AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
ORAL STATEMENT
PRESENTED TO
Internal Revenue Service
PUBLIC HEARING:
Proposed Regulations Regarding the Valuation of Interests in Corporations and Partnerships for Estate, Gift, and Generation-Skipping Transfer (GST) Tax Purposes (REG-163113-02, Docket ID IRS-2016-0022)
December 1, 2016

Good morning, my name is Justin Ransome. I am a partner at Ernst & Young, LLP. My testimony today is on behalf of the American Institute of Certified Public Accountants (AICPA), the national professional association representing more than 418,000 members in 143 countries.

I would like to acknowledge that the AICPA has not yet submitted its written comments regarding the proposed regulations as we are in the process of finalizing them and expect to have them to you in the near future. My testimony today is indicative of the substantive issues that we address in our written comments.

General Comments

While our comments address many issues with the proposed regulations, my testimony will focus on three major areas we believe Treasury and the IRS need to address in the final regulations: (1) the put right in the -3 proposed regulations; (2) the 3-year look back rule in the -1 proposed regulations; and (3) the rules for determining control of an entity.

Let me start by stating that the AICPA is concerned that the proposed regulations under section 2704, issued on August 4, 2016, are overly broad and general in nature. We request that once Treasury and the IRS have considered the over 9,000 comment letters it has already received (and knowing that it will receive at least one more), that they withdraw the current proposed regulations and re-propose them with another comment period before these regulations are finalized with an effective date extended until the regulations are finalized.

We also request that Treasury and the IRS provide an exception from the proposed regulations, particularly the -3 proposed regulations for family-owned businesses that carry-on a trade or business (as Treasury and the IRS have interpreted that term for purposes of section 162 of the Internal Revenue Code).

Now I turn to the three major topics that my testimony addresses.

Put Right

First, I would like to address what I will refer to as "the put right" set forth in the -3 proposed regulations and referred to in the -2 proposed regulations.

Under the exceptions to the disregarded restrictions contained in the -3 proposed regulations, it states that “any restriction that otherwise would constitute a disregarded restriction under this section will not be considered a disregarded restriction if each holder of an interest in the entity has a put right.” The proposed regulations explain that a “put right” is a right, enforceable under applicable local law, to receive from the entity or its holders on liquidation or redemption of the holder’s interest, within six months after the date the holder gives notice of the holder’s intent to withdraw, cash and/or property with a value that is at least equal to the minimum value of the interest determined as of the date of liquidation or redemption.

Many of our members have interpreted the aforementioned language to mean that if there is a transfer of an interest in a family-owned business to a family member, the value the transferred interest is to be determined as if it included a put right at minimum value because any restriction on the right to withdraw that is more restrictive than the put right set forth in the proposed regulations is disregarded. We also understand that this is a common interpretation among many other practitioners in the estate planning community.

We understand that on many occasions after the proposed regulations were published, representatives from Treasury and the IRS have stated that such an interpretation is incorrect and overly broad. However, if this is a common interpretation among many practitioners in the estate planning community, as it is currently drafted, we think it is quite possible that IRS agents may form such an interpretation of this put right as well.

We recommend that Treasury and the IRS remove this put right language from the final regulations as we disagree with its impact as many are interpreting it. If this recommendation is not accepted, we recommend that Treasury and the IRS clarify and provide in the final regulations more specifics as to when this put right applies, including several examples.

Three-Year Rule

Next, I would like to address what I will refer to as the “three-year” rule contained in the -1 proposed regulations. The current -1 regulations define a “liquidation right” as the right or ability to compel the entity to acquire all or part of the holder’s equity interest in the entity, whether or not this would cause the entity to liquidate. It further provides that a lapse of a liquidation right occurs when an exercisable liquidation right is restricted or eliminated. However, this rule generally does not apply if the rights with respect to the transferred interest are not restricted or eliminated. As a result of this exception, if an interest holder who has the aggregate voting power to compel the entity to acquire the holder’s interest makes an inter-vivos transfer of a minority interest that results in the loss of the interest holder’s ability to compel the entity to acquire his or her interest, the transfer is not treated as a lapse.

The proposed regulations amend this exception to provide that the exception regarding transfers of interests that do not result in the restriction or elimination of rights associated with the transferred interest are limited to transfers that occur more than three years before the transferor’s death.

The AICPA is concerned that including the value of a lapse of an interest in a decedent's gross estate after the interest was transferred amounts to the inclusion of a phantom asset in the decedent's gross estate. While sections 2035 through 2043 all include provisions for the inclusion of the value of certain assets in a decedent's gross estate, there is nothing in section 2704 that would require such an inclusion if such asset was not otherwise a part of the decedent's gross estate. Although we recognize the power given to Treasury and the IRS by section 2704 to apply it to rights similar to voting and liquidation rights, we ask Treasury and the IRS to reconsider whether they should use this power to create phantom assets in a decedent's gross estate when the statute does not call for such treatment.

We also believe that the change is unnecessary given that a transfer of an interest in a family-controlled entity to another member of the family is subject to the disregarded restriction provisions contained in the -3 regulations, specifically the put right to which I have previously referred. In other words, if the transfer was subject to the -3 regulations at the time of transfer, it is unnecessary to have the three-year rule. That is, of course, if our current understanding of the put right is what was intended by Treasury and the IRS.

Finally, if this three-year rule becomes part of the final regulations, we ask that it only affect transfers that occur after the date the final regulations are published. The proposed regulations provide that the amendments to the -1 regulations apply to "lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register." Specifically included is the three-year look back rule.

The AICPA is concerned that Treasury and the IRS may apply the three-year look back rule to transfers that occurred three years prior to the effective date of the final regulations. If the three-year look back rule were to apply to such transfers, it would unfairly treat taxpayers who made transfers believing Treasury and the IRS would not subject such transfers to the new section 2704 regulations. In other words, we believe that none of the regulations should have retroactive effect, and it appears that as currently drafted, the proposed regulations would have a retroactive effect for transfers caught by the three-year rule.

We further ask that Treasury and the IRS provide examples as to the three-year rule and inclusion of such transfers in a decedent's estate. Pursuant to section 2704(a)(2), the amount of the transfer is calculated as the excess of the fair market value of all of the interests held by the individual immediately prior to the lapse over the fair market value of these interests after the lapse.

The AICPA is not clear as to how section 2704(a)(2) would apply to a transfer that is subject to the three-year rule. The first question that arises is the proper date to apply section 2704(a)(2): (1) the date of transfer; or (2) the date of death. As the purpose of section 2704(a) is to measure the decline in value due to a transfer, we recommend that the final regulations provide that the date of transfer is the proper date to apply section 2704(a)(2). To use the date of death values would allow appreciation or depreciation to enter into the calculation, which is clearly not contemplated by section 2704(a)(2).

The second question that arises is how the taxpayer should calculate the decrease in the lapse. The examples in the current regulations and as amended by the proposed regulations do not contain an example regarding the calculation of the amount subject to gift or estate tax under section 2704(a)(2). We will have an example in our written comments that highlights our confusion.

Rules Determining Control of an Entity

Next, I would like to address a couple of the rules for determining control of an entity.

The proposed regulations, as drafted, result in uncertainty over the determination of which members of a family are included in assessing control of an entity.

Section 2704 applies if the transferor and members of the transferor's family control an entity. Section 2704(c)(2) defines the term "member of the family" to include: (1) the individual's spouse, (2) any ancestor or lineal descendant of the individual, (3) any brother or sister of the individual, and (4) the spouse of any individual described in (2) or (3).

Section 2704(c)(1) provides that "control" has the meaning given to such term under section 2701(b)(2). This section provides a definition of control, but also provides for a more expansive description of a family member than the definition provided by section 2704(c)(2). Specifically, section 2701(b)(2) delineates "an applicable family member" as "any lineal descendant of any parent of the transferor or the transferor's spouse."

Similarly, the -2 and -3 regulations refer to existing -2(b)(5) regulations for a more expansive definition of family members than what is provided by section 2704(c)(2). As with the above, under existing -2(b)(5) regulations, a family member also includes "any lineal descendant of any parent of the transferor or the transferor's spouse."

Several of our members have noted that the expanded definitions above may result in the potential inclusion of the transferor's nieces and nephews in the determination of entity control. However, such an expansion appears to exceed the intended scope of section 2704. Therefore, we recommend that the final regulations clarify that "member of the family" does not include lineal descendants of any parent of the transferor (or of their spouse).

Further, we recommend that Treasury and the IRS clarify, preferably with examples, the mechanics of the test for determining control. Specifically, we request examples regarding how the attribution rules apply for purposes of determining control and that the attribution rules do not result in the double counting of interests owned by family members.

The AICPA appreciates the opportunity to comment today. We hope Treasury and the IRS will consider these thoughts as they consider what to do next with the regulations. We look forward to working with Treasury and the IRS on this issue.