American Bankers Association

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Phoebe A. Papageorgiou
Vice President, Trust Policy
202-663-5053
phoebep@aba.com

November 2, 2016 *Via FederalRegister.gov*

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: IRS Proposed Rule Re Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest, 81 Federal Register 51413 (August 4, 2016).

Dear Commissioner Koskinen:

The American Bankers Association[1] (ABA) appreciates the opportunity to comment on the Internal Revenue Service (IRS) proposed rule limiting valuation discounts of family interests in certain entities, such as corporations, partnerships, or limited liability companies (LLCs) (collectively, family entities), for estate, gift, and generation-skipping transfer tax purposes (collectively, transfer taxes). ABA represents banks, savings associations, and trust companies that may be affected by the rule in a number of ways, including family-owned banks whose owners would be subject to these limitations on discounts, as well as banks that provide both fiduciary and lending services to related or unrelated families, their entities, and trusts. ABA's comments will focus particularly on the somewhat narrow aspect of the rule that is specific to banks acting in fiduciary and lending capacities.

Background on the Proposal

Section 2704 of the Internal Revenue Code (Code) provides special valuation rules for transfer tax purposes when making intra-family transfers of family entities that are subject to restrictions on liquidation, as well as lapsing voting or liquidation rights. Among other things, under these proposed rules, the IRS is further defining that certain restrictions on liquidating the entity (known as "applicable restrictions") would be disregarded in determining the fair market value of the transferred interest, as would newly delineated "disregarded restrictions" that limit the ability to redeem or liquidate an interest in the entity.

Treatment of Liquidation Restrictions in Bank Loans

Understanding that many bank loans to family entities contain commercially reasonable limitations on liquidation of an interest, proposed 26 CFR 25.2704-2(b)(4) makes the following exception to the definition of "applicable restriction" that would otherwise be disregarded:

[1] The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.

> (i) Commercially reasonable restriction. An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.[2]

In other words, under the proposal, the IRS will recognize applicable restrictions included in loans from unrelated banks. However, if the bank offering the loan is also a related person by way of being a "fiduciary of a trust," the applicable restriction will be allowed *only* if the bank is "publicly held."

Consider the example of a bank trust department that is acting as trustee of a family trust, while the commercial side of the bank has extended a loan to a related family entity. If that bank is "publicly held," the loan's provisions restricting liquidation would be recognized. But if the bank is closely held, or perhaps just not traded on a national stock exchange, even if the bank is not otherwise related to the family entity, its loan restriction would be disregarded. It is unclear just which banks would be affected by this disparate treatment, because the term "publicly held" is not defined in the proposed rule or related sections of the Code or regulations.

Regardless of term's meaning, ABA believes that given bank regulations governing activities with related parties, discussed further below, it is unnecessary for the IRS to discriminate between loans extended by banks that are "publicly held" and loans extended by other banks.[3] The IRS's concern about potential conflicts of interest in loan terms has been mitigated by these important regulations. Furthermore, it would be inherently unfair to families, otherwise unrelated to the bank, to be penalized under these valuation rules simply because they seek financial and fiduciary services with a bank that is not "publicly held."

Bank Regulations Governing Activities with Related Parties

We understand the IRS's concern for potential conflicts of interest when related persons provide loans to family entities. However, all banks, whether family owned, closely held, publicly held, or publicly traded, are in the business of making loans and are subject to regulations requiring these loans to be made at an arm's length for the safety and soundness of the institution. The proposed rule's requirement that a bank "fiduciary of a trust" be publicly held is unnecessary to preserve the objectivity of these loans.

Specifically, Regulation O, *Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks*,[4] applies to all state-chartered and national banks that are insured by the Federal Deposit

[2] The proposed rule contains other provisions that refer to banks that are "publicly held," including 25.2704-3(b)(1)(iv), 25.2704-3(b)(5)(ii), and *Example 2* in that proposed section. For simplicity's sake, this letter focuses on the language in 25.2704-2, but the same argument applies to all references in the proposed regulations.

[3] In fact, the existing regulation that the IRS proposes to amend does not discriminate based on whether the bank is "publicly held."

[4] 12 CFR Part 215.

Insurance Corporation. This regulation governs extensions of credit by the bank to an executive officer, director, or principal shareholder of the bank (insiders), as well as to the related bank holding company if there is one, and any other subsidiary of that bank holding company. The regulation also regulates extensions of credit by a bank to a company[5] controlled by an insider.

Among other things, 12 CFR 215.4 generally prohibits loans to bank insiders that are not "made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not" insiders and "does not involve more than the normal risk of repayment or present other unfavorable features." In addition, the regulation requires prior approval by a majority of the bank board of directors of any loan made to an insider of more than $25,000 or more than 5% of the bank's unimpaired capital or unimpaired surplus. Any interested party must abstain from participating directly or indirectly in the vote.

Bank regulators monitor compliance by requiring quarterly reporting of all extensions of credit made by the bank to its insiders since the date of the previous report of condition. Further, upon receipt of a request from a member of the public, a member bank must disclose the names of its executive officers and principal shareholders who, along with their related interests, received extensions of credit, either from the member bank or from all correspondent banks of the member bank, that in the aggregate equaled or exceeded 5 percent of the member bank's capital and unimpaired surplus or $500,000, whichever is less.

In addition, under Regulation W, *Transactions between Member Banks and Their Affiliates*,[6] banks are prohibited from initiating "covered transactions," including loans and other extensions of credit, with "affiliates"[7] if that transaction exceeds 10% of the bank's capital stock and surplus, or the aggregate of covered transactions with all affiliates exceeds 20% of the bank's capital stock and surplus. Similar to Regulation O, any loan covered by this regulation must always be on terms and conditions consistent with safe and sound banking practices and include terms that are at least as favorable to the bank as those that would be offered in good faith to nonaffiliated companies.

We strongly believe these regulations address and eliminate the IRS's concern behind the proposed amendment to the definition of a "commercially reasonable" restriction in a loan. Even family-owned banks that are extending credit to other entities controlled by the same family must make those loans and any applicable restrictions on liquidation in an arm's length fashion. Clearly, there is no need to limit the proposed exemptions solely to loans made by publicly held banks.

Conclusion

ABA appreciates this opportunity to comment on the proposed rule. We urge the IRS to recognize existing bank regulations governing activities, such as extension of credit, between the bank and

[5] The term "company" is broadly defined and includes "any corporation, partnership, trust (business or otherwise), association, joint venture, pool syndicate, sole proprietorship, unincorporated organization, or any other form of business entity not specifically listed herein." 12 CFR 215.2(b).

[6] 12 CFR Part 223.

[7] The term "affiliates" is broadly defined to include, among other things, "Any company that is controlled, directly or indirectly, by trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the bank or any company that controls the bank." 12 CFR 223.2.

related parties and not to discriminate based on whether the bank is "publicly held." If you have any questions about the letter, please write the undersigned at phoebep@aba.com.

Sincerely,

Phoebe A. Papageorgiou
Vice President, Trust Policy