THE VALUATION DISCOUNT: A DOUBLE-EDGED SWORD

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THE VALUATION DISCOUNT: A DOUBLE-EDGED SWORD

I. INTRODUCTION

Estate planners and their clients have actively pursued the valuation discount as one of the primary methods of transfer tax reduction. It has been the genesis of many family business enterprises. However, with the changing transfer tax climate created by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the creation of a circumstance that causes a discount of value may not be needed and, in fact, may cause unnecessary taxes and estate administration problems.

II. DISCOUNT

For purposes of this paper, "discount" shall refer to a reduction of value of an asset that occurs because the factors affecting the asset prevent it from being freely and readily bought and sold for an amount that would be received if the asset was unaffected by related circumstances, *e.g.*, the ownership of the asset by a business entity. The discount of value can arise in a number of situations, including:

- Undivided interests,
- Lack of a ready market,
- Minority interests, or lack of control,
- Blockage (too much of a good thing),
- Burdens or restrictions on the sale of the asset, and
- Illiquidity of the asset.

These factors can depress the value of an asset from 20-60 % of its "unencumbered" value.

The discussion below will consider the impact of discounts on the transfer and administration of the client's property. The discounts have a direct impact on options and elections to be made by the personal representative of the estate under the terms of the governing instruments and the Internal Revenue Code. Discounts impact the availability of deductions, formula funding, equitable adjustments, and income tax issues relative to basis. Most importantly, discounts affect (1) the tax payments of the estate and its beneficiaries and (2) the fairness of the estate administration *vis-à-vis* the relative shares of the beneficiaries.

III. TAX ELECTIONS

The elections available to the executor with respect to the estate tax are numerous and distinct. An executor of an estate involving discounted assets will want to make sure that he or she has reviewed all of the available elections and has used them to the greatest extent possible. Doing so can preserve a significant portion of the estate for future generations.

A. Responsibility for Making Elections

Estate tax elections available are made by the estate's executor.[1] Examples are the QTIP election, the alternate valuation election, the QFOBI deduction, the special-use valuation election, and the election to extend the time for payment of the estate tax attributable to a closely-held business interest, and the redemption of stock.

B. Section 2032 - Alternate Valuation

The alternate valuation election is an irrevocable election under I.R.C. § 2032 to value all property included in the gross estate that is not distributed, sold, exchanged, or otherwise disposed of as of the date that is six months after death. If the election is made and any property was distributed, sold, exchanged, or otherwise disposed of within the six-month

[1] I.R.C. § 2203 defines the term "executor" when it is used in connection with the estate tax to mean ". . . executor or administrator of the decedent or, if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent." Treas. Reg. § 20.2203-1 states that "the term 'person in actual or constructive possession of any property of the decedent' includes, among others, the decedent's agents and representatives; safe deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country."

period, such property will be valued as of the date of the distribution, sale, exchange, or other disposition. I.R.C. § 2032(a)(1).

Section 2032(a)(3) provides that an interest which is affected by mere lapse of time is to be valued at the date of death value, even if alternate valuation is elected, with an adjustment for any difference in value that is not the result of lapse of time. Examples of interest that are affected by mere lapse of time are patents, a life estate for the life of someone other than the decedent, remainders, and reversions. Treas. Reg. § 20.2032-1(f).

The alternate valuation election is made by the executor on the estate tax return, and the latest date on which the election may be made is one year after the date that the return was required to be filed, including extensions. I.R.C. § 2032(d). In light of this rule, if the executor receives a six-month extension to file the estate tax return, the alternate valuation election would not have to be made for 27 months after the decedent's date of death by filing a timely amended estate tax return.

The alternate valuation election may not be made unless it decreases both (1) the value of the gross estate, and (2) the amount of any estate or generation-skipping transfer taxes that are owed by the estate. I.R.C. § 2032(c). Consequently, if an estate tax is not owed, the executor cannot elect alternate valuation in order to obtain a higher cost basis in the assets that pass to the decedent's beneficiaries under Code § 1014(a).

The issue of discounts can arise in the context of alternate valuation and is one of those times when it pays to think ahead. For example, a sale or other disposition of the estate's interest in a family limited partnership within the six-month period may provide a higher valuation for alternate valuation purposes and such higher value could lead to the disqualification of the estate to elect alternate valuation (and could lead to the date of death valuation being questioned by the IRS).

Note that Rev. Rul. 68-154, 1968-1 C.B. 395, states that in determining the alternate valuation of the decedent's interest in a partnership, the value as of the alternate valuation date of the partnership interest should be determined by valuing the various partnership assets owned at the date of death at their value on the alternate valuation date, even though the assets in that partnership were different on the alternate valuation date.

The discount can also be affected by post-mortem events such as where uncertain and contingent factors which were present on date of death may no longer be present as of the alternate valuation date. For example, the date of death value may have reflected a discount for an uncertainty which is no longer an uncertainty as of the alternate valuation date, thus lowering or eliminating a discount. In *Estate of Van Horne v. Commissioner*, 720 F.2d 1114 (9th Cir. 1983), the issue was whether a blockage discount should be allowed in valuing 14,000 shares of stock owned by the estate on the alternate valuation date when a blockage discount was appropriate on date of death because the estate owned 56,000 shares. Between the date of death and the alternate valuation date, 42,000 shares were sold in several blocks, all at a discount of $2.00 per share approved by the probate court. The Ninth Circuit held that, for purposes of determining whether a blockage discount is appropriate in valuing the 14,000 shares remaining in the estate on the alternate valuation date, the relevant block of stock to be valued is 14,000 shares. The Court found that the record failed to show that the estate could not dispose of the 14,000 shares within a reasonable period of time without depressing the market price of the stock. Therefore, the IRS did not err in refusing to allow a blockage discount of the 14,000 shares as of the alternate valuation date. *See also Estate of Sawade v. Commissioner*, 795 F.2d 45 (8th Cir. 1986). As a result, when an estate holds a large block of stock that is declining in value, the executor must decide whether to sell the stock within the six month period and report the proceeds as part of the gross estate using the alternate valuation, or to hold the stock beyond the alternate valuation date and argue for a blockage discount.

C. Section 2057 – Qualified Family Owned Business Deduction

A deduction from the gross estate is allowed under Code[2] § 2057 for the adjusted value of a qualified family-owned business interest (QFOBI). The maximum amount of the deduction is $675,000, and the deduction is coordinated with the unified credit so the exemption equivalent amount cannot exceed $625,000 (regardless of the amount otherwise in effect for that year) if the full $675,000 QFOBI deduction is used. The QFOBI deduction will be repealed for estates of decedents who die after December 31, 2003.

1. Qualification

For purposes of the QFOBI deduction, the term "qualified family-owned business interest" means an interest as a proprietor in a trade or business carried on as a proprietorship; or an interest in an entity carrying on a trade or business, if at least:

a. 50% of the entity is owned (directly or indirectly) by the decedent and members of the decedent's family,

b. 70% of the entity is owned (directly or indirectly) by members of two families, or

c. 90% of the entity is owned (directly or indirectly) by members of three families.

I.R.C. § 2057(e)(1).

For an estate to qualify for the QFOBI deduction, the sum of (a) the includable qualified family-owned business interest, plus (b) the amount of includable gifts of qualified family-owned business interests, must exceed 50% of the adjusted gross estate. I.R.C. § 2057(b)(1)(C)(ii).

2. Example

Assume the following facts. John Rancher's financial statement shows that he has $3 million in a home, cash, and securities. He also owns a cattle ranch which he operates in conjunction with his son. John Rancher's assets dedicated to the ranching operation are worth $4 million. None of the property is an undivided interest in land. John Rancher's son also contributes assets to the ranching operation. The two own the cattle herd (an easily divisible asset) and have arranged to use each other's land in the ranching operations.

If John Rancher, a single person, dies in 2002 or 2003 (when the estate tax exemption is $1 million), the estate tax on his $7 million estate would be $3,145,000 without discounts and without the QFOBI deduction. The closely-held business interest ratio is 57.14% and, therefore, the executor could elect to deduct $675,000 from the gross estate pursuant to the QFOBI deduction under Code § 2057, reducing the estate tax to $2,917,500.

If, on the other hand, John Rancher and his son had contributed their respective lands and livestock to a limited partnership, the arrangement would be expected to produce a valuation discount. Assume that the discount would amount to a mere 20% of the value of John Rancher's closely-held business assets. John Rancher's interest in the limited partnership now has a taxable value of $3,200,000. The estate tax on the total estate of $6,200,000 would be $2,705,000 without the QFOBI deduction and $2,477,500 with the QFOBI deduction since a 20% discount would produce a QFOBI ratio of 51.61% and still qualify for the deduction. However, the estate will not qualify for the QFOBI deduction if a 25% discount is applied to the limited partnership because the ratio of the qualified family-owned business interest would fall to 50% (and must be over 50% to qualify). If a 25% discount is applied, the total tax would increase from $2,477,500 to $2,595,000.

Therefore, in the partnership arrangement, the amount of this discount is critical. Without the QFOBI deduction and with a 30% or greater discount, the estate tax liability will be reduced beyond the 20% discount/QFOBI

[2] "Code" references the Internal Revenue Code of 1986, as amended, unless otherwise noted.

situation. Furthermore, the estate would not be subject to the onerous post-mortem ownership and operation requirements of Section 2057.

D. Section 2032A – Special Use Valuation

The executor of an estate may elect under Code § 2032A to value qualified farm or other closely-held business real property included in the decedent's gross estate. The value is based on the formulated actual use of the property as a farm or as real property used in the closely-held business, rather than its fair market value based on highest and best use.[3]

Twenty-five percent or more of the adjusted value of the gross estate must consist of the adjusted value of real property which: (1) was acquired from or passed from the decedent to a qualified heir, (2) was used by the decedent or a member of his family as a farm or in a business for a total of at least 5 years during the 8-year period ending on the decedent's death, and (3) there was material participation by the decedent or a member of his family in the operation of the farm or business for a total of at least 5 years during the 8-year period ending on the decedent's death. I.R.C. § 2032A(b)(1).

Additionally, at least 50% of the adjusted value of the gross estate must consist of the adjusted value of real or personal property which was being used by the decedent or a member of his family as a farm or in a business on the date of the decedent's death, and was acquired from or passed from the decedent to a qualified heir. I.R.C. § 2032A(b)(1). For purposes of the 50% test, personal property used in farming or in another business is taken into account even though the personal property is not subject to special use valuation. For purposes of the 25% test, however, only qualified real property is taken into account.

Because the QFOBI deduction is a deduction from the gross estate, it does not affect the qualification tests for Code § 2032A (special use valuation) or Code § 6166 (pay-out election). However, the qualification tests for an election under either § 2057 or § 6166 are affected by an election under § 2032A. Therefore, an election to reduce the value of certain farm or business real estate under § 2032A will reduce both the numerator and the denominator of the qualification tests for §§ 2057 and 6166. I.R.C. § 2032A(a).

3. Real Property Within a Corporation

Real property may qualify for special use valuation even though the decedent owned the property indirectly through ownership of an interest in a corporation, partnership, or trust, but only if the decedent's interest in the business qualifies as an interest in a closely-held business on the date of the decedent's death and for at least 5 years of the 8-year period preceding the death (combined with periods of direct ownership). "Closely held business" for this purpose must satisfy the tests of Code § 6166(b)(1) (pay-out election). I.R.C. § 2032A(g). Where the decedent's interest in qualified real property is through ownership of stock in a closely-held corporation, the estate must apportion the value of the qualified real and personal property owned by the corporation according to the decedent's stock interest and use the apportioned value of the property for purposes of the percentage qualification requirements. For example, where the qualified real property is owned by a corporation and the decedent owns 41% of the corporate stock, the decedent's 41% interest is used for the 50% and the 25% tests. Priv. Ltr. Rul. 8108179.

4. Effect of Discount on Qualification of Corporate Owned Land

The adjusted value of the gross estate as described in § 2032A(b)(3) for purposes of meeting the percentage tests is the value on the applicable valuation date, determined without regard to Code § 2032A, employing the usual valuation techniques in arriving at the fair market value. That fair market value is then reduced by amounts allowable as deductions for unpaid mortgages and indebtedness under Code § 2053(a)(4). Therefore, if a minority discount or undivided interest discount is allowable in

[3] When an executor elects the special use valuation method, the basis of the real property for income tax purposes is its value determined under the special use valuation method rather than its fair market value. I.R.C. § 1014(a)(3).

determining the value of the decedent's interest under Code § 2031, the discounted value will be used in arriving at the adjusted value of the gross estate for purposes of the percentage tests. Upon satisfaction of the percentage tests, the qualifying property will be re-valued under the applicable special-use valuation method described in Code § 2032A(e)(7) or (8), employing the limitation in Code § 2032A(a)(2) of the Code. *But see* Priv. Ltr. Rul. 8302005.

5. Effect of Discount – Undivided Interest

When calculating the 50% and 25% tests, the values used in the numerator and denominator would be based on fair market value that would incorporate appropriate discounts. If, for example, the decedent owned farmland with a fair market value of $500,000 and had an adjusted gross estate of $2 million, the 25% test under Code § 2032A would be met. However, if the decedent owned an undivided one-half interest in a million dollars worth of farmland, which because of the undivided one-half interest was discounted 20%, the numerator would be $400,000 and the denominator (i.e., the adjusted value of the gross estate) would be $1.9 million, resulting in a ratio of 21% which would fail to meet the 25% test.

6. Special Use Value v. Discounted Value

The Tax Court has held that where an estate elects special use valuation for stock in a family corporation that owns farmland, it cannot further reduce the special use value to reflect a minority discount. *Estate of Maddox v. Commissioner*, 93 T.C. 228 (1989). In the *Maddox* case, the decedent owned 35.5% of the outstanding common shares of Maddox Farms, Inc. The corporation owned assets worth $2,442,000. However, after valuing the farmland at its special use value, the value of the corporate assets was $1,376,000, of which the decedent's 35.5% share was $488,000. The IRS and the estate agreed that, if special use valuation had not been elected, the estate would be entitled to a 30% minority discount. The estate contended that it was entitled to both special use valuation and the 30% discount. This would have reduced the estate tax value of decedent's stock to $342,000. The IRS disagreed.

The Tax Court held that the estate could not claim both special use valuation and a minority discount. The court noted that the IRS had yet to issue regulations explaining how the special use valuation rules apply to interests in corporations as Code § 2032A(g) required it to do. In the absence of regulations, the Court construed Code § 2032A(g) as giving the estate the same rights it would have had if the farm were not incorporated and the decedent had owned a direct 35.5% interest in the farm. According to the Court, to allow both special use valuation and a minority discount would give an advantage, unintended by Congress, to estates of decedents who owned farms through corporations. Regulations have not been issued to date which would change this result.

Priv. Ltr. Rul. 9119008 also follows the *Maddox* case in stating that § 2032A(g) was meant solely as a device to lift an entity veil for the purposes of extending the § 2032A benefits to the underlying property and that no minority discount or lack of marketability discount is permitted to reduce the value of the stock where the land is specially valued under § 2032A of the Code. Likewise, the IRS states in a Technical Advice Memorandum that, where an estate elects special use valuation for a decedent's majority interest in the stock of a ranching corporation, no premium is applied to the decedent's voting control of the corporation. Tech. Adv. Mem. 9220006.

The total decrease in value that may result in valuing property under the special use rules may not exceed a specified dollar amount that is indexed for inflation. With respect to a year when the maximum reduction under § 2032A was $750,000, the Tenth Circuit distinguished *Maddox* and approved the use of a minority discount in conjunction with a special use election for purposes of determining the fair market value from which the $750,000 maximum reduction in value must be subtracted. *Hoover v. Commissioner*, 69 F.3d 1044 (10th Cir. 1995).

In the *Hoover* case, the decedent owned a 26% minority interest in a family limited partnership that operated a cattle ranch. The fair

market value of the ranch at the date of the decedent's death was $10.5 million, of which her 26% share was $2.73 million. The estate applied a 30% minority discount to this amount to arrive at a figure of $1.911 million as the fair market value of the decedent's interest in the ranch through the partnership. The special use value of the decedent's interest was $533,548. Because the difference between the fair market value and the special use value exceeded $750,000, the estate reduced the fair market value of the decedent's interest in the ranch by $750,000, and reported the taxable value of the interest for estate tax purposes as $1,161,000 ($1,911,000 minus $750,000).

The IRS contested the method used by the estate, arguing that the appropriate value of the decedent's interest in the ranch was $1,980,000, which was the undiscounted fair market value of $2,730,000 reduced by $750,000. The Tax Court agreed with the IRS, holding that when an estate makes a special use election, it gives up the ability ever to employ a minority discount in its calculations. In so holding, the Tax Court relied on *Maddox*, which it said was indistinguishable from this case. The Tenth Circuit, however, saw a difference between the two cases and reversed.

According to the Tenth Circuit, the difference between *Hoover* and *Maddox* is that the $750,000 limitation was not involved in *Maddox*. There, the difference between the fair market value and the special use value was less than $750,000, so the estate reported the special use value itself on the estate tax return. The problem arose when the estate attempted to reduce the special use value further by applying a minority discount. In *Hoover*, the difference between the fair market value and the special use value exceeded the $750,000 limitation. For this purpose, the Court held, fair market value has the same meaning it has under other circumstances. Thus, the $750,000 maximum reduction under the special use rules is a reduction from the value that would otherwise be reported if no special use election were made. If no special use election had been made in this case, the value of the decedent's 26% partnership interest includable in her gross estate would clearly incorporate a minority discount. The IRS has acquiesced in the Tenth Circuit's decision in *Hoover* in its Action on Decision 1998-006.

Therefore, under the *Hoover* case, if the difference between the fair market value (which can apply discounts) and the special use value exceeds the maximum reduction under § 2032A (currently $800,000), the estate can only reduce the fair market value of the applicable property by $800,000. If the difference between the fair market value (applying applicable discounts) and the special use value does not exceed the maximum reduction amount, the estate can elect to report the value of the applicable property using its special use valuation. Under the *Maddox* case, however, the estate cannot further reduce the special use value by employing additional discounting principles.

E. Section 6166 – Pay-out of Estate Tax in Installments

The executor of an estate may elect to pay a portion of the estate tax over an extended period of time if the value of the decedent's closely-held business interest exceeds 35% of the adjusted gross estate. I.R.C. § 6166(a)(1). The maximum amount of tax which may be paid in installments under Code § 6166 is the ratio to the total tax as (a) the closely-held business amount, bears to (b) the amount of the adjusted gross estate. I.R.C. § 6166(a)(2).

1. <u>Facts</u>

John Rancher is a widower. His financial statement shows that he has $2 million in home, cash, and securities. He also owns a cattle ranch which he operates in conjunction with his son. John Rancher's assets dedicated to the ranching operation are worth $1,400,000. None of the property is owned as an undivided interest. John Rancher's son also contributes land to the operation, and this land is owned by the son. The two own the cattle herd and have arranged to use each other's land in the ranching operations.

2. <u>Undiscounted Scenario</u>

If John Rancher dies in 2004 (when the estate exemption is $1,500,000), the estate tax

bill on his undiscounted estate of $3,400,000 would be approximately $897,000. The closely-held business interest ratio is approximately 41.18%, and therefore, the executor could elect to defer the payment of approximately $370,000 of the tax bill under the favorable interest rates and payment terms of Section 6166.

3. Discounted Scenario

If, on the other hand, John Rancher and his son had contributed their respective lands and livestock to a limited partnership, the arrangement would be expected to produce a significant estate planning discount. For purposes of our discussion, we will assume that the discount would amount to 35% of the unaffected value of John Rancher's closely-held business assets. John Rancher's interest in the limited partnership now has a taxable value of $910,000. The estate tax on the total estate of $2,910,000 would be $661,800. However, the estate will not qualify for a Section 6166 payment program because the ratio of the closely-held business interest has fallen below the required 35%.

There are a number of considerations regarding the best economic position for the estate in the above example. Most importantly, the total amount of estate taxes paid is reduced by $235,200 when the closely-held business interest is discounted. However, the discounted business interest value causes a loss of the Code § 6166 election, and, therefore, the initial tax payment upon filing the return is higher in the discounted situation versus the undiscounted ($661,800 vs. $527,616). Finally, the income tax basis of the undiscounted closely-held business interest is $490,000 greater than in the discounted limited partnership program.

4. Community Property Attribution Dilemma Under Section 6166

It may be necessary for the executor to elect attribution of family member ownership in order to qualify an estate for Section 6166 benefits. For example, if a corporation had more than 45 shareholders, the qualification of the decedent's estate for installment payment of the estate tax requires that the decedent's gross estate have 20% or more in *value* of the voting stock. I.R.C. § 6166(b)(1)(C)(i). If a husband and wife owned 40% of the stock, the decedent's community property one-half interest would include 20% of the shares in his estate. However, the value of this minority interest would likely not be equal to 20% of the value required by the closely held business interest test.

Code § 6166(b)(2)(B)(i) allows the executor to elect to consider the total community property interest in meeting the value test. If the combined community is necessary to qualify the decedent's stock as a closely held business interest, there is no deferral of the first tax installment payment for five years nor will the estate qualify for the 2-percent interest rate (defined in Code § 6601(j)). I.R.C. § 6166(b)(7).

F. Section 303 – Redemptions

Section 303 of the Internal Revenue Code provides that a distribution of property from a corporation to an estate in redemption of its stock held by the estate is to be treated as a distribution in full payment for the stock redeemed. I.R.C. § 303(a). This very important provision allows the estate to receive distributions from the corporation as a sale of the stock (taxable as capital gains) and not as a dividend (taxable as ordinary income).

The requirements for this favorable income tax treatment are –

- The amount of the distribution cannot exceed the total of transfer taxes (including interest) imposed because of the decedent's death and the amount of funeral and administration expenses allowable as deductions to the estate under Code § 2053. I.R.C. § 303(a)(1) and (2).

- The distributions from the corporation in redemption of the stock must occur within the time limitations spelled out in Code § 303(b)(1) and (4).

- The value of the stock (for federal estate tax purposes) included in the decedent's gross estate exceeds 35% of the excess of the value of the gross

estate of the decedent over the sum of the amounts allowable as deductions under Code §§ 2053 or 2054. I.R.C. § 303(b)(2)(A).

If the business enterprise which John Rancher and his son formed is taxed as a corporation, the 303 redemption might not be allowed if a 35% discount is allocated to the stock of John Rancher.

G. Penalties for Over- and Under-Valuations

An over-valuation of property on an estate tax return usually does not result in underpayment of estate tax, except in cases where an over-valuation of a closely-held business allows the estate to qualify for the QFOBI deduction or special-use valuation. An estate tax over-valuation can also result in a penalty for an underpayment of income tax. This could occur if an individual who inherited property from a decedent sold the property and under-reported the gain because the estate tax valuation of the property was substantially inflated. In this case, the penalty would be applied against the heir.

1. Income Taxes

In Rev. Rul. 85-75, 1985-1 C.B. 376, a decedent left his entire estate to his surviving spouse. Because of the marital deduction, there was no estate tax liability regardless of the size of the estate. Included on the return was a building owned by the decedent which had a fair market value on the date of death of $2 million. The estate tax return reported the value for the building as $3.5 million. The surviving spouse claimed a depreciation deduction on her income tax return using a basis of $3.5 million. Upon audit, the IRS adjusted the deduction to reflect a basis of $2 million and assessed the penalty for a valuation overstatement.

2. Transfer Taxes

The penalty for an underpayment due to a substantial estate or gift tax valuation understatement is 20% of the amount of the underpayment. I.R.C. § 6662(b)(5). A "substantial" estate or gift tax valuation understatement occurs when the value of any property claimed on an estate or gift tax return is 50% or less of the amount determined to be correct. I.R.C. § 6662(g)(1). The penalty doubles to 40% if the understatement constitutes a "gross" valuation misstatement. I.R.C. § 6662(h)(1). There is a gross valuation misstatement when a substantial estate or gift tax valuation understatement is 25% or less of the correct value. I.R.C. § 6662(h)(2)(C). The penalty does not apply if the underpayment of the estate or gift tax attributable to the understatement is less than $5,000. I.R.C. § 6662(g)(2).

3. Use Appraisers

Under- and over-valuation penalties should not be assessed as long as the valuations are based upon professional and competent appraisals. *See* I.R.C. § 6662(b)(3) and 6662(e) (as to valuation overstatements) and § 6662(b)(5) and 6662(g) (as to valuation understatements). Accordingly, it can pay to hire a qualified appraiser when reporting subjectively valued transfers on estate and gift tax returns.

IV. POST-MORTEM CIRCUMSTANCES

A. The *Proctor* Dilemma

There have been a number of cases considered by the courts which involved a valuation change arising from events that occur on or after the date of death, often because of circumstances created by the estate plan. An example of this is *Estate of Foy Proctor*, T.C. Memo. 1994-208 (1994). One of the key issues in *Proctor* was at what point in time does a devaluing circumstance have its effect.

1. Facts

Foy Proctor owned a ranch valued at $6 million. He gave the ranch to Texas Tech University under the terms of his will. The gift of the ranch was subject to a "gift" of an option granted an individual to lease the ranch for grazing purposes for a term not to exceed the duration of the life of the individual plus six months. The lease was to be negotiated and renegotiated from time to time so that it would provide for lease terms conforming to the fair market value of the land for grazing purposes.

The lease was to have such terms and restrictions as were appropriate to maintain and preserve the market value of the property.

Substantial expert testimony was introduced which uniformly opined that the lifetime lease option reduced the value of the ranch. The unfettered fee simple value was $6 million. The burden on the property with the lifetime lease option reduced the value for many reasons, including the fact that fair market lease rental was a relatively low return on the value of the property. The court weighed all of the evidence and held that the value of the ranch burdened by the lease option was $4,836,320.

2. Issues

At what value is the ranch includable in the gross estate? What is the allowable charitable deduction for the estate?

a. General Principles

Code § 2031(a) provides that the value of the gross estate is to be determined by including the value of all of the decedent's property at the time of his or her death. *Proctor* at 94-1134. The value of the property included in the gross estate is the fair market value of the property at the moment of decedent's death. Treas. Reg. § 20.2031-1(b).

In *Proctor*, a primary issue revolved around a determination of what circumstances applied on the date of death. One party argued that on the date of death, the decedent owned a fee simple interest in the ranch property unburdened by the lease option. Therefore, the includable amount was $6 million.

However, another party contended that the decedent's interest in the ranch was that which passed at the moment of his death. Therefore, the Section 2031(a) value would be that of the fee simple interest in the ranch *subject to* the lifetime lease option. *Proctor* at 94-1129.

b. The Problem

The obvious problem in this case is the allowable deduction under Code § 2055, which limits the value of the charitable deduction to an amount not to exceed the value of the transferred property required to be included in the gross estate. Thus, the inclusion value in the gross estate and the value for the charitable deduction may not be the same. *See Provident Nat'l Bank v. United States*, 581 F.2d 1081 (3d Cir. 1978) (marital deduction); *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981) (charitable deduction); and *Estate of Chenowith v. Commissioner*, 88 T.C. 1577 (1987) (marital deduction).

There was no significant argument in *Proctor* that the value of the charitable deduction was the fair market value of the ranch subject to the lifetime lease option. The argument centered around the value of the Proctor ranch in the gross estate. If the Section 2031(a) value was $6 million, then the estate would owe additional estate taxes because the charitable deduction would not completely eliminate the includable value of the ranch on Schedule A of the estate tax return. If, on the other hand, the value for inclusion in the gross estate was the ranch subject to the lifetime lease option, then this amount would equal the charitable deduction and thereby eliminate the estate tax on the "disappearing value."

c. Holdings

The *Proctor* court held that the inclusion value under Section 2031(a) was $6 million. The proper value was that which existed at the moment of the decedent's death relative to what the decedent owned. The decedent owned an unencumbered fee simple interest in the ranch. Neither decedent's death nor his will altered *his* ownership interest in the ranch.[4] *Proctor* at 94-1134. The court further held that the maximum charitable deduction allowable in this case was the value of the ranch less value deduction caused by the lifetime lease option.

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[4] *Estate of McClatchy v. Commissioner*, 147 F.3d 1089 (9th Cir. 1998). The increase in the stock's value was occasioned, not by death, but by transfer to a non-affiliated estate; death alone did not alter the value. This case dealt with whether federal securities laws applicable to the decedent while alive, but disappearing at the moment of death and not applicable to the estate, would be considered in the valuation of stock. The post-mortem transformation was not considered. Therefore, it would be parallel to *Proctor*.

3. Estate Planning Opportunity

An estate planning opportunity exists when one considers the holding of the *Proctor* court relative to the devaluation effect of the lease. The lifetime lease option would have caused a reduction of the fee simple land value at the moment of death if the lifetime lease option had been granted *before* Mr. Proctor died. The *Proctor* court acknowledged that the effect of the lifetime lease option on this particular property created an approximate 20% discount. Therefore, if the lifetime lease option does not contain any ingredients of gift, but is negotiated at arm's-length for full fair market value, then the option should result in a devaluation assuming the yield from the lease would be something less than the potential yield from fee simple ownership.

The discount effect of a lease option could be combined with special use valuation to further lower the estate tax. For example, the landowner could grant a long-term lease option to a family member who would satisfy the qualified use test and the material participation test (as may be required) both before and after the landowner's death. Therefore, the lease option would produce a discount of the full fair market value of the property, and special use valuation could produce an additional statutory reduction of the taxable value (not to exceed $800,000 for deaths occurring in 2002).

B. The Swinging Gate

The estate tax is levied on the transfer itself. *Estate of Simplot v. Commissioner*, 249 F.3d 1191, 1194 (9th Cir. 2001). The tax is on the act of the testator, not on the receipt of the property. *Id.* Thus, the estate tax is assessed on the value of the property in the hands of the decedent at the time of its transfer by death (or the alternate valuation date). *Id.* The value of the transfer is established at the moment of death, and it is not based on the potential of the property to be realized at a later date. *Id.*

However, for purposes of determining the deduction allowable for transfers to the surviving spouse (or in an appropriate trust for the surviving spouse) or to charity, the deduction is limited to the value of the property received. Numerous cases have demonstrated this valuation anomaly can produce significant differences between the inclusion value and the deduction value as it did in the *Proctor* case.

1. Ahmanson

In *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981), the decedent owned a controlling interest in the stock of HFA Co. as well as 100% of the stock of Ahmanco (99 non-voting shares and one voting share). The testator's will gave his controlling interest in HFA Co. to Ahmanco. The will gave the 99 non-voting shares in Ahmanco to a charitable foundation, and the one remaining voting share was to be held in trust with the right to vote vested in the testator's son.

The court stated:

> We must distinguish, however, the effect of "pre-distribution" transformations and changes in value brought about by the testator's death, from changes in value resulting from the fact that under the decedent's estate plan the assets in the gross estate ultimately come to rest in the hands of different beneficiaries. . . . There is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one.

Ahmanson at 768. The court held that the charitable deduction for the 99 shares of non-voting stock was less valuable than the equivalent value of 99% of 100% of the stock. The court stated further:

> The statute does not ordain equal valuation as between an item in the gross estate and the same item under the charitable deduction. Instead, it states that the value of the charitable deduction "shall not exceed the value of the transferred property required to be included in the gross estate."

Id. at 772.

The *Ahmanson* case represents two important principles. First, the post-death but "pre-distribution" circumstances of the estate plan are to be considered in determining the value of the asset that is transferred at the time of death. Second, the gift to the charity is considered a separate transfer insofar as valuation is concerned. Thus, the gift to the charitable organization may well be affected by applicable discounts or other value-depressing circumstances as the lifetime lease option in *Proctor*.

2. Chenoweth

The case of *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987), demonstrates that these same principles can result in an enhanced value. In *Chenoweth*, the testator owned 100% of the stock of the corporation. The will gave 51% of the stock to the spouse in a manner that qualified for the marital deduction. Forty-nine percent of the stock was given to the decedent's daughter. The executor of the estate took a marital deduction by adding a control premium of 38.1% to the value of the 51% interest in the stock.

The *Chenoweth* court wrestled with the issue of when an asset was to be valued for (1) inclusion purposes under Section 2031, and (2) deduction purposes under Section 2056. The court relied on Treas. Reg. §20.2056(b)-4(a), which provides: "The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse. . . ." The court held that the control premium is properly considered in computing the amount of the marital deduction.

C. Drafting Considerations

The estate planner must be careful in structuring the gifts to the surviving spouse and charities so that the gap between the inclusion value and the deduction value does not occur unless intended and anticipated with appropriate tax allocation provisions.

Gifts to the surviving spouse of a minority interest of corporate stock when the decedent holds the entire amount could result in the *Ahmanson* effect which increases the taxable portion of the estate. Likewise, a gift of an undivided fractional interest in real estate held totally by the decedent would produce a discount rendering the value of the marital deduction gift at something less than the proportionate interest of the whole.

On the other hand, *Chenoweth* points out that a small extra amount to the marital deduction or charitable deduction could create a premium which would reduce the taxable value of the gift to the children. This situation would allow for funding the non-marital gifts with discounted assets.

D. The Estate Planning Dilemma – Community Property

The community property character of spouses' property in Texas has created a fortuitous circumstance regarding discounts. For example, a couple owning 55% of the stock during the marriage has typically placed majority control in the hands of the decedent and in his or her spouse. However, the death of either spouse creates a minority holding because the deceased spouse's estate will hold only one-half of the community position, or 27.5%. *Voila!* An automatic minority position is created subject to applicable discounts to which a 55% interest would not be entitled. The IRS has been rejected numerous times in its attempt to apply a family attribution scenario which would couple the decedent's community half to the surviving spouse's community half for valuation purposes. Therefore, family attribution of the surviving spouse's one-half community property interest to the decedent's interest is disallowed when valuing the holdings of the decedent's estate, even though the surviving spouse gained control of the decedent's interest under the terms of the decedent's estate plan. *Propstra v. United States*, 680 F.2d 1248, 1252 (9th Cir. 1982); *Estate of Bright*¸ 658 F.2d 999, 1005 (5th Cir. 1981); *but see, Estate of Fontana*, 118 T.C. No. 16 (2002).

A dilemma arises regarding community property with the increasing estate tax exemption and possible repeal of the estate tax. Either result will raise questions regarding the advantage or disadvantage of community property and the valuation of that property upon

death of the first spouse to die. Should the community property estate remain intact so that a discount applies to both community property interests with resulting lower basis under either Section 1014 (before repeal) or Section 1022 (after repeal)? Should the spouses partition the community estate to create a separate property situation so that property would be less "discountable"?

For example, if a husband and wife owned $1 million of land and $1 million of securities, should they consider a partition and exchange where one spouse will own all of the land as his or her separate property, and the other spouse would own all of the securities as his or her separate property. As a result of this approach, the death of the spouse owning all of the land would avoid an undivided interest discount in the valuation of the property. Therefore, the basis adjustment would be effective as to the full fair market value of the real estate. The possible downside of this approach is the securities would not receive a new basis. This would be bad if the securities have significantly appreciated. This may be good, however, if there has been a significant decline in the value of the securities relative to their cost basis.

E. Issues Arising When Funding Bequests

An executor or trustee faces issues with regard to valuation discounts when selecting assets to fund outright bequests, when funding formula bequests, and when dividing trust assets upon termination of a trust.

1. Illustration of Dilemma on Funding Pecuniary Gifts

Assume a decedent provided for a pecuniary bequest of the GST exempt amount to two individuals who would be considered skip persons for GST tax purposes, with the residuary estate passing outright to the decedent's children. The dispositive instrument requires the value of any asset used to fund the bequest to be its fair market value as of the date of distribution. The executor wants to fund the bequests to the two individuals with fractional interests in real estate that the decedent owned 100% of at his death. Assume the real estate has not changed in value since the date of death. Because the real estate in this situation was entirely owned by the decedent at his death, no fractional interest discount is appropriate for federal estate tax purposes on the decedent's estate tax return in calculating the gross estate. However, a discount would be applicable if undivided interests in the real estate is used to fund each bequest to the two individuals. To better illustrate this point, assume the executor funded the bequest to the two skip persons with an undivided one-half interest in real estate with the total fair market value of $1 million. If an undivided interest discount of 20% would apply to an undivided one-half interest in the land, the generation-skipping transfer gifts are funded only to the extent of $800,000. Accordingly, the executor would need $200,000 more of assets to complete the gifts. In this scenario, the executor may face complaints by the grandchildren if he does not choose additional assets to fund the GST gifts or may face complaints by the children if the executor chooses to fund the GST gifts with $1 million of land plus $200,000 of other assets.

With regard to the income tax consequences, funding a pecuniary bequest is treated as a sale of an asset, with the result that gain or loss can be recognized if an asset other than cash is used. Under Code § 267, losses are ignored for income tax purposes under certain circumstances. Although the general rule under Code § 267(b)(13) is that losses generated by a transaction between an executor and a beneficiary are not recognized, there is an exception for a sale or exchange in satisfaction of a pecuniary bequest. Therefore, if a discount is applied in the above illustration so that the fair market value of the property used to fund the pecuniary bequest is less than the basis, the difference would be a loss that would be recognized by the estate on its fiduciary income tax return.

2. Division of Trust Estate

Another example of when a fiduciary needs to be mindful of discounts is dividing the assets of a trust among the beneficiaries upon its termination. Assume, for example, that a trust has three beneficiaries. Its primary assets are a

farm worth $200,000 and cash and other securities worth $100,000. The three beneficiaries are to receive equal amounts at the time of the trust termination. The trust instrument allows the trustee to divide the trust among the beneficiaries in cash or in kind or partly in both instead of fractionalizing each asset. Two of the beneficiaries want to own and operate the farm, and the third beneficiary has no desire to own a farm. If the trustee distributed an undivided one-half interest in the farmland to each of the two beneficiaries and the remaining assets to the third beneficiary, the trustee is likely to find himself in a situation where the two beneficiaries receiving the farm might complain that they did not receive a full one-third of the trust value since a discount for an undivided one-half interest in the farm should have been applied.

3. Discretionary Funding of Marital, Charitable, and Generation-Skipping Gifts

When there is a formula pecuniary bequest permitting the fiduciary to select assets to be valued as of the date of distribution, premiums and discounts should apply to ensure proper funding but should not affect the date of death values. Likewise, the power to select the property to satisfy the marital and charitable gifts should not affect the amount of the deduction.[5]

An example would be where a decedent's estate includes 100% of the stock in a closely-held corporation. The formula marital deduction gift is $500,000 under decedent's will and tax return facts. The stock is worth $1.5 million on date of distribution. On that date, the executor distributes one-third of the stock to a marital deduction trust, based on a pecuniary formula that mandates date of distribution values. The issue will be what effect minority, lack of marketability, and other appropriate discounts will have on the stock. If one-third of the stock is discounted, the marital deduction bequest will be under-funded, and the executor will have a duty to distribute more assets to the trust to make up the gift.

If a reverse pecuniary formula is used (producing a $1,000,000 credit shelter trust), and two-thirds of the stock is distributed to a credit shelter trust to equal the $1 million gift, the trust will be over-funded if the stock carries a control premium. Minimum worth or pick-and-choose fractional formulas and fairly representative formula language will have similar problems because they require re-valuation of assets at date of distribution.

Under Rev. Proc. 64-19, 1964-1 C.B. 682, if there is a true fractional formula under which a fixed percentage of each and every asset in the residue of the decedent's estate has to be allocated to a marital trust, valuation discounts should not result upon distribution since actual date of distribution values should not be considered; only date of death values are to be considered in determining the fraction. However, this will not eliminate the fiduciary duty issues.

4. Partial QTIP Election

When a partial QTIP election is made, a trust may be divided into separate trusts to reflect the partial election if authorized under the governing instrument or otherwise permissible under local law. Treas. Reg. § 20.2056(b)-7(b)(2)(ii). The division of the trust (for date of death purposes) must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust. Treas. Reg. § 20.2056(b)-7(b)(2)(B). A trust may be divided if the fiduciary is required, either by applicable local law or by the express or implied provisions of the governing instrument, to divide the trust on the basis of the fair market value of the assets of the trust at the time of the division. Treas. Reg. § 20.2056(b)-7(b)(2)(C). According to the rationale in Rev. Proc. 64-19, valuation discounts and premiums should not result upon funding and division of the trust if it is to be based on a true fractional formula. *See also* Treas. Reg. § 20.2056(b)-5(c)(2). However, if the executor or trustee is allowed to pick and choose assets to fund the newly-divided trusts using date of distribution values, then valuation discounts and premiums may

[5] The failure of the executor to fully fund a pecuniary marital gift does not reduce the amount of the marital deduction. Rev. Rul. 84-105, 1984-2 C.B. 197.

need to be applied, depending on the nature of the assets chosen, in order to correctly fund the trusts.

F. Duty of Impartiality

Ordinarily, a will or trust is created for more than a single beneficiary. A fiduciary has a duty to act impartially in the administration of an estate and treat all beneficiaries fairly by not sacrificing the interest of one beneficiary in favor of another, unless the testator specifically expresses an intent that one beneficiary be treated differently than another. The duty of the executor and trustee to deal impartially among the several beneficiaries is well recognized. *See Estate of Smith v. Commissioner*, 77 T.C. 326 (1981); *Dupont v. Southern Nat'l Bank of Houston*, *Texas*, 771 F.2d 874 (5th Cir. 1985); A. Scott and W. Fratcher, THE LAW OF TRUSTS, §§ 170 and 183 (4th ed. 1987); RESTATEMENT (SECOND) OF TRUSTS § 183.

A fiduciary also has the responsibility to conserve estate or trust property and make the property reasonably productive, which includes a duty to minimize the overall tax burden on an estate or trust and its beneficiaries, and to handle any tax controversy or litigation. *See* TEX. PROB. CODE § 37; TEX. TRUST CODE §§ 113.002 and 113.051; A. Scott and W. Fratcher, THE LAW OF TRUSTS, §§ 170 and 176 (4th ed. 1987). This responsibility must be carried out with an eye towards the duty of impartiality.

The tax elections and administrative decisions which arise in estates and trusts that have assets subject to discount or premiums may cause conflicts between the beneficiaries. The executor or trustee must strike a balance. The drafter of estate planning documents should consider language that (1) gives the executor direction, and (2) exculpates the executor from liability for his or her decisions.

G. Equitable Adjustment

The duty to act impartially and the duty to reduce taxes often collide and provide a potential for conflict among the various beneficiaries' interests. This conflict has given rise to the doctrine of equitable adjustments. An equitable adjustment is the re-allocation of assets from the account of one beneficiary to the account of another beneficiary to compensate for the disproportionate sharing of a tax burden.

A good example of a situation giving rise to a potential equitable adjustment is created by the conflicting provisions of most state principal and income acts and the provisions of Code § 642(g). Certain estate expenses and losses may be deducted either as estate tax deductions under Code §§ 2053 and 2054 or as income tax deductions under Code § 642. Section 642(g) requires a fiduciary to elect to take such expenses or losses either on the estate tax return or on the fiduciary income tax return, but not on both returns. According to most principal and income acts, however, such expenditures will be allocated to and paid from the estate's principal account regardless of which return the deduction is taken. This was the issue in the famous 1955 New York case of *In Re Warms' Estate*, 140 N.Y.S.2d 169 (1955).

The problems created by the duty of impartiality have become more important today because of the numerous tax-related issues and elections that must be considered in post-mortem planning. The exercise of discretionary powers that saves taxes often conflicts with the duty of impartiality. When a tax savings plan is formulated for an estate or trust, unless the plan is initially fair, it must be made fair by equitable adjustment.

V. PARTNERSHIP DISCOUNT VS. BASIS ADJUSTMENT

Discounts of limited partnership interests have been recognized by the courts in numerous cases. *Estate of Dailey*, T.C. Memo. 2001-263 (40%); *LeFrak*, T.C. Memo. 1993-526 (30%); *Estate of Cervin*, T.C. Memo. 1994-550 (20%); *Williams*, T.C. Memo. 1998-59 (44%); *Estate of Stevens*, T.C. Memo. 2000-53 (25%); *Forbes*, T.C. Memo. 2001-72 (30%); *Strangi*, 115 TC 478 (2000) (31%); *Estate of Knight*, 115 T.C. 506 (2000) (15%); *Estate of Shepard*, 115 T.C. 376 (2000) (15%); and *Estate of Jones*, 116 T.C. 121 (2001) (48%).

The discounting of partnership interests was very important in the 1990's because the estate tax rate ranged from 37% to 55% (plus 5%

surcharge on estates greater than $10 million in value) which substantially exceeded the income tax rates. Therefore, the lower basis in the partnership interest arising from the applicable discount was far favorable to a higher basis with relatively higher estate tax.

EGTRRA changed the landscape in 2001. The significantly increasing estate tax exemption from $1 million for deaths occurring in 2002, to $3.5 million for deaths occurring in 2009, will result in no estate tax liability for many estates. However, the basis adjustment rule of I.R.C. § 1014 will continue to apply for deaths occurring on or before December 31, 2009.

Family business entity planning (aka discount planning) has been very appropriate for the client with a general portfolio of $1 million to $2.5 million ($2 million to $5 million for community property estate of husband and wife). Assets such as stocks, bonds, land, and oil and gas properties, could be placed into one or more family limited partnerships and significant transfer tax savings would occur due to the discounts.

Considering the increased estate tax exemption, the possibility of estate tax repeal, and the limited basis adjustments of I.R.C. § 1022 following repeal, one must carefully consider the appropriateness of a value discount within any given estate plan. The larger exemptions established for estates of decedents dying before December 31, 2009 and the additional benefit of unlimited stepped-up basis in assets requires careful consideration in the asset structure within the client's portfolio. In particular, an unneeded discount could arise by the creation of a family limited partnership (whether intended for discount purposes, management purposes, asset protection purposes, or otherwise) because the nature of the limited partnership interest would require a lower value, and therefore, a lower basis.

A. Section 754 Election

The basis of a partnership interest acquired from a decedent is the fair market value of the interest as of date of death (or the alternate valuation date) with adjustments that (1) increase the basis by the successor's share of partnership liabilities, and (2) decrease the basis by items of income in respect of decedent. McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 23.04(1) (1997). An election under Code § 754 which affects the transfer of a decedent's partnership interest causes the bases of the partnership's assets to be increased or decreased, with respect to the successors in interest, by the difference between the adjusted basis of the interest in the successor's hand and his or her proportionate share of the basis of partnership assets. *Id.* at ¶ 23.04(2).

The basis is adjusted pursuant to the rules of Code § 743(b). The Section 743(b) adjustment substantially reduces the continuing partnership's gain allocable to the decedent's successors upon the sale of partnership properties.

The amount of increased basis for income tax purposes of an asset held in a partnership will be directly affected by the discount. For example, consider two scenarios. The first would be that decedent owns 1000 acres of land worth $1,000 per acre. The decedent's pre-death income tax basis in the property is $400,000. The decedent gifts his children, A and B, a segregated 500-acre tract having a fair market value of $500,000. Decedent's remaining 500-acre tract is owned in full fee simple interest. Therefore, upon decedent's death, his 500-acre tract will be valued without discount at $500,000. Code § 1014 will give the children (who are the beneficiaries of his estate) a new income tax basis of $500,000 in the decedent's 500-acre tract. As a result, the children will avoid the income tax on a $300,000 gain. Assuming the gift and estate tax exemptions under EGTRRA avoid the payment of gift and estate taxes by the decedent, then the transfer would be totally tax-free for gift and estate tax purposes, and the capital gain on $300,000 of value will be avoided.

On the other hand, if the decedent and his children form a family limited partnership and contribute their respective interests in the 1000 acres to the partnership, then decedent's 500-acre fee simple interest is converted to a 50% limited partnership interest. Assume that the discount applicable to this particular partnership interest is 40%. The resulting fair market value

of the decedent's partnership interest is $300,000.

If the partnership has an effective Section 754 election in place, the inside basis of the assets attributable to the decedent's partnership interest would be increased to $300,000. Therefore, upon sale of the land, there would be a $200,000 capital gain that would have been avoided if there had been no discount factor.

The discount of the partnership interest would additionally affect two other options available to estates and partnerships upon the death of a partner. These options include (1) an election to distribute selected properties under the allocation of basis rules of Code § 732(c), and (2) the option to distribute selected partnership properties in liquidation of a deceased partner's interest pursuant to special allocation basis rules of Code § 732(d). All three of the above options are very important relative to the continuing partnership.

B. Section 1022 Basis Adjustments – Post-Repeal

Two very significant events occur on January 1, 2010 should the current provisions of EGTRRA continue to be the law as of that date. First, the estate tax is repealed. Second, the adjustment in basis occurring under Code § 1014 will no longer occur. Beginning in 2010, the beneficiaries of a decedent's estate will receive a carryover basis in the property subject to adjustments permitted under Code § 1022.

The executor of a decedent's estate will be permitted to allocate to specific assets additional basis of at least $1.3 million (not to exceed the actual value of the assets). Additionally, $3 million of additional basis can be allocated to assets transferred to the surviving spouse in a qualified manner. This basis allocation cannot be made to certain types of assets, such as IRD and property acquired by the decedent by gift (other than from his or her spouse) within three years of the date of death. I.R.C. § 1022(d)(1)(C).

The obvious issue that arises in light of repeal, as well as the limited step up in basis for smaller estates, is the negative effect of devaluation factors. Assets within a closely-held entity, such as an FLP, could well have the carryover basis unadjusted if the basis of the partnership interest in the hands of the decedent was equal to or greater than the fair market value of a discounted partnership interest.

For example, a decedent transfers land worth $1 million to an FLP. The decedent's basis in the land is $700,000. Before decedent's death, he has conveyed a 50% interest in the partnership to his children. Therefore, his remaining 50% partnership interest has an income tax basis of $350,000.

If the decedent dies in a post-repeal period, the IRS may argue that the decedent's interest in the partnership carries a 30+ percent discount. Therefore, the fair market value of the decedent's partnership interest would be $350,000 or less. The executor of the decedent's estate would not be able to allocate any of the Section 1022 basis adjustment to the value of the partnership interest and gain the benefits of a Section 754 election for the increased basis. On the other hand, if the partnership had been dissolved and the land partitioned so that the decedent owned his 50% interest in the land in full fee, his $350,000 basis in $500,000 worth of land would be entitled to a $150,000 basis adjustment should the executor so elect.

VI. SECTION 2053 DEDUCTIONS

Discount factors can also have an effect on the amount of the deduction available for debts and expenses of administration under Code § 2053.

A. Administration Expenses

In *Estate of Joslyn v. Commissioner*, 500 F.2d 382 (9th Cir. 1974), the issue was whether the underwriting expenses for the sale of stock were deductible as expenses of administration under Code § 2053. The Tax Court disallowed them on the grounds that, since the expenses of the stock offering were clearly allowed in determining the value of the stock to be included in the decedent's estate, the same expenses were not also deductible under § 2053(a).

The decedent owned 66,099 shares of the common stock of Joslyn Manufacturing and Supply Company at his death. The stock was

not then listed on any national exchange, but was traded on the over-the-counter market. The shares were valued on the estate tax return at approximately $3 million as of the date of death. Upon audit, the IRS proposed an increase in the date of death value of the shares to approximately $3.1 million. This computation included a discount for blockage elements in the amount of approximately $370,000. These adjustments to the valuation were accepted by the executor and were not in issue before the Tax Court.

It was necessary to sell a portion of the decedent's stock to meet administration expenses and to pay taxes. Arrangements were made for a secondary offering through a national underwriter, and the expenses totaled approximately $370,000. The payment of the entire expense was allowed by the California Probate Court as an expense of administration. The estate claimed a § 2053 deduction on the federal estate tax return for the total expenses which were disallowed by the IRS. The taxpayer argued that expenses of administration allowed by a probate court are generally allowable as a deduction for federal estate tax purposes under Treas. Reg. § 20.2053-1(b)(2). The IRS argued the estate would be getting a double deduction. The *Joslyn* court held on appeal that a deduction was allowable under Code § 2053 for expenses incurred in selling the large block of stock to pay taxes and expenses, even though the expense figure had been used to calculate a blockage discount to reduce the valuation of the stock based on market quotations.

Rev. Rul. 83-30, 1983-1 C.B. 224 subsequently stated that underwriting fees incurred in marketing a large block of stock are not to be considered in determining a blockage discount to value the stock under § 2031 of the Code but are deductible as an administration expense under § 2053(a)(2). The executor showed in this ruling that, as of the date of death, the price at which the block could have been sold to the public through an underwriter was expected to be less than the current quoted market price. The ruling notes that, in such a situation a blockage discount is allowable, citing Treas. Reg. § 20.2031-2(e) (the price at which the stock could be sold through, rather than to, an underwriter may be a more accurate indication of value than market quotations). This indicates that the relevant figure is the price that the public would pay to the underwriter for the stock, and not the price that the underwriter would pay the estate. Accordingly, underwriting fees should not be considered in determining the blockage discount. However, the underwriting fees are deductible under § 2053 of the Code as administration expenses if the sale through an underwriter was necessary to administer the estate.

The issue was again revisited in *Gillespie, III v. U.S.,* 73 AFTR 2d 94-2374 (2d Cir. 1994). In this case, the Court of Appeals upheld the district court decision that, when calculating the fair market value of a large block of stock, the estate cannot subtract underwriting and registration expenses of a hypothetical offering from the stock's price. Therefore, the fair market value of a large block of stock held by an estate is its market price at date of death, minus a blockage discount, without further reduction for hypothetical underwriting fees and other sale-related expenses. Estates can deduct actual underwriting fees as administration expenses under Code § 2053(a)(2). The Court further concluded that the position articulated by the IRS in Revenue Ruling 83-30 was not unreasonable or inconsistent with any provision of the Code. *See also Rifkind v. United States*, 54 AFTR 2d 84-6453 (Ct. Cl. 1984).

B. Claims Against an Estate

A key case regarding the valuation of a claim against an estate under Code § 2053 is *Estate* of *Van Horne v. Commissioner*, 78 T.C. 728 (1982). In this case, the decedent was obligated to pay a monthly sum to her former husband for the remainder of his life. The decedent's ex-husband properly filed his claim against the decedent's estate, and the claim was approved by the probate court. The decedent's ex-husband died seven months after the decedent, thus extinguishing the estate's obligation after only seven payments. His early death was unexpected at the time of her death. The Tax Court held that the obligation was fully

enforceable as of the date of decedent's death, and the estate is entitled to a deduction for the actuarial value of the debt computed without regard to events occurring subsequent to the date of death.

On the other hand, uncertain and contingent claims must be discounted in order to value them under § 2053. *See, e.g*., Priv. Ltr. Ruls. 9321004 and 9152005. In the case of a claim that is potential or contingent on the date of the decedent's death, the claim must become certain and be asserted before the end of a reasonable period of administration. *See Estate of Theis v. Commissioner*, 81 T.C. 741 (1983).

In *Estate of Algerine Smith*, 108 T.C. 41 (1997), the Tax Court was faced with two issues. The first was whether the decedent's estate was entitled to a deduction under § 2053(a)(3) in the amount reported on the estate tax return for a claim launched against the estate by Exxon for $2,482,719, or whether it was entitled to a deduction in the amount ultimately paid to Exxon in settlement of the claim which was $681,840. Second, the court had to decide whether the income tax benefit derived by the estate as a result of the application of Code § 1341(a) is an asset includable in the decedent's gross estate.

The estate argued it should be entitled to a deduction under § 2053 for the entire amount reported on the estate tax return, based on the theory that post-death events may not be considered in determining the valuation of a decedent's estate. Although the court agreed that post-death events may not be considered where the valuation of a claim is valid and fully enforceable at the time of decedent's death, the court held that post-death events warrant consideration where the decedent's creditor has only a potential, unmatured, contingent, or contested claim that requires further action before it becomes a fixed obligation of the estate. The court found that the estate's liability was uncertain and relied on the Ninth Circuit's acknowledgment in *Propstra* that "the law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims." Accordingly, the Tax Court in *Smith* concluded that the estate's § 2053 deduction was limited to the amount ultimately paid in settlement of Exxon's claim.

The fact that the estate ultimately paid restitution to Exxon on royalties previously included in the decedent's income entitled the estate to relief under § 1341(a) for re-payment of amounts previously taken into income under a claim of right. The Tax Court found that the facts giving rise to the estate's § 2053 deduction and its right to § 1341 relief were "inextricably linked." The court concluded that under such circumstances it would be inappropriate to consider one in the determination of the decedent's taxable estate while excluding the other. As a result, the court ruled that the taxable estate must be increased by the amount of § 1341 relief that is attributable to the amount the estate paid to Exxon in settlement of its claim.

The Fifth Circuit held on appeal, in *Estate of Algerine Smith v. Commissioner*, 198 F. 3d 515 (5th Cir. 1999), that claims in dispute at the time of death are to be valued without consideration of post-death events. Therefore, Exxon's claim had to be valued as of the decedent's death and had to be appraised on information known or available up to, but not after, that date. At the same time, the Fifth Circuit expressed its belief, based on the facts, that the estate was not entitled to deduct the full amount that was being claimed by Exxon at the date of death. On remand to the Tax Court, the estate once again argued that it was entitled to deduct the entire amount that Exxon had originally sought and did not present other evidence supporting the value it advocated. The IRS, on the other hand, supplied the Tax Court with evidence of pre-death facts and occurrences, supporting the IRS's value of the Exxon claim. Evaluating the evidence, the Tax Court determined that the date of death value of the claim was $681,840 as contended by the IRS. *Estate of Algerine Smith*, T.C. Memo. 2001-303 (2001).

The IRS has stated it will follow *Smith* only in cases appealable to the Fifth Circuit in its Action on Decision 2000-004, stating that every court, except the Fifth Circuit, has addressed the § 2053(a)(3) issue where the claim is contested, contingent, or unenforceable on the

date of death and has considered post-death events in determining the allowable deduction. *See Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982) (holding the law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims under § 2053). *But see O'Neal v. United States,* 258 F.3d 1265 (11th Cir. 2001); *McMorris Estate v. Commissioner*, 243 F.3d 1254 (10th Cir. 2001).

Therefore, if claims are made on or prior to a decedent's death and are subsequently settled by the estate for a lesser amount, the Service will consider post-death events in valuing the deduction, except perhaps in the Fifth Circuit. Furthermore, if the facts surrounding and supporting such claim for deduction also involve repayment of income taken under a claim of right, the combination of these circumstances will necessarily result in the creation of an asset under § 1341(a) which inures to the estate and increases its value. The end result in such situations is a netting of tax benefits through a set-off of the value of the § 2053 deduction and the corresponding credit arising under § 1341(a).

VII. CONCLUSION

A. Plan Ahead

Factors affecting the valuation of assets for transfer tax purposes can produce both advantages and disadvantages. Therefore, it is critical that the estate plan not only focus on the "discount" and resulting tax savings but on the impact the structure will have on the overall estate plan. It has been demonstrated above that discount factors could adversely affect the marital and charitable deductions, the income tax basis adjustment, and the fairness of the asset distributions.

Additionally, the executor and trustee in charge of administering an estate plan should carefully consider the distribution program in order to assure that adverse tax and equity consequences do not occur.

B. Drafting

The taxpayer should consider whether the fiduciaries in charge of his or her estate administration should have discretion in funding distributions from the estate or trust. Specific directions that eliminate discretion may assure that the marital and charitable deduction gifts are maximized. Also, specific instructions might well eliminate equitable adjustment issues and enhance the orderly administration of the estate.

On the other hand, discretion of the fiduciaries allows them to be flexible in the administration of the estate. Flexibility is often important because of changed circumstances between the date the estate plan is crafted and the date it is administered. The client should consider exculpatory provisions to protect the fiduciaries in the exercise of this discretion. These protective provisions should address tax questions as well as differing values that might be argued by the beneficiaries.

C. Unintended Results

One must be careful in the pursuit of the discount. Too aggressive "trashing" of the economic interest passing to the beneficiaries will give the Internal Revenue Service the opportunity to argue that the transfer is not complete or that it does not qualify for other favorable treatment. *See Hackl v. Commissioner*, 118 T.C. No. 14 (March 27, 2002).

D. Beneficiary Participation

It is important to have a funding agreement to memorialize the various post-mortem distributions which were made. This is particularly important when issues regarding valuation discounts are present. Either because of the personalities involved or because of the size and complexity of the estate, it is often preferable to have a written memorial to document the closure and distribution of a trust or estate. The document should clearly set forth who was involved in the decisions, what decisions were considered, what information was available to make the decisions, and what decisions were made and why. A good source for guidance on this subject is David P. Hassler's excellent article and forms in the State Bar of Texas 2001 Advanced Drafting-Estate Planning and Probate Course, Article 13, entitled "Drafting Comprehensive Estate Closure and Distribution Memos."