and control rights as the original owner, making discount valuation issues moot. Such an outcome may undermine the entire family's role in the business, but it would ensure that the family avoids artificially high gift or estate tax bills.

Even if a family ignores these perverse incentives, the proposed regulation will still shape how the family structures the transfer. The proposed regulations will eliminate discounts of the value of transfers that do not include shareholder or partner voting rights, making it more difficult to place family business leadership in the hands of the most capable individuals. The proposed regulations will also make it more expensive to restrict the liquidation of interests, since family members will inherit larger tax bills.

3. The proposed regulations unfairly discriminate against family businesses by denying them the same treatment afforded to other entities

In addition to undermining succession planning, the proposed regulations place family businesses at a competitive disadvantage by subjecting intra-family transfers of family businesses to additional tax burden. Under the proposed regulations, intra-family transfers of shares in non-family businesses would continue to receive standard valuation discounts, while comparable shares in family businesses would not.

At the same time, family businesses, in particular family farms, are disproportionately asset rich but cash poor and may well have to liquidate some assets to pay the higher gift and estate taxes. As the Department of Agriculture notes, 98 percent of U.S. farms are fami-

ly operations, “and even the largest farms are predominately family run.”<sup>31</sup> “[M]uch of the net worth of farm households is illiquid....because it is largely based on assets necessary to continue farming.”<sup>32</sup> Land alone constitutes 79 percent of family farms’ total assets.<sup>33</sup> Accordingly, the proposed regulations are likely to place such family businesses at risk.

### **C. Economic Impacts: The Proposed Regulations Would Discourage Saving and Investment, and Undermine Job Creation**

Taken in the aggregate, the potential negative impacts of the proposed regulations on family business would impact the broader U.S. economy. In particular, the proposal would undermine savings, investment, growth, and job creation.

- **Reduced Savings and Investment.** Econometric research shows that the estate tax has reduced the amount of capital stock in the economy, because it encourages individuals to reduce savings and increase consumption. This has the perverse effect of shrinking the tax base for the income tax, such that policies expanding transfer-tax incidence and liability may actually undermine overall tax revenues or at least be offset by reduced revenues from other taxes.<sup>34</sup>
- **Slower Economic Growth.** Based on econometric research, the estate tax is a dampener on economic growth because it blocks family businesses from expanding and re-

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<sup>31</sup> U.S. Dep’t of Agric., *Structure and Finances of U.S. Farms: Family Farm Report* i, 2 (2010).

<sup>32</sup> *Id.* at 32.

<sup>33</sup> *Id.*

<sup>34</sup> See Marco Cagetti & Mariacristina De Nardi, Nat’l Bureau of Econ. Research, *Estate Taxation, Entrepreneurship, and Wealth*, Working Paper 13160 (June 2007); U.S. Cong., Joint Econ. Comm., *Reconsidering the True Revenue Yield of the Estate Tax*, Research Report 109-38 (June 2006); U.S. Cong., Joint Econ. Comm., *Cost and Consequences of the Federal Estate Tax: An Update*, (July 25, 2012) (surveying literature).

duces capital investment and productivity.<sup>35</sup> As a result, policies that expand transfer-tax incidence and liability may actually decrease overall federal tax revenues.<sup>36</sup>

- **Less Job Creation.** Econometric research also shows that the estate tax’s impact on family businesses—in particular, the ways that it reduces their size and ability to grow—reduces job creation across the economy. Accordingly, policies that increase its incidence and liability are likely to have the same effect. Such policies, in turn, are also likely to reduce income-tax revenues, offsetting any potential increased revenues from such policies.<sup>37</sup>
- **Increased Compliance Costs.** Survey and other data indicate that the additional compliance costs resulting from the proposed regulations could potentially exceed the net revenue (if any) that it generates.<sup>38</sup>

In short, the proposed regulations are likely to negatively impact the economy, while doing little or nothing to increase overall federal tax revenue.

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<sup>35</sup> See John Ligon, Rachel Greszler & Patrick Tyrrell, *The Economic and Fiscal Effects of Eliminating the Federal Death Tax*, Heritage Found. Backgrounder No. 2956 (Sept. 23, 2014).

<sup>36</sup> See, e.g., Stephen J. Entin, Am. Fam. Bus. Found., *A Score of the Death Tax Repeal Permanency Act*, (April 2011).

<sup>37</sup> See John Ligon, Rachel Greszler & Patrick Tyrrell, *The Economic and Fiscal Effects of Eliminating the Federal Death Tax*, Heritage Found. Backgrounder No. 2956 (Sept. 23, 2014); Richard E. Wagner, *Federal Transfer Taxation: A Study in Social Cost* (1993). See generally Curtis Dubay, *The Economic Case Against the Death Tax*, Heritage Found. Backgrounder No. 2440 (July 20, 2010) (surveying literature).

<sup>38</sup> See Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for Wealth Transfer Taxes*, 45 Nat’l Tax J., 119 (1992); B. Douglas Bernheim, *Does the Estate Tax Raise Revenue?* 1 Tax Policy & Econ. 113 (1987), pp. 113–138; Alicia H. Munnell & C. Nicole Ernsberger, *Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes*, 19 New Eng. Econ. Rev. 3 (Nov./Dec. 1988).

#### **IV. The Proposed Regulations Fail *State Farm's* "Reasoned Decision Making" Standard**

Under Section 706(2)(A) of the Administrative Procedure Act, a court must "hold unlawful and set aside agency action, findings, and conclusions" that the court finds to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). To satisfy this standard, an agency engaged in rulemaking "must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962); see also *Judulang v. Holder*, 132 S. Ct. 476, 484 (2011) (same). A court will find that an agency failed to articulate a "rational connection" when the agency "has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Id.*

When the agency is "changing its course," additional explanation is required. *Id.* at 42. Specifically, the agency must not only provide "good reasons for the new policy," but also "a reasoned explanation...for disregarding facts and circumstances that underlay or were engendered by the prior policy." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 516 (2009); see also *State Farm*, 463 U.S. at 42 (holding that an agency is "obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance"). In other words, "[a]n agency may not...depart from a prior policy *sub silentio* or simply disregard rules that are still on the books." *Id.* at 515. Treasury has failed to meet this burden with respect to the changes in law identified above.

The *State Farm* “reasoned decision making” standard applies with full force to Treasury regulations, including regulations that address estate and gift tax valuation rules. See *Balestra v. United States*, 803 F.3d 1363, 1368 (Fed. Cir. 2015) (“We evaluate [Treasury’s] explanation for its action under *State Farm*.”). In the context of tax regulations, the *State Farm* Standard requires that the Treasury: (1) “attempt[] to marshal empirical evidence” to justify the rule; (2) rationally connect the choice it made with the empirical evidence it marshalled; and (3) respond to significant comments and offer reasoning that “refutes the commentators’ evidence.” *Altera Corp. & Subsidiaries v. C.I.R.*, 145 T.C. 91 (2015).

**A. The Proposed Regulations Are Not Justified and Are Factually Unsupported**

The Treasury Department’s rationale for the proposed regulations is doubly flawed. First, Treasury tacitly relies on congressional inaction as a justification for rulemaking. In addition, Treasury fails to provide the requisite empirical evidence to support its position. In both these ways, it fails to satisfy the *State Farm* “reasoned decision making” standard.

“It is axiomatic that administrative agencies may issue regulations only pursuant to authority delegated to them by Congress.” *Am. Library Ass’n v. FCC*, 406 F.3d 689, 691 (D.C. Cir. 2005). If Congress chooses not to delegate that authority, “an agency literally has no power to act.” *New York v. FERC*, 535 U.S. 1, 18 (2002) (quotation marks omitted). As such, an agency cannot rely on congressional inaction as a reason for promulgating a regulation.

Yet that is precisely what the Treasury Department is attempting to do here. For a decade now, Treasury has been trying to persuade Congress to overturn *Kerr v. Commissioner*, 113 T.C. 449 (1999), by amending Code Section 2704. See IRS, *Priority Guidance Plan 16* (2004) (listing as a concern “section 2704 regarding the liquidation of an interest”). In *Kerr*,

the Tax Court found that restrictions on the ability to liquidate a transferred interest in a transferred entity “are excepted from the definition of an applicable restriction pursuant to [I.R.C.] section 2704(b)(3).” *Kerr v. Commissioner*, 113 T.C. 449, 473 (1999), *aff’d*, 292 F.3d 490 (5th Cir. 2002)).

The Treasury Department believes that *Kerr* renders the statute and its regulations “substantially ineffective,” and thus is proposing a rule to circumvent *Kerr*. 81 Fed. Reg. at 51,415. In fact, as recently as its 2013, Treasury’s “Revenue Proposals” to Congress contained a detailed proposal to amend Section 2704 to “create an additional category of restrictions (‘disregarded restrictions’) that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family.” Dep’t of Treasury, *General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals* 79 (Feb. 2012). Having failed to persuade Congress to adopt that proposal, Treasury is now attempting to codify the proposal through rulemaking. However, compensating for congressional inaction is no justification for agency rulemaking under *State Farm*. Instead, it is proof of unreasoned and likely *ultra vires* action.

The proposed rule further falls short of the *State Farm* standard by failing to marshal any empirical data, as Treasury’s analysis of the proposed rule’s economic impact reveals. Treasury declares “that this regulation will not have a significant economic impact on a substantial number of small entities.” 81 Fed. Reg. at 51,418. But it provides no evidence, and attempts no empirical analysis, to support this claim. Instead, Treasury asserts that the rule targets “interest[s] in certain closely held entities and not the entities themselves.” *Id.* However, as an empirical matter this distinction makes no difference in many family firms. As described at length above, family firms are often asset rich but cash poor, and some will



have to liquidate business assets to satisfy the increased tax liabilities. *See supra* Sections III.B, C. This reality perhaps explains why Treasury failed to provide the empirical evidence, but it does not excuse the failure as a matter of administrative law.

Furthermore, by failing to evaluate the proposed regulations' impact on family businesses, Treasury fails to consider an important aspect of the problem that Congress intended it to. Congress recognized the threat that the estate tax poses to family businesses in Code Section 6166, which provides tax-liability deferral and installment payments for certain estates that contain interests in closely held businesses. 26 U.S.C. § 6166. The proposed regulations' deemed lapse scheme, however, would exacerbate the problem that Congress sought to address in Code Section 6166, by including additional assets (in the form of rights deemed to have lapsed) in estates that are unlikely to qualify for Section 6166 relief, because any business-ownership interests have already been transferred. This result demonstrates that the deemed lapse approach is illogical and unreasonable, in light of the policies legislated by Congress. At the least, Treasury must consider the consequences of the proposed regulations' interaction with Section 6166.

Moreover, in this instance, Treasury is reversing course from the statutory interpretation it adopted in Revenue Ruling 93-12, as discussed above, which was issued three years after the enactment of Section 2704. In that ruling, the IRS conceded the propriety of valuation discounts on intra-family transfers of the same kind that it now proposes to disregard. Yet Treasury's proposal does not discuss Revenue Ruling 93-12, does not acknowledge its change in position, and certainly does not explain why it is now seeking to "disregard[] facts and circumstances that underlay or were engendered by the prior policy." *Fox Television Sta-*

*tions, Inc.*, 556 U.S. at 516. This, in itself, renders the proposed regulations arbitrary and capricious.

Significantly, Treasury has failed to determine that the restrictions targeted by its rule do “not ultimately reduce the value of such interest to the transferee,” a statutory factor that the agency is obligated to address. 26 U.S.C. § 2704(b)(4). Its failure to make a showing that each restriction addressed by its proposal satisfies this statutory factor constitutes a per se violation of the *State Farm* standard. Treasury has the burden, which it has not even attempted to carry, to “attempt[] to marshal empirical evidence” to justify each aspect of its proposed regulatory approach. *Altera Corp. & Subsidiaries v. C.I.R.*, 145 T.C. 91 (2015).

Finally, Treasury fails to provide evidence that the benefits of the proposed rule will outweigh its costs, as required under the *State Farm* standard. *See infra* Section IV.G.

In sum, Treasury fails to marshal empirical evidence to justify the rule, rationally connect the choice it made with the empirical evidence it marshalled, consider factors that Congress directed it to consider, and identify how and explain why it has changed course. These failures render its proposed regulations arbitrary and capricious.

#### **B. The Proposed Regulations Unaccountably Depart from Valuation Standards and Arbitrarily Target Family Businesses**

The proposed regulations depart from longstanding practice and accepted valuation standards, without any adequate justification for so doing. Moreover, Treasury fails to explain why the proposed regulations would treat similarly situated businesses—closely held family businesses and closely held non-family businesses—differently. Because of these arbitrary omissions, the proposed regulations fail to meet the *State Farm* standard.

“Government is at its most arbitrary when it treats similarly situated people differently.” *Etelson v. Office of Pers. Mgmt.*, 684 F.2d 918, 926 (D.C. Cir. 1982). As such, “[w]here an

agency applies different standards to similarly situated entities and fails to support this disparate treatment with a reasoned explanation and substantial evidence...its action is arbitrary and capricious and cannot be upheld.” *Burlington N. & Santa Fe Ry. Co. v. Surface Transp. Bd.*, 403 F.3d 771, 777 (D.C. Cir. 2005). This is particularly true in the context of rulemaking, where an agency has a special duty to examine relevant data and articulate a reasoned explanation for its action. *See Petroleum Commc’ns, Inc. v. FCC*, 22 F.3d 1164, 1172 (D.C. Cir. 1994) (noting in the context of rulemaking that “[w]e have long held that an agency must provide adequate explanation before it treats similarly situated parties differently”).

The Treasury Department arbitrarily departs from valuation standards by treating similarly situated estates differently. The IRS has long recognized the legitimacy of applying lack of control and lack of marketability discounts to shares in closely held companies. *See, e.g., Estate of Andrews v. C.I.R.*, 79 T.C. 938, 953 (1982) (“The minority shareholder discount is designed to reflect the decreased value of shares that do not convey control of a closely held corporation. The lack of marketability discount, on the other hand, is designed to reflect the fact that there is no ready market for shares in a closely held corporation.”); *Heck v. C.I.R.*, 83 T.C.M. (CCH) 1181 (T.C. 2002) (same). Indeed, the agency recognizes three approaches for calculating the discounts: the comparable companies analysis, the discounted economic income approach, and the discounted cash flow analysis. *See Estate of Mitchell v. C.I.R.*, 83 T.C.M. (CCH) 1524 (T.C. 2002). The proposed regulations unreasonably discard all three based on a factor completely unrelated to the value of the inherited shares—the date on which the original owner of the shares dies. *See Magnin v. C.I.R.*, 81 T.C.M. (CCH) 1126, 1138 (T.C. 2001) (“While the appropriate amount of discount to apply in each case is

a question of fact, it is unreasonable to argue that no discount should be applied to a minority interest in a closely held corporation.”). The departure from valuation standards based on an irrelevant criterion is the height of arbitrariness.

In addition, Treasury offers no explanation for its disparate treatment of closely held family and non-family businesses. At present, individuals who inherit shares in closely held non-family businesses routinely receive lack of control and lack of marketability valuation discounts. *See, e.g., Estate of Giustina v. C.I.R.*, 111 T.C.M. (CCH) 1551 (T.C. 2016) (increasing discount rate from 16.25 percent to 18 percent because partnership agreement contained provision stating that limited-partner interest could be transferred only to another limited partner or person receiving approval of two general partners); *Estate of Litchfield v. C.I.R.*, 97 T.C.M. (CCH) 1079 (T.C. 2009) (granting lack of marketability valuation discounts for estate’s minority stakes in two closely held S corporations); *Estate of Ford v. C.I.R.*, 53 F.3d 924 (8th Cir. 1995) (finding that 20-percent minority interest discount and 10-percent lack of marketability discount were properly allowed).

The proposed regulations would deny this discount to similarly situated family businesses without offering an “adequate explanation” for this disparate treatment and for its departure from standard valuation metrics. In fact, the proposed regulations offer no explanation at all. Absent such explanation, the “action is arbitrary and capricious and cannot be upheld.” *Burlington N. & Santa Fe Ry. Co.*, 403 F.3d at 777.

The problem with the disparate treatment, however, runs deeper. In comparison to other firms, family businesses are more likely to reinvest their revenues into the business,

and tend to have more of their assets tied to the operation of the business.<sup>39</sup> Family firms are thus particularly vulnerable to tax increases, especially tax increases that are divorced from business realities. This makes Treasury’s failure to address its disparate treatment of family firms arbitrary and illogical and indicates that the agency’s proposed action is fundamentally unreasonable.

**C. The Proposed Regulations Would Result in Unreasonable, Arbitrary, and Unfair Imposition of Tax Liability**

1. The “Deemed Lapse” Rule

The three-year “deemed lapse” rule, if adopted, would overturn well-established gift and estate tax valuation principles embodied in case law and Rev. Rul. 93-12. Under the facts of Example 1 above (echoing Rev. Rul. 93-12), P owned 100 percent of the common stock of X corporation and gave it all away in equal 20-percent blocks to P’s children. If the three-year “deemed lapse” rule were to be applied, P would be subjected to estate tax inclusion of a “lapsed right” to compel liquidation of X as of P’s death if P died within three years of the gifts of stock to P’s children. Thus, the effect of such a “deemed lapse” rule would be to include in P’s estate 100 percent of the net liquidation value of X as of P’s death, less the minority-interest-discounted value of the X stock that P gifted to P’s children prior to P’s death.

Similarly, in Example 2, where M recapitalized ABC Co. and gifted the 90-percent nonvoting equity to M’s children, if M died within three years of gifting the nonvoting Class B equity interests to M’s children, the impact of the proposed three-year rule would be to tax M’s estate on both (i) the value of M’s retained 10 percent Class A (voting) equity interest,

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<sup>39</sup> Nicholas Kachaner, George Stalk, Jr. & Alain Bloch, *What You Can Learn from Family Business*, Harv. Bus. Rev. (Nov. 2012), available at <https://hbr.org/2012/11/what-you-can-learn-from-family-business>.

plus (ii) the difference between (a) 90 percent of the full net liquidation value of ABC Co. (i.e., the net liquidation value attributable to the 90 percent Class B equity gifted within three years of death), and (b) the nonvoting-discounted value of the Class B shares gifted to the children (valued as of the date of gift).

Indeed, under a three-year “deemed lapse” rule, as illustrated by the impact of such a rule in Examples 1 and 2 (as well as the proposed, amended Examples 4 and 7 in the proposed regulations), any business owner who relinquished control to other family members, whether by gifting all of the owner’s equity or simply enough to “lose” individual control, would be subjected to a three-year estate-tax-inclusion risk that *does not exist* under current law and is unsupported by statute.

In Example 3 above, because F never had “control” of NewCo (having acquired only the 99-percent nonvoting equity interest from inception), the three-year rule presumably would not apply. However, in many situations involving family transfers of business interests, there comes a time when control is transferred to younger-generation family members *without any lapse of voting rights*. Those situations should not be subjected to a “deemed lapse” rule or a “three-year rule,” because doing so would ignore the economic realities and impose unfair and unwarranted tax burdens that Congress never intended.

As explained above, Treasury fails to properly identify and adequately justify the substantial policy shift reflected in these examples. In addition, these examples illustrate the absurd results of Treasury’s proposed “deemed lapse” approach.

## 2. Application of Section 2704(b) to Transferred Interests in an Entity

Several examples serve to illustrate the unfair, unreasonable, and arbitrary results of proposed regulations Section 25.2704-3:

**a. Minimum Value.** Proposed regulations Section 25.2704-3(b)(1)(ii) defines “minimum value” as “the [equity] interest’s share of the net value of the entity determined on the date of liquidation or redemption.” Thus, under a literal interpretation of the regulation, if family members collectively “could” liquidate an entity, any gift of a minority or nonvoting equity interest still would have to be valued “as if” the donee, acting alone, held a right to compel liquidation of the entity and/or a redemption of his or her equity interest at “full net liquidation value” or, as defined in the proposed regulations, the “minimum value.”

In fact, few business entities could survive if each individual equity holder could “force” a liquidation or redemption of that equity holder’s individual interest in the entity. Further, in recognition of that economic fact, put rights or redemption rights at an individual equity holder level, if granted at all, almost invariably call for a discount to be applied if the entity (or other equity holders) are forced to liquidate any particular equity holder’s interest in the entity.

Applying such a “minimum value” concept would reverse the result in Rev. Rul. 93-12 (Example 1), by requiring each 20-percent gifted, minority block of common stock to be valued “as if” each donee-child could “force” a liquidation of his or her 20 percent equity interest at its “net liquidation value” or “minimum value.”

Similarly, in Example 2 (recapitalization and gift of nonvoting equity interests), the gift of nonvoting equity interests to M’s children would be valued at “minimum value” for gift tax purposes, thereby ignoring the economic reality that the actual (and gift tax) value of such nonvoting interests should reflect their nonvoting character and the real limitation on the ability of each such equity holder to realize “minimum value.”

Finally, in Example 3, upon the death of F (who retained only nonvoting equity interests), the “minimum value” presumably would be applied in determining the estate tax value of F’s nonvoting equity, once again effectively ignoring the economic reality that a buyer of such a nonvoting equity block could not, in fact, compel a liquidation of the nonvoting equity for “minimum value.”

**b. Six-Month Limitation on Deferred Redemption Payments.** Proposed regulations Section 25.2704-3(b)(1)(iii) would treat any deferral greater than six months of payment of redemption proceeds as a “disregarded restriction.” In practice, due to cash flow and financing limitations on business operations, the redemption proceeds for many individual equity holders’ interests in closely-held businesses are paid over several years. The mere fact that a promissory note over several years is involved should not be treated as a “disregarded restriction.”

**c. Limitations on Use of Promissory Notes to Finance Redemptions.** Proposed regulations Section 25.2704-3(b)(iv) would treat as a “disregarded restriction” many common arrangements to finance redemptions with promissory notes issued by the redeeming entity. For example, it appears that a promissory note would be “acceptable” consideration only if issued by “an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business” *and* only to the extent that “the liquidation proceeds are not attributable to passive assets.” Further, any such promissory note must be issued at “market interest rates” rather than the Applicable Federal Rate (“AFR”), and the note must have “a market value on the date of liquidation or redemption equal to the liquidation proceeds.” There is no justification for any special limitations on an entity’s ability to finance redemptions with promissory notes.



### 3. Limitations on When Non-Family Member Interests May Be Taken into Account

Proposed regulations Section 25.2704-3(b)(4), in addition to being *ultra vires*, is also arbitrary and unreasonable.

First, its 10-percent/20-percent equity ownership requirements are completely arbitrary, with no basis in statute and no justification premised on economic reality. If an enterprise has eight 5-percent non-family owners, *none* of the outside equity ownership would be recognized. However, if the enterprise has four 10-percent owners then (if the other requirements are satisfied), the non-family member interests *all* would be recognized.

Second, the proposed three-year holding rule would mean that no non-family member equity interests could be taken into account for transfer-tax valuation purposes during the first three years of an enterprise's existence.

Third, the most arbitrary (and impractical) proposed requirement is the "put right" that a non-family equity holder must have in order for his or her equity holding to "count." It is completely impractical and unrealistic to expect any business or investment entity to give *any* equity holder an absolute right to "put" his/her/its equity interest and demand a redemption with six months' notice at full liquidation value. By requiring that such a put right be granted to a non-family member before that non-family member's equity interest is taken into account for purposes of determining family "control" of an enterprise, the proposed regulations, as a practical matter, would require that virtually *all* non-family member equity interests must be disregarded.

**D. The Proposed Regulations Are Unreasonable Because They Ignore Economic and Practical Realities**

The proposed regulations fail to acknowledge that business exigencies unrelated to tax liabilities shape how families structure their estates and assets. Indeed, the proposed regulations would restrict the options available to families to create business structures that reflect their business judgments and family values.

Families impose control and liquidation restrictions on shares in a family business for a multitude of reasons that have nothing to do with tax liability. For example, a family may seek to ensure that the shares in the family business remain in the family, to prevent a family member from selling the shares immediately upon receiving them, or to structure succession so all heirs receive equal shares of the business and the most capable heirs have control. By disregarding such routine arrangements, the proposed rules ignore business realities and will make prudent succession planning much more difficult, if not impossible.

Similarly, families transfer interests in a family business to non-family members for a host of reasons unrelated to tax liability. For example, businesses sometimes reward employees for their dedicated service by offering them shares in the company, or as part of their compensation package. Businesses also engage in philanthropy by donating ownership stake to charitable organizations. By “disregard[ing] the interest held by a nonfamily member that has been held less than three years before the date of the transfer, [or] that constitutes less than 10 percent of the value of all the equity interests,” the proposed regulations penalize such arrangements, and deprive businesses of important flexibility. 81 Fed. Reg. at 51,415.

**E. The Proposed Regulations Unrealistically Presume Harmonious, Complete Family Control**

A consistent legal fiction embedded in the proposed regulations is that owners of a “family-controlled enterprise” will, in all circumstances, act in concert. In other words, the proposal assumes that family businesses will be operated so that any individual family member will be able to convince the collective members of the family to exercise “control” in a manner that will allow that individual transferee (or, in some cases, the transferor, with respect to retained equity interests) to cause a redemption of his or her interest in the family-business at any time with six months’ notice, and that the redemption would allow the family member to realize the equivalent of a full liquidation value (i.e., as if the entire enterprise were liquidated and the family member would receive his/her full pro rata share of those “deemed” full liquidation proceeds).

This fiction is not consistent with reality, and Treasury identifies no basis in fact for it. Survey evidence paints a very different picture, showing that conflicts among family members are typical in family businesses and that such conflict is particularly acute with respect to matters of control and succession.<sup>40</sup> Because Treasury cannot muster evidence that families operate their businesses with complete harmony and without disagreements among family members, there is no support for effectively disregarding all restrictions on an individual family member’s power to compel a liquidation of the enterprise or a redemption of his or her equity interest in the enterprise. Indeed, such an assumption amounts to an improper end-run around the statutory limitations discussed above, including the statutory bar on disregarding restrictions under Code section 2704(b)(4) that “reduce the value of such

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<sup>40</sup> See PriceWaterhouseCoopers, *Global Family Business Survey 2014* (2014), available at <http://www.pwc.com/gx/en/pwc-family-business-survey/assets/family-business-survey-2014.pdf>.

interest to the transferee.” Simply assuming *the major premise* underlying a regulatory approach is the height of unreasoned and arbitrary decision making.

**F. The “Put Right” Concept Unreasonably Ignores the Illiquidity of Family Businesses and the Destructive Impact of Forcing Debt onto Family Business Balance Sheets**

The concept in the proposed regulation of essentially “requiring” a put right at “minimum value” (i.e., full net liquidation value) is untenable and unreasonable. In order to survive, family businesses must contend with swiftly changing technological developments, market conditions, and global competition. Few businesses, if any, could operate under the threat of potentially having to buy out (with six months’ notice) any and all individual equity holders. That threat would also make it impossible for businesses to access debt financing. The proposed “put right” and “minimum value” definitions completely fail to take into account the destructive impact such provisions would have on family businesses. Having to make arrangements to finance redemptions of individual equity holders with just six months’ notice would paralyze most businesses. Again, Treasury’s failure to consider the consequences of this provision constitutes arbitrary and unreasoned decision making.

**G. The Cost of the Proposed Regulations Is Disproportionate to Any Conceivable Benefit**

Treasury also fails to engage in the cost-benefit analysis required under the *State Farm* “reasoned decision making” standard in the proposed regulations. Specifically, Treasury offers no evidence that the benefit of the proposed rules would outweigh the costs to individuals and the economy as a whole, including that the proposed regulations would increase overall government revenue. To the contrary, the economic evidence discussed above suggests that the proposed regulations would not pass cost-benefit muster. For this reason alone, the proposed regulations do not satisfy the *State Farm* standard.

As the Supreme Court clarified last year, agencies must engage in a cost-benefit analysis to satisfy the *State Farm* standard. *Michigan v. EPA*, 135 S. Ct. 2699, 2707 (2015). As the Court explained, “reasonable regulation ordinarily requires paying attention to the advantages *and* the disadvantages of agency decisions,” including a “[c]onsideration of cost” to those affected. *Id.* (emphasis in original). Mere consideration of costs and benefits, though, is not enough. An agency also fails to engage in reasoned decision making if the costs of a regulation significantly outweigh its benefits. *Id.* (“One would not say that it is even rational, never mind ‘appropriate,’ to impose billions of dollars in economic costs in return for a few dollars in health or environmental benefits.”); *see also Metlife, Inc. v. Fin. Stability Oversight Council*, 2016 WL 1391569, at \*1 (D.D.C. Mar. 30, 2016) (“FSOC also focused exclusively on the presumed benefits of its designation and ignored the attendant costs, which is itself unreasonable under the teachings of *Michigan v. Environmental Protection Agency*.”). This principle applies with special force to tax regulations, given the Code’s overriding purpose of funding the operations of government, without unduly disrupting productive economic activity. For example, a regulation that reduces net tax revenue while also disrupting economic activity, or one that disrupts a substantial amount of economic activity for little or no revenue benefit, is one that likely fails to adequately address the advantages and disadvantages of its policy choices and so is not reasonable. By extension, failure to adequately ascertain and consider the costs and benefits of a particular tax policy is *per se* unreasonable.

Nowhere in the proposed regulations does Treasury engage in the requisite cost-benefit analysis. This omission “is itself unreasonable under the teachings of *Michigan v. Environmental Protection Agency*.” *Metlife, Inc.*, 2016 WL 1391569, at \*1. Nonetheless, even if

Treasury performed a cost-benefit analysis, the proposed rule would fall short of the *State Farm* standard. Studies show that increases in estate taxes, at best, produce only modest revenue gains for government, and may even result in an overall decrease in government revenue.<sup>41</sup> At the same time, the estate tax imposes compliance costs on taxpayers that equal direct revenue raised, and is responsible for the loss of 118,000 jobs and \$847 billion in the stock of capital in the economy.<sup>42</sup> Accordingly, any regulatory action to increase the incidence or amount of transfer-tax liability is likely to fail a cost-benefit analysis and therefore fail to constitute reasoned decision making. In addition, given the evidence regarding the negative economic and tax effects of policies like those contained in the proposed regulations, failure to analyze these issues is itself unreasonable.

An increase in transfer taxes that targets family businesses, which typically have a high proportion of illiquid assets, is even less defensible.<sup>43</sup> For example, the Congressional Budget Office estimates that 5 percent of all estates, and 12 percent of farmers' estates, subject to estate taxes had greater tax liabilities than liquid assets.<sup>44</sup> The proposed regulations could force some businesses to shutter or sell off assets, which will have ripple effects

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<sup>41</sup> U.S. Cong., Joint Committee on Taxation, *Costs and Consequences of the Federal Estate Tax* 13 (May 2006) (“[T]here is abundant evidence that the estate tax...may actually cause income revenue losses for the federal government.”).

<sup>42</sup> *Id.* at 17; Alfredo B. Goyburu, *The Economic and Fiscal Effects of Repealing Federal Estate, Gift and Generation-Skipping Taxes*, Heritage Ctr. for Data Analysis 1 (2002). *See supra* Section III.D.

<sup>43</sup> *See supra* Section III.A.

<sup>44</sup> Douglas Holtz-Eakin, *Effects of the Federal Estate Tax on Farms and Small Businesses*, Cong. Budget Off. Paper 12 (July 2005), available at <https://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/65xx/doc6512/07-06-estatetax.pdf>.

throughout the economy. Because the evidence indicates that these costs exceed any potential benefits, the proposed regulation is irrational.

In short, the proposed regulations are arbitrary and capricious because they do not include a cost-benefit analysis, and create costs that are disproportionate to any benefits.

## **V. The Proposed Regulations Fail To Comply with the Regulatory Flexibility Act**

The proposed regulations do not comply with the Regulatory Flexibility Act (“RFA”) and must be re-proposed, if they are not abandoned altogether.<sup>45</sup> The RFA requires that proposed rules subject to notice-and-comment rulemaking requirements be accompanied by “an initial regulatory flexibility analysis,” describing the “impact of the proposed rule on small entities.” 5 U.S.C. § 603(a). The proposed regulations do not include such an analysis.

While Treasury provides a certification that the new rules “will not have a significant economic impact on a substantial number of small entities,” 81 Fed. Reg. at 51,418, a certification of this nature is only valid if the agency offers “a statement providing the factual basis for such certification.” 5 U.S.C. § 605(b). Treasury’s purported “factual basis” is that there is *no* impact on small entities because the proposed regulations “affect the transfer tax liability of individuals” and “the assumptions under which [small businesses] are valued,” rather than “the entities themselves.” 81 Fed. Reg. at 51,418. This is actually a legal argument about what entities are “directly affected and regulated by the subject regulations,” and, because it does not administer RFA, Treasury is entitled to no deference on this question.<sup>46</sup> *Aeronautical Repair Station Ass’n, Inc. v. FAA*, 494 F.3d 161, 176 (D.C. Cir. 2007).

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<sup>45</sup> See 5 U.S.C. § 601 *et seq.*

<sup>46</sup> Even if Treasury maintains that there is an additional “factual basis” in its notice aside from its legal argument about what entities are directly regulated, the certification would be

Treasury's position is untenable. It acknowledges that the proposed rules directly impact and regulate "interest[s] in certain closely held entities," including small entities, and the "assumptions under which they are valued." 81 Fed. Reg. at 51,418. That amounts to "a significant economic impact" on small entities. 5 U.S.C. § 605(b). Congress has effectively recognized as much in the Tax Code. *See* 26 U.S.C. § 6166. Treasury's proposed distinction between an "interest" in an entity and its "structure" does not hold water: the interests in a corporation, combined, *constitute* its structure.<sup>47</sup> Indeed, if accepted, Treasury's argument would allow it to propose a rule rendering all equity in small businesses worthless—such as by changing "the assumptions under which they are valued," 81 Fed. Reg. at 51,418, to tax 100 percent of that value—and yet certify *zero* impact on small businesses. A rule that would run every small entity in the country out of business cannot be said to have no "significant economic impact on a substantial number of small entities." 5 U.S.C. § 605(b). For the same reason, a rule impacting their valuation clearly imposes an "economic impact."

This situation is therefore altogether different from the case where the impact of a rule on small entities is contingent on the decisions of third parties, *Am. Trucking Ass'ns v. EPA*, 175 F.3d 1027, 1044 (D.C. Cir. 1999), or otherwise amounts to an indirect, economic pressure on small entities, *Mid-Tex Elec. Co-op., Inc. v. FERC*, 773 F.2d 327, 341 (D.C. Cir. 1985). The proposed rules directly regulate the "assumptions under which" small entities

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arbitrary and capricious. *See N. Carolina Fisheries Ass'n v. Daley*, 16 F. Supp. 2d 647, 652 (E.D. Va. 1997). Treasury has not explained how regulations impacting the worth of small businesses somehow do not impact them.

<sup>47</sup> *See, e.g.*, Franklin A. Gevurtz, *Corporation Law 112 et seq.* (West 2000) (including an entire chapter called "Financial Structure" discussing, *inter alia*, "the Rights of Shares" and "Distributions to Stockholders").



“are valued,” and those entities are therefore directly regulated, notwithstanding that the tax is addressed to the equity-holders.<sup>48</sup>

The Treasury Department argues in the alternative that “any economic impact” on small businesses is “derived from the operation of the statute, or its intended application,” and “not from the Proposed Regulations.” 81 Fed. Reg. at 51,418. This logic also would nullify the RFA, because *every* regulation is “derived from the operation of [a] statute” and must be consistent with “its intended application.” To combat this contention, Congress expressly defined “rule” in the RFA to include “any rule for which the agency publishes a general notice of proposed rulemaking.” 5 U.S.C. § 601(2). Moreover, Treasury’s implicit point that the regulations do nothing to change the status quo directly contradicts both Treasury’s actions in proposing the regulations and their stated purpose in overturning the current case law construing “the operation of the statute” and “its intended application.” *See* 81 Fed. Reg. at 51,415 (stating that the purpose of the rule is to reverse *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff’d*, 292 F.3rd 490 (5th Cir. 2002)). Obviously, the proposed regulations are intended to do something other than mimic or duplicate “the operation of the statute.” And if Treasury is unwilling to acknowledge even that, then the proposed regulations are per se arbitrary and capricious. *See supra* § IV.A.

The reasons outlined above mandate an initial regulatory flexibility analysis. Because Treasury has not complied with this requirement, it must re-issue the proposed regulations for further comment. This requirement stems from the “procedural” nature of the RFA, *Aeronautical Repair*, 494 F.3d at 177, and its separate requirements for *both* a “final regulatory

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<sup>48</sup> *See Aeronautical Repair*, 494 F.3d at 177 (finding that regulation “immediately addressed to” air carriers directly impacted their contractors and subcontractors, which would also be required to meet its standards).

flexibility analysis” to be issued with a final rule, 5 U.S.C. § 604(a), and *also* an “initial regulatory flexibility analysis” to be issued “[w]henver an agency is required...to publish [a] general notice of proposed rulemaking for *any* proposed rule,” *id.* § 603(a) (emphasis added). Just as a properly conducted initial analysis does not excuse an agency from conducting a final analysis, *Aeronautical Repair*, 494 F.3d at 177–78, a final analysis here would not excuse the failure to conduct an initial analysis. The public has not had the opportunity to comment on an initial regulatory flexibility analysis, and Treasury is not permitted to impede that opportunity.

### **Conclusion**

For the reasons stated above, the proposed regulations are *ultra vires*, bad policy, inadequately supported, and impermissibly arbitrary in their design and function. They should be withdrawn.

Respectfully submitted,

The Family Business Estate Tax Coalition

## **Appendix A**

### **Three Case Studies on How the Proposed Regulations Would Impact Family-Owned Businesses**

The proposed regulations would have real-world consequences for businesses across the nation. The following three case studies, based on real-world examples, demonstrate the difficult decisions and harsh and unfair consequences the proposed regulations would impose on family businesses.

#### **Case Study 1: Passing on a family farm to the next generation**

A third-generation California farmer would like his four children to carry on the family's agricultural legacy by continuing to operate the farm after he passes away. Like the average American farm, land and machinery account for approximately 90 percent of the farm's assets. The farmer is concerned that, after his death, one of his children's decision to liquidate his or her stake in the farm will require the others to liquidate a significant portion of the farm's land and machinery. To prevent this from occurring, the farmer imposes liquidation restrictions on all four stakes: liquidation or sale of one child's shares will require majority consent. This restriction ensures that the farm can continue as a successful family-owned business even if one of his children decides to leave farming entirely.

Under the proposed regulations (Section 25-2704-2(b)(1)), the liquidation restrictions would be disregarded for purposes of calculating estate taxes because the liquidation restrictions "may be removed by...the transferor's family...[acting] collectively." That is, because the children can agree by unanimous consent to remove the liquidation restrictions, the proposed regulations assume that the liquidation restrictions do not decrease the real value of the shares. As a result, upon the death of the farmer, the farm will be subject to the 40-percent estate tax for the entire value of the farm, after exclusions.

Because only about 10 percent of the farm's assets are liquid, the children face a difficult choice. First, the children may unanimously agree to sell some of the farm's land and equipment to pay the tax bill—the very outcome that the farmer sought to prevent and a major blow to the business. Alternatively, they may be able to mortgage the land to pay the tax bill, threatening the farm's future. If the first two options are unavailable, the children may be forced to sell the farm, putting an end to the family business. These options may be further complicated if the children do not agree on which course to take, given that unanimous consent is required to approve a sale. In any case, the farm will be in jeopardy.

**Case Study 2: A parent dies after passing on his manufacturing business to his children**

While in good health, the owner of a machine-parts manufacturing business founded by her father retires and passes along the business to her three children. She imposes liquidation restrictions on the transferred shares to encourage the children to manage the business together. With no expectation that their mother will pass away in the next three years, the children pay gift taxes on the transfer at a discounted rate.

In the two years following the transfer, the children take out loans to expand the business by developing a new line of machine parts. The mother then dies unexpectedly. Under the three-year lookback provision in the proposed regulations (Section 25-2704-1(c)(1)), an estate tax would be imposed on the mother's estate on account of the transferred property under a deemed lapse theory even though that property is not held by the mother's estate and not accountable to pay estate tax. That tax would be due immediately because, the mother having already transferred the business, her estate is not eligible to defer liability or pay in installments. The blow to family capital may leave the children, who expanded the company under the assumption that their mother's estate would not be subject to estate-tax

liability for assets she had already transferred, without the necessary liquidity to continue operating the company or to continue its expansion.

### **Case Study 3: A parent brings his children into the family business**

A middle aged father who founded a construction business seeks to bring his three children into the family business, but is not yet ready to retire and relinquish control. He gives each child a 30-percent equity stake in the business and retains (with his 10-percent equity stake) 100 percent of day-to-day control. He plans to eventually transfer control to the child who proves herself most able to run the business.

Under the proposed regulations, the father would have to reconsider his succession plan. The proposed regulations (Section 25-2704-2(b)(2)) would deny the children lack-of-control discounts on their shares, even though none of them control the company and two of them never will. As a result, the children will be forced to pay taxes based on an artificially inflated valuation, making it more likely that they will have to sell their stakes and reducing the amount of money available to invest in the business.