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July 22, 2008

VIA HAND DELIVERY: COURIER'S DESK, CC:PA:LPD:PR (REG-112196-07)

The Honorable Eric Solomon
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Mr. Douglas Shulman
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Regulations Relating to Internal Revenue Code Section 2032

Dear Assistant Secretary Solomon and Commissioner Shulman:

The American College of Trust and Estate Counsel (the "College") is submitting comments on proposed regulations relating to the election to value assets includable in a decedent's estate on the alternate valuation date under section 2032 of the Internal Revenue Code.

The College is a professional association of more than 2,500 lawyers from throughout the United States. Membership in the College is limited to those individuals who are elected by their peers on the basis of professional reputation and ability in the fields of trusts and estates law and on the basis of having made substantial contributions to these areas of the law through lecturing, writing, teaching, and bar association activities. College members have extensive experience in rendering advice to taxpayers on matters of federal transfer taxes and estate planning, with a focus on estate and gift tax planning and compliance.

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INTRODUCTION

The College supports the basic objectives of the proposed regulations under section 2032 and agrees that Treasury Regulation § 20.2032-1(c), in its present form, invites potential abuse and warrants clarification, revision, or both. The College agrees with many provisions of the proposed regulations and applauds the elimination of potential loopholes that may now exist under a distorted interpretation of the current regulations.

The College is concerned, however, that the proposed regulations are an overreaction to the Tax Court Memorandum Decision in Kohler v. Commissioner, T.C. Memo. 2006-152, and will result in an unfair application to some taxpayers unless portions of the proposed regulations are revised. In addition, the College has some suggestions to clarify several provisions of the proposed regulations.

College's Concerns. The College has these main concerns about the proposed regulations:

- The lack of a clear definition of “outside the control of the decedent” under proposed regulation § 20.2032-1(f)(1) will create confusion as to what post-death events are market conditions; and
- Because of the lack of a definition of outside the control of the decedent under proposed regulation § 20.2032-1(f)(1), the potential application of the rules under proposed regulation § 20.2032-1(f)(3) to reorganizations could be overly broad.

LACK OF DEFINITION OF OUTSIDE THE CONTROL OF THE DECEDENT

Proposed regulation § 20.2032-1(f)(1) provides, in part,

The term *market conditions* is defined as events outside of the control of the decedent (or the decedent’s executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued.

The College is concerned about the definition of “market conditions” and the use of the phrase “outside of the control” of the decedent, the decedent’s executor or trustee, or any other person whose property is being valued (the “estate”). Because there is no clear definition of “outside the control,” the proposed regulations could lead to constructions inconsistent with the objectives of the proposed regulations. As the Supreme Court noted in United States v. Byrum, 408 U.S. 125, 137 (footnote 10), a “control” standard is “so vague and amorphous as to be impossible of ascertainment in many instances.”

The College is concerned that, during examinations, this phrase will be given a much broader definition than intended. One extreme example is where the decedent grants his or her executor a power of sale over estate assets and the executor fails to sell marketable securities that decline in value during the six month period following the decedent's death. The executor's failure to sell the marketable securities is not outside the control of the decedent's executor since the executor had the power of sale. Accordingly, it is possible that the use of the term "outside the control" in proposed regulation § 20.2032-1(f)(1) may have unintended consequences without the use of a more definitive standard, such as the standard that we discuss later in this letter.

THE BREADTH OF THE REORGANIZATION RULES

In the Background to the proposed regulations, there is a discussion of the Tax Court Memorandum Decision in Kohler v. Commissioner, which may have prompted the issuance of the proposed regulations. Because the College is confident that some taxpayers will attempt to distort the decision in Kohler to support an inappropriate reduction in alternate valuation, the College believes that the concerns about Kohler are legitimate. The proposed regulations, however, use a meat cleaver approach to solving the problem when the proposed regulations should have used a scalpel.

The legitimate concern about the Kohler decision is its possible extension to post-mortem entity formations or post-mortem fractionalizations of interests which have no legitimate and substantial business (including investment) purpose – in effect the creation of valuation discounts for the primary purpose of lowering transfer taxes. In contrast, the facts in Kohler do not appear to be abusive. Although the closely held company in question was reorganized after the decedent's death and his personal representative would have been able to elect a cash option or pursue dissenters' rights, the negotiations commenced well before the decedent's death, and there appeared to be very valid business purposes for the reorganization. In addition, it appears that the reorganization may have been finalized irrespective of any action taken by the decedent's estate, and a prudent fiduciary may very well have preferred the stock of a very successful closely held business to other investment options which would have been available if one of the cash options had been elected.

The College requests that you carefully review the rules applicable to post-mortem reorganizations, particularly reorganizations involving public companies. Reorganizations serve a valid and viable business purpose and in our increasingly fast paced business environment may become more common. Taxpayers should generally be allowed the benefits granted by Congress.

The tax laws already include very substantial safeguards against abuse involving reorganizations.

First, any corporate organization must be supported by a valid business purpose. Treas. Reg. § 1.368-2(g). This income tax requirement applies equally to acquisitive reorganizations, such as combinations of businesses, and to nonacquisitive reorganizations, such as the recapitalization in Kohler. Such a business purpose requirement goes materially beyond the basic safeguards provided by Chapter 11 and Chapter 12 and should significantly reduce the potential for any tax abuse.

Second, the proposed regulations focus on the estate's possible election to take a cash option in lieu of stock in the reorganized company, as in Kohler. That is the only apparent basis for asserting that a minority shareholder, as in Kohler, has sufficient "control" to cause the transfer restrictions imposed on the estate's stock as part of the reorganization to be considered as not being the result of market conditions. Cash options are not limited to those provided under the express terms of a reorganization, however. Because dissenters' rights apply to most reorganizations under state law, almost every reorganization would include a cash option (whether granted under the reorganization or required by state law) and would run afoul of the proposed regulations under section 2032. The potential applicability of the control standard in the proposed regulation is thus much more widespread than may be initially apparent, and goes much further than is necessary. The income tax laws already impose a substantial barrier against abuse in the form of constructive receipt principles. The response to the Kohler decision in the proposed regulations goes materially beyond what has generally been regarded as the appropriate standards for determining constructive receipt for income tax purposes in a corporate reorganization setting. There are valid reasons for the constructive receipt boundaries in an income tax context. There are equally valid reasons for not exceeding those boundaries in an estate tax context.

The College believes that the business purpose and constructive receipt principles, by themselves, should generally provide sufficient safeguards to police potential abuse from corporate reorganizations. To the extent that a reorganization is regarded as abusive, notwithstanding these safeguards, the Internal Revenue Service should still be able to fall back on section 2703. Unless the transfer restrictions imposed as part of the reorganization represent a bona fide business arrangement, are not a device to transfer property to members of the decedent's family for less than adequate and full consideration, and are comparable to similar arrangements entered into by persons in an arm's length transaction and are thus excepted under section 2703(b), such transfer restrictions would be disregarded for purposes of determining the alternate value of the estate's stock or equity interest subject to such transfer restrictions. Section 2703 should be a very effective backstop for corporate reorganizations and a very effective deterrent of abuse in regard to all reorganizations.

In addition to these legal considerations, the proposed regulations pose practical problems. If the reorganization involves a combination of entities, in many if not most instances, it would be almost impossible to determine the alternate value of the assets traceable to any of the combined entities. Any attempt to untangle the combined assets and then value those

attributable to the respective entities which were parties to the combination would be totally impractical and speculative. This would create an administrative nightmare and would mean that an estate would not be able to elect the congressionally mandated benefits of section 2032.

As a further practical consideration, marketable securities are materially less likely to pose concerns than equity interests in closely held entities, but the proposed regulations do not distinguish between public companies and closely held companies. If anything, the ready market for marketable securities may make it more likely that any changes in the value of such marketable securities resulting from a reorganization of a public company are within the "control" of the estate, which could sell such marketable securities at any time, and thus may be regarded as changes not resulting from market conditions under the proposed regulations. This would be an anomalous result. At a minimum, any change in value caused by a post-mortem reorganization of a company whose shares are publicly traded should be presumed to be caused by market conditions.

Overall, the College believes that Treasury and the Internal Revenue Service should not be overly concerned about a reorganization with a business purpose sufficient to qualify as a reorganization under section 368. The availability of a cash option under the reorganization or dissenters' rights under state law should make no difference. The business purpose and constructive receipt principles applicable to a reorganization, backstopped by section 2703, should be more than sufficient to police abuse even by an estate which has the power, acting unilaterally, to determine the terms of a post-mortem reorganization and to cause such reorganization to be consummated. In the instances the Internal Revenue Service regards as abusive, the Service should be able to challenge the restrictions under section 2703 without casting an unduly wide net under the section 2032 regulations.

Accordingly, the College requests that you carefully review the rules applicable to post-mortem reorganizations.

ALTERNATIVE TO CONTROL STANDARD

The College appreciates the difficulty of defining changes in value not resulting from market conditions. The College proposes that in lieu of the control standard described in the proposed regulations, the final regulations define a change in value not resulting from market conditions as a change in value attributable to an event, other than a corporate or other entity reorganization, that

- (1) the estate was a party by reason of the estate's volitional affirmative act or consent,
- (2) would not have occurred, at least with respect to the estate, but for the volitional affirmative act or consent of the estate, and

(3) in the case of an interest in an entity or a distribution from an entity, is not the result of -

(a) management decisions in the ordinary course of the business or activities of that entity,

(b) a distribution by the entity not in excess of the net income of the entity earned in the alternate valuation period following the decedent's death, or

(c) a legitimate and substantial business (including investment) purpose other than carrying out the dispositive terms of the decedent's will, revocable trust, or other controlling instrument.

Any change in value resulting from a reorganization would be regarded as a change resulting from market conditions, except to the extent of any cash or other property received pursuant to the reorganization and not treated as excluded property under regulation § 20.2032-1(d).

Under any circumstances, much more should be required than a mere ability to sell, which could be construed as the standard for determining control under the proposed regulations. If the decedent or his or her estate does not have the unilateral power to cause an event to happen, or at least to block an event from happening, any change in value resulting from that event should be considered as resulting from market conditions.

CLARIFYING SUGGESTIONS REGARDING POST-MORTEM ENTITY FORMATIONS AND DISTRIBUTIONS

In regard to the other areas addressed in the proposed regulations, the College shares the concerns addressed by the proposed regulations of the Service with certain qualifications.

1. **Post-Mortem Entity Formation**. In regard to the post-mortem formation of corporations, partnerships, and limited liability companies, the College fully recognizes the potential for abuse. In some instances, however, the formation of an entity, especially where one or more operating businesses are involved, may resemble acquisitive reorganizations. For example, both sections 351 and 368 could apply to certain transactions. For the reasons stated above, the College encourages the adoption of rules for such entity formations similar to the rules applicable to reorganizations. Absent a compelling business purpose, however, the College would not take exception to any reasonable approach to curtailing the abusive post-mortem formation of entities that does not involve use of a control standard. In this regard, the College recognizes that the Internal Revenue Service's ability to challenge a post-mortem entity formation would probably be limited under section 2703, thus warranting special scrutiny under the final section 2032 regulations.

2. **Post-Mortem Distributions from Entities.** The College suggests that the proposed regulations contain clarification regarding distributions from an entity after death. The College believes that any distribution during the six-month period following death, with a record date after the date of death, should not be added back to the assets held by the entity for purposes of determining the alternate value of an interest in an entity so long as the distribution is consistent with historic distributions or is from post-mortem earnings of the entity. If a decedent personally owned income producing real estate, the net rents from such real estate for the six months after death would not be includible for purposes of determining the alternate valuation date value of the real estate. Why should the results be any different if the real estate is held by a corporation or other entity in which the decedent owns an interest as of his or her death?

Under Treasury Regulation § 20.2032-1(d), post-mortem distributions attributable to an entity's post-mortem earnings are "excluded property." In contrast, the proposed regulations could be construed as requiring that the alternate value of an interest in an entity be determined by treating the entity as holding on the alternate valuation date all post-mortem distributions of cash or other property to the estate from such entity. The College suggests that the approach taken in regard to the entity distribution provisions of Treasury Regulation § 20.2032-1(f), when finalized, should, at a minimum, be consistent with the approach taken in Treasury Regulation § 20.2032-1(d). Post-mortem distributions attributable to an entity's post-mortem earnings should not be taken into account in determining the alternate value of the estate's interest in the entity.

3. **Distribution of Fractional Interests.** The College supports the effective disallowance of fractionalization discounts resulting from distributions of fractional interests in an entity or the distribution of undivided fractional interests in real estate. See Examples 4 and 5 of Prop. Reg. Sec. 20.2032-1(f)(3)(ii).

PREMIUMS AS WELL AS DISCOUNTS.

A change in value resulting from market conditions should apply to increases in value as well as to decreases in value. For example, if an estate holds only a minority interest in an entity as of the decedent's date of death but for valid business (or investment) reasons acquires an additional interest within six months after the date of death, resulting in the aggregate in a controlling interest held by the estate, the alternate value should be determined on a minority interest basis.

TECHNICAL RECOMMENDATIONS

A cross reference to section 2703 would be appropriate if reorganizations are excepted from the normal rules.

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Similarly, the College recommends that the preparation of these regulations in final form be coordinated with the promulgation of proposed and final regulations under section 2704(b)(4) (item 13 under the heading "Gifts, Estates and Trusts" on the Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2007), so as to provide for the treatment of the object of those regulations in a comprehensive and consistent manner.

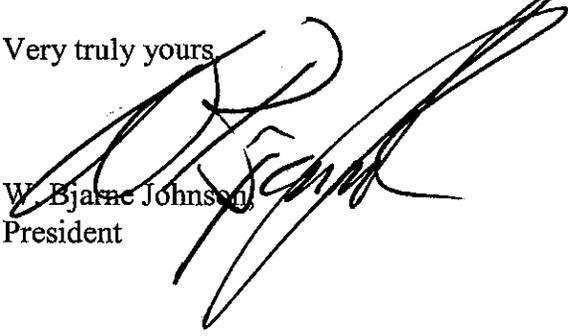
Example 3 of proposed regulation § 20.2032-1(f)(3)(ii) is unusually complicated, involving the creation of four limited partnerships in which the estate has a 25 percent interest. The reciprocal relationship between four and 25 percent seems to have no relevance to the point of the example and therefore is merely a distraction that could limit understanding of the example. An example with just one partnership would seem to work just as well and would avoid the problem.

CONCLUSION

The College supports for the most part the concepts set forth in the proposed regulations. The College is concerned, however, that the proposed regulations may create new problems and are an over-reaction to the Kohler decision.

We thank you for giving us this opportunity to provide these comments. The two individuals primarily responsible for the preparation of the comments, Mr. Milford B. Hatcher (404.581.8510; mbhatcher@jonesday.com) and Mr. Dennis I. Belcher (804.775.4304; dbelcher@mcguirewoods.com), are available to answer your questions. Mr. Ronald D. Aucutt, Mr. Steven B. Gorin, and Mr. Bruce Stone also participated in the preparation of the comments.

Very truly yours


W. Bjarne Johnson
President

cc: Mr. Michael J. Desmond, Tax Legislative Counsel, Treasury Department
Ms. Anita Soucy, Attorney Advisor, Treasury Department
The Honorable Donald Korb, Chief Counsel, Internal Revenue Service
Ms. Linda E. Stiff, Deputy Commissioner for Services and Enforcement
Ms. Theresa M. Melchiorre
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