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To: John Morrall@EOP

cc:

Subject: Comments Regarding Federal Regulations Including Federal Regulations Affecting Small Business

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March 28, 2002

Pamela Faith Olson
Deputy Assistant Secretary for Tax Policy
U.S. Department of the Treasury
Room 1334
1500 Pennsylvania Avenue, NW
Washington, DC 20220

VIA FAX AND U.S. MAIL

Re: Prop. Treas. Reg. § 1.1041-2
(REG-107151-00)

Dear Ms. Olson:

Last week at the invitation of Secretary of Labor Chao, I participated in the Women's Entrepreneurship in the 21st Century Conference. President Bush addressed the Conference and asked a group of the participants to identify for OMB a regulation in their area of specialty that adversely affected small business, and particularly family-owned business. As the family tax lawyer in the group, the choice was easy. At the President's direction, I have brought to OMB Director Daniels' attention Temp. Treas. Reg. § 1.1041.

Temp. Treas. Reg. § 1.1041 issued in September, 1984, approximately 30 days after the enactment of the Domestic Relations Tax Reform Act of 1984 ("DRTRA"). With respect to family businesses, DRTRA's "private ordering" concept permitted a family to use a corporate redemption or a corporate dividend to divide a family business on the occasion of the owners' divorce. DRTRA and the temporary regulation worked well for about 10 years, at which time IRS got whipsawed between a Ninth Circuit opinion holding tax deferral treatment for the wife and a Tax Court opinion holding no dividend treatment for the husband. In a footnote, the Tax Court's opinion noted that taxpayers' inconsistent filing might well result from the 10-year delay in issuing clarifying final regulations about the division of family business in

divorce.

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The organized bar had for years been working on various DRTRA regulation projects and proposing final regulations to IRS and Treasury. About eight years ago, that effort focused squarely on the division of family businesses in divorce. IRS, burned by its whipsaw, had embarked on a litigation policy that classed all family business divisions involving a divorce such that the party remaining in the business not only bought out the departing party, but was treated as having received a dividend from the corporation to accomplish the buyout. In short, the litigation policy doubled the tax tab families might otherwise pay when family crisis occasioned one of the owners departing the business (in general 40 percent dividend/ordinary income treatment versus 20 percent redemption/capital gain treatment).

In 2000, Treasury had a regulation project under consideration which I thought would come down on the "right side" with respect to private ordering. In short, it would restore to families the ability to choose between redemption and dividend treatment when dividing a family business. It also would give them a specific blueprint to follow to ensure that if redemption treatment were selected, IRS would not be whipsawed, and it would have to honor documents providing for redemption of the departing party. The Joint Committee on Taxation got ahead of Treasury, however, and in April, 2001 issued a simplification report calling for redemption treatment for the division of family businesses in divorce if the parties' corporate transaction was clearly documented as a redemption. On August 2, 2001 Treasury issued its proposed regulation on the subject. It adopted the Joint Committee's position, which was really the position Treasury had developed with representatives of the private bar in preceding years. However, the Treasury's proposed regulation is flawed in one respect.

The effective date in the proposed regulation would only permit family businesses to avail themselves of its clarifying relief if their transaction is entered into after the effective date of the regulation. In a special circumstance, a few other family business divisions can become eligible. However, the vast majority of families who, in some cases for more than fifteen years, have argued at IRS and in the courts that they should be accorded redemption treatment would be left without relief. It is incumbent on Treasury to change the effective date in the proposed regulation such that all cases that were at issue on August 2, 2001 are covered by the final regulation. After all, it is on *this* date that the Joint Committee and the Treasury Department both were on record as providing redemption treatment in appropriate circumstances for family businesses divided at divorce. This was the intention of the 18-year-old statute still awaiting final interpretation by Treasury.

I have filed comments with IRS about the proposed regulation. I am including them for your convenience with the copy of this letter which I shall send you via U.S. Mail. I have excerpted from the comments the discussion of the effective date rules and attached that excerpt to the correspondence which you are receiving via fax.

Based on my experience at last week's entrepreneurship conference, including the benefit of Secretary O'Neill's remarks about eliminating tax barriers to the efficient operation of small

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business, I am encouraged that Treasury with the urging of OMB at President Bush's direction, will spare the thousands of families adversely affected by a misinterpreted statute which the government's own publicly announced policy seeks to restore to its correct application.

Thank you for your consideration of these materials. I am, of course, available to discuss this subject with you further at your request.

Very truly yours,

Marjorie A. O'Connell

cc: B. John Williams, Chief Counsel, Internal Revenue Service (via U.S. mail)
Mitchell E. Daniels, Jr., Director, OMB (via e-mail and U.S. mail)