



November 1, 2016

VIA ELECTRONIC SUBMISSION

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224
Notice.Comments@irsounsel.treas.gov

Re: IRS Proposed Rulemaking Estate, Gift, and Generation-skipping Transfer Taxes; Restrictions on Liquidation of an Interest, REG-163113-02

Dear Mr. Wilkins:

The Office of Advocacy (Advocacy) offers the following comment to the Internal Revenue Service (IRS) in response to the above-referenced proposed rules issued on August 4, 2016.¹ The proposed rules relate to the valuation of interests in a closely-held partnership or corporation for estate, gift, and generation-skipping transfer tax purposes. Because the IRS certified that the proposed rules will not have a significant economic impact on a substantial number of small entities, and because the statement in support of the certification lacks a factual basis, Advocacy recommends that the IRS publish for public comment either a supplemental Regulatory Flexibility Act (RFA) assessment with a valid factual basis or an Initial Regulatory Flexibility Analysis (IRFA). Advocacy also encourages the IRS to extend the comment period for the proposed regulations by 60 days.

The Office of Advocacy

Congress established Advocacy under Pub. L. 94-305 to represent the views of small entities before Federal agencies and Congress. Advocacy is an independent office within the U.S. Small

¹ Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest, 81 Fed. Reg. 51413 (proposed Aug. 4, 2016) (to be codified at 26 C.F.R. pt. 25).



Business Administration (SBA); as such the views expressed by Advocacy do not necessarily reflect the views of the SBA or the Administration. The Regulatory Flexibility Act (RFA),² as amended by the Small Business Regulatory Enforcement Fairness Act (SBREFA),³ gives small entities a voice in the rulemaking process. For all rules that are expected to have a significant economic impact on a substantial number of small entities, federal agencies are required by the RFA to assess the impact of the proposed rule on small entities and to consider less burdensome alternatives. In addition, section 241 of SBREFA specifically applies the RFA to all IRS interpretative rules that impose on small entities a collection of information requirement.

The Small Business Jobs Act of 2010 requires agencies to give every appropriate consideration to comments provided by Advocacy.⁴ The agency must include, in any explanation or discussion accompanying the final rule's publication in the Federal Register, the agency's response to these written comments submitted by Advocacy on the proposed rule, unless the agency certifies that the public interest is not served by doing so.⁵

Background

Section 2704 of the Internal Revenue Code provides special valuation rules relating to intra-family transfers of interests in corporations and partnerships. In general, for the transfer of a business interest via estate or gift, the interest is taxed based on the Fair Market Value of the amount of the gift on the transfer date.

In the case of an interest in a closely-held corporation or partnership, however, case law has evolved to permit discounts in valuing interests where the interests represent minority positions for which there is no ready market.⁶ This tax policy, known as a "valuation discount," allows the transferor of a closely held business interest to reduce the value of a small percentage of their ownership interest (on a per share basis), which reduces the amount of the transfer subject to tax.

On August 4, 2016, the IRS issued proposed rules relating to the valuation of interests in corporations and partnerships for estate, gift, and generation-skipping transfer tax purposes.⁷ Among other things, the proposed regulations would eliminate most of these valuation discounts for operating businesses. Specifically, if finalized, the proposed regulations would disallow certain discounts for lack of control (minority interests) and lack of marketability that are commonly applied to lower the value of such transferred interests for gift, estate and generation-skipping transfer tax purpose.⁸

The Department of Treasury (Treasury) has explained that the proposed regulations are intended to make section 2704 applicable again, following a series of judicial decisions and state law

² 5 U.S.C. §601 et seq.

³ Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. §601 et seq.).

⁴ Small Business Jobs Act of 2010 (PL 111-240) § 1601.

⁵ Id.

⁶ 81 Fed. Reg. 51413, 51415.

⁷ 81 Fed. Reg. 51413.

⁸ Id.

changes that made it "so easy to avoid [section] 2704(b) that it really doesn't apply anymore."⁹ Ultimately, Treasury anticipates that the proposed rules will "close a tax loophole that certain taxpayers have long used to understate the fair market value of their assets for estate and gift purposes."¹⁰

In the Special Analysis portion of the proposed rules, the IRS certifies that the proposed regulations "will not have a significant economic impact on a substantial number of small entities." The IRS supports this certification by stating that the proposed regulations will "affect the transfer tax liability of individuals who transfer an interest in certain closely held entities and not the entities themselves."¹¹ The IRS adds "any economic impact on entities affected by section 2704, large or small, is derived from the operation of the statute, or its intended application, and not from the proposed regulations in this notice of proposed rulemaking."¹²

Small Business are Concerned that the Proposed Rules do not Estimate the Burden Imposed by the Proposal or Contemplate Less Burdensome Alternatives to the Proposal

Since the date the IRS issued the proposed rules, small business owners and representatives have been in contact with Advocacy to express concern about the proposal. On October 18, 2016, Advocacy hosted a conference call with small business owners and a Department of Treasury representative. These small business owners report that the IRS fails to estimate the costs that the proposed regulations would impose.

Small business stakeholders indicated to Advocacy that the proposed regulations, if finalized, would be such a large departure from current IRS policy and industry practice that expensive new business valuations would need to be completed for closely held businesses. Even more problematic for small business owners, by eliminating valuation discounts, the proposed regulations would negatively impact succession planning for many small businesses. As an example, the IRS proposed regulations would result in increased estate taxes on the death of owners of small family businesses, possibly causing them to liquidate the business or sell large or controlling interests to non-family members outside of the business.

In addition, small business owners stated to Advocacy that the proposed regulations are so complicated that many of its new requirements seem unclear. As the proposed regulations lack clarity, small business stakeholders reported that they are unable to consider and recommend less burdensome alternatives that would accomplish the same regulatory purpose of the IRS proposal. For this reason, small business owners and representatives expressed hope to Advocacy that the IRS would extend the period to comment on the proposal so that they may have more time to weigh the changes proposed in this rulemaking, and to propose alternatives.

⁹ Mathew R. Madara, Tax Notes, Proposed Estate Tax Regs Have Been Misconstrued, Official Says, Tax Notes, (Oct. 3, 2016).

¹⁰ "Treasury Issues Proposed Regulations to Close Estate and Gift Tax Loophole," available at <https://www.treasury.gov/connect/blog/Pages/Treasury-Issues-Proposed-Regulations-to-Close-Estate-and-Gift-Tax-Loophole.aspx>.

¹¹ 81 Fed. Reg. 51413, 51418.

¹² Id.

The Proposed Rules Do Not Provide a Valid Factual Basis for Certification under the RFA

The RFA states that “[w]henever an agency is required by section 553 of this title, or any other law, to publish general notice of proposed rulemaking for any proposed rule, or publishes a notice of proposed rulemaking for an interpretive rule involving the internal revenue laws of the United States, the agency shall prepare and make available for public comment an initial regulatory flexibility analysis [IRFA]. Such analysis shall describe the impact of the proposed rule on small entities.”¹³

Under section 605(b) of the RFA, an agency may avoid the requirement of producing an IRFA if the agency certifies that a proposed regulation will not have a significant economic impact on a substantial number of small entities. In addition, the agency must provide a factual basis in support of the certification.¹⁴ A certification that does not provide an adequate factual basis is not sufficient.¹⁵ The RFA requires the agency to conduct an analysis that demonstrates it has considered the potential effects of the regulations on small entities as part of its certification.¹⁶ A certification is not intended for agencies to avoid considering alternatives that would minimize the economic impacts on small entities.¹⁷ At a minimum, the factual basis should include: (1) identification of the regulated small entities based on the North American Industry Classification System; (2) the estimated number of regulated small entities; (3) a description of the economic impact of the rule on small entities; and (4) an explanation of why either the number of small entities is not substantial or the economic impact is not significant under the RFA.

In this case, the IRS has certified that the proposed regulation will not have a significant economic impact on a substantial number of small entities. The IRS supports this certification by stating “any economic impact on entities affected by section 2704, large or small, is derived from the operation of the statute, or its intended application, and not from the proposed regulations in this notice of proposed rulemaking.”¹⁸ The IRS also observes that the proposed regulations will “affect the transfer tax liability of individuals who transfer an interest in certain closely held entities and not the entities themselves.”¹⁹ These two statements are insufficient under the RFA and do not serve as a valid support of the IRS certification.

1. The proposed regulations are a legislative rulemaking that should be subject to an RFA analysis

The IRS contends that “any economic impact on entities affected by section 2704, large or small, is derived from the operation of the statute, or its intended application, and not from the proposed regulations in this notice of proposed rulemaking.”²⁰ This rationale suggests that any regulatory

¹³ 5 U.S.C. § 603.

¹⁴ 5 U.S.C. § 605(b).

¹⁵ *Theiss v. Principi*, 18 Vet. App. 204, 214 (2004).

¹⁶ *North Carolina Fisheries Ass’n v. Dailey*, 16 F. Supp. 2d 647, 652 (E.D. Va. 1997).

¹⁷ *North Carolina Fisheries Ass’n v. Dailey*, 27 F. Supp. 2d 650, 661 (E.D. Va. 1998) (“Congress has not intended for administrative agencies to circumvent the fundamental purposes of the RFA by invocation of the certification program.”).

¹⁸ *Id.*

¹⁹ 81 Fed. Reg. 51413, 51418.

²⁰ *Id.*

implementation of a statute should not be subject to an RFA analysis. Advocacy does not agree with this analysis. The proposed regulations are a legislative rulemaking that should be subject to an RFA analysis.

The Administrative Procedure Act (APA) provides that, unlike legislative rules, interpretative rules are not subject to notice and comment requirements.²¹ This narrow exemption applies when an agency issues an initial interpretative rule and when it appeals or amends an interpretative rule.²² An agency rulemaking is subject to notice and comment under the APA when it issues a rule or an interpretation that is a change from an existing regulation because such a rule is considered legislative rulemaking rather than an interpretive rule.²³

In the present case, the proposed regulations would change the implementation of the Internal Revenue Code related to the valuation of interests for estate, gift, and generation-skipping transfer tax purposes, and the proposed rules would be a binding force of law on all regulated entities, including small entities. Furthermore, as the IRS notes, the proposed rules not only revise the administration of the statute, but also reverse existing case law. Because the proposed rules would change the implementation of the Internal Revenue Code, the current regulations, and case law, the proposed rules are a legislative rulemaking and are subject to the requirements of APA notice and comment rulemaking.

The RFA applies to any legislative rule subject to notice and comment rulemaking under section 553(b) of the APA. Section 241 of SBREFA specifically applies the RFA to all IRS interpretative rules that impose on small entities a collection of information requirement. In this case, the IRS proposed regulations are a statutory rulemaking, and therefore, the small business impacts of the proposal should have been analyzed under the RFA. Even in the event that the proposed rules are considered an interpretative rulemaking, because the proposal imposes collection of information requirements on small entities related to the valuation of interests in a closely-held partnership or corporation for estate, gift, and generation-skipping transfer tax purposes, the proposal would still be subject to an RFA analysis.

2. The proposed regulations directly regulate small business

Advocacy does not agree with the IRS suggestion that the proposed regulations do not directly regulate small businesses. The proposed regulations directly affect how small business interests are valued and transferred. As described above, small business owners and representatives in

²¹ 5 U.S.C. § 553(b)(A).

²² See *Perez v. Mortg. Bankers Ass'n.*, 135 S. Ct. 1199 (2015).

²³ *Christensen v. Harris Cty.*, 529 U.S. 576, 588 (2000) (holding that where an agency's rule is unambiguous, the court would "permit the agency, under the guise of interpreting a regulation to create de facto a new regulation" if it granted deference to the agency's interpretation); *Huerta v. Ducote*, 792 F.3d 144, 153 (D.C. Cir. 2015) ("To the extent the agency has interpreted its own "stale complaint" regulation, that interpretation is "to be accorded deference unless it is clearly contrary to the plain and sensible meaning of the regulation." The Board's position will be deemed "arbitrary and capricious if it departs from agency precedent without explanation." (citing *Taylor v. Huerta*, 723 F.3d 210, 213 (D.C. Cir. 2013); *Dillmon v. Nat'l Transp. Safety Bd.*, 588 F.3d 1085, 1090 (D.C. Cir. 2009)); *Air Transport Ass'n of Am. v. FAA*, 291 F.3d 49, 55 (D.C. Cir. 2002) ("It is well established that an agency may not label a substantive change to a rule interpretation simply to avoid the notice-and-comment requirements.").

contact with Advocacy expressed concern that the proposed regulations would negatively impact the operation of small businesses as a result of the changes the proposed rules contemplate.

In the certification statement, the IRS does not identify or estimate the number of regulated small entities, nor does it describe compliance requirements. Given that the rule as proposed is a legislative rulemaking that directly impacts small businesses, Advocacy believes that the factual basis for the IRS certification is invalid.

If an agency cannot properly certify the proposed rule, then an IRFA must be developed and published in the Federal Register with a period for notice and comment. An IRFA must contain: (1) a description of the reasons why the regulatory action is being taken; (2) the objectives and legal basis for the proposed regulation; (3) a description and estimated number of regulated small entities; (4) a description and estimate of compliance requirements, including any differential for different categories of small entities; (5) identification of duplication, overlap, and conflict with other rules and regulations; and (6) a description of significant alternatives to the rule.²⁴

Recommendations

Advocacy recommends that the IRS publish for public comment either a supplemental RFA assessment with a valid factual basis in support of a certification or an IRFA before proceeding with this rulemaking. By publishing for comment either a supplemental RFA assessment or an IRFA, the IRS will satisfy the requirements of the RFA. Moreover, small businesses will have adequate data to assess the amount of paperwork burden that may be generated by the proposed rules. The IRS will also gain valuable insight into the effects of the proposal.

In addition, in its supplemental RFA assessment or IRFA, the IRS should more clearly describe the new requirements of the proposed rules. This will provide the small business stakeholders with an opportunity to better evaluate the proposal and consider less burdensome regulatory alternatives to recommend to the IRS. Finally, Advocacy encourages extending the comment period by an additional 60 days to allow small businesses more time to consider the impact of the proposed regulations.

²⁴ 5 U.S.C. § 603.

If you have any questions or require additional information please contact me or Assistant Chief Counsel Dillon Taylor at (202) 401-9787 or by email at Dillon.Taylor@sba.gov.

Sincerely,



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Copy to: The Honorable Howard Shelanski
 Administrator
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