October 31, 2016

Sent:

Re: Comments Regarding Proposed Treasury Regulation (REG. 163113-02)

Dear Sir/Madam:

This letter is being sent to you regarding Proposed Treasury Regulations (hereafter, “proposed regulations”) affecting Internal Revenue Code §2704.[[1]](#footnote-1)

It is the position of our firm that these proposals ignore economic realities and, if finalized in their present form, will work to artificially inflate values for a specific targeted group of taxpayers and not others (and therefore lead to taxation of citizens without uniformity). The information set forth below highlights the profound effect that they will have on future valuations of all business entities, but most significantly, small businesses, family owned businesses and family farms, making the transfer of these businesses and farms to junior generation family members significantly more costly in terms of transfer taxes, with the ultimate effect of putting many of those enterprises out of business.

**OUR FIRM**

The following comments are respectfully submitted for your consideration.

**POSITIONS ON THE PROPOSED REGULATIONS**

The proposed regulations will result in valuation outcomes which will have no direct relationship to market reality and will instead be based upon a constructed definition of value which has never existed and has no historical basis in tax statute, judicial findings, and, importantly, economic and finance principles. The proposed regulations will force all business valuators to change from using methodologies based upon generally accepted valuation principles to methodologies which lack any reasonable market basis or economic foundation. We have addressed below, ten of the most significant problems with Reg. 163113-02.

**1. The Term “Minimum Value” Should Not Replace Fair Market Value**

Fair market value has been the definition of value for estate and gift cases for nearly 100 years. The Treasury Department has defined this term in Treasury Regulations §20.2031‑1 (b) and §25.2512-1. Under these regulations,

“Fair market value” is defined as: “The amount at which a property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.”

Valuation is, in part, a subjective determination. However, the traditional standard of fair market value leads to a valuation process that makes the determination of value more scientific and based on market reality because transactions between buyers and sellers occur millions of times every day in the stock market. This is true whether the parties are related or unrelated.

Numerous studies have consistently shown that publicly traded stock on an Exchange is sold at a discount for lack of control. This discounting arises because an individual purchasing a share of publicly traded stock is most often purchasing a non-controlling interest in that company, and correspondingly does not have the right to force the company to pay dividends, force liquidation, etc. Under the definition of fair market value, the impact upon value based upon non-controlling versus controlling interests can be tested and measured, and the results are both consistent and economically sound.

It is the position of our firm that fair market value, as traditionally defined in the Treasury Regulations and as set forth above, is that standard of value that is most appropriate in the determination of value to be used under Treasury Regulations for Estate and Gift Tax purposes. It is based upon time-tested valuation principles and practices which are consistent with data based on market evidence.

**2. The IRS has Consistently Supported Valuation Discounts**

The IRS has consistently recognized that valuation discounts are appropriate in valuing non-controlling interests in closely held businesses. Two such recent examples are the IRS Job Aids relating to "Discount for Lack of Marketability Job Aid for IRS Valuation Professionals" dated September 25, 2009, and "Valuation of Non-Controlling Interests in Business Entities Electing to be Treated as S Corporations for Federal Tax Purposes" dated October 29, 2014.  The commentary within each of these Job Aids clearly articulate the need and reasoning for a discount and is accepted by all of the major business valuation credentialing.[[2]](#footnote-2)

Valuators/appraisers, accountants, attorneys, and the IRS have consistently utilized the definition of fair market value. The definition applies in a number of applications, including litigation, financial accounting, family disputes, and estate planning. In determinations of fair market value for purposes of valuing privately held enterprises and equity ownership interests therein for both income tax and estate and gift tax purposes, investment risks attendant to a lack of control and a lack of marketability have long been accepted considerations by the business valuation community, the IRS, and courts.

**3. Fair Market Value Assumes a Hypothetical Buyer**

Inherent in the definition of fair market value is the assumption that the seller, as well as the buyer, are both hypothetical individuals who are, based upon the economics, attempting to obtain the best price for their situation. At no point has the definition of fair market value been formally altered, or interpreted, to assume that in a family controlled business, a particular buyer and/or particular seller should be considered. While the IRS has attempted to argue that treatment of family controlled businesses should be different, the courts have consistently held that there is no family attribution and that under the definition of fair market value, we are to assume that both the buyer and seller are hypothetical.

A consistent position was laid out by the IRS in Revenue Ruling 93-12[[3]](#footnote-3) as a result of past court case decisions, in which the IRS held that minority interests in family owned businesses should be valued subject to a valuation discount as stated in Section 25-2512(f) of the Internal Revenue Code. This revenue ruling (93-12) revoked Revenue Ruling 81-253[[4]](#footnote-4) and stated that: “A minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be part of a controlling interest.”

**4. Families Do Not Act in Accord**

Many valuation assignments where we are engaged concern family owned businesses in which family members do not act in harmony and accord. In many cases, family members are more likely to be in discord. Under the new artificial definition of value in the proposed regulations, the IRS makes a presumptive assertion that *all* members of a family owned business will act in the best interest of the family in their decisions and not act with contradictory agenda. There is absolutely no support for this position.

What the provisions of the proposed regulations fail to recognize is the fact that the divorce rate in the United States is over 50%. This is *prima facie* evidence that the majority of families do not act in accord.

**5. The Six Month Put Right Has No Basis in Market Reality**

In the proposed regulations, the IRS has instructed the valuator/appraiser to “assume” that the transferee has the right to “Put” back their interest to the company within six months of the date of valuation. Market data clearly shows that the time it takes to liquidate one’s interest in a closely held company typically takes substantially longer than six months. In *Champion*, the court stated: “In the case of unlisted stock…the price at which sales of stock are made in arm's-length transactions in an open market is the best evidence of its value.” *Champion v. Commissioner,* 303 F.2d 887, 893 (5th Cir. 1962), reversing and remanding T.C. Memo. 1960-51. To our point, history demonstrates that obtaining an “arm’s-length transaction could take much longer than six months.” Numerous studies have consistently shown that sales of interests in closely held companies (especially minority interests), often take years to liquidate. This lack of marketability is a substantial risk factor for any holder of a non-controlling, non-marketable equity interest. This risk is absolutely rooted in economic realty and should be fully reflected in the valuation of that interest.

One of the three primary approaches to business valuation is the Market Approach. This approach, advocated under Revenue ruling 59-60, allows members of the business valuation profession, and the users of business valuations (including the IRS), to incorporate “actual” transaction data into the valuation process, thereby bringing a direct assessment of market activity into that process. If business valuators are to use the multiples of transactions in the open market as one of the accepted valuation methodologies, these multiples must be recognized as being based upon liquid publicly traded companies, and as such, must be subsequently discounted to reflect the practical challenges and costs associated with selling an interest in a privately owned enterprise. To do otherwise is to inappropriately determine value.

**6. The Term “Minimum Value” Results in an Artificially High Outcome**

The claim being made in the proposed regulations that taxpayers are transferring assets at an artificially low value is not only false, but contradicts nearly 100 years of American case law, regulations, transaction data, market studies, and valuation methodologies.

The proposed regulations require valuators to employ a new definition of value which is referred to therein as “minimum value.” Further, the proposed regulations require valuators to simultaneously employ generally accepted appraisal methodologies. However, the term minimum value does not currently exist within the International Glossary of Business Valuation Terms,[[5]](#footnote-5) or any business valuation principles, treatises, or governing professional standards. The proposed regulations attempt to establish a new standard of value which is not “generally accepted” nor could it be for a variety of reasons. For this reason, generally accepted appraisal principles and the proposed regulations are inconsistent on their face and contradictory to each other.

Further, the result of applying minimum value results in an “artificially high” valuation, but creating “real” tax increases and an unreasonable tax burden to a targeted group—family owned businesses and family farms. Minimum value is based upon a flawed definition of value with no basis in market transactions or market reality. For example, shares of stock in a public company, such as General Motors, can be purchased or sold online, and nowhere is it asked if the purchaser or seller are related to other shareholders—such relationships are not even remotely a consideration in determining transaction price. However, and as noted earlier, the value of these shares reflect a built-in discount for lack of control. That is market reality.

It is our position that fair market value in estate and gift tax contexts should continue to apply in the valuation of all businesses, whether family controlled or not. Any other definition of value will result in an artificially increasing value on the estate, gift, and generation-skipping tax obligations on the transfers of these interests.

**7. We Disagree with the Proposed Regulations’ New Definitions of Control**

We note that the proposed regulations expand the historical definition of control in two primary ways:

The **first** of these relates to an expansion of the definition of the term “attribution,” as that term is currently defined in Treasury Regulation 25.2701-6, Indirect holding of interests. Under subparagraph (a)(1) of that regulation:

“…an individual is treated as holding an equity interest to the extent the interest is held indirectly through a corporation, partnership, estate, trust, or other entity…”

The proposed regulation, in Section 25.2704-2, Transfers subject to applicable restrictions, under subparagraph (d) Attribution provides:

“An individual, the individual’s estate, and members of the individual’s family are treated as holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in Treasury Regulation 25.2701-6, Indirect holding of interests.”

The definition of the term “member of the family” is currently defined in Treasury Regulation Section 25.2702-2(a)(1) as:

“With respect to any individual, member of the family means the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the foregoing.”

Thus, the proposed regulation expands the family attribution rules to include all “indirect” interests held by a transferor in consideration of determining control. It is our position that separate legal entities such as those currently set forth, including corporations, partnerships, estates, trusts, or other entities (presumably limited liability companies), have been created under a state law where the intent is to allow for a separate legal existence of an operational or investment activity carried on for the purpose of making a profit. Ownership interests, both direct or indirect, as they might apply to a specific member, should not be expanded to include family members being attributed indirect ownership as that attribution completely dismisses the legal and economic standing of that member in that entity; as well as the legal protections offered in its creation.

The **second** way in which the proposed regulations expand the definition of control is by lowering the threshold for control with changes in the proposed regulation to Treasury Regulation Section 25.2701-2(b)(5)(iv) Other business entities, to at least 50% of either the capital or profits interests of the entity or arrangement, *or* ownership of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement.

We view the expansion of the definition of control to include “at least” 50% ownership as both technically, and practically, incorrect. The current regulation specifies “more than” 50% ownership which provides one the ability and power to direct the management and policies of the company; and has been the traditional (and legal) threshold of control throughout the business valuation industry and in *all* professional standards.

While the determination of whether the attribute of control exists in the ownership of any business enterprise, the determination most often rests on the state law in which the entity was formed. To reduce control to “at least 50%” ownership from “more than 50%” is to essentially say that two fractional interests of voting stock or equity in an entity each have equal control does not make economic sense.

**8. Under these Proposed Regulations, Valuators may be Limited in their Ability to Perform Qualified Appraisals**

The proposed regulations conflict with Treasury’s definition of a “qualified appraisal”:

IRC Section 170(f)(11)(E)(i), paraphrased, provides that the term “qualified appraisal” means an appraisal that is (1) treated as a qualified appraisal under regulations or other guidance prescribed by the Secretary, and (2) conducted by a qualified appraiser in accordance with generally accepted appraisal standards and regulations or other guidance prescribed by the Secretary. An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards…

In the 2016-2017 Edition of The Appraisal Foundation’s Uniform Standards of Professional Appraisal Practice (USPAP), Standards Rule 9-4(d) states:

“An appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of the extent to which the interest appraised contains elements of ownership control and is marketable and/or liquid.”

All of the industry’s major valuation organizations recognize the applicability of valuation discounts and have long done so. For instance, The Professional Standards of (NACVA) Section IV Development Standard H, Fundamental Analysis, state: “For a conclusion of value, the member must obtain and analyze applicable information, as available, to accomplish the assignment, including, (8) Size of interest to be valued and its control, liquidity and marketability characteristics.”

Statements on Standards for Valuation Services Section 100.40, published by the American Institute of Certified Public Accountants, 2015, states: “During the course of a valuation engagement, the valuation analyst should consider whether valuation adjustments (discounts or premiums) should be made to a pre-adjusted value. Examples of valuation adjustments for a valuation of a business, business ownership interest, or security include a discount for lack of marketability or liquidity and a discount for lack of control.”

The proposed regulations fail to consider the economic reality of investor risk associated with holding a fractional equity ownership interest in a privately held company that carries neither the attribute of control or marketability. These discounts, very often, take into consideration other issues apart from those enunciated in the proposed regulations, specifically elements that warrant consideration of discounts include the ability to:

1. Appoint or change management,
2. Decide on compensation levels,
3. Enter into binding contracts,
4. Decide on the amounts of dividends or distributions,
5. Determine capital expenditures,
6. Change the capital structure,
7. Determine policy, including changing the directions of the business, and
8. Block any of the above actions.

Failure to consider or recognize valuation discounts will result in a value that is not determined in accordance with generally accepted appraisal standards, and ultimately be considered “hypothetical” as defined in the USPAP.

**9. The Proposed Regulations Force Valuators to Perform Hypothetical Appraisals**

Business valuators that issue business valuation reports under the proposed assumption that any holder can demand liquidation of his/her interest at any time at minimum value and receive cash or property pro rata to the interest, would be required to disclose the nature of such an assumption as a qualifying assumption and limiting condition. Further, in accordance with business valuation standards, the business valuator would be required to state that the valuation is “hypothetical” in nature, which is not consistent with the standard of value defined as fair market value. Thus, the proposed regulation requires the business valuator to arrive at a fair market value of interests under hypothetical assumptions that are known to be untrue and in conflict with governing legal documents and state law.

According to the fair market determinations of value under the proposed regulations, “…if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor’s family, and the transferor and/or members of the transferor’s family control the entity immediately before the transfer, any restriction described in paragraph (b) of this section[[6]](#footnote-6) is **disregarded**, and the transferred interest is valued as provided in paragraph (f) of this section.”[[7]](#footnote-7)

The foregoing guidance provides that the value of the transferred interest is to be determined under the fair market value standard and employing generally applicable valuation principles. However, the business valuator in his/her determination of fair market value is to assume that all disregarded restrictions do not exist in the governing documents or anywhere else, such as under state law. However, these disregarded restrictions are absolutely real and legally binding on the holders of such equity interests in the family entity, thus forcing the business valuator to make “hypothetical” assumptions and render a hypothetical appraisal, which is *not* fair market value.

Of great significance, it should be pointed out that the proposed regulations do not make the same assertions with respect to equity ownership interests held by equity holders outside the familial equity owner group. It is difficult to understand how these provisions and restrictions can be considered in the valuation of one identical interest held by a non-family member, while disregarded when it is a family member. This inconsistency clearly shows the proposed regulations were ill-conceived by requiring the hypothetical findings noted above and because it lacks any relationship with market realities.

**10. It will be Impossible to Comply with USPAP or Any Other Industry Standards and Simultaneously Comply with the Proposed Regulations.**

According to USPAP, a “Hypothetical” appraisal or a “Hypothetical Condition” is defined as:

A condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of analysis. Hypothetical conditions are contrary to known facts about the physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends, or about the integrity of data used in an analysis.[[8]](#footnote-8)

In addition, USPAP defines an “Extraordinary Assumption” as:

An assumption directly related to a specific assignment, as of the effective date of the assignment results, which, if found to be false, could alter the appraiser’s opinions or conclusions. Extraordinary assumptions presume as fact otherwise uncertain information about physical, legal, or economic characteristics of the subject property;[[9]](#footnote-9)

The difference between whether a condition is hypothetical or extraordinary rests on what the appraiser knows about the condition in question. If an appraiser cannot verify a certain condition that is critical to the valuation, but which the appraiser has a reasonable basis to accept as true, then the condition is an extraordinary assumption. Alternatively, if the appraiser is asked to use a condition he/she knows to be false, but which is necessary for the analysis, a hypothetical condition applies.[[10]](#footnote-10)

It appears that the assumption delineated in the proposed regulations about disregarded restrictions would be a hypothetical condition because such conditions under the proposed regulations are known to be false and contrary to fact as evidenced by the governing documents and state law. Any such appraisal report would require that the value be clearly labeled as hypothetical, the purpose of such appraisal is stated, and the conditions assumed are set forth in the report.

The USPAP, the AICPA in their Statement of Standards for Valuation Services (“SSVS”), and the NACVA in its professional Standards all require that “hypothetical conditions” be disclosed in the business valuation report, with reasons for their inclusion.[[11]](#footnote-11)

Based upon the foregoing, business valuations rendered for gift and estate tax purposes under the proposed regulations would require that such opinions or estimates of value be labeled as hypothetical determinations, and not fair market value.

**SUMMARY AND REQUESTED REVISIONS**

Based upon the forgoing discussion and reasoning put forth, we hereby respectfully recommend and request that the proposed regulations be **withdrawn** in their entirety. It is our position that the proposed regulations, as currently drafted, contain too many problematic provisions to effectively cure all defects by virtue of specific provision modifications within those proposed rules. Moreover, dependent upon which of the provisions within the proposed regulations are deemed appropriate for modification by Treasury and the IRS, those changes advanced will still require consideration in view of the entire set of proposed rules. As such, we believe the clear and appropriate action at this time is to withdraw the rules as currently proposed.

Thank you for affording us the time to consider our comments on the proposed regulations.

Respectfully,

1. All references herein to the Internal Revenue Code, the Code, or IRC is intended to reference Title 26 of the United States Code and the Internal Revenue Code of 1986, as amended, unless otherwise noted. [↑](#footnote-ref-1)
2. Revenue Ruling 59-60, C.B. 19589-1, p. 237. [↑](#footnote-ref-2)
3. Revenue Ruling 93-12, 1993-1 C.B., p. 202. [↑](#footnote-ref-3)
4. Revenue Ruling 83-253, 1981-2 C.B., p187. [↑](#footnote-ref-4)
5. The International Glossary of Business Valuation Terms, as adopted by the American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts (prior to current name change) and the Institute of Business Appraisers, 2000. [↑](#footnote-ref-5)
6. Proposed Regulation Section 25.2704-3(b) Disregarded restrictions means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor’s family (subject to paragraph (b)(4) of this section), either alone or collectively. [↑](#footnote-ref-6)
7. Proposed Regulation Section 25.2704-3(a). [↑](#footnote-ref-7)
8. USPAP 2016-2017 Edition, Page 3. [↑](#footnote-ref-8)
9. *Ibid*. [↑](#footnote-ref-9)
10. USPAP 2016-2107 Edition, Page 307. [↑](#footnote-ref-10)
11. NACVA Professional Standards, V – Reporting Standards, Paragraph C. [↑](#footnote-ref-11)