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)

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Good morning. My name is Michelle Gallagher. I am a certified public accountant (CPA), accredited in business valuation (ABV), and certified in financial forensics (CFF). I own and operate the valuation and forensic accounting firm of Gallagher Valuation & Forensics, PLC, and I am a principal with the accounting firm of Gallagher, Flintoff & Klein, PLC in Lansing, Michigan.

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 am the Chair of the AICPA ABV Credential Committee and Past Chair and member of the ABV Exam Task Force and member of the AICPA Family Limited Partnerships (FLP) Issues Task Force.

As some background, in 2007, the AICPA issued detailed professional standards (the "Standards") for business valuation conclusions and calculations for all types of engagements, including gift and estate matters. All AICPA members must comply with these Standards, and a majority of licensing jurisdictions for CPAs also require compliance. These Standards are codified by AICPA as VS Section 100 (Formerly SSVS1) and are considered generally accepted valuation principles for CPA business appraisers.

My comments today will focus on valuation related issues from a business appraiser's perspective, specifically our concerns on how the proposed regulations do not follow generally accepted valuation principles as they redefine three important valuation concepts 1) fair market value (FMV), 2) control, and 3) marketability.

Redefining Fair Market Value

First, let's discuss FMV. The definition of FMV used universally by business appraisers assumes both a hypothetical willing buyer and seller, dealing at arm's length. The proposed regulations replace these key elements. Under the proposed regulations, there is no longer a presumption of hypothetical parties or an arm's length transaction between such parties.

Included in AICPAs VS100 Standards is an International Glossary of Business Valuation Terms. This International Glossary has been adopted and approved by many professional business valuation organizations, including the AICPA, the American Society of Appraisers, the National Association of Certified Valuation Analysts, the Canadian Institute of Chartered Business Valuators, and the Institute of Business Appraisers.

According to the International Glossary used by business appraisers, the definition of FMV is… "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."

This definition is consistent with Treas. Reg. § 20.2031-1(b), which the courts have consistently relied on for decades as well as Revenue Ruling 59-60 and a number other Treasury and IRS references, such as publications.

As stated in Proposed Reg. § 25.2704-3(f) : "If a restriction is disregarded under this section, the fair market value of the transferred interest is determined under *generally accepted valuation principles* as if the disregarded restriction does not exist in the governing documents, local law, or otherwise."

In other words, Treasury and the IRS are asking business appraisers to rely on some new concept or definition of FMV, which appears more like what we business appraisers call "Investment Value." Investment Value, as defined by the International Glossary, is "the value to a particular investor based on individual investment requirements and expectations."

At recent presentations by Treasury and IRS representatives, I have heard them reference the proposed regulations as nothing more than a subtraction issue, like going to the butcher shop and trimming off the fat. So, let's go to that butcher shop and compare the concept of fair market value to it. When a butcher trims off the fat, that piece of meat is now customized and unique to that particular customer. When comparing this to an interest in a closely-held business, business appraisers use market data (publicly traded companies, M&A transactions, publicly-held real estate limited partnership transactions, closed-end funds, etc.) when determining the FMV of the subject interest. Think of the market data we use as similar to the untrimmed piece of meat at the butcher shop. When the fat is trimmed away, a unique piece of meat has been created for that particular customer with no comparison to the market, so it has its own value to that customer.
Another real-life example is a Snickers bar. If you take the peanuts out of the Snickers bar, what do you have? Something different…something with a different taste, a different market, and different value to consumers. It's not a Snickers bar anymore. The proposed regulations are asking us to value that unique piece of meat from the butcher shop or that unique Snickers bar with no market data to support it, which means it is not FMV – it is Investment Value.

By changing or bifurcating the definition of FMV, business appraisers will be required to perform different valuations using different methodologies for assets affected by the proposed rules, depending upon whether the asset was transferred to family donees/heirs, third parties (non-family members), and/or charities. Taxpayers may also need different valuations for income tax or employee stock ownership plan (ESOP) purposes, as the definition of fair market value may now differ from those definitions as well.

The proposed regulations are also creating a significant administrative burden on the taxpayer who would have an asset with two different values and two different basis amounts to track – a basis for income tax and a basis for estate tax. Taxpayers will also have the additional burden of needing to file adequate disclosure statements, indicating gift tax returns are being filed with contrary positions.

Redefining Control

Now let's turn to control. Another concern we have with the proposed regulations is how they redefine control. Under the proposed regulations, all family members (those with controlling interests and non-controlling interest alike), are assumed to work and interact together, which is not reality. I work with family-owned businesses all the time and can truly attest to this. I'll bet everyone in this room can think of at least one family member they would never want to do business with…I know I can! The fact is, issues of family control and attribution were litigated for years, resulting in the IRS acquiescence of this position with the issuance of Revenue Ruling 93-12. The definition of control in the proposed regulations is in direct conflict with Revenue Ruling 93-12.

Further, the proposed regulations provide stringent requirements before ownership interests held by unrelated third parties are even relevant to the analyses, which are not commercially reasonable.

Under generally accepted valuation principles, an adjustment for lack of control is often used to compensate for the inability of a minority interest holder to control any company decisions. Available market data broadly supports that the FMV of a non-controlling interest, even in an asset holding company, is worth less than its pro-rata value of the company as a whole. Sources for this market data include closed-end mutual funds, real estate limited partnerships, an others. The proposed regulations require the business appraiser to ignore this market data.

In addition to ignoring certain unrelated third party owners and market data, under the proposed regulations, business appraisers are required to ignore governing documents and local law when certain restrictions exist. These requirements will force business appraisers to make hypothetical assumptions that are contrary to fact or unlikely to occur and again, are not consistent with the definition of FMV.

Redefining Marketability

Finally, I want to discuss marketability. Marketability is the ability to quickly convert an ownership interest to cash, with minimal cost and maximum certainty about the price that is received. Under generally accepted valuation principles, an adjustment for lack of marketability is often used to compensate for the difficulty of selling an interest in a closely-held company that is not traded on any exchange.

The proposed regulations include what appears to tax and valuation experts as a mandatory put right, which would change how business appraisers assess the marketability (or lack thereof) of an ownership interest in a closely-held business. A put right is commonly defined as a right to sell a security at a specified price within a specific time. With the proposed regulations requiring assumptions related to liquating interests at a "minimum value", in cash, within six months, we can easily see how many experts are interpreting this as a deemed put right. This deemed put right would increase the risk of any operating entity where all holders have such a right, and it is not commercially reasonable to assume that each member of a closely-held entity would have unlimited put rights like this. The deemed put right also would appear to override all other provisions of the proposed regulations; arms' length parties (or families, for that matter) would never negotiate such arrangements.

Other provisions in the proposed regulations that are related to marketability and are not commercially reasonable include:

Disregarding limitations on the ability of an interest holder to compel liquidation is not realistic because such limitations are placed in company agreements all the time to facilitate the operation of entities to achieve their business purposes.

Limitations on interest holders' redemption and liquidation amounts to at least "minimum value" are unreasonable because closely-held businesses are typically illiquid, and, in the real world, there are no guaranteed minimum values for any investment.

Limitation of the deferral of full redemption/liquidation payment to no more than six-months after the holders gives notice is unreasonable because such terms are generally not offered by closely-held businesses as such terms would likely put them out of business.

Payment of any portion of the full amount in any manner other than cash is unreasonable because it is not possible for illiquid companies and can result in a forced liquidation of the entity. . Often it is not feasible for a closely-held family business to obtain financing to redeem interests. If the business is able to obtain such financing, the leverage may substantially increase company risk and debt costs.
If the proposed regulations are not revised to address the perceived put right and these commercially unreasonable provisions, business appraisers will need alternative methods and guidance for determining marketability adjustments for closely-held business interests.

Conclusion

In conclusion, the AICPA urges Treasury and the IRS to withdraw the proposed regulations. If that is not pursued, then Treasury and the IRS should take into consideration the points we have raised and issue new, clarified proposed regulations for public comment, providing an extended effective date. Treasury and the IRS should give more time for practitioners and taxpayers to understand the regulations before they become effective. Treasury and the IRS also should apply the regulations only to family-owned entities that hold passive investments and not to family-owned businesses that carry on a trade or business. Finally, Treasury and the IRS should provide a grandfathering rule, providing an exemption for transactions occurring prior to the issuance of the final regulations.

The AICPA appreciates the opportunity to comment today. We hope Treasury and the IRS will consider these thoughts as they decide what to do next with the regulations. We would also encourage Treasury and the IRS to utilize the vast knowledge and experience of our more than 418,000 members to assist in drafting new or revised proposed regulations. Thank you for the opportunity to testify today.