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November 2, 2016

Mr. John D. MacEachen
CC:PA:LPD:PR (REG-163113-092)
Internal Revenue Service, Room 5203
Ben Franklin Station, P.O. Box 7604
Washington, D.C. 20044

RE: Comments on Proposed Regulations on Estate, Gift, and Generation Skipping Transfer Taxes; Restrictions on Liquidation of an Interest (REG-163113-092)

Dear Mr. MacEachen:

The Independent Community Bankers of America (ICBA) appreciates the opportunity to comment on a proposal by the Internal Revenue Service (IRS) to amend the rules governing the “treatment of lapsing rights and restrictions” (Section 2704) under the Estate and Gift Tax Subtitle of the Internal Revenue Code (IRC). The proposed regulations address the use of discounts for minority interests (or “lack of control”) and lack of marketability in the valuation of interests transferred within families.

ICBA represents nearly 6,000 community banks across the nation of all sizes and charter types. Community banks employ 700,000 Americans, hold \$3.6 trillion in assets, \$2.9 trillion in deposits, and \$2.4 trillion in loans to consumers, small businesses and the agricultural community.

ICBA requests that the IRS withdraw the proposed regulations for the reasons described in this letter.

Generational Transfers Preserve the Character and the Survival of Community Banks, Family Farms, and Family-Owned Small Businesses

Many community banks have been held and operated within families for as many as four generations. ICBA’s current chairman, Rebeca Romero Rainey of Centinel Bank of Taos in Taos, New Mexico, is a third-generation community banker. Centinel was founded by Ms. Romero Rainey’s grandfather, Eliu E. Romero, in 1969 after he was denied a loan to finance his start-up law practice. Another ICBA member bank, Industrial Bank in the District of Columbia, is also led by a third-generation community banker, B. Doyle Mitchell, whose grandfather founded the bank in 1934. Industrial Bank is the oldest and largest African American-owned commercial bank in the metropolitan Washington, D.C. area.

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While available data is limited, ICBA estimates that nearly 1,000 community banks are majority family-owned.¹ The number could be much greater. A 2015 study by the Federal Deposit Insurance Corporation (FDIC) based on a survey of examiners of community banks headquartered in 21 states in the central United States found that a majority of community banks in this region are family-held and family-run.²

This close family and cross-generational association is critical to the identity, the business model, and the competitive advantage of community banks in an evolving financial system in which it is becoming more challenging for them to preserve their independence. The FDIC study noted above found that closely-held community banks surveyed, including family-held community banks, consistently outperformed widely-held community banks in recent years in terms of financial performance and efficiency.³ To account for this superior performance, the study cites economic theory suggesting that managers of closely-held banks benefit from the ability to make decisions over a longer time horizon than managers of widely-held banks, among other advantages.

This formal research confirms what community bankers know from experience. Their survival and the prosperity of the communities they serve depends on their being rooted in these communities and leveraging their personal, first-hand knowledge of the community and its people. Community banks thrive by developing small business and consumer relationships that span generations. In an industry becoming more dominated by large money center banks and automated underwriting, these first-hand relationships and customized products and services provide community banks with a critical competitive advantage. More importantly, this business model better serves community bank customers, both consumers and businesses alike, and better promotes local economic growth and vitality.

This “relationship lending” model is closely linked to the intra-generational character of community banks as well as many of the family-owned businesses and family farms that community banks primarily serve. Community banks provide nearly 50 percent of all small business loans in the country and 77 percent of all agricultural loans, according to a study by scholars at Harvard’s Kennedy School.⁴ In particular, the FDIC study found that closely-held community banks are nearly twice as likely as widely-held banks to specialize in agricultural lending.⁵ Second, third, and even fourth generation community bankers often serve the respective generations of a family, family-owned business or family farm. If a community bank or a business it serves changes hands at the death of an owner, the link is harder to sustain. If the bank is headquartered in a rural area – as many family-held community banks are – it may have difficulty in attracting qualified management. The FDIC study cautions that the successful

¹ ICBA 2015 Lending Survey

² “Financial Performance and Management Structure of Small, Closely Held Banks.” FDIC Quarterly. 2015, Volume 9, No. 4. Page 41.

³ Ibid. Page 43.

⁴ “The State and Fate of Community Banking.” Marshall Lux and Robert Greene. Mossavar-Rahmani Center for Business and Government at the Harvard Kennedy School. February 2015.

⁵ FDIC Quarterly. Page 43.

performance of closely-held community banks may be jeopardized by difficulties related to management succession.⁶ This is the reason the proposed regulations are a special threat to the tested and successful model of family-held community banks and the economic growth it helps sustain: The proposed regulations jeopardize the succession of community banks from generation to generation.

Discounts Reflect Fair Market Value Standard and Are Supported by Legislative History

The transfer of community banks from generation to generation relies on careful estate planning that makes use of all available, legitimate features of current tax law, including discounts for minority interests and marketability that can materially reduce transfer taxes. These discounts, which have been used for decades and are settled law, reflect economic value. A minority stake in a community bank or other business, with no control over critical decision making, including decisions over liquidation and distributions, is clearly worth substantially less than a majority stake. Likewise, a stake that is not readily marketable cannot be easily converted into cash and is worth less than a highly marketable stake.

These discounts are also available when members of a family control, in aggregate, a majority stake in a community bank or other business. A fair market value standard, articulated in the legislative history of Chapter 14 of the IRC (“Special Valuation Rules), governs such valuations. “This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer. Accordingly, courts generally have refused to consider familial relationships among co-owners in valuing property. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.”⁷

Many estate tax practitioners believe the proposed rules would effectively end the availability of these discounts, or at a minimum, drastically limit their availability.

The Proposal Would Result in Forced Sales, Consolidation and a Less Competitive Banking System

Without these discounts, intra-family transfers of community banks would in many cases become unaffordable. Generations that have grown up in a community bank, built relationships with customers, learned the specialized business of community lending and would like to carry it forward would be unable to do so because the estate would be forced to sell its interest in the bank to pay an inflated estate tax liability.

These forced sales of once family-owned community banks to other community banks or, frequently, to larger regional or national banks, coupled with a recent surge in regulatory burden, would accelerate the current trend toward consolidation in the banking sector. Consolidation reduces competition and results in fewer product offerings, lower rates on deposits, higher rates

⁶ Ibid. Page 42.

⁷ Conference Report on the Omnibus Budget Reconciliation Act of 1990. Congressional Record of the 101st Congress. October 18, 1990. Page:S15679.

on loans and higher fees. Large areas of the country could be left without any local bank presence or access to the customized products and services in which they specialize. As an FDIC Community Banking Study showed, in one out of every five counties in the United States, the only physical banking offices are those operated by community banks.⁸

ICBA asks that you consider the damaging impact your proposed regulations would have, if finalized, on community banks, communities, consumers, small business, and small farm borrowers.

Significant Changes to the Estate Tax Should Be the Purview of Congress

The use of legitimate discounts in estate planning has a significant effect on taxes paid by estates, reducing the effective rate by 30 percent or more in many cases. The availability of discounts is as consequential as the estate tax rate and exclusion, which have been fiercely contested in Congress for over a decade before they were made permanent in 2013. Eliminating or nearly eliminating widely-used valuation discounts will have a material impact on estates and on the amount of revenue collected by Treasury.

ICBA believes that sensitive tax policy that is as controversial and as consequential as the estate tax should be decided by Congress. We note that the President's budget request to Congress in four consecutive years (2009 through 2012) included a proposal for legislation to expand Section 2704 of the IRC. Clearly, the Administration viewed estate tax valuation discounts as a legislative matter. Congress was under Democratic control in 2009 and 2010 and under divided control in 2011 and 2012. A number of major tax bills were enacted during that period that might have served as vehicles. Nevertheless, Congress declined to act on the President's proposal. Having failed to obtain legislation, the Administration chose instead to issue proposed regulations which are substantially similar to the legislative proposal included in past budgets. Why the change? ICBA believes the Administration made the correct choice initially: Any proposal to eliminate or nearly eliminate valuation discounts and thereby significantly increase the estate tax should be submitted to Congress for consideration and debate.

Individual Provisions

ICBA comments on two provisions of the proposed regulations which would have an adverse impact on community banks and the customers they serve.

Three-Year Look Back Rule Would Impose an Arbitrary Standard

The current regulation allows for appropriate discounts in cases where an owner transfers a portion of his or her interest in a business before the owner's death and such transfer results in a lapse of voting or liquidation rights. These discounts apply to valuations under the gift tax at the time of the transfer and under the estate tax for any subsequent transfers at the time of the transferor's death.

⁸ FDIC Community Banking Study. December 2012.

There are legitimate business reasons for owners to transfer a portion of their interests in a business as they transition to retirement and transfer control of their companies to the next generation. The discounts available under the current regulations appropriately reflect the economic value of such transfers.

The proposed rules would provide that the transfer of an interest that results in the lapse of a voting or liquidation right that occurs within three years of the transferor's death is deemed to occur at death and is includible in the transferor's estate. Thus, transfers that occurred over time and at the death of the transferor would be consolidated and valued as a single transfer. This requirement would often have the effect of eliminating discounts that applied to the gifts before death and to the estate at death.

ICBA believes that the three-year lookback would be arbitrary and the result perverse. Why is a transfer discounted when it occurs more than three years before death but not discounted when it occurs within three years of death? Two transfers that occur within weeks of each other relative to the death of the transferor could result in significantly different estate and/or gift tax liabilities. The standard appears to presuppose that an owner's death can be timed for estate planning purposes. Surely, this was not the IRS's intention. There are no doubt cases in tax law where use of a "bright line" standard is appropriate. We do not believe the interval of time before a taxpayer's death is such a case.

Estate Planners Should Be Able to Rely on State Law

Section 2704 provides that certain restrictions on liquidation authority must be disregarded in valuing transferred interests in businesses. This section also provides an important exception for "any restriction imposed, or required to be imposed, by any Federal or State law" (Section 2704(b)(3)(B)). When a restriction on liquidation authority is required by federal or state law, it is not disregarded and may be taken into account in the valuation of transferred interests. For example, many states have laws governing partnerships and limited liability companies (LLCs) that require the consent of a super majority of owners to liquidate an entity. In most states, these are statutory default provisions that businesses may choose to eliminate in their governing documents.

The current regulations under Section 2704 (26 CFR 25.2704-2(b)) reflect the intent of this statutory exception for state law restrictions. Only restrictions that are more restrictive than state law must be disregarded. Restrictions that are consistent with state law, even when they are default provisions that can be superseded by a business, are not disregarded and may be considered in valuing transferred interests. These state law restrictions are the basis of legitimate discounts used by certain community banks that, for example, are organized under holding companies structured as LLCs. In addition, state law restrictions are the basis of legitimate discounts used by many family-owned businesses that community banks serve.

The proposed regulations drastically narrow the exception for liquidation restrictions imposed by state law so that it would apply only when a business does not have the ability to supersede the restrictions in its governing documents.

ICBA believes this is an extreme and unwarranted interpretation of the statutory provision that allows family businesses to rely on state law, whether or not they have the ability to override state law. If finalized, this proposed rule will upend lawful estate planning at thousands of family businesses across the country, including community banks, and curtail the use of legitimate discounts based on state law liquidation restrictions that depress the value of business interests.

Thank you for the opportunity to comment on the proposed regulations. ICBA welcomes the opportunity to meet with Treasury or the IRS to discuss our comments in more detail.

Sincerely,

/s/

Alan Keller
First Vice President, Legislative Policy
Independent Community Bankers of America