NFIB
The Voice of Small Business.

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Department of the Treasury
Internal Revenue Service
1111 Constitution Avenue NW.
CC: PA:LPD:PR (REG-1631113-02)
Courier's Desk
Washington, DC 20224

RE: Docket No. IRS REG–163113–02, RIN 1545–BB71; Comments of the National Federation of Independent Business (NFIB) on the Department of the Treasury and Internal Revenue Service's Proposed Regulations on Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest

The National Federation of Independent Business (NFIB) submits these comments for the record to the Department of the Treasury and Internal Revenue Service regarding the Proposed Regulations on "Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest," published in the August 4, 2016, edition of the Federal Register. (81 Fed. Reg. 51,413).

NFIB is the nation's leading small business advocacy association, representing members in Washington, DC, and all 50 state capitals. Founded in 1943 as a nonprofit, nonpartisan organization, NFIB's mission is to promote and protect the right of its members to own, operate, and grow their businesses.

On behalf of the NFIB, I write to express our deep concerns with the Department of the Treasury and Internal Revenue Service Proposed Regulations on "Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest," (Proposed Regulations.)[1] For the reasons that follow, chiefly the significant harm and to small family-owned businesses, we respectfully request that the Proposed Regulations be withdrawn.

I. Small Business and the Estate Tax Regulations

The Proposed Regulations arbitrarily target family-owned businesses, making it more difficult for small family businesses to compete, grow and thrive into future generations. In fact, research has shown that nearly 50 percent of family businesses anticipate that they will pass down their business to a family member. Furthermore, NFIB research has

[1] 81 Fed. Reg. 51,413 (Aug. 4, 2016).

found that the estate tax is a major concern of small business owners[2]. In a recent survey, 34 percent of small business owners said they incurred additional expenses, such as hiring a consultant or tax advisor, or purchasing additional life insurance, because of the estate tax. An additional 15 percent said that while they had not yet incurred additional expenses, they expected to in the future. Therefore, family businesses are fearful of, and must plan ahead for, the estate tax. The Proposed Regulations will make that prospect and process more difficult.

As drafted, the regulations seek to eliminate or greatly reduce the discounts for lack of control and lack of marketability for "family related entities" in many or potentially all circumstances, resulting in the creation of artificial value and corresponding artificially inflated tax burden. The Proposed Regulations create an arbitrary divide based on whether an entity's ownership has a familial connection. This distinction violates a foundational tenet that our system of taxation should accord similarly situated taxpayers similar treatment. Here, the tax code would apply differently for closely held family businesses than to the exact same closely held non-family business, leaving the family business with a higher estate tax burden. This disparate treatment violates sound tax policy principles and places family-owned small businesses at a significant disadvantage—meaningfully deterring the business continuing on to next generation.

Moreover, the Proposed Regulations unrealistically presume harmonious family control. The best business decisions are often the result of debate and disagreement. That vital decision-making process is no different for family businesses merely because that process might take place in a dining room rather than a boardroom. Perhaps more so than in a traditional hierarchical business structure, family members will voice their different opinions on all areas, both big and small, involved in the ongoing and future direction of the business regardless of their titled position. Accordingly, the tacit assumption underlying many of the proposed new rules that family members "always" would act in concert to "defeat" any restrictions on a family member's legal rights to compel a liquidation of the entity or of that individual's equity interest is a false and unfair assumption. Thus, the Proposed Regulations should be withdrawn because they are grounded on a faulty theory of family attribution.

Lastly, because the value of family-owned businesses is tied to illiquid assets, such as land, buildings, or intangible property such as goodwill, the Proposed Regulations significantly increase the business viability risk altogether. Moreover, when a business owner is placed in a situation where they are forced to sell business assets to pay the an inflated tax, the result can be assets sold at "fire sale prices," which further hurts the prospects that surviving family members will be able to carry on the business. Protecting these family businesses from the estate tax is important in order to keep these businesses operating for future generations.

[2] NFIB Research Foundation. *Taxes and Spending: Small Business Owner Concerns*. March 2013.

II. The Proposed Regulations Exceed Treasury's Limited Authority

Treasury is plainly acting beyond its limited delegated powers. Treasury's authority in this regard is not unbounded but rather is meaningfully restrained by both an express statutory limitation and an unambiguous legislative history. These Proposed Regulations fail this crucial two-part test.

First, in section 2704(b)(4) of the Internal Revenue Code, Congress authorized the Treasury Department to issue regulations to disregard certain restrictions in determining the value of transfers but only if "such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle *but does not ultimately reduce the value of such interest to the transferee*." In effect, this authorization provides Treasury with limited power to target restrictions that operate as a device that reduce a transfer tax but does not affect its true economic value to a willing purchaser. Treasury has not shown that the restrictions targeted by the Proposed Regulations satisfy this standard. As a matter of economic reality, they do not.

Second, Treasury's interpretation of its statutory authority is at odds with the legislative history found in the Conference Report of the 1990 Omnibus Budget Reconciliation Act , which created Chapter 14 of the Internal Revenue Code. That Conference Report explicitly stated, "*These rules do not affect minority discounts or other discounts available under present law. The conferees intend that no inference be drawn regarding the transfer tax effect of restrictions and lapsing rights under present law.*[3] Treasury does not have discretion to remove certain valuation discounts without further Congressional action.

In fact, Treasury shared the viewpoint that further Congressional action was required until very recently. For four years, from 2009 through 2013, the annual budget contained a proposal to *change the statute* to create an additional category of restrictions ("disregarded restrictions") in valuing interests in family controlled entities. The proposal, if enacted, would have given Treasury authority to issue new regulations that direct what assumptions should be used in valuing these interests budget.[4] Having failed to persuade Congress to pass legislation effectuating this change, Treasury excluded this provision from the past three budget proposals, relying instead on these Proposed Regulations. However, this demonstrates that even Treasury acknowledged that the law first must be changed.

Thus, Treasury's authority does not apply to a restriction that does "ultimately reduce the value of such interest to the transferee" and does not have the effect of eroding traditional transfer tax valuation discounts for minority interest and lack of marketability and prohibits any family attribution. Without additional Congressional authority expressing a different intent, Treasury must respect these traditional discounts available for all businesses and not single out certain entities.

[3] 1990 U.S.C.C.A.N. 2374, 2835-43, H.R. CONF. REP. 101-964.

[4] This statutory proposal was contained in the Treasury Department's "Greenbook" for 2009, 2010, 2011 and 2012, which discussed various tax proposals in the President's budget. However, in the 2013 Greenbook, the section 2704 statutory proposal was noticeably absent.

III. Specific Concerns Regarding Proposed Regulations Application to Small Business

The Proposed Regulations exceed the authority delegated to Treasury and would be devastating and highly disruptive to family-owned small businesses. First and foremost, the Proposed Regulations would drastically increase the estate tax burden solely on family businesses. As such, the IRS will apply different accounting methods to value the family and non-family business interests. While it is unfair to target only family entities, it cannot be overstated that the new selectively higher estate tax will be based on artificial, hypothetical valuations that are completely unmoored from the willing buyer – willing seller foundational concept underlying estate and gift tax valuation, and business valuation more generally.

a. The Three-Year "Deemed Lapse" or "Deathbed" Transfers

The current regulations provide that "a transfer of an interest that results in the lapse of a liquidation right is not subject to this section [Sec. 2704] if the rights with respect to the transferred interest are not restricted or eliminated."[5] This express statutory language provides that a majority owner can transfer minority stakes to his or her children without the transfer being considered a lapse because the voting rights were not restricted by reason of the transfer. The Proposed Regulations, in the name of simplicity, introduce fresh uncertainty into such transfers by creating a new test that will eliminate this result for any "deathbed" transfers, defined as occurring within three years of death. Instead, transfers within three years of death would be "treated as a lapse occurring on the transferor's date of death, includible in the decedent's gross estate."[6] In effect, the new rule will remove all previous valuation discounts in a highly complex way—by deeming a lapse where there has not been one. The rule's mechanics would then require otherwise completed transfers, with all the attendant expenses, to be performed a second time—adding back discounts taken at the time of the transfer to the gross estate should the transferor, unfortunately, happen to become deceased within three years.

This proposed rule would be especially damaging in the context of a small family-owned business transferring minority ownership to the next generation. The rule establishes an artificial and arbitrarily lengthy "deathbed" period of three-years. There is nothing in the statute, legislative history, or medical science literature that indicates Treasury has the authority to disregard otherwise proper transfers. The mechanics of the lookback approach to the rule are highly complex and would likely result in the double taxation of a phantom asset. It will increase the likelihood of taxpayer controversies concerning gift tax valuation to the transferee and estate tax valuation, the exact timing of the deceased owner's planning and superfluous unnecessary planning costs to include considerations of all possible outcomes. Importantly, as evidence of the rule's capricious nature, none of these concerns arise should the transferor survive three years plus a day or if the business is non-family controlled.

[5] Treas. Reg. §25.2704-1(c)(1).
[6] Prop. Reg. §25.2704-1(c)(1).

b. The Proposed Regulations Wrongfully Disregard Non-Family Ownership

The Proposed Regulations create a new "bright-line" test for when nonfamily ownership will be respected for gift and estate valuation. Pursuant to this new test, Treasury will disregard all nonfamily ownership unless, among other conditions, the nonfamily member held the interest for at least three years prior to the transfer.[7]

Treasury is without basis in statute, legislative history or reason for requiring the equivalent to a 3-year "vesting" period before Treasury and the IRS will recognize non-family ownership for valuation purposes. For example, this rule would ignore all non-family ownership acquired within this arbitrary three year period even if it was purchased for fair market value, earned as an employee incentive or comprised an otherwise meaningful substantial stake. The effect of disregarding all non-family ownership is an artificially high valuation for family-owned interests and probable double taxation of the value of the nonfamily ownership. The result for the small family-owned business will be an increased tax based solely on an inflated valuation and only imposed on family businesses.[8] This portion of the Proposed Regulations goes beyond Treasury's authority and will deter transfers to employees and future generations.

IV. The Proposed Regulations additional "Disregarded Restrictions" Exceed Treasury Authority.

Prop. Reg. 25.2704-3 would create a new category of "disregarded restrictions" for estate and gift tax purposes that seek to regulate an individual owner's ability to liquidate or redeem their interests.[9] However, as mentioned above, Treasury has only limited authority to act in instances where "such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but *does not ultimately reduce the value of such interest to the transferee.*" (Emphasis added.) In general, this new category of "disregarded restrictions" concern the rights, timing, value and payment inherent in individual ownership. In effect, the Proposed Regulations would mandate that otherwise prudent limitations on an individual ownership interest, entered for legitimate business and family purposes and having real economic effect, simply be ignored for valuation purposes.[10] Specifically, the regulations would prescribe that overall conditions including the manner and timeframe in which the federal tax law will recognize otherwise completely legitimate restrictions. The time, manner and ability to compel a liquidation payment are significant matters for all operating businesses, but

[7] Prop. Regs. provide that all of the following conditions must be satisfied: (1) the nonfamily member held the interest for at least three years prior to the transfer, (2) the nonfamily member owns at least a ten (10%) percent equity interest in the entity, (3) the total equity interests of nonfamily members, collectively, constitute at least twenty percent (20%) of all equity interests in the entity, and (3) the nonfamily member has a put right.

[8] While the focus here is on the 3-year "vesting" of non-family ownership created by the Proposed Regulations, the other requirements for non-family ownership to be recognized such as the 10 / 20 percent ownership rule thresholds are equally troubling, completely arbitrary and should be discarded.

[9] Treasury cites authority granted by Sec. 2704 for this new class of restrictions.

[10] Importantly, these new restrictions extend to cover an individual owner's liquidation or voting rights as they pertain to their interest and not to the entity as a whole.

are especially important for smaller businesses with limited ability to quickly raise the necessary funds to cash out an owner or owners.

This novel regulatory fiction ignores the sound business judgment of the business owners and potential investors, resulting in an entirely fabricated valuation that would only apply to family businesses. Moreover, the new disregarded restrictions created by Prop. Reg. 25.2704-3, exceed Treasury's limited authority to act with regard to restrictions that do not actually affect value.

V. Specific Concerns of "Disregarded Restrictions" Harm to Small Business

As stated above, at its core the new category of "disregarded restrictions" is an attack on a family business owner's sound business judgement and a real tax increase based on a wholly artificial valuation rationale. A business owner, family-controlled or not, should be able to establish the rights and limitations associated with an ownership interest that is in the best needs of the business. Liquidation rights are extremely important to an operating business. For the sake of remaining owners and employees, it is crucial that a business simply choosing to do so have the ability continue in operation. Tax regulations should not encroach in this sphere of decision-making and should certainly not impose deleterious incentives on the process.

a. Imposition of a 6-month "Put-Right" and Minimum Value Concepts Ignore Legitimate Business Planning and Requirements of Family Businesses

The Proposed Regulations would disregard for valuation purposes a provision that defers or permits the deferral of the payment of the <u>*full redemption*</u> proceeds for a term longer than <u>*six months*</u> after the date the holder provides notice of intent to withdrawal or liquidate their interest.[11] Generally, this requirement has been interpreted as requiring a "put right" or a right to receive from the business, within six months' notice, cash equal to the minimum value of the interest on the liquidation date. Minimum value is defined as that interest's proportional share of the total fair market value of the business.

Example 5 in Prop. Reg. 2704-3 highlights the fiction created by the Proposed Regulations. In Example 5, the partnership agreement states that a liquidating partner would receive fair market value for their partnership interest payable over 5-year period. The example holds that partnership interest is valued by disregarding the restriction on payment because it extends beyond a period of six months. The result is a fictionally higher valuation and tax. The example does not indicate that the actual payment over 5 years is improper and will not be allowed. And in reality, the withdrawing partner may receive payment over that period, or some alternate period determined for wholly non-tax reasons. The example demonstrates a situation where a partnership (partner, or estate) is taxed on a value greater than is inherent in the interest being received.

[11] Prop. Reg. 25.2704-2(b)(4)(iv) contains an exemption for a limitation on liquidation rights from classification as a disregarded restriction for interests with the ability to be sold back to the business without delay and for a "minimum value."

Limitations on the payment schedule for a liquidating partner are completely valid. No better example exists of the unreasonableness contained in the Proposed Regulations than the belief by Treasury that a restriction on full payment delayed beyond six months should be disregarded. The mere fact that Treasury regards such an item as a "restriction" is a complete contradiction. A six-month full payment timetable is completely unrealistic and demonstrates disregard and a profound lack of understanding of business realities. One would question why Treasury would encourage a business to deplete its operating reserves in such an advanced harmful manner so that it can avoid being taxed on a false valuation.

Imposing a put right to a business arrangement is an unrealistic and unworkable way to structure a business. It would be impossible to attract investors if anyone and everyone can withdraw their share of the business at any time. Similarly, long-term business planning is inconceivable while under immediate hazard of withdrawal. For these completely sensible reasons, businesses do impose restrictions on withdrawal rights. Moreover, because these "put rights" would be an artificial creation by the regulations, and not exist in the real world (i.e. business governing documents), family business owners at best would be taxed on wholly artificial value. At worst, the regulations would completely discourage business formation and continuation, even including businesses with significant non-family ownership.

The proposed regulations, if finalized in a manner that adopts the minimum value standard, would represent the biggest change in estate tax planning since the adoption of Chapter 14 in 1990. They would eliminate minority (lack of control) discounts for family controlled entities, whether passive or active, by reason of a deemed put right. Valid business reasons exist for setting conditions that would delay receipt of the total liquidation proceeds beyond six months and should not be disregarded for valuation purposes. Setting conditions on a payment schedule beyond a mere 6-months goes beyond Treasury's statutory authority in that such a restriction does "ultimately reduce the value of interest to the transferee," contrary to section 2704.

b. Limitations on Use of Promissory Notes to Finance Liquidations or Redemptions and other Property

The Proposed Regulations also seek to regulate the method of payment for a redeemed or liquidated partner. Under the Proposed Regulations, a term that authorizes or permits payment of any portion of the full liquidation amount in any manner other than cash or property is classified as a disregarded restriction. The regulations allow a very limited exception for promissory notes for qualified active businesses.[12] For example, it appears that a promissory note would be "acceptable" consideration only if issued by "an entity engaged in an active trade or business, at least 60 percent of the value consists of the non-passive assets of that trade or business" *and* only to the extent "the

[12] To qualify for the exception, a promissory note must require periodic payments, at market interest rates, and have a fair market value on date of liquidation equal to liquidation proceeds.

liquidation proceeds are not attributable to passive assets." Further, any such promissory note must be issued at "market interest rates".

There is no justification for any special or peculiar limitations on an entity's ability to finance redemptions with promissory notes. The regulations will increase the likelihood that the IRS will challenge such notes, even if they meet the conditions on having no economic consequence and no reason to demand payment because they are between related parties. IRS might use regulations to deny interest deduction paid by business to liquidated partner based on disagreement over proper interest rate.

Oddly, the Proposed Regulations would appear to favor the payment of a liquidated partner by sale or transfer of business assets. Thus, the partnership agreement allowing payment to a liquidating partner in a business property would not be classified as a disregarded restriction. This is the classic example of the harm created or encouraged by the regulations—a business forced to redeem a liquidating partner if no cash is available would have to literally sell a business asset potentially causing the end of the ongoing venture. At the very least, if the redeemed partner were to receive payment in a business asset, the possibility exists for a significant marketability discount.

VI. The Proposed Regulations Fail To Comply with the Regulatory Flexibility Act

The Proposed Regulations do not comply with the Regulatory Flexibility Act ("RFA") and must be re-proposed, if they are not abandoned altogether as we request.[13] The RFA requires that proposed rules subject to notice-and-comment rulemaking requirements be accompanied by "an initial regulatory flexibility analysis," describing the "impact of the proposed rule on small entities." 5 U.S.C. § 603(a). The Proposed Regulations do not attempt to include any such analysis.

Treasury merely provides a hollow self-certification that the new rules "will not have a significant economic impact on a substantial number of small entities," 81 Fed. Reg. at 51,418, a certification of this nature is only valid if the agency offers "a statement providing the factual basis for such certification." 5 U.S.C. § 605(b). Treasury's purported "factual basis" is that there is *no* impact on small entities because the proposed regulations "affect the transfer tax liability of individuals" and "the assumptions under which [small businesses] are valued," rather than "the entities themselves." 81 Fed. Reg. at 51,418. This is actually a legal argument about what entities are "directly affected and regulated by the subject regulations," and, because it does not administer RFA, Treasury is entitled to no deference on this question.[14] *Aeronautical Repair Station Ass'n, Inc. v. FAA*, 494 F.3d 161, 176 (D.C. Cir. 2007).

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[13] *See* 5 U.S.C. § 601 *et seq*.

[14] Even if Treasury maintains that there is an additional "factual basis" in its notice aside from its legal argument about what entities are directly regulated, the certification would be arbitrary and capricious. *See N. Carolina Fisheries Ass'n v. Daley*, 16 F. Supp. 2d 647, 652 (E.D. Va. 1997). Treasury has not explained how regulations impacting the worth of small businesses somehow do not impact them.

Treasury's position is untenable. It acknowledges that the proposed rules directly impact and regulate "interest[s] in certain closely held entities," including small entities, and the "assumptions under which they are valued." 81 Fed. Reg. at 51,418. That amounts to "a significant economic impact" on small entities. 5 U.S.C. § 605(b). Treasury's proposed distinction between an "interest" in an entity and its "structure" is unconvincing: the interests in a corporation, combined, *constitute* its structure.[15] Indeed, if accepted, Treasury's argument would allow it to propose a rule rendering all equity in small businesses worthless—such as by changing "the assumptions under which they are valued," 81 Fed. Reg. at 51,418, to tax 100 percent of that value—and yet certify *zero* impact on small businesses. A rule that would run every small entity in the country out of business cannot be said to have no "significant economic impact on a substantial number of small entities." 5 U.S.C. § 605(b). For the same reason, a rule impacting their valuation clearly imposes an "economic impact."

The Treasury Department argues in the alternative that "any economic impact" on small businesses is "derived from the operation of the statute, or its intended application," and "not from the Proposed Regulations." 81 Fed. Reg. at 51,418. This logic also would nullify the RFA, because *every* regulation is "derived from the operation of [a] statute" and must be consistent with "its intended application." To combat this contention, Congress expressly defined "rule" in the RFA to include "any rule for which the agency publishes a general notice of proposed rulemaking." 5 U.S.C. § 601(2). Moreover, Treasury's implicit point that the regulations do nothing to change the status quo directly contradicts both Treasury's actions in proposing the regulations and their stated purpose in overturning the current case law construing "the operation of the statute" and "its intended application." *See* 81 Fed. Reg. at 51,415 (stating that the purpose of the rule is to reverse *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*, 292 F.3rd 490 (5th Cir. 2002)). Obviously, the proposed regulations are intended to do something other than mimic or duplicate "the operation of the statute."

The reasons outlined above mandate an initial regulatory flexibility analysis. Because Treasury has not complied with this requirement, it must re-issue the proposed regulations for further comment. The public has not had the opportunity to comment on an initial regulatory flexibility analysis, and Treasury is not permitted to impede that opportunity.

Conclusion

Legitimate business needs unrelated to tax are the primary determining factor in how families structure their estates and assets. This includes the legitimate goal that a business be carried on by following generations. The Proposed Regulations assume these realities away. In doing so, the Proposed Regulations unnecessarily and unfairly restrict the options available to families to create business structures that reflect their business judgments. By imposing a tax on such routine arrangements, the proposed rules ignore business realities and will make succession planning more difficult.

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[15] *See, e.g.*, Franklin A. Gevurtz, Corporation Law 112 *et seq*. (West 2000) (including an entire chapter called "Financial Structure" discussing, *inter alia*, "the Rights of Shares" and "Distributions to Stockholders").

Any regulation in this area must be consistent with the Congressional intent not to eliminate minority discounts or other discounts that are grounded in economic reality. The regulations single out one group of family-owned companies and treat them in a manner that is radically different from that afforded to all other taxpayers. But the owner of an interest in a family-owned company should be treated in a manner comparable to the manner in which the owner would be treated if the other owners were unrelated parties.

For the above reasons, we respectfully request that the Proposed Regulations be withdrawn.

Sincerely,

Daniel Bosch
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