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CC:PA:LPD:PR (REG-163113-02)
Room 5203
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

Re: Estate, Gift, and Generation-skipping Transfer Taxes: Restrictions on Liquidation of an Interest (REG-163113-02)

To Whom It May Concern:

The American Farm Bureau Federation (AFBF) appreciates the opportunity to file these comments in connection with proposed regulations concerning the valuation of interests in corporations and partnerships for estate, gift, and generation-skipping transfer tax purposes. AFBF is the nation's largest general farm organization. Our members live and farm in all 50 states and Puerto Rico, and they are engaged in every segment of crop and livestock production.

Farm Bureau puts a high priority on laws and policies that enhance the ability of family-owned farm and ranch businesses to transfer to the next generation of operators. The proposed changes to I.R.C Sect. 2074 addressed in these comments would significantly endanger the future of family farms in America. The proposed changes wrongly set forth more restrictive rules for using valuation discounts that would make it more difficult for our nation's family-owned farms and ranches to survive intergenerational transfers.

Family business in the agriculture sector

Agriculture continues to be a significant contributor to the U.S. economy. The output of America's farms added $177.2 billion—about 1 percent of the U.S. gross domestic product (GDP) in 2014. The overall contribution of the agriculture sector to GDP grows even larger when agriculture-related sectors—forestry, fishing, and related activities; food, beverages, and tobacco products; textiles, apparel, and leather products; food and beverage stores; and food service and drinking places—that rely on agricultural inputs in order to contribute added value to the economy are included. In total, agriculture and agriculture-related industries contributed $985 billion to the U.S. GDP in 2014, a 5.7-percent share. The strength of U.S. agriculture is built on the back of the family farm and ranch. Family farms and ranches account for 97 percent of operations and 90 percent of production. The ability of families to transfer land from one generation to another is critical to the long-term viability of agriculture and those that rely on it for their livelihood.

Overview of proposal

In early August, the IRS issued new I.R.C. §2704 regulations that could seriously impact the ability to generate minority interest discounts for the transfer of family-owned entities. *Prop. Reg. – 163113-02 (Aug. 2, 2016).* The proposed regulations, if adopted in their present form, will impose significant restrictions on the availability of valuation discounts for gift and estate tax purposes in a family-controlled environment. *Prop. Treas. Regs. §§25.2704-1; 25.2704-4; REG-163113-02 (Aug. 2, 2016).* They also redefine via regulation and thereby overturn decades of court decisions honoring the well-established willing-buyer/willing-seller approach to determining fair market value (FMV) of entity interests at death or via gift of closely-held entities, including farms and ranches. The proposed regulations would have a significant impact on estate, business and succession planning in the agricultural context for many agricultural producers across the country and will make it more difficult for family farm and ranch businesses to survive when a family business partner dies.

Specifically, the proposed regulations treat transfer within three years of death as death-bed transfers, create new "disregarded restrictions" and move entirely away from examining only those restrictions that are more restrictive than state law. As such, the proposed regulations exceed the authority granted to the Treasury by Congress to promulgate regulations under I.R.C. §2704 and should be withdrawn.

Background

The transfer of a decedent's taxable estate is subject to tax. *I.R.C. §2001(a).* The value of the transfer includes the FMV at the time of death of all property, real or personal, tangible or intangible, wherever situated. *I.R.C. §2031(a).* FMV is defined as "the price at which the property would change hands between a willing-buyer and a willing-seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." *Treas. Reg. §20-.2031-1(b).* Existing regulations specify that it is appropriate to adjust the FMV of assets to take into account the lack of majority control, lack of marketability and fractional ownership interests. *Treas. Reg. §20.2031-2(f).* Doing so conforms to the willing buyer/willing-seller test—a willing buyer would necessarily require a discount to reflect the "true" FMV of the property at issue based on the rights acquired. *See, e.g., Estate of Hoover v. Comr., 69 F.3d 1044 (10th Cir. 1995).* Consequently, the courts have consistently upheld valuation discounts in accordance with the regulations that are supported by sufficient appraisal evidence.

Relatedly, for gift tax purposes, the lapse of an individual's voting or liquidation right is treated as a gift or a transfer that is includible in the gross estate if the individual's family holds control of the entity both before and after the lapse. *I.R.C. §2704(a).* In addition, when a transferor transfers an interest and the family controls the entity before the transfer, a restriction that limits the ability of an entity to liquidate that is more restrictive than state law is ignored in valuing the transfer. *I.R.C. §2704(b).* This Code provision also authorized the IRS to issue regulations if the restriction has the effect of reducing the value of the transferred interest, but does not ultimately reduce the value of the ownership interest to the transferee. *I.R.C. §2704(b)(4).* However, what the IRS proposes does just that— it would reduce the value of the ownership interest to the transferee. Thus, the proposed regulations represent a complete change in position of the IRS

concerning valuation discounts and a return to a position that has been soundly rejected by the courts.

With Rev. Rul. 93-12, 1993-1 C.B. 202, the IRS announced its official position that a minority discount would not be disallowed simply because a transferred interest, when aggregated with the interest held by family members, would be part of a controlling interest. The ruling announced an official change of the IRS position from what it took in Rev. Rul. 81-253, 1981-2, C.B. 187. In that 1981 revenue ruling, the IRS announced its position that no minority discount would be allowed with respect to transfers of shares of stock between family members if, based upon a composite of the family members' interests at the time of the transfer, control of the corporation existed in the family unit. In essence, before the change of position announced in Rev. Rul. 93-12, the IRS attributed the control held by the family as a whole to each family member's partial interest. But, even before the change of position, several key court decisions upheld the application of minority interest discounts to family ownership interests. *See, e.g., Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981); Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982); Estate of Andrews v. Comr., 79 T.C. 938 (1982); Lee v. Comr., 69 T.C. 860 (1978).* As a result of these court opinions, the IRS changed its official position with the issuance of Rev. Rul. 93-12 and also formally revoked Rev. Rul. 81-253. Therefore, the proposal would take the IRS back to its position taken in the judicially-rejected Rev. Rul. 81-253, 1981-2, C.B. 187.

Historic discount planning for farmers and ranchers.

Over the past few decades, valuation discounting through the use of family-owned business entities has become a popular estate and gift tax planning technique for farmers and ranchers (and other small businesses). If structured properly, the courts have routinely validated discounts ranging from 10 to 45 percent. Valuation discounting has proven to be a very effective strategy for transferring business assets to subsequent generations. It is a particularly useful technique with respect to the transfer of small family businesses and farming/ranching operations.

Similar, but lower, valuation discounts can also be achieved with respect to the transfer of fractional interests in real estate. As noted in the background section, the basic concept behind discounting is grounded in the IRS standard for determining value of a transferred interest—the willing-buyer, willing-seller test. Under this standard, it is immaterial whether the buyer and seller are related—it's based on a hypothetical buyer and seller. Thus, there is no attribution of ownership between family members that would change a minority interest into a majority interest. The courts have blessed this regulatory determination of FMV.

For farmers and ranchers, the family limited partnership (FLP) has become a popular estate and succession planning structure to conduct the closely-held business particularly where management and control are important. FLPs have non-tax advantages, but a significant tax advantage is the transfer of present value as well as future appreciation with reduced transfer tax. *See, e.g., Estate of Kelley v. Comr., T.C. Memo. 2005-235.* For example, in the ag context, a common strategy is to have the parents contribute most of the partnership assets in exchange for general and limited partnership interests. The nature of the partnership interest and whether the transfer creates an assignee interest (an interest where giving the holder the right to income from

the interest, but not ownership of the interest) with the assignee becoming a partner only upon the consent of the other partners, as well as state law and provisions in the partnership agreement that restrict liquidation and transfer of the partnership interest can result in discounts from the underlying partnership asset value. In general, FLPs have withstood IRS challenge and produce significant transfer tax savings. But, under the proposed regulations, transfers to assignees will be ignored for discount purposes if the assignee does not have full rights and powers of an owner (i.e., lacks voting power or liquidation rights). This provision effectively negates any state law provision that allows for assignee rights. Such state law provisions are an important tool for providing additional liability protection, but would be negated for discount purposes. Again, this has nothing to do with the traditional willing-buyer/willing-seller method for determining FMV and represents a regulatory attempt to redefine value.

> **Example:** Bert and Myrtle, a married couple who operate a farm, create an FLP with the interest of the general partnership totaling 10 percent of the company's value and the limited partnership interest totaling 90 percent. Each year, both parents give each of their children limited-partnership shares with a market value not to exceed the gift tax annual exclusion amount (presently $14,000). In this way, the parents progressively transfer business ownership to their children without having to incur estate or gift taxes. Even if the limited partners together own 99 percent of the company, the general partner will retain all control and is the only partner with unlimited liability. If the FLP is structured for business reasons (consolidation of farming and ranching assets; liability protection; succession planning, etc.) discounts for non-marketability and minority interest will apply. Thus, transfers of assets from one generation to the next can be conducted with substantial transfer tax cost savings.

The proposed regulations would eliminate much of the value of this common planning technique by removing minority discounts in family contexts. The proposed regulations would move entirely away from evaluating each transaction in light of whether: (1) the arrangement was a device to transfer property to a family member for less than adequate consideration; (2) was not the result of arm’s length negotiations having a valid business purpose; and (3) involved an implied understanding for gifts made that the grantor would retain economic benefits of gifted property. This is another example of the proposed treasury regulations moving away from the willing-buyer/willing-seller test.

Proposed Regulations

The proposed regulations have two main negative consequences for farmers and ranchers:

(1) A three-year “lookback” to determine whether a minority valuation discount should apply. This component will effectively eliminate so-called “death bed” transfers to obtain a minority interest at death. *Prop. Treas. Reg. §25.2704-1(c)(1).*

(2) A set of new “disregarded restrictions” that will apply in situations where the family will retain control after the transfer to deny a minority discount and, perhaps, no lack of marketability discount, and a shift away from looking only at restrictions that are more

restrictive than state law. *Prop. Treas. Reg. §25.2704-3(a); Prop. Treas. Reg. §25.2704-2(b)(4).*

Commentary and application of the proposal

Under the proposed regulations, basically any type of entity is subject to the test to determine control of the entity and to determine whether a restriction is imposed under state law—corporations, partnerships and other business entities (LLCs that are not S corporations, for example). The proposal defines "family control" as the holding of at least 50 percent of either the capital or profits (by vote or value) of the entity, or the holding of an equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. In addition, an individual's estate and members of an individual's family are treated as holding interests indirectly through a corporation, partnership, trust or other entity. Family members include ancestors or descendants of the transferor, siblings of the transferor and any spouse of the transferor's ancestor, descendant or sibling. Similarly, non-family ownership is ignored if the interest at issue has been held for less than three years from the valuation date, or represents less than a 10 percent interest in the entity, or the total percentage of all non-family interests in the entity is less than 20 percent or the non-family interest holder lacks the right to "put" the interest to the entity for "minimum value" for cash or property.

1. As for the proposed three-year lookback rule, the proposed regulations treat transfers occurring within three years of death that result in the lapse of a liquidation right or voting right as transfers (of the lapsed right) as occurring at death. *Prop. Treas. Reg. §25.2704-1(c)(1).* Under the proposal, a lapse of a liquidation right includes the effect of creating an interest that is insufficient to force liquidation or distribution (e.g., the creation of a minority interest by a controlling party). *Prop. Treas. Reg. §25.2704-1(c)(2)(i)(B).* But, the rules only apply if the entity is controlled by the holder of the right and members of the holder's family immediately before and after the lapse. *Prop. Treas. Reg. §25.2704-1(a)(1).*

   Thus, if the transferor of the interest fails to outlive the transfer by three years, the lapse of the voting or liquidation right caused by the transfer is treated as a lapse that occurs on the transferor's date of death and is included in the transferor's gross estate under I.R.C. §2704(a). That will have the effect of adding back any claimed minority discount at the time of the gift thereby creating a "phantom asset" that will be included in the taxable estate (at, presently, a 40 percent tax rate).

   > **Example:** Ralph owns 80 percent of a farming partnership that was worth $20 million. Ralph's wife owns the other 20 percent. Ralph gifts a 20 percent interest to his son and a 20 percent interest to his daughter, thus reducing his ownership interest to 40 percent. At the time of the gifts, he discounted each one by 25 percent for minority interest. Assume that each gift had a gross value of $4 million, but after the discount was valued at $3 million. Thus, instead of using up $8 million of his coupled estate/gift tax exemption, Ralph used up $6 million. If Ralph's dies within three years of the transfers, his estate will be increased by $2 million due to the

disallowed discounts ($1,000,000 x 2)   An extra estate tax of $800,000 (at a 40 percent rate) would be triggered (assuming that Ralph's estate is taxable at death).

Similar in effect to the lapse provision's effect on gifted interests is the gift rule provision involving "minimum value." Under this proposed rule, a gift of an entity interest to a family member may be required to be valued at its proportional value of the entity with no discount factored in.

> **Example**: A farm partnership is worth $10 million and Jeff owns a 40 percent interest. Jeff transfers a 10 percent interest to his son, Jeyson, and a 10 percent interest to his daughter, Jill. After the transfers, Jeff holds a 20 percent interest in the partnership. The transfers would typically be eligible for a discount in the range of 25 percent for minority interest and 15 percent for lack of marketability. Thus, the transfers would be valued at $1.2 million rather than $2 million. Under the proposed regulations, Jeff would be required to value the interest at 20 percent of the $10 million "enterprise" value, resulting in the transfer being valued at $2 million. That extra $800,000 would have an gift/estate tax cost of $320,000 ($800,000 x 40 percent).

2. With respect to disregarded restrictions, as noted above, a new set of disregarded restrictions will apply in situations where family members retain control after the transfer. For this purpose, "family control" is defined as the holding of at least 50 percent (by vote or value) of any entity. The term "family member" includes an ancestor or descendant of the transferor, the siblings of the transferor and any spouse of such ancestor, descendant or sibling. This would include nieces and nephews, but not aunts, uncles and spouses of any generation the same or below the transferor or the transferor's spouse are not included. This all means that "family member" is defined such that it would virtually always apply to family farm and ranch businesses. Also, it is important to note that "family control" is defined in a manner that doesn't require majority control. Therefore, virtually all family farm and ranch businesses would be denied the use of these discounts.

   This has important planning implications:

   > **Example:** Assume that grandfather started a farming business in 1950 and, upon his death in 1985, left it equally to his three children. Those three children all worked together in continuing the family farming operation subsequently died and left their respective interests in the farming operation to their children. Based on the definition of "family member", the grandchild is deemed to own 1/3 of the interest that the grandfather owned (by virtue of inheriting it from the grandchild's parent). Also, each grandchild would be deemed to own the interests held by their siblings. If that amount aggregates to 50 percent or more, the farming entity would be a "controlled entity" as to any particular family member, and a minority interest discount (and, perhaps, a lack of marketability

discount) would be denied, irrespective of the longstanding willing-buyer/willing seller test for determining FMV.

A restriction on the right to liquidate an interest in an entity would be disregarded if it will lapse at any time after the transfer, or if the transferor or the family may remove or override the restriction. *Prop. Treas. Reg. §25.2704-3(b)(1).* Those restrictions include those that either: (1) limit the ability of the interest holder to liquidate the interest; (2) limit the liquidation proceeds to an amount that is less than minimum value; (3) defer the payment of the liquidation proceeds for more than six months; or (4) allow the payment of the liquidation proceeds in any way other than in cash or other property (a note from the entity, from an owner in the entity or from a related party is not considered property, other than an exception for a note involving an active business entity that is adequately secured and at a market interest rate).

Furthermore, on the restriction effect issue, restrictions that are imposed by federal or state law are generally respected. However, two restrictions in state law would be ignored in valuing the transferred interest. *Prop. Treas. Reg. §25.2704-2(b)(4)(ii).* Those restrictions involve restrictions that only apply in the absence of a contrary provision in the governing documents or that otherwise may be superseded by the owners of the entity; and restrictions for which an optional provision in federal or state law does not include the restriction or that allows the restriction to the removed or overridden.

This is more restrictive than current law. Under I.R.C. §2703(a)(2), the value of property for transfer tax purposes is determined without regard to any restrictions on the right to use property. But, I.R.C. § 2703(b) exempts a restriction that is a bona fide business arrangement, is not a device to transfer property to family members for less than full consideration, and has terms comparable to those in an arm's-length transaction. I.R.C. §2704(b) applies when an interest in a corporation or partnership is transferred to a family member, and the transferor and family members hold, immediately before the transfer, control of the entity. In such instances, any applicable restrictions (such as a restriction on liquidating the entity that the transferor and family members can collectively remove) are disregarded in valuing the transferred interest. *I.R.C. §2704(b)(1).* Current regulations provide that an applicable restriction is a limitation on the ability to liquidate the entity that is more restrictive than the restriction that would apply under state law in the absence of the restriction. *Treas. Reg. §§25.2704(a).*

Thus, the proposed regulations would remove the existing exception for local law and define an "applicable restriction" as one imposed under the terms of the entity's governing documents, a buy-sell agreement, a redemption agreement, or an assignment or deed of gift or any other document, and a restriction imposed by local law. The proposal also defines "an applicable restriction" as any local law that requires a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of I.R.C. §2704. Therefore, common restrictions utilized in family entity planning will not result in discounts.

Example:[1] John owns 98 percent of a farming limited partnership. His son and daughter each own one percent. The partnership agreement calls for the termination in 50 years, or earlier, if all of the partners agree. It also requires all of the partners to approve any changes to amend. None of these provisions are required by local law. John transfers a 33 percent limited partnership interest to his son and a 33 percent interest to his daughter. Because the prohibition on withdrawal from the limited partnership (a restriction that is not required by local law), and because it can be removed by the family members, John's transfers will be valued without considering the liquidation restriction of a minority interest resulting in the loss of the discount and increased estate tax liability.

It is important to note that many states presently allow entities to add provisions to override any restrictions on transfer. As a result of the proposed regulations, if they are finalized in their present form, there will be few applicable restrictions that will reduce the value of family-controlled entities.

In addition, the proposal adds a list of specifically disregarded restrictions as anything that—limits the holder's ability to liquidate the interest; limits the liquidation proceeds to an amount that is less than a minimum value; defers the payment of the liquidation proceeds for more than six months; or permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes. The preamble to the regulation provides for an additional disregarded restriction—any limitation on time and manner of payment of the liquidation proceeds that defers payment beyond six months. Also, the preamble bars any payment of liquidation proceeds in any manner other than cash or property. Thus, if a "family" retains control of the entity there will not be any minority interest discount and (perhaps) no lack of marketability discount.

What all of this means is that long utilized estate and business planning techniques engaged in for various business purposes, which also have the side effect of generating a minority interest and (likely) lack of marketability discount in the context of a family business entity, would no longer create such discounts. Again, this is an example of the Treasury Department creating regulations to redefine FMV in an arbitrary manner and outside the intent of Congress and as established by case law.

Call for withdrawal

When the so-called "freeze" rules were initially enacted in 1990 with I.R.C. §§2701, 2703 and 2704 (and the regulations thereunder) they were designed to deal with what IRS viewed as abuses with respect to partnerships and limited liability companies (LLCs) that restricted the ability of a partner/member to liquidate the entity. However, the legislative history of Chapter 14 (I.R.C. §§2701, 2703 and 2704) indicates that the Congress intended ordinary minority and marketability valuation discounts to be respected, even in a family context. *See Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-580, section 11602a; H.R. Conf. Rept. No. 101-964.*

[1] This example is courtesy of Paul Neiffer, Principal, CliftonLarsonAllen, Kennewick, WA.

In addition, the courts have validated various planning concepts that have preserved valuation discounts. Clearly, the Treasury has wide latitude to issue regulations impacting valuations. But, the Code is clear that the asset being transferred (such as an FLP interest) is the asset that is subject to valuation under the willing-buyer/willing-seller test. Valuation in the entity context is not tied to the value of the underlying assets. The proposed regulation sets forth more restrictive rules to limit valuation discounts, contrary to longstanding congressional intent to allow discounts in a family-business context.

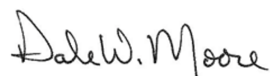
Unfortunately, the proposed regulations eliminate the minority discount for family entities where family ownership and/or control is 50 percent or more of the entity, such as farming and ranching operations, at the time of death. Thus, the enhanced value due to the disallowed discount would be included in the decedent's estate at death and thereby could increase the estate tax liability of surviving family business partners.

There are various effective dates for the proposed regulations. The rules defining control are to take effect on the date of publication of final regulations. The proposed rules that treat lapses of rights as a transfer are proposed to be effective on the date of publication of final regulations for lapses of rights created after Oct. 8, 1990. That would make it nearly impossible to avoid the application of the final regulation by various estate planning techniques. Also, the rules disregarding restrictions created on or after Oct. 8, 1990 are proposed to be effective for transfers of property occurring 30 or more days after the date of publication of final regulations.

Clearly, the statute, as noted above, does give the Treasury the discretion to write regulations in this area. The regulatory authority for additional regulations under I.R.C. §2704 contained in I.R.C. §2704(b)(4) is very broad. *However, having discretion does not grant the authority to invalidate 26 years of carefully thought-out family business transition planning.* In several areas, the proposed regulations go well beyond the legislative history and purpose of Chapter 14 and are invalid even when evaluated under the deferential standard used to test the validity of regulations. That legislative history explicitly states that Chapter 14 was not intended to "affect minority discounts or other discounts available under [former] law." *136 Cong. Rec. §15679, 15681 (Oct. 18, 1990).* The willing-buyer, willing-seller test is a well-established and time-honored concept, and should not be replaced with an alternative rule that essentially allows the Treasury to define value in an arbitrary manner.

The proposed regulations should be withdrawn. The regulations exceed the scope of the Treasury's authority to write regulations involving this area of tax law and represent a rejection of the time-tested and court sanctioned willing-buyer/willing-seller test to determining fair market value.

Sincerely,



Dale Moore
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