August 24, 2021

The Honorable Ron Wyden
Chairman
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Richard Neal
Chairman
U.S. House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Mike Crapo
Ranking Member
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Kevin Brady
Ranking Member
U.S. House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Re: Green Book American Families Plan Proposal - Reform the Taxation of Capital Income and Treat Transfers of Appreciated Property by Gift or on Death as Realization Events

Dear Chairmen Wyden and Neal, and Ranking Members Crapo and Brady:

The American Institute of CPAs (AICPA) is commenting on the proposal in the Treasury Green Book, *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals* (the Proposal), issued May 2021, as part of the American Families Plan (AFP) to reform the taxation of capital income and treat transfers of appreciated property by gift or on death as realization events. There are many provisions of the proposal that need clarification, are overbroad or need further consideration. This letter addresses one of those issues.

That issue is the proposal requiring a partial interest owner to provide a value that represents a proportional share of the fair market value (FMV) of the entire entity, which assumes that every shareholder, even those lacking control over the property, has equal access to adequate information to determine the FMV of the entire property.[1] This assumption is contrary to reality for many minority interest holders, who often are not privy to the same scope of data available to controlling shareholders. Although the issues around access to information by holders of partial interests, especially minority interests, has been, and continues to be, a valuation issue, we are concerned that the Proposal requires that the valuation *must* be based on the full value of the whole asset. This would be a new requirement, and in light of difficulties getting information to value the whole asset, we think it is not reasonable. Whether the valuation is of an individual property with multiple owners or of an entity with multiple members, partners, or shareholders, this difficulty in accessing data needs to be considered in any proposed legislation.

[1] See *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals*, May 2021, Department of the Treasury, beginning on page 61, proposal as part of the American Families Plan that would reform the taxation of capital income and, in particular, would treat transfers of appreciated property by gift or on death as realization events.

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Another concern is that there will be two different regimes for valuation: one for transfers or "deemed sales" subject to a capital gains tax (e.g., on normal business transactions, income tax reporting, and charitable gifts, etc.), and a second for gift and estate taxes, which creates confusion regarding post-transfer basis and perhaps even an opportunity for taxpayers to create artificial transactions in order to "game" the basis rules to exploit the lowest tax result.

In addition, as mentioned at the end of our comments, there are other provisions in the Proposal that are related to the taxation of the capital assets and are not commercially reasonable and should be reconsidered.

General Comments with Regard to Valuation Issues and Professional Valuation Standards

The text in the Proposal to reform the taxation of capital income and treat transfers of appreciated property by gift or on death as realization events provides new law on capital gain taxation including:

- A definition of when a realization event occurs;
- A basis to determine what percentage of value transferred is taxable; and
- Restrictions on discounts for estate and gift-related transfers of ownership interests.

The AICPA is concerned that some of the provisions within the Proposal are inconsistent with well-established valuation principles and could result in valuations that do not reflect the true economic value of transferred assets. These inconsistencies could, in turn, negatively affect taxpayers.

The focus of these comments is on valuation-related issues from business appraisers' perspectives, including our concerns with how the Proposal: 1) assumes taxpayers have a level of access to information that may not exist; and 2) could significantly affect fundamental valuation principles that are core concepts within the valuation profession.

<u>Limited Access to Information</u>

Provided below in *italics* is the proposed issue within the 'Reform the Taxation of Capital Income' section of the Proposal that we urge members of Congress to review and revise before considering legislation in this area:

> A transfer would be defined under the gift and estate tax provisions and would be valued using the methodologies used for gift or estate tax purposes. However, for purposes of the imposition of this tax on appreciated assets, the following would apply. *First, a transferred partial interest would be its proportional share of the fair market value of the entire property.* [**Emphasis added**]

The "proportionate share of the fair market value of the entire property" requirement has, in the opinion of the AICPA, a fatal flaw assumption that the partial owner has adequate insights or access to information that would allow for a determination of FMV of the entire property. This determination is often not possible. For example, a minority interest holder in a private or public company may not have the ability or legal right to obtain the information necessary to value the entire company. And without some recourse, taxpayers will not be able to provide the Treasury or Internal Revenue Service (IRS) any reasonable and supportable value of the partial interest. The AICPA recommends that this criterion be removed or, if not removed, revised to provide law that takes into account the limitations faced by many owners of partial interests.

Effect on Fundamental Valuation Principles

In addition to the concerns raised about limited access to information, the "proportionate share of the fair market value of the entire property" requirement will result in valuations that fail to take into account the unique legal, economic, and business characteristics of transfers of partial interests in closely-held entities. In short, values developed under this requirement will not be representative of FMV. The proposed language will result in at least two separate valuation paradigms: tax valuations (which include various different valuation paradigms) and fair market value valuations.

The universally accepted definition of fair market value in the United States assumes both a hypothetical willing buyer and a hypothetical willing seller, dealing at arm's length. The identified text within the Proposal eliminates these key elements for partial transfers because there is no longer a presumption of an arm's length transaction between such parties.

The AICPA's valuation standard, Statement on Standards for Valuation Services, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (VS 100) defines FMV as:

> Fair Market Value — the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

The AICPA's 428,000 members within the United States and worldwide are required to adhere to VS 100. The AICPA's definition of fair market value is consistent with guidance promulgated by the Treasury in Reg. § 20.2031-1(b) and in IRS Rev. Rul. 59-60.[2] Courts have historically relied on the Rev. Rul. 59-60 fair market value definition to value interests in closely-held entities.

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[2] All references to "section" are to the Internal Revenue Code of 1986, as amended, and all references to "Reg. §", "Prop. Reg. §", and "regulations" are to U.S. Treasury regulations promulgated thereunder, unless otherwise specified.

Appraisers consider a myriad of economic, contractual, and business factors in valuing partial interest transfers. The definition of fair market value provided in Reg. § 20.2031-1(b) and Rev. Rul. 59-60 requires an appraiser to consider the price at which property would change hands between willing buyers and sellers acting at arm's length in an open and unrestricted market. The AICPA's and Rev. Rul. 59-60 fair market value definitions necessitate the review of advantages and disadvantages of partial interest ownerships in closely-held entities. Appraisers must consider the effects of partial interest ownership characteristics on the appraised property's value. Willing buyers and sellers evaluate the pros and cons of partial ownership interests and review the following aspects of ownership to arrive at fair market value:

- The ability to oversee or manage the business;
- Rights to subsequently transfer or sell the interest; and
- Benefits and limitations of particular business interests being valued, including benefits and limitations adhering to a partial ownership interest rather than ownership of 100% of a business enterprise.

Failure to consider and evaluate unique characteristics of partial ownership interests will result in valuations that do not reflect market-based values. Valuations performed for other purposes (e.g., income tax, ESOP) will likely result in significantly different values for the same assets – even if valued using the same valuation date.

A simple example to illustrate this inconsistency (and the discounts discussed below): Taxpayer A owns a 40% partial interest in a company, 100% of which is valued at $3.75 million. On the same day, Taxpayer A transfers half of the 40% interest (20% of the whole) to a charity and gifts the other half to a grandchild. Each half is identical in every way. The value of the interest transferred to charity, determined under Reg. § 20.2031-1(b) and Rev. Rul. 59-60 and taking into account discounts for lack of marketability and control is determined to be $500,000 (a total discount of 33.3%). The value of the interest transferred to the grandchild, valued using the Administration's proposed proportionate value rule, is $750,000 because it is a 20% interest of a company valued at $3.75 million and no discounts are allowed. The result is a $250,000 valuation difference for identical interests in the company.

This result is just one example of how this proposed requirement will distort values and create discrepancies in the requirements to which taxpayers may be subject.

Discount for Lack of Control

Many considerations factor into determining the FMV of an asset. One of these considerations, which is often aligned with transfers of less than 50% ownership interests, is the discount for lack of control (DLOC). The identified text within the Proposal appears to prohibit applying a DLOC

to transfers of partial interests. This prohibition is contrary to guidance on partial interest transfers promulgated in well-established IRS rulings and case law.

The IRS has challenged the application of minority interest discounts to transfers of partial ownership interests among family members in the recent past. Attribution rules, as they came to be known, were successfully challenged in a number of court cases. The IRS position was ultimately reversed with the issuance of Rev. Rul. 93-12.

The identified text in the Proposal appears to be a legislative override that will reverse Rev. Rul. 93-12 and the related case law that have been driven, in part, by market-based principles integrated into the concept of FMV. Revenue Ruling 93-12 appropriately captures the importance of valuing partial interests, especially minority interests, and reflects the views of willing buyers and willing sellers who consider the economic effect of having limited or no control in their ownership transfers. For example, a minority interest can be worth far less than a proportionate value of the total entity if the controlling interest can restrict cash flows to the minority interest. Restricted cash flows could be in the form of, but are not limited to: 1) not declaring dividends to pay taxes in pass-through entities (those taxed as partnerships or S corporations); 2) no control over strategic investments or leverage decisions that may be detrimental to the company value; and 3) no board of directors' representation.

The AICPA recommends Congress incorporate the concepts articulated in Rev. Rul. 93-12 into the requirements to which taxpayers will need to adhere when computing taxes on appreciated assets transferred by gift or through an estate.

Discount for Lack of Marketability

Owners of closely held corporations are affected by their inability to readily convert their stock into cash. A discount for lack of marketability (DLOM) is used to compensate for the difficulty of selling shares of stock that are not traded on a stock exchange compared with those that can be traded publicly. This discount relates primarily to the time, cost and risks related to selling stock in a closely held business.

Examples of marketable assets that may not be considered liquid include closely held stock, partnership interests, and securities issued under restrictive Securities & Exchange Commission (SEC) guidelines (e.g., Rule 144). The effect of this lack of liquidity often results in a discount in price to the purchaser as an incentive for the investment of capital. Without such a discount, all other things being equal, an investor is less likely to invest in an asset that may not be readily convertible to cash when a comparable asset has that liquidity feature. The DLOM is a common issue for valuation analysts when performing a valuation engagement for estate and gift tax purposes.

There are many notable studies that support DLOM (e.g., restricted stock studies, pre-IPO studies) as well as Tax Court cases (e.g., *Mandelbaum v. Commissioner*). An IRS publication issued in 2009, "Discount for Lack of Marketability—Job Aid for IRS Valuation Professionals," provides non-authoritative guidance on methodologies and considerations when applying DLOM to assets.

The AICPA recommends that Congress also consider the widely recognized concepts of DLOM when drafting any requirements that involve the valuation of non-liquid assets.

Administrative Burden

Finally, the Proposal will also create a significant administrative burden on the taxpayer, who would have an asset with two different values and two different basis amounts to track. There will also be additional burden on taxpayers needing to file adequate disclosure statements, indicating gift tax returns are being filed with contrary positions.

Other provisions in the Proposal that are related to the the taxation of the capital assets and are not commercially reasonable and should be reconsidered include:

- Capital gains recognized as a result of a transfer that are subject to immediate taxation would require access to sufficient liquid assets to pay the taxes due. This is an unreasonable requirement when the transfers are non-liquid assets such as real estate, business interests, etc., because it may require the forced liquidation of some or all of the assets transferred.

- It is unclear if the deferral of payment of taxes for certain family-owned businesses means that, when interests are transferred through an estate, estate tax returns will remain subject to assessment under the statute of limitations until the business is no longer family owned and operated.

- Many taxpayers are likely to have challenges in determining basis due to a lack of access to needed records. While the Proposal provides that Treasury would be granted authority to issue regulations, including rules and safe harbors for determining basis when records are unavailable, specific Congressional guidance and intent is needed on this issue. The Proposal's requirements for transfer taxation may necessitate an increasingly complex set of exceptions and mitigating provisions that may create a significant administrative burden for taxpayers that are looking to comply with the new rules. For example, if taxpayers transfer assets from one partnership to another for non-tax reasons, perhaps for asset management or for family succession planning purposes, this transfer would be a recognition event under the Proposal, even if the entities have identical ownership, and there is no change in control. To resolve this issue and many others similar to it, exceptions will need to be provided so that taxpayers can comply with the provisions but not face unreasonable compliance burdens and unexpected tax liability.

- It is unreasonable to expect that individuals will have full knowledge of all transactions for the 90-year lookback period.[3]

- The taxation of the capital gains on gift or death in many cases would be the third time that the gain is taxed.

  - Under present law, the income from a closely held C corporation is taxed at the corporate level when it is earned. The remaining income after tax is then often accumulated at the C corporation for working capital and expansion. The total value of the C corporation, including the value of the accumulated earnings, is then taxed when the ownership of the business is gifted or held at death. The gift or estate tax taxes the accumulated income that is retained in the business.

  - Under the administration's Proposal, the value of the accumulated income would be taxed a third time by taxing the appreciation of the value of the business as a deemed disposition for income tax purposes on gift or at death. The recognition of income on the transfer of the accumulation of the previously taxed C corporation earnings results in a third tax. This is illustrated as follows:

Business Income	$ 100.00	$ 100.00	
Corporate income tax at the proposed 28% rate	(28.00)	(28.00)	First tax
Net earnings accumulated at the business level	$ 72.00		
Value included in taxable estate	$ 72.00		
Proposed capital gain tax upon death of shareholder at 43.4%	(31.25)	(31.25)	Second tax
Remaining, included in taxable estate	40.75		
Estate tax at 40%	(16.30)	(16.30)	Third tax
Remaining after taxes	$ 24.45	$ 24.45	

Only $24.45 of the $100.00 of business income would remain after federal taxes. This illustration does not take into account any state tax liability on the income.

- The Proposal would subject the capital gains income to the same rates of taxation as ordinary income but continue the limitations on the ability of taxpayers to utilize capital losses.

- There are other issues that are not addressed in the Green Book Proposal and need further clarification. For example:

[3] See Proposal page 62.

- On the deemed sale, to the extent of a loss on the sale, how would that loss interplay with the related party disallowance rules of section 267?

- What will be the effect of these taxable transfers on the passive activity loss rules and loss carryforwards?

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The AICPA is the world's largest member association representing the CPA profession, with more than 428,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please feel free to contact Eileen Sherr, Director – AICPA Tax Policy & Advocacy, at (202) 434-9256 or Eileen.Sherr@aicpa-cima.com; Lauren Pfingstag, Director – AICPA Congressional and Political Affairs, at (407) 257-0607 or Lauren.Pfingstag@aicpa-cima.com; Jan Lewis, Chair of the AICPA Tax Executive Committee at (601) 326-7119 or JanLewis@HaddoxReid.com or Bethany M. Hearn at (217) 373-3109 or bethany.hearn@CLAconnect.com , Chair of the AICPA Forensic and Valuation Services Executive Committee.

Sincerely,

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cc: Members of the Senate Committee on Finance
Members of the House Committee on Ways and Means
Mr. Thomas Barthold, Chief of Staff, Joint Committee on Taxation
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
Mr. Mark Mazur, Acting Assistant Secretary for Tax Policy, Department of the Treasury