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VIA ELECTRONIC SUBMISSION

Internal Revenue Service
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Room 5205
P.O. Box 7604
Washington, D.C. 20224
Notice.Comments@irscounsel.treas.gov

RE: Small Business Legislative Council (SBLC) Comments on Proposed Regulations under Section 2704 (**Notice 2017-38**)

To Whom It May Concern:

The SBLC offers the following comments to the proposed regulations under Section 2704 issued on August 4, 2016. The SBLC is more than a 40 year-old, permanent, independent coalition of the trade and professional associations set forth below that share a common commitment to the future of small business. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. SBLC policies are developed by consensus among its membership. The SBLC's goal is to maximize the advocacy and presence of small business on Federal legislative and regulatory policy issues, and to disseminate information on the impact of public policy on small businesses.

Family-owned businesses play an integral role in the small business engine that fuels growth and provides jobs in this country. Family-owned businesses can be found operating in every major sector of the American economy while the majority of small business farms and ranches are family-owned. In 2014, family-controlled companies made up 15% of the American companies on the *Fortune* Global 500.[1] According to data reported in the Harvard Business Review last year, family-owned or controlled businesses employ 60% of the workers and create 78% of new jobs in the U.S.[2] Moreover, in 2014 Ernst and Young calculated that family-owned businesses generated 57% of the US's GDP.[3] It is important for our economy, and yet very difficult, for these family-owned businesses to successfully transition the business to the next generation. Many members of the associations that comprise the SBLC are family-owned businesses, and many have been in business for more than one generation. It is essential that new regulations do not cause unnecessary harm to this vital business sector of our economy.

[1] *Business in the Blood*, THE ECONOMIST, November 1, 2014.
[2] Claudio Fernandez-Araoz, Sonny Iqbal and Jorg Ritter, *Leadership Lessons from Great Family Businesses*, HARVARD BUSINESS REVIEW, April 2015.
[3] Ernst & Young, *Family Business Yearbook 2014*.

The proposed regulations under Section 2704 apply *only* to family-owned businesses. It appears that their intent is to eliminate minority discounts and largely eliminate marketability discounts. As we will show in more detail below, it is fundamentally unfair to single out active family-owned small businesses for worse treatment under the tax laws than non-family-owned businesses.[4] **The SBLC believes that the proposed regulations are not needed and are harmful to the many family-owned businesses in the country and thus, should be withdrawn and not replaced.**

At the core of these proposed regulations is the assumption that restrictions on withdrawal or liquidation do not affect the value of a family member's interest in a family-owned business. Even stranger, because the proposed regulations appear to prohibit any consideration of restrictions on withdrawal and liquidation in a family-owned business context, they appear to arrive at the conclusion that *any* family member has the ability to withdraw his/her interest from the entity, at virtually any time (and receive payment within 6 months), at its "net asset value." The value of this right appears to be determined by multiplying the net asset value by the ownership percentage, which means that the proposed regulations eliminate all minority discounts in the family-owned business context. Of course, this does not square with reality in the business world. One would search long and hard for a willing buyer to pay the same amount on a percentage basis for a 5% interest in either a family-owned or non-family-owned closely held business as they would for a 51% interest. This is because a willing buyer would not pay the price called for in the proposed regulations for a minority interest in a company that would give them no management or control rights over the entity and with no ability to determine when they could get a return on their investment. This is how the proposed regulations artificially inflate the value in the family-owned enterprise because the value is not based on the real or true fair market value of the interest. Keep in mind this assumption is only applicable to family-owned entities – an exact replica of the company but closely held by non-related owners would be valued as if the restrictions on withdrawal or liquidation do apply, which is what makes sense in the real world of business for both active family-owned and non-family-owned entities.

To buttress this assumption, the proposed regulations disregard interests held by non-family members in the determination of whether the family would have the ability to remove a restriction, unless the non-family member held the interest for three or more years before the date of the transfer (another totally new three year rule *which has no statutory basis*), *and* holds 10% or more of the value of all of the equity interests, *and* that when combined with the interests of other non-family members owns 20% or more of the value of all equity interests *and* has a right to put the interest to the entity and receive a minimum value.[5] The idea behind adding all of these new regulatory requirements before a non-family member's interest is taken into account is that the non-family members in family-owned businesses are merely figure heads who will simply do whatever the family wants! Once again it appears that the drafters of these regulations have no familiarity with active family-owned businesses. It is not all that unusual for a family-owned entity to have two or three competing family members or groups of members such that the outside interest actually holds the controlling vote. This can be the case if the outside non-family

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[4] For the purposes of these comments, references to "family-owned businesses" are also intended to include family controlled businesses.

[5] Prop. Treas. Reg. § 25.2704-3(b)(4).

member holds even a 1% interest and does not have a right to put the interest to the entity! Bright line tests are helpful but not when they serve to obfuscate the actual facts and circumstances and thereby serve an injustice by making a rule applicable when it should not be.

A number of our association members report that their members are deeply concerned about the negative impact the proposed regulations will have on their family-owned small business. They have been told by advisors who specialize in transitioning family-owned businesses to the next generation, and their estate planning experts, as well as appraisal experts, that the proposed regulations will cost them a great deal of money (many are hearing estimates of at least a 30% increase in tax costs) and make it far more difficult to transition the business successfully to the next generation. Unfortunately, the experts who must determine the fair market value of family-owned small businesses tell us the regulations are so unclear that they cannot interpret them. Absent more clarity and detail than what is currently provided under the proposed regulations, the appraisers do not have sufficient guidance as to how to appraise the value of the family-owned business. The appraisers believe based on the insufficient information contained in the proposed regulations that they will have to do *two* appraisals for family-owned businesses (unlike other closely held businesses owned by non-related parties which will only require one appraisal). One appraisal will reflect the *real* fair market value of the business enterprise and a new second appraisal will reflect the *artificially higher inflated value* for tax purposes which appears to be required under the proposed regulations as currently drafted simply because the business is owned by a family. **This second appraisal will be an additional expense only for family-owned businesses and at this juncture the appraisal experts would not even know how to prepare the artificially inflated appraisal. Again, there is no statutory basis for this new costly and burdensome requirement.**

This kind of discriminatory and costly burden imposed on only one type of taxpayer should only be acceptable if some legitimate purpose is served from a policy viewpoint and there is no other less costly or burdensome way to accomplish the policy goal. Here, the SBLC can find *no* legitimate public policy for imposing these artificial rules on *active* family-owned businesses. Further, even if some abuse did exist in the *active* family-owned business arena (*of which we are not aware*), we cannot imagine that this sledge hammer approach, which will adversely impact the successful transition of family-owned businesses to the next generation, represents the least burdensome and costly approach to a problem that most experts in the country do not believe exists.

Importantly, the proposed regulations do not appear to carry out the intent of Congress as reflected in the Conference report issued with the enactment of section 2704. This report stated that “these rules do not affect minority discounts or other discounts available under present law.” Minority and lack of marketability discounts were available under the law at the time of enactment of section 2704. Nonetheless, despite IRS spokespersons’ recent comments to the contrary, it is hard to read these proposed regulations and determine that they are about anything other than “affecting minority discounts or other discounts available under present law”!

An example of what we perceive to be an impermissible expansion into the legislative arena is Reg. §25.2704-1(c)(1). This proposed section of the regulations literally makes up a new “within 3 years of death rule” which, absent Congressional legislation, we believe exceeds Treasury’s regulatory mandate under §2704(b)(4). This change was ostensibly made to prevent deathbed transfers and to avoid the IRS having to prove facts and circumstances as presently required.

However, just because the Treasury thinks a 3 year of death rule would be easier to deal with, doesn't mean it has the authority to effectively attempt to legislate such a rule into existence. One of the problems with the proposed regulations is that there are a number of areas where there is more than one reasonable interpretation of the same proposed regulation. The proposed regulation setting forth a new 3 year of death rule provides a perfect example of this problem. As proposed, it appears that this new 3 year death rule could have a retroactive effective date. Thus, any transfer which results in the transferor losing a liquidation or voting right (even made before the proposed regulations!) where the transferor dies within 3 years of the transfer and death occurs after the proposed regulations become final could very well be subject to the new rules. This type of rule embodies the worse kind of law – where a family-owned business has done everything correctly but because of a retroactive effective date, *a rule that didn't even exist at the time the transaction took place now applies even though there was no way the family-owned business could have ever known the rule would even come into existence.* Underscoring this comment, we are aware of no experts who thought the Treasury would ever promulgate proposed regulations of such sweeping breadth against active family-owned businesses. SBLC submits that this is the very definition of an unfair rule – one which undermines not only serious transition planning in the family-owned business context, but also the needed respect for our tax system.

From a planning viewpoint, very few people take actions in contemplation of death within two or three years before the event – primarily because few people know they are going to die years before they do. Thus, to extend a concern for deathbed transfers to three years appears to be a bit extreme. SBLC sees this rule as one more trap for the unwary or the unlucky! Even worse, one can read the proposed regulations to require that *more phantom value has to be brought back into the estate than what would have been included if the gift had never been made in the first place*. Not only does this fly in the face of common sense, but these proposed regulations would make the successful transition of a family-owned business to the next generation even harder than it already is.

Many experts have analyzed why successful transitions to the next generation of a family-owned business are so difficult to accomplish and what a family needs to do to increase the chances of success. Steps that greatly assist with the transition include the patriarch or matriarch of the business giving up control to the younger generation not only by giving them a significant voice in the running of the business but also by giving them an actual interest in the business. This step of transferring the management of the business to the next generation is fraught with difficulties – vendors and/or banks not knowing or not being comfortable with or trusting the younger generation, the older generation not wanting to transfer real power, intra-family fighting, particularly amongst siblings and/or cousins, not enough resources to pay estate taxes, if needed, and so on. We are concerned that the reality of what it takes to run a successful, active family-owned business is not understood by Treasury and the Internal Revenue Service. Rather it seems that Treasury and the Internal Revenue Service are adopting a fiction that all members of the family-owned business are in perfect agreement with one another and that there is no such thing as a real minority discount when it comes to a family-owned business. Experts who advise active family-owned businesses know that the issues that arise among family members, are the same as, or worse than, those that they handle with non-related owners of a closely held business. Only those with little or no actual exposure to active family-owned businesses can believe in this kumbaya view of the interworking of an active family-owned business.

SBLC believes that there is simply no justification for requiring an appraiser to value an active family-owned business greater than a non-family-owned business. Imagine two businesses that are identical in every way – number of employees, number of owners, amount of revenue generated, amount of customers and inventory, etc., etc., but one is family-owned and one is not. These regulations appear to say that the family-owned business must be valued at a significantly higher value than the non-family owned business *simply because it is family-owned*. The SBLC contends this defies common sense and should not be allowed to stand.

Finally, the vast majority of estate planning and appraisal experts in the country believe these proposed regulations will eliminate minority discounts and largely eliminate lack of marketability discounts for family-owned business entities. Recently, some IRS spokespeople have said that this was not the intent of the proposed regulations. Such a total lack of agreement as to what the proposed regulations even mean demonstrates how, at a minimum, they need to be extensively clarified and re-proposed. If the proposed regulations were intended to say something else, then it is incumbent upon the IRS to write them in such a way that brooks no other interpretation than what was intended. At this point, the taxpayer being attacked – the family-owned business – has no way of even knowing how these proposed regulations are to be interpreted because there are so many open questions – for instance, as to effective date and valuation issues with the three year of death rule or how an appraiser is to interpret the regulations in order to come up with the artificially inflated value that appears to be mandated.

The SBLC believes the proposed regulations should be withdrawn and not replaced because they serve no legitimate purpose that can justify the additional costs and burdens that will put the country's active family-owned businesses at a disadvantage to their non-family-owned counterparts. In the event new proposed regulations are withdrawn and reproposed they should *at a minimum* (i) exempt all *active* family-owned businesses, (ii) make it clear that appraisals are based on the real fair market value of the entity and not on some inflated value engineered by the tax code, (iii) not include any new 3 years of death rule, and (iv) take no action which would adversely impact minority and lack of marketability discounts as they stood when section 2704 was enacted. It is not clear under the proposed regulations how an active family-owned business is defined. Because what constitutes an active business has changed over the years due largely to rapid advances in technology, the SBLC suggests that the definition of an active business should not be tied to an outdated "bricks and mortar" type of definition (e.g., Code §6166). Instead, we recommend defining an active business by negative inference – start with a presumption that the family-owned business is active unless it meets a specific exception, such as owning more than say 40% of its assets in cash and/or marketable securities that are beyond that reasonably needed to run the business (e.g., accumulated earnings tax).

We welcome the opportunity to meet with Treasury to discuss these comments in more detail or to answer any questions you might have.

Sincerely,

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AmericanHort
American Moving & Storage Association
American Pet Products Association
American Road & Transportation Builders Association
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America's Small Business Development Centers
Door Security & Safety Professionals
Electronics Representatives Association
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