COMMENTS

HAS THE IRS GONE TOO FAR WITH ITS ALTERNATE VALUATION DATE PROPOSED REGULATIONS?

by
Skye Christakos[*]

The alternate valuation method under section 2032 of the Internal Revenue Code can rescue an estate from a drastic market decline and it can save an estate money, even when the market is fine. Although the election is always available for estates that meet the criteria, in a declining market, the alternate valuation date can likely reduce tax obligations more than in a steady or increasing market. Following a recent Tax Court decision, the IRS proposed new regulations to reinterpret the valuation rules for estates electing the alternate valuation date. The IRS's stated purpose in promulgating the proposed regulations was to clarify that the alternative valuation date was to be used in the case of a reduction in the value of the gross estate due to market conditions following the date of the decedent's death, but not due to other post-death events. This Comment analyzes why the proposed regulations, though aimed at the reasonable goal of reducing abuse, fail to meet the stated objectives. In addition, the proposed regulations eliminate many of the benefits of the alternate valuation election. By completely reinterpreting the section, the proposed regulations not only confuse the issue, but they eviscerate the entire purpose behind the election. The IRS should either drastically change the proposed regulations or eliminate them completely to save itself from needless litigation over the meaning, validity, and application of the new regulations. The most effective change would be to alter the current regulations' sections on dispositions.

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I. INTRODUCTION ... 492
II. THE PAST: THE HISTORY OF SECTION 2032 ... 495
III. THE PRESENT: THE PROPOSED REGULATIONS ... 498
IV. PRIOR INTERPRETATIONS: CASE LAW AND PRIOR REGULATIONS ... 499
V. THE FUTURE: THE HAVOC THAT THE PROPOSED REGULATIONS WILL CREATE ... 504
  A. *The Regulations Create Confusion by Introducing New Terms* ... 505
  B. *The Regulations Fail to Overturn* Kohler ... 507
  C. *The Regulations Sweep Too Broadly* ... 509
  D. *The Regulations Provide an Unworkable Solution* ... 511
  E. *The Regulations are Inconsistent with Section 2032* ... 511
VI. POSSIBLE SOLUTIONS: WAYS TO FIX OR CHANGE THE PROPOSED REGULATIONS ... 514
VII. CONCLUSION ... 516

I. INTRODUCTION

Taxpayers are always looking to save money. This is especially important now, when the United States, and much of the world, is in a recession.[1] Estate taxes,[2] at a tax rate of 35%,[3] are a large liability. For an estate suffering from a decrease in value, the use of the six month alternate valuation date can mean a large tax savings. When the market is healthy, taxpayers still use the alternate valuation election to reduce tax liabilities through a variety of techniques: some legitimate, some abusive.

The alternate valuation date can rescue an estate from a drastic market decline, and it can save an estate money, even when the market is fine. Although the election is always available for estates that meet the criteria, in a declining market, the alternate valuation date can likely reduce tax obligations more than in a steady or increasing market.[4] The

[1] In 2008, the stock market dropped dramatically, making 2009 the third worst stock market year in history. Mark Davis, *2008 Finishes As the Third-Worst Stock Market Year in History*, KAN. CITY STAR, Jan. 1, 2009, *available at* http://www.istockanalyst.com/article/viewiStockNews/articleid/2918185 (explaining that Standard & Poor's stock index fell 38.5% in 2008 and Dow Jones stock index fell 33.8% that year).

[2] The proposed regulations were promulgated in 2009, prior to the changes to the tax system in 2010. Although the United States temporarily had no federal estate tax, which was then reinstated and made retroactive to January 1, 2010 (Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296, H.R. 4853 (Dec. 17, 2010), the proposed regulations are still valid and may be enacted to effect the federal estate tax as it stands now. Since the major changes in the tax system have not affected the proposed regulations, this Comment approaches the estate tax from the 2009 perspective.

[3] I.R.C. § 2001(c)(2006) (decreasing tax rate to 35% for 2011–2012).

[4] For a look at both the benefits and downsides of alternate valuation, see generally Jonathan G. Blattmachr & Alvina H. Lo, *Alternate Valuation—Now, Perhaps, More Important Than Ever*, 111 J. TAX'N 90 (2009).

Internal Revenue Code imposes a tax on the transfer of the taxable estate of every decedent who is a U.S. citizen or resident.[5] Section 2031[6] specifies that the decedent's gross estate is valued at the date of the decedent's death and includes "all property, real or personal, tangible or intangible, wherever situated."[7] However, the decedent's estate, if qualified, can elect the alternate valuation date under section 2032.[8] Normally, that alternate valuation date is six months after the decedent's date of death.[9] However, if the property is "distributed, sold, exchanged, or otherwise disposed of" within that six months, the valuation date is the date of the "distribution, sale, exchange, or other disposition."[10] As a result, in declining market conditions, the section 2032 election can be extremely beneficial to an estate that has experienced a decrease in value from the date of the decedent's death.

To qualify for the election, the taxpayer must show that both the value of the gross estate and that of the federal estate tax will have decreased as of the alternate valuation date.[11] Once made, the election applies to all of the property of the gross estate.[12]

The predecessor to the current section 2032 was originally introduced to deal with the significant decline in estate values during the Great Depression.[13] Following a recent Tax Court decision to which the Internal Revenue Service (IRS) nonacquiesced,[14] the IRS proposed new regulations to reinterpret the valuation rules for estates electing the alternate valuation date.[15] These new regulations reinterpret the meaning of section 2032 in an effort to avoid taxpayer abuse of the alternate valuation date election.

Part II of this Comment will examine the background of section 2032: when it was introduced, what its original intent was, and its current status among estate planning professionals. The legislative history of section 2032 indicates what Congress originally intended section 2032 to achieve. As discussed in Part III, the proposed regulations imply that,

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[5] I.R.C. § 2001.

[6] All section references are to the Internal Revenue Code, unless otherwise indicated.

[7] I.R.C. § 2031(a).

[8] *Id.* § 2032.

[9] *Id.* § 2032(a).

[10] *Id.* § 2032(a)(1).

[11] *Id.* § 2032(c).

[12] Treas. Reg. § 20.2031-1(b) (2009).

[13] Prop. Treas. Reg. § 20.2032, 73 Fed. Reg. 22,300, 22,301–02 (Apr. 25, 2008) [hereinafter Prop. Treas. Reg. Preamble] (introducing proposed rulemaking REG-112196-07).

[14] The IRS nonacquiesces in a case to show that it has adopted a "policy of declining to be bound by lower-court precedent that is contrary to the agency's interpretation of its organic statute, but only until the Supreme Court has ruled on the issue." BLACK'S LAW DICTIONARY 1149 (9th ed. 2009).

[15] Prop. Treas. Reg. § 20.2032-1(f)(1), 73 Fed. Reg. at 22,300–03.

based on legislative history, only decreases in market value were meant to be allowed at the alternate valuation date.[16] Although prompted by the drastic market decline in 1929, Congress never meant for section 2032 to be limited specifically to one type of decline in value.

Part III of this Comment will examine the proposed regulations. The IRS's stated purpose in promulgating the proposed regulations is "to clarify that the election to use the alternate valuation method under section 2032 is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market conditions, but not due to other post-death events."[17] Part III will also examine the potential effects of the proposed regulations on estate planning if such regulations were to go into effect as-is, disregarding the many comments and needed clarification.

Part IV of this Comment will examine the significant cases and prior regulations that have analyzed section 2032 since its original inception. The IRS interprets the outcomes of *Flanders v. United States*[18] and *Kohler v. Commissioner*[19] as contradictory and attempts to eliminate that contradiction through the proposed regulations. However, by looking at more of the cases that have shaped the current approach to alternate valuation, it is possible to see that the cases can be aligned without needing the proposed regulations to reinterpret the entire Code section.

Part V of this Comment will analyze why the proposed regulations, though aimed at the reasonable goal of reducing abuse, fail to meet the stated objectives. In addition, the proposed regulations eliminate many of the benefits of the alternate valuation election. By completely reinterpreting the section, the proposed regulations not only confuse the issue, but they eviscerate the entire purpose behind the election. Other problems will also be discussed, including a confusing contradiction created by the proposed regulations in regard to stock dividends[20] and general confusion regarding new terms introduced in the proposed regulations.[21] Part V will also discuss that the outcome in *Kohler*, despite

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[16] Prop. Treas. Reg. Preamble, *supra* note 13.

[17] *Id.* at 22,302.

[18] 347 F. Supp. 95 (N.D. Cal. 1972).

[19] T.C.M. (RIA) 1038 (2006).

[20] *Compare* Treas. Reg. § 20.2032-1(d)(4) (2010), *with* Prop. Treas. Reg. § 20.2032-1(f)(1), 73 Fed. Reg. at 22,302.

[21] *See* Robert D. Borteck, *Postmortem Entity Discounts Using Alternate Valuation*, 120 TAX NOTES 323, 328 (2008) ("[T]he new term 'market conditions' has an uncertain meaning, particularly when considered in juxtaposition with the longstanding concept of fair market value."); W. Bjarne Johnson, *Trust and Estate Lawyers Recommend Changes to Proposed Regs on Alternate Valuation Method Election*, TAX NOTES TODAY, Aug. 12, 2008, LEXIS, 2008 TNT 156-14 (2008) (requesting a definition of "outside the control" because it is amorphous and overbroad); Kathleen M. Martin, *ABA Members Comment on Proposed Regs on Alternate Valuation Method Election for Estates*, TAX NOTES TODAY, July 25, 2008, LEXIS, 2008 TNT 144-14 (2008) (requesting changes in term "market conditions" for better clarity and requesting clarification of the language "or other person whose property is being valued"); William J. Wilkins,

prompting the proposed regulations, would not be affected by the suggested changes.

Part VI will look at possible changes and alternatives to the proposed regulations. The IRS should either drastically change the proposed regulations or eliminate them completely to save itself from needless litigation over the meaning, validity, and application of the new regulations. The most effective change would be to alter the current regulations' sections on dispositions.

This Comment is meant to focus on the various negative effects the proposed regulations would have on all areas of estate law.[22] As they are written, the proposed regulations cause more harm than good and should be corrected to address abusive situations and not solely market conditions.

II. THE PAST: THE HISTORY OF SECTION 2032

Originally, a decedent's gross estate was always valued as of the decedent's date of death. However, in 1929 the stock market crashed, sending estate values through the floor. As a result, taxes potentially swallowed estates that were worth far less when it came time to pay taxes than they had been as of decedent's date of death. Many estates had decreased in value so much that they were entirely consumed by tax obligations.[23]

In order to eliminate this problem, Congress enacted section 2032 in 1935.[24] The House suggested a one-year-later alternate valuation date.[25]

ABA Tax Section Members Comment on Proposed Regs on Alternate Valuation Method Election, TAX NOTES TODAY, Aug. 12, 2008, LEXIS, 2008 TNT 156-15 (2008) (requesting clarification of term "outside of the control of" with respect to how control should be determined and with respect to who may exercise control, as well as clarification of term "post-death events" to exclude certain events that although within control of an executor, trustee, or other person, may appropriately be treated as market conditions).

[22] Alternate valuation is especially important when it comes to post-mortem entity discounts, an increasingly important area of law. Post-mortem entity discounts allow the valuation of a minority share of a closely-held company to be valued lower than its pro rata share through discounts for lack of marketability and control. These discounts can offer significant tax savings. Although this Comment will touch on that topic, it is not intended to be a comprehensive examination of the issue. For a thorough examination of the topic and how the proposed regulations apply in a specific example see Borteck, *supra* note 21, at 323–31 (explaining effects of current section 2032 on a real life example and how proposed regulations would change the outcome).

[23] *See* Maass v. Higgins, 312 U.S. 443, 446 (1941).

[24] Section 2032 was originally known as section 302(j) of the Revenue Act of 1926, Pub. L. No. 69-20, 44 Stat. 9 (1926), as amended by Revenue Act of 1935, Pub. L. No. 75-407, § 202, 49 Stat. 1014, 1022 (1935), repealed by Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 3, 730 (1955), repealed by Tax Reform Act of 1986, Pub. L. No. 99-514, § 2, 100 Stat. 2085, 2095 (1986).

Intended to address the shrinkage-in-value problem, the amendment was meant to allow an election of a later valuation date after values declined to prevent the estate from paying taxes on assets that no longer had the same value as they did at the decedent's date of death.[26] Clearly, Congress wanted to help estates find relief from post-mortem decreases in the value of estate property as a result of the declining stock market.[27]

However, when the alternate valuation date was proposed, no mention was made of confining the election to value changes stemming merely from overall market decline.[28] The statute explicitly excepted changes in value due to "mere lapse of time" from being valued as of the alternate valuation date.[29] Additionally, the statutory section allowed for a different date of valuation if the property was distributed, sold, exchanged, or otherwise disposed of, but no other restrictions were placed on the alternate valuation date election.[30] Declining market value may have been the impetus for proposing an optional valuation date[31] but was not the sole factor in allowing the election or even mentioned in the text of the amendment itself.[32] In fact, the amendment was meant "[t]o prevent any undue hardship [to an estate] arising from a decline in value after the date of death . . . ."[33] In other words, the amendment was meant "to ensure equitable treatment of estates when the value of property in the gross estate drops dramatically after the decedent's death."[34]

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[25] H.R. REP. NO. 74-1885, at 10 (1935) (Conf. Rep.) ("In lieu of this [deduction] provision, the conference action inserts a provision giving the executor an election with respect to the time as of which the property included in the gross estate is to be valued. Under existing law the valuation is made as of the date of death. If the executor exercises the election given him by the conference agreement, all the property included in the estate on the date of death is to be valued as of the date 1 year after the decedent's death, except that the value (at the time of distribution, sale, exchange, or other disposition) of property distributed, sold, exchanged, or otherwise disposed of, is taken in lieu of its value as of 1 year after death.").

[26] *See Maass,* 312 U.S. at 446 ("It is agreed that the purpose of [the alternate valuation section] was to mitigate the hardship consequent upon shrinkage in the value of estates during the year following death."); *see also* S. REP. NO. 74-1240, at 8–10 (1935).

[27] *See* S. REP. NO. 74-1240, at 9; *see also* 79 CONG. REC. 14,632 (1935) (statement of Samuel B. Hill) (discussing hardships arising from sudden decline in market values).

[28] H.R. REP. NO. 74-1681, at 9 (1935).

[29] Revenue Act of 1935, Pub. L. No. 75-407, § 202(a), 49 Stat. 1014, 1023 (1935).

[30] *Id.*

[31] "Optional valuation" was renamed "alternate valuation" when section 2032 recodified section 811(j) in 1954. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 2032, 68A Stat. 3, 381 (1955). This Comment uses the terms interchangeably.

[32] § 202(a), 49 Stat. at 1022–23.

[33] H.R. REP. NO. 74-1681, at 9.

[34] Martin, *supra* note 21.

The section was recodified in the Code of 1939, becoming section 811(j), and became section 2032 in 1954.[35] No substantive changes were made in these recodifications,[36] although the 1954 change reiterated that "[t]he option to value property a year after death initially was provided during the depression of the early 1930s because by the time estate taxes were paid, property values had dropped substantially . . . ."[37]

Since being codified at section 2032, the alternate valuation provision has been amended twice. In 1970, Congress decreased the time limit for filing estate tax returns from 15 months after the date of decedent's death to nine months.[38] This was intended to facilitate faster distribution of decedent's property to beneficiaries and to ensure that the government received its taxes sooner.[39] As a result, the alternate valuation date had to occur before the estate tax return was due and was therefore shortened from one year to six months.[40]

Section 2032 was amended again in 1984. Congress added subsection (c) to allow the election only if both the value of the gross estate and the estate tax were reduced.[41] The amendment was meant to prevent taxpayers from making the alternate valuation election merely to increase the income tax basis of the estate assets.[42] Prior to the amendment in 1984, in situations where the gross estate was below the estate tax threshold,[43] the taxpayer could increase basis without increasing (or triggering) estate tax because of the corresponding increase in the unlimited marital deduction.[44] Throughout the legislative history of the 1984 amendment, Congress continued to emphasize its commitment to the equitable purpose of alternate valuation.[45] Declining market conditions, and market conditions in general, are not mentioned as a reason for the provision.[46] Nowhere in the legislative history is there an affirmative statement that any decline in value should be taken into

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[35] Prop. Treas. Reg. § 20.2032-1(f)(1),73 Fed. Reg. 22,300, 22,301 (Apr. 25, 2008).

[36] *See* H. R. REP. NO. 74-1885 (1935), 1939-1 (pt. 2) C.B. 660, at 663–64 (1935); H.R. REP. NO. 83-1337, at 90 (1954).

[37] H.R. REP. NO. 83-1337, at 90.

[38] S. REP. NO. 91-1444, at 5–6 (1970).

[39] *Id.* at 5.

[40] Excise, Estate, and Gift Tax Adjustment Act of 1970, Pub. L. No. 91-614, § 101(a)(1), 84 Stat. 1836, 1836 (1970).

[41] I.R.C. § 2032(c) (2006).

[42] *See* STAFF OF J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 1121 (Comm. Print 1984) (increasing income tax basis allowed beneficiary to reduce capital gain on subsequent sale of property to a third party).

[43] I.R.C. § 2010(c).

[44] Martin, *supra* note 21.

[45] H.R. REP. NO. 98-432, at 1521 (1983) (stating that purpose of provision is to provide "relief for estate tax purposes where the value of the property decreased after death so that estate taxes are not inordinate.").

[46] Martin, *supra* note 21.

account under the election. This is likely because the assumption was too obvious to state, indicated by the additional absence of any statements in the legislative history for the 1935 enactment that limited the election to market conditions.[47]

III. THE PRESENT: THE PROPOSED REGULATIONS

The proposed regulation is meant to "clarify that the election to use the alternate valuation method under section 2032 is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market conditions, but not due to other post-death events."[48]

The IRS, in the preamble to the proposed regulations, lays out a history of section 2032 and a discussion of several cases that have interpreted the section.[49] The narrative history is selectively culled to emphasize only the weight placed on market conditions by the legislative history and case law.

The proposed regulation begins by stating:

> The election to use the alternate valuation method under section 2032 permits the property included in the gross estate to be valued as of the alternate valuation date to the extent that the change in value during the alternate valuation period is the result of market conditions. 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.[50]

To clarify post-death events further, the proposed regulations elaborate that "any interest or estate affected by post-death events, other than market conditions, is included in a decedent's gross estate under the alternate valuation method at its value as of the date of the decedent's death, with adjustment for any change in value that is due to market conditions."[51] Although convoluted, by this, the IRS appears to mean any events within the control of the decedent. Additionally, the proposed regulation explains "post-death events" as an event that:

> includes, but is not limited to, a reorganization of an entity (for example, corporation, partnership, or limited liability company) in which the estate holds an interest, a distribution of cash or other

[47] *See* H.R. REP. NO. 74-1681, at 9; S. REP. NO. 74-1240, at 8–10; *see also* 79 CONG. REC. 14,632 (1935) (statement of Samuel B. Hill) (making only statement regarding hardships arising from sudden decline in market values, but not limiting election to that purpose).

[48] Explanation of Prop. Treas. Reg. § 20.2032-1(f), 73 Fed. Reg. 22,300, 22,302 (Apr. 25, 2008) (explaining provisions).

[49] Prop. Treas. Reg. Preamble, *supra* note 13, at 22,301–02.

[50] Prop. Treas. Reg. § 20.2032-1(f)(1), 73 Fed. Reg. at 22,302.

[51] *Id.* § 20.2032-1(f)(3)(i), 73 Fed. Reg. at 22,302.

property to the estate from such an entity, or one or more distributions by the estate of a fractional interest in such entity.[52]

Next, the proposed regulations include five examples to explain how to apply the new standard.[53] Example 1 is a post-mortem reorganization of a C corporation.[54] Example 2 reuses the same facts as Example 1, but adds in a declining stock value during the alternate valuation period due to "changes in market conditions."[55] Example 3 discusses post-mortem formulation of closely held entities among the estate and family members.[56] Example 4 involves an estate distributing interests of an LLC to different beneficiaries on different dates to take advantage of minority discounts.[57] Example 5 demonstrates that post-mortem distributions through testamentary trusts of a property, Blackacre, are treated similarly to the distributions of the LLC in Example 4.[58] These examples emphasize the point that no reorganizations, distributions, or post-mortem entity discounts, such as lack of marketability or control, will be allowed. As a result, the alternate valuation date is limited to a much smaller subset of situations, reducing its usefulness to an estate.

IV. PRIOR INTERPRETATIONS: CASE LAW AND PRIOR REGULATIONS

The IRS includes only three cases in its discussion of the history of section 2032 in the preamble of the proposed regulations.[59] Because the regulations so limit their review of case law, this Comment does so too. This section will examine the cases mentioned in the proposed regulations and find a cohesive theory for the various outcomes.

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[52] *Id.*

[53] *Id.* § 20.2032-1(f)(3)(ii), 73 Fed. Reg. at 22,302–03.

[54] *Id.* (refusing to allow taxpayer to take discounts for lack of marketability and lack of control).

[55] *Id.* at 22,303 (permitting state to use alternate valuation for changes in market condition, rather than any discounts resulting from reorganization).

[56] *Id.* (refusing to allow discounts for lack of marketability and lack of control because reduction in value not attributable to market conditions).

[57] *Id.* (valuing each distribution on its distribution date, but not allowing discounts for lack of marketability or control in valuation on distribution date). The remaining interest held by the estate was valued on the alternate valuation date, but was also prevented from using lack of marketability and control discounts. *Id.* However, if the distributions had lost value because of market conditions, the distributions or the estate could take that reduction in value into account. *Id.*

[58] *Id.* (valuing property shares as of distribution date, without allowing for lack of marketability or control deductions, and stating that had property declined in value due to real estate market conditions, then that reduction in value would be allowed).

[59] Prop. Treas. Reg. Preamble, *supra* note 13, at 22,301–02 (citing *Maass v. Higgins*, 312 U.S. 443 (1941), *Flanders v. U.S.*, 347 F. Supp. 95 (N.D. Cal. 1972), and *Kohler v. Comm'r*, T.C.M. (RIA) 1038 (2006)).

First, the proposed regulations mention *Maass v. Higgins*.[60] Though the issue before the *Maass* Court was not the direct issue raised by the proposed regulations, the Court did discuss the original purpose of then section 811(j).[61] The Court determined what method of valuation to use for property not in existence as of the decedent's date of death. Without any real mention of the legislative history when the section was enacted, the Court determined that "[i]t is agreed that the purpose of subdivision (j) was to mitigate the hardship consequent upon shrinkage in the value of estates during the year following death."[62] No mention of "market conditions" is present in the case.

The regulation glosses over *Maass* in the preamble, and it relies most heavily on *Flanders v. United States*[63] (a district court case out of California from 1972) and *Kohler v. Commissioner*[64] (a Tax Court memorandum opinion).[65]

In *Flanders*, the estate held in trust an undivided one-half interest in a ranch.[66] The trustee, during the alternate valuation period, voluntarily agreed to restrict the use of the property for ten years under the California Land Conservation Act of 1965, which reduced property taxes.[67] This drastically decreased the decedent's value in the undivided interest.[68] The estate further reduced the value based on a lack of marketability discount.[69] The court upheld the IRS's argument that the post-mortem restrictions added by the conservation agreement should be ignored for valuation of the estate.[70] In so holding, the court examined the legislative history of section 2032 and determined that the history indicated that the section considered only changes in value on the alternate valuation date as those caused by "market conditions (as distinguished from voluntary acts changing the character of the

[60] 312 U.S. 443, 449 (1941) (holding that post-mortem rents, dividends, and interest are not to be includable in decedent's gross estate).

[61] *Id.* at 446.

[62] *Id.*

[63] 347 F. Supp. 95. (N.D. Cal. 1972).

[64] T.C.M.(RIA) 1038 (2006). Tax court memorandum opinions are usually cases that involve "application of familiar legal principles to routine factual situations, nonrecurring or enormously complicated factual situations, obsolete statutes or regulations, straightforward factual determinations, or arguments patently lacking in merit . . . ." Mary Ann Cohen, *How to Read Tax Court Opinions*, 1 HOUS. BUS. & TAX L.J. 1, 7 (2001). Memorandum opinions are not considered as precedential as published Tax Court opinions or division opinions. *Id.* at 7–10.

[65] Prop. Treas. Reg. Preamble, *supra* note 13, at 22,301–02.

[66] *Flanders*, 347 F. Supp. at 96.

[67] *Id.*

[68] *Id.* (calculating loss at 88% of the value, having dropped from $220,000 to $30,000).

[69] *Id.* (reducing the value again to $25,000).

[70] *Id.* at 99.

property) . . . ."[71] This test appears to be what the IRS bases its "market conditions" standard on in the proposed regulations.[72]

The *Flanders* decision appears to be based entirely on one remark made to the House floor by the House manager that an alternate valuation period "would eliminate many of the hardships which were experienced after 1929 when market values decreased very materially between the period from the date of death and the date of distribution to the beneficiaries."[73] Although, as explained earlier, one of the purposes behind enacting an optional valuation period was to protect estates from sudden market drops, it was not the only reason behind the enactment of the section.[74]

The *Flanders* decision appears to be the main support offered by the IRS for the proposed regulations. For a district court to make a determination based on only one statement of legislative history is bad enough, but for the IRS to, as one commenter put it, "derive from it an absolute rule that the only changes in value that can be considered under the alternate valuation method are those caused by market forces" is making too much of both the statement and the court decision.[75]

However, in *Kohler*, the Tax Court did not follow the dubious precedent set by *Flanders* in valuing post-reorganization stock.[76] The stock being considered was that of a privately held family business, Kohler Company (Kohler Co.), with substantial assets.[77] Kohler Co. started its reorganization before the decedent's death "to remove the outside shareholders, facilitate estate planning, give later generations a vote on company matters, and ensure that later generations would be able to take control when necessary."[78] During the tax-free, section 368(a) reorganization, new classes of stock were created that had various voting rights and dividend preferences, to replace the old shares of common stock.[79] Family members could trade old common stock shares for cash or a combination of voting and nonvoting stock, subject to transfer

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[71] *Id.*

[72] Prop. Treas. Reg. § 20.2032-1(f)(1), 73 Fed. Reg. 22,300, 22,302 (Apr. 25, 2008) ("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.").

[73] *Flanders*, 347 F. Supp. at 98 (citing 79 CONG. REC. 14,632 (1935) (statement of Samuel B. Hill)).

[74] *See supra* Part II (elaborating that Great Depression market conditions were reason for proposing alternate valuation date, but market conditions were not sole purpose for protections of alternate valuation date).

[75] Phillip H. Martin & Nathan Honson, *Law Firm Questions Need for Proposed Regs on Alternate Valuation Method Election*, TAX NOTES TODAY, Oct. 9, 2008, LEXIS, 2008 TNT 197-13 (2008).

[76] Kohler v. Comm'r, T.C.M. (RIA) 1038, 1052 (2006).

[77] *Id.* at 1040.

[78] Martin, *supra* note 21 (summarizing facts of *Kohler* case).

[79] *Kohler*, T.C.M. (RIA) 2006-152 at 1042.

restrictions and purchase options.[80] Non-family members could receive cash for each share or exercise dissenter's rights, but could not accept new shares.[81] The decedent, a family member, died prior to the completion of the reorganization.

The decedent did not have a controlling interest in the company, owning only 12.85% of the pre-reorganization voting stock.[82] The decedent (or the estate) could not have blocked or approved the reorganization on its own. Therefore, the estate's only option was to either accept the new shares offered or cash out at $52,700 per share.[83] After the reorganization, the estate owned a larger percentage of the company; but at only 14.45%, the estate still did not have the power, according to the court, to "change management, change the board of directors, or amend the articles of incorporation."[84] The executor of the decedent's estate elected the alternate valuation date, which was after the reorganization was completed. The estate's shares of the reorganized stock were appraised by their experts at approximately $50 million on the date of death and $47 million as of the alternate valuation date.[85] The IRS determined a deficiency, due to their expert's appraisal of decedent's stock at $144.5 million as of the alternate valuation date.[86]

On appeal, the court summarized the IRS's argument to be that the court "should value the pre-reorganization stock on the alternate valuation date, or, alternatively, . . . ignore the transfer restrictions and the purchase option in valuing the post-reorganization stock."[87] The IRS could not argue that the reorganization was a distribution because the parties stipulated that the reorganization was a tax-free reorganization, which is specifically exempted from being considered a distribution.[88] The court held that the fair market value of Kohler Co.'s stock[89] on the

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[80] *Id.*

[81] *Id.*

[82] *Id.*

[83] *Id.* Before the reorganization, the estate owned 975 shares of Kohler Co. stock. *Id.* at 1040. At $52,700 a share, the estate's cash out value would have been $51,382,500 (not calculated out by the court). The court in *Kohler* valued the estate's post-reorganization stock at $47,009,625, more than $100 million less than the IRS's valuation of the stock at $156 million. *Id.* at 1049–50. The cash out value that the estate could have elected to receive (against the wishes of the beneficiaries) was close to the estimated (by the estate's appraisers) date of death value of $50.11 million. *Id.* at 1043.

[84] *Id.* at 1042–43.

[85] *Id.* at 1043. *See also id.* at 1050 (finding estate's experts to be "thoughtful and credible").

[86] *Id.* at 1043. *See also id.* at 1048–50 (expressing "grave concerns" about valuation methods and conclusions of IRS's expert).

[87] *Id.* at 1045.

[88] Treas. Reg. § 20.2032-1(c) (2010).

[89] Fair market value is defined as "the price at which property would change hands between a willing buyer and a willing seller, neither being under any

alternate valuation date was the correct value, which was its post-reorganization value, "including the transfer restrictions and the purchase option."[90] The court's analysis was based on subsection (c) of the current regulations: A section 368(a) tax-free reorganization is not considered a distribution, exchange, sale, or other disposition under section 2032(a).[91] Because the reorganization was exempted from being a distribution (which would have triggered valuation as of the date of distribution),[92] the estate could elect alternate valuation.

The court refused to follow *Flanders*, as proposed by the IRS, and stated that the statute was not ambiguous and that there was no need to look to legislative history.[93] Additionally, the court found the regulation was "consistent with the legislative history relied on by the District Court in [*Flanders*] because the legislative history describes the general purpose of the statute, not the specific meaning of 'otherwise disposed of' in the context of tax-free reorganizations."[94]

After *Kohler* was decided for the taxpayer, the IRS nonacquiesced in the Tax Court opinion.[95] Shortly after the nonacquiescence, the IRS announced a proposed regulation modifying the existing regulation on section 2032 alternate valuation method.[96] The IRS seemed to feel that *Kohler* was inconsistent with *Flanders* and that this inconsistency required it to issue the proposed regulations and overturn *Kohler*. However, there is a way to see the two cases as embodying the same principles without resorting to the proposed regulations. In a case omitted from the proposed regulations, *Estate of Johnston v. United States*, the court considered *Maass* and the alternate valuation date.[97] Although not on the topic covered in the proposed regulations, the court in *Johnston*

compulsion to buy or to sell and both having reasonable knowledge of the relevant facts." Treas. Reg. § 20.2031-1(b).

[90] *Kohler*, T.C.M. (RIA) 2006-152 at 1047.

[91] Treas. Reg. 20.2032-1(c) ("The phrase 'distributed, sold, exchanged, or otherwise disposed of' . . . does not . . . include an exchange of stock or securities in a corporation for stock or securities in the same corporation or another corporation in a transaction, such as a merger, recapitalization, reorganization or other transaction described in section 368 (a) or 355, with respect to which no gain or loss is recognizable for income tax purposes under section 354 or 355.").

[92] I.R.C. § 2032(a)(1) (2006).

[93] *Kohler*, T.C.M. (RIA) 2006-152 at 1046.

[94] *Id. See also* Treas. Reg. § 20.2032-1(c) (clarifying meaning of "otherwise disposed of" and exempting tax-free reorganizations from being included as a distribution or disposition).

[95] Kohler v. Comm'r, T.C.M. (RIA) 2006-152 (2006), *nonacq.*, AOD 2008-01 (March 3, 2008).

[96] Proposed Treasury Regulation section 20.2032-1(f) was proposed on April 25, 2008, less than two months after the nonacquiescence decision of *Kohler* on March 3, 2008. Kenneth H. Ryesky, *Former IRS Attorney Comments on Proposed Regs on Alternate Valuation Method Election for Estates*, TAX NOTES TODAY, July 3, 2008, LEXIS, 2008 TNT 129-13 (2008).

[97] Estate of Johnston v. United States, 779 F.2d 1123, 1126 (5th Cir. 1986).

emphasized that the question was which arguments were "unreal and artificial and which comport[] with our common understanding."[98] The court underlined the fact that "[t]he alternate valuation date was not enacted to permit an estate to reduce its tax liability by disposing of estate assets."[99] This is effectively an anti-abuse standard.

Avoiding abuse of the alternate valuation period is what the proposed regulations seem to be aimed at, but fail to achieve. In other areas of estate tax disputes, as in *Johnston*, the Tax Court has read into the Code a requirement that an estate's action must have a justifiable and noteworthy non-tax motive.[100] That anti-abuse standard exists in the alternate valuation cases: courts are trying to avoid allowing taxpayers to take voluntary, affirmative actions that lower the estate tax obligation, but have no "legitimate and significant non-tax reason."[101] Just as the court in *Johnston* wanted to avoid any argument that was "unreal and artificial," the court in *Flanders* tried to avoid artificial reductions in asset value during the alternate valuation period.[102]

In *Flanders*, where the taxpayer drastically reduced the value of the land by choosing something that served no real purpose to the estate other than a major reduction in taxes, the court did not support that move.[103] Restricting use of the property for ten years served no real purpose other than reduction of estate taxes. However, in *Kohler*, where the reorganization began even before the decedent's date of death and served a legitimate purpose in removing non-family stockholders, the court approved the estate's valuation as of the alternate valuation date.[104] The cases cited by the preamble can be read as cohesive, if an anti-abuse standard is read-in.

V. THE FUTURE: THE HAVOC THAT THE PROPOSED REGULATIONS WILL CREATE

The IRS, through its proposed regulations, seems to treat any taxpayer who elects an alternate valuation date as trying to cheat the system. This complete reinvention of the alternate valuation election through the proposed regulations has potential value because there is

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[98] *Id.* at 1127.

[99] *Id.* at 1128.

[100] Estate of Mirowski v. Comm'r, T.C.M. (RIA) 381, 396 (2008) (citing Estate of Bongard v. Comm'r, 124 T.C. 95, 118 (2005) (holding that section 2036(a) exception for bona fide sale is satisfied when "the record establishes the existence of a legitimate and significant non-tax reason for creating the family limited partnership")).

[101] *Id. See also* Martin & Honson, *supra* note 75 (suggesting that control test is unworkable and offering alternative test of "legitimate and substantial non-tax purpose").

[102] *Johnston*, 779 F.2d at 1127.

[103] Flanders v. United States, 347 F. Supp. 95, 99 (N.D. Cal. 1972).

[104] Kohler v. Comm'r, T.C.M. (RIA) 1038, 1052 (2006).

likely some abuse of the alternate valuation election. However, the IRS needs to consider whether the proposed regulations, as they stand, are workable or succeed at what the IRS was trying to achieve, because not every alternate valuation election is abusive. In an article discussing the proposed regulations, one commentator said:

> There is no more of an abuse in . . . administer[ing] an estate to take advantage of the relief afforded under section 2032 than it is to . . . administer an estate so as to be able to take advantage of the marital deduction, the charitable deduction, the unified credit and/or any other legitimate tax savings mechanism.[105]

The proposed regulations add several layers of confusion and difficulty in application. The problems with the proposed regulations include: failure to adequately define terms, failure to achieve intended goals, sweeping too broadly, providing an unworkable solution, and most importantly, being inconsistent with section 2032 and existing regulations.

A. *The Regulations Create Confusion by Introducing New Terms*

In the comments produced during the notice and comment period for the proposed regulations, the predominant area of confusion was the introduction of new terms that were not clearly defined or explained. "Market conditions" and "outside the control of" were the most questioned.[106]

The term "market conditions" is both overbroad and uncertain.[107] The proposed definition—"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"[108]—leaves the reader unclear as to what is actually meant to be a market condition. For instance, would control by a taxpayer's close

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[105] Borteck, *supra* note 21, at 330.

[106] *See id.* at 328 ("[T]he new term 'market conditions' has an uncertain meaning, particularly when considered in juxtaposition with the longstanding concept of fair market value."); Johnson, *supra* note 21 (requesting definition of "outside the control" because it is amorphous and overbroad); Martin, *supra* note 21 (requesting changes in term "market conditions" for better clarity and requesting clarification of language "or other person whose property is being valued"); Wilkins, *supra* note 21 (requesting clarification of term "outside of the control of" with respect to how control should be determined and who may exercise control, as well as clarification of term "post-death event[s]" to exclude certain events that, although within the control of an executor, trustee, or other person, may appropriately be treated as market conditions).

[107] The IRS defined the term "market conditions" very broadly: it is everything outside the decedent's, executor's, or trustee's control. Prop. Treas. Reg. § 20.2032-1(f)(1), 73 Fed. Reg. 22,300, 22,302 (Apr. 25, 2008). However, given that the term implies overall market decline, the phrase could be changed for clarity, because market conditions are not limited to only that category.

[108] *Id.*

relatives (such as the family members in the Kohler Co.) or related entities be imputed to the taxpayer? Or would the estate's executor/trustee be the only one considered under the control standard? One commenter suggested that, as defined, the term "market conditions" could eliminate actions that were not meant to be eliminated by the proposed regulations.[109]

By including "events outside of the control of the decedent" in the definition of market conditions, the proposed regulations further confuse the matter.[110] Since the proposed regulations do not include a definition of what constitutes control, the term lends no clarity to "market conditions" nor does it narrow down how control should be determined.[111] The Supreme Court once said a control standard is "so vague and amorphous as to be impossible of ascertainment in many instances."[112] As a result, either the phrase will be given an overly broad reading, or will lead to results inconsistent with the stated purpose of the proposed regulations. At the very least, the proposed regulations should attempt to define what control means, perhaps using a numerical threshold,[113] and should define who can wield control: the estate only or

[109] Martin, *supra* note 21. Martin went on to recommend an alternative definition of market conditions as "all events and forces that affect the fair market value of estate property, excluding, however, events arising solely from action that is controlled and initiated by the decedent (or the decedent's executor or trustee), that is not negotiated at arm's length, that is independent of and not in reaction to market force events, and that artificially reduces the fair market value of the property being valued on the alternate valuation date." *Id.*

[110] Prop. Treas. Reg. § 20.2032-1(f)(1), 73 Fed. Reg. 22,300, 22,302 (Apr. 25, 2008).

[111] *See* Carol A. Cantrell, *CPA Firm Seeks Clarity Under Proposed Regs on Alternate Valuation Method Election*, TAX NOTES TODAY, Sept. 26, 2008, LEXIS, 2008 TNT 188-21 (2008) (expressing concern about a "lack of clarity from the IRS about whether the exercise of an employee stock option, statutory or nonstatutory, within the 6-month alternate valuation date is a post-death event under the new proposed regulations, or rather a disposition, or a mere change in form"); Jeffrey H. Hoops, *AICPA Recommends Changes to Proposed Regs on Alternate Valuation Method Election*, TAX NOTES TODAY, Sept. 3, 2008, LEXIS, 2008 TNT 171-8 (2008) (suggesting that "the focus on the term 'market conditions' is misleading"); Johnson, *supra* note 21 (discussing concern about definition of "market conditions" and vague and amorphous control standard test that will likely be overbroad); Martin, *supra* note 21 (believing that proposed regulations contemplate two different definitions of value and requesting that proposed regulations define term "value" and clarify its use); Martin & Honson, *supra* note 75 (suggesting that not only is definition of "market conditions" overbroad but that it may also be under-inclusive); Wilkins, *supra* note 21 (listing requested clarifications, including definition of "outside the control of" in two different ways: "post-death events" and the hypothetical valuation method).

[112] United States v. Byrum, 408 U.S. 125, 137 n.10 (1972).

[113] Wilkins, *supra* note 21 (recommending that a "numerical threshold for 'control' be adopted" and suggesting use of Code's threshold of "at least 50%" because proposed regulations and Chapter 14 of Code address similar topics).

related parties.[114] And how far does control extend? For example, if an executor does something that inadvertently ruins the value of the estate, should the regulations include that as within the control of the executor?

B. *The Regulations Fail to Overturn* Kohler

In addition to leaving readers confused by undefined and vague terms, the proposed regulations will fail to achieve the intended goal. The regulations are aimed at overturning *Kohler* and reducing impermissible taxpayer reduction in value under the alternate valuation section. First, most commenters agree that *Kohler* would not have come out any differently under the proposed regulations.[115] Second, the steps that the proposed regulations take go too far, eliminating even permissible transactions from consideration under the alternate valuation election.

Kohler may have been the impetus for the creation of the proposed regulations, but the regulations were drafted in such a way that *Kohler* would likely not have had a different outcome had the regulations been in effect. First, the control standard included in the definition of market conditions, as vague as it is, appears to exempt the *Kohler* estate from the scope of the regulations. As discussed earlier, the decedent did not have a controlling interest in the company.[116] As a result, the decedent (or the estate) could not have blocked or approved the reorganization on its own. Clearly, the estate was not in control of the reorganization, especially since the reorganization started before the death of the decedent, at which point the decedent had no management involvement with the company.[117] Therefore, because the reorganization was not

[114] If the IRS imputes control to the taxpayer from other parties, it risks finding itself on the slippery slope of endless factual inquiry. For example, imagine a family company like Kohler Co. where the family gets along. While the taxpayer may not have control, what if friendly family members would do as the taxpayer wanted? Even without imputation, the control standard is difficult to apply, which is why the Supreme Court does not favor its usage. *See Byrum*, 408 U.S. at 137 n.10.

[115] *See* Hoops, *supra* note 111 (suggesting that decedent in *Kohler* case did not have control and therefore proposed regulations would not have been applicable to him); Martin, *supra* note 21 ("If the estate initiated and controlled the reorganization, then we agree with the conclusion reached in Example 1. However, if the estate did not initiate or control the reorganization, as in Kohler, we would respectfully disagree with the conclusion reached in Example 1."); Martin & Honson, *supra* note 75 ("Although the proposed regulations were drafted in response to the Kohler opinion, they would not change the result in Kohler."); Wilkins, *supra* note 21 (stating belief that "the Proposed Regulations would, if applicable to the Kohler case, have had no effect at all").

[116] Kohler v. Comm'r, T.C.M. (RIA) 1038, 1042 (2006).

[117] *Id.* at 1040 ("Frederic was not involved in management and was never a director or officer of Kohler.").

within the control of the decedent's estate, arguably Kohler Co. reorganization would have qualified as a market condition.[118]

Second, the decline in value of the stock in *Kohler* was a result of a market change, not the reorganization of Kohler Co. Therefore, the proposed regulations, had they been in effect, would not have affected the outcome.[119] The reorganization qualified as a tax-free reorganization under section 368(a).[120] Additionally, the parties stipulated that the reorganization was tax-free.[121] As a result, the fair market value of the post-reorganization stock had to equal the fair market value of the pre-reorganization stock for the reorganization to be tax-free.[122] This means that the fair market value of the pre-reorganization stock, when the transfer restrictions and purchase options did not apply, was the *same* as the post-reorganization stock when the transfer restrictions and purchase options did apply.[123] The appraiser did not change the lack-of-marketability discount as a result of the newly added transfer restrictions and purchase options, meaning that those restrictions had no effect on the fair market value of the post-reorganization stock, in the expert's opinion.[124] The decline in value of the stock was not attributable to the reorganization, but rather, as Kohler Co.'s trial lawyers put it, "a generalized, precipitous decline in the market during the summer of 1998."[125] Therefore, any change in value of the stock between the decedent's date of death and the alternate valuation date six months later was solely attributable to the market and therefore is well within the defined limits of "market conditions," as the proposed regulations define

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[118] Prop. Treas. Reg. § 20.2032-1(f)(1), 73 Fed. Reg. 22,300, 22,302 (Apr. 25, 2008) ("The term *market conditions* is defined as events outside the control of the decedent[] . . . that affect the fair market value of the property being valued.").

[119] Martin & Honson, *supra* note 75 ("The decline in value that allowed the Estate to use the alternate valuation date resulted from a generalized, precipitous decline in the market during the summer of 1998.").

[120] *Kohler*, T.C.M. (RIA) 2006-152 at 1042.

[121] *Id.* at 1046 n.7.

[122] I.R.C. §§ 354, 368(a) (2006). *See also Kohler*, T.C.M. (RIA) 2006-152 at 1046 n.7 (citing Rev. Rul. 74-269, 1974-1 C.B. 87; Rev. Proc. 86-42, 1986-2 C.B. 722) ("[P]rerequisite to advance ruling that a type A merger will be tax free is a representation that the fair market value of the acquirer stock and other consideration received will be approximately equal to the fair market value of the target stock surrendered in the exchange."); Rev. Proc. 81-60, 1981-2 C.B. 680, 682 ("[P]rerequisite to advance ruling that a type E recapitalization will be tax free is a representation that the fair market value of the shares to be surrendered will equal the shares to be received in exchange.").

[123] Martin & Honson, *supra* note 75 (discussing effect of proposed regulations on *Kohler*, from perspective of having been the counsel for petitioners in *Kohler v. Commissioner*).

[124] *Id.*

[125] *Id. See also Kohler*, T.C.M. (RIA) 2006-152 at 1042 (recognizing that Kohler Co.'s decision to reorganize was partially based on falling markets).

them. Again, the proposed regulations do not change *Kohler*'s outcome, despite that being the impetus for their promulgation.[126]

C. The Regulations Sweep Too Broadly

Given this result, it is clear that the proposed regulations go too far in trying to correct a perceived problem. The IRS is correct in saying that there is a potential problem with estates extending *Kohler* to take advantage of "post-mortem entity formations or post-mortem fractionalizations of interests which have no legitimate and substantial business (including investment) purpose . . . ."[127] For example, the situations discussed in Examples 3 and 4 of the proposed regulations that involve formation of entities post-mortem only to divide the property to take advantage of minority discounts are clearly abusive.[128] While disallowing valuation discounts for the primary purpose of lowering taxes is a reasonable goal, the proposed regulations go overboard in trying to achieve that goal. The proposed regulations, as they currently stand, sweep too broadly and encompass even legitimate transactions using valuation discounts.

For example, imagine a closely-held business owned by feuding family members. A minority shareholder is at war with the majority shareholder. Later, that minority shareholder dies. The majority, in an effort to oppress the estate and any future beneficiaries, launches a reorganization similar to the one in *Kohler*. The decedent's estate, with its minority share, drastically drops in value as a result.[129] That sort of oppression by the controlling shareholders would not be considered "market conditions" under the proposed regulations but is clearly out of the control of the minority shareholder decedent. In order to prevent this inequity, the proposed regulations need more elucidation on situations that involve closely held entities.[130]

[126] The preamble to the proposed regulations does not state that the IRS thinks the proposed regulations will reverse *Kohler*. Prop. Treas. Reg. Preamble, *supra* note 13, at 22,301. Nevertheless, that is the implication, both in the timing of the regulations' promulgation, only two months after the nonacquiescence in *Kohler*, and also in the first example offered in the proposed regulations, which is clearly a Kohler Co. reorganization fact pattern. *Id.* at 22,301–02; Prop. Treas. Reg. § 20.2032-1(f)(1), 73 Fed. Reg. 22,300 (Apr. 25, 2008).

[127] Johnson, *supra* note 21.

[128] Prop. Treas. Reg. § 20.2032-1(f)(3)(ii), 73 Fed. Reg. at 22,303.

[129] Ryesky, *supra* note 96 (describing similar example based on *Kiriakides v. Atlas Food Systems & Services, Inc.*, 541 S.E.2d 257 (S.C. 2001), involving warring factions in a closely held entity). The author argues that "oppressed shareholders in a Kiriakides-type situation are truly victims of market factors beyond their control." *See id.*

[130] Ryesky, *supra* note 96 ("Each closely-held security trades in its own unique market, and each such market may be affected by specialized and unique events, personalities and other conditions which would be irrelevant to the markets of other securities, publicly-traded or otherwise. The new regulations should account for the difference between the ill effects of an unfavorable market (with all factors

As noted earlier, the courts appear to have come down on the side of preventing artificial lowering of taxes. This appears to be the aim of the proposed regulations, but they sweep too broadly and will not include changes in value during the alternate valuation period that should be included for fairness. One of the basic problems with the new "market conditions" test is that many changes in value can be considered "market conditions" under the extremely broad definition but are non-abusive transactions, such as actions taken to prevent the loss of key employees, actions taken in response to a hurricane, and actions negotiated at arm's length.[131]

Post-mortem distributions are treated awkwardly under the proposed regulations, which would lead to confusion in application of the regulations.[132] Section 2032 says that if property is "distributed, sold, exchanged, or otherwise disposed of" during the six-month alternate valuation period, then it will be valued as of the date of that distribution, sale, exchange, or other disposal.[133] However, the proposed regulations include "distributions . . . of a fractional interest" in post-death events valued as of the date of decedent's death.[134] Not only does this proposal contradict the statute,[135] as discussed later, it makes no mention of sales. Therefore, "one could effectively accomplish with a 'sale' what the proposed regulations are trying to prohibit with a 'distribution.'"[136]

Additionally, according to one commenter, the new regulations do not account for any difference between the "ill effects of an unfavorable market . . . on one hand, and self-inflicted financial wounds on the other

constituting the particular to be considered) on one hand, and self-inflicted financial wounds on the other hand.").

[131] *See* Martin, *supra* note 21; *see also* Martin & Honson, *supra* note 75 (citing Rev. Rul. 58-436, 1958-2 C.B. 366, which discussed appreciation of cattle due to weight gain—which was within the control of the estate, who could have not fed the cattle—and concluded that the weight gain should still be considered as of the alternate valuation date); Wilkins, *supra* note 21 (offering other examples such as "actions taken to quell labor unrest, and actions taken in response to increases in health insurance premiums or other costs").

[132] *See* Borteck, *supra* note 21, at 330 (stating that proposed regulations eliminate difference between sale and distribution, contrary to statute); Martin, *supra* note 21 ("The proposed regulations define post-death events other than market conditions to include only 'distributions' of fractional interests in estate property. . . . [O]ne could effectively accomplish with a 'sale' what the proposed regulations are trying to prohibit with a 'distribution.'").

[133] I.R.C. § 2032(a)(1) (2006).

[134] Prop. Treas. Reg. § 20.2032-1(f)(3)(i), 73 Fed. Reg. 22,300, 22,302 (Apr. 25, 2008).

[135] I.R.C. § 2032(a)(1) (valuing distributions as of date of distribution, not decedent's date of death).

[136] Martin, *supra* note 21 (offering example to prove statement); *see also* Borteck, *supra* note 21, at 330 (making the same point and offering another example).

hand."[137] Although the IRS has already indicated that it will litigate the outcome of *Kohler* with the nonacquiescence, litigation over the validity of the regulations would be exponentially worse as every estate electing alternate valuation due to a decline in value would have to prove lack of control.

D. *The Regulations Provide an Unworkable Solution*

Further, the solution suggested by the proposed regulations is unworkable. The regulations seem to suggest that any asset that has undergone a "mere change in form" be valued as if the change in form had never occurred, as of its alternate valuation date.[138] For example, in a situation like *Kohler*, if the decedent had the requisite amount of control as determined by the regulations, when a company reorganizes, the proposed regulations would value the stock at its pre-reorganization value on the alternate valuation date, six months later. How would any changes in value due to "market conditions" be determined if the stock no longer exists at that time?[139]

In a post-mortem entity discounts example, a minority interest beneficiary will have to pay estate tax on the full value if the decedent's executor had control over the distribution of minority interests, despite the fact that the fair market value of the minority interest is lower as a result of lack or marketability and lack of control discounts.[140] For example, assume the beneficiaries of the estate in the previous example each receive 10% minority interests in the company. According to the proposed regulations, these interests will be valued at their full value, 10% of the company's value, not allowing for lack of marketability or lack of control discounts. This anomalous result means that the 10% interests are being taxed at their pro rata value, despite the fact that their fair market value is arguably less, due to lack of control and marketability.

E. *The Regulations are Inconsistent with Section 2032*

Most significantly, however, the proposed regulations are inconsistent with statutes and existing regulations. While inconsistency with prior regulations will lead to confusion in application, inconsistency

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[137] Ryesky, *supra* note 96 (arguing that "relation through blood and/or affinity to a company insider does not guarantee a favorable advantage in trading a company's securities").

[138] Martin & Honson, *supra* note 75 ("If this is in fact the intent of the proposed regulation, the requirement is unsupportable under *Section 2032* and is an impractical and often wholly unworkable rule.").

[139] Hoops, *supra* note 111 (requesting additional examples to explain application of new rule).

[140] Borteck, *supra* note 21, at 330.

with the statutes creating the alternate valuation date is a fatal flaw.[141] Section 2032 relates only to the timing of valuation; it says nothing about how to value the assets involved, offering no techniques, standards, or criteria to make valuation assessments, and only states what date should be used to value those assets.[142] Section 2031, on the other hand, does contain specific statutory guidance on how to value unlisted stock and securities.[143] Congress knows how to dictate method of valuation, if it sees fit to do so.[144] Because section 2032 relates only to timing, by promulgating these proposed regulations that dictate a method and approach to valuation, the IRS is overstepping its bounds. "It is not the province of the IRS to attempt to achieve through regulations what Congress has not seen fit to achieve (or has failed to achieve) through legislation."[145] By trying to add in new material such as the limitation on valuation based on market conditions, the IRS is legislating where it is not allowed to do so.[146] Admittedly, Congress is not likely to make any estate tax revisions in its current paralysis. The IRS is in a hard place, wanting revisions to section 2032, but being unable to depend on Congress to make the changes to prevent abuse and answer questions. However, the IRS still cannot legislate, even if Congress is not willing or able to do so.

The only limitation offered by section 2032 is that the effect of the mere lapse of time will be disregarded for purposes of valuation.[147] It does not provide for any limitations based on market conditions. The statute containing the alternate date valuation election was originally enacted over 70 years ago. In that time, although the statute has been amended

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[141] Smith v. Comm'r, 332 F.2d 671, 673 (9th Cir. 1964) ("The Commissioner may not prescribe any regulations which are not consistent with the statute; or which may add a restriction to the statute which is not there.").

[142] Borteck, *supra* note 21, at 328 ("Section 2032 does not state or suggest that diminutions in the fair market value of an asset attributable to well-recognized principles of valuation that apply to minority interests in closely held entities cannot be considered for purposes of alternate valuation. In fact, the opposite is true.").

[143] I.R.C. § 2031(b) (2006) (ordering determination of unlisted stock and securities through use of comparable companies for valuation).

[144] Borteck, *supra* note 21, at 328 ("Congress's ability and domain to effect this kind of change in valuation rules is reflected in [legislation proposed in March 2007] that would have resulted in a statutory change in valuation rules comparable to those set forth in the proposed regulation for lifetime transfers of fractionalized interests in closely held entities. While that particular legislation was not enacted, it is proof positive that Congress is certainly aware of the issue, generically, and that if or when it wishes to change the law in this regard it knows how to do it.").

[145] *Id.*

[146] The IRS can be given rulemaking authority to promulgate legislative regulations. This authority is granted by Congress by statute, allowing the Secretary of the Treasury to adopt regulations as necessary or appropriate to carry out the provision of a particular Code section. Section 2032 does not contain such language to promulgate legislative regulations. As a result, the regulations must be interpretative, as issued under section 7805(a). I.R.C. § 7805(a).

[147] I.R.C. § 2032(a)(3).

several times,[148] Congress has never seen fit to limit the alternate date valuation election to market conditions. That longevity, while not a guarantee of perfection, indicates that Congress, the courts, and, for a long time, the IRS have approved of the statute as it stands, with no interpretation necessary. Why would such a drastic change be necessary now, after all this time?

Another problem is the proposed regulations treatment of distributions. Under section 2032, if property is "distributed, sold, exchanged, or otherwise disposed of," it is valued as of the date of distribution, not as of the decedent's date of death or the alternate valuation date.[149] Under the proposed regulations, however, "distributions by the estate of a fractional interest" in an entity are considered post-death events, to be valued on the decedent's date of death.[150] This inconsistency makes the proposed regulations invalid.

Additionally, the current Treasury Regulations under section 2032 do not contain any limitation regarding market conditions.[151] The regulations require a shrinkage in value, not a shrinkage caused by market conditions.[152] Further, the current longstanding regulations conflict with the proposed regulations in their treatment of tax-free reorganizations by including them in the definition of "post-death events."[153] The proposed regulations do not change the portion of the regulations explaining "distributed, sold, exchanged, or otherwise disposed of." However, under the current regulations, that phrase specifically excludes transactions that are mere changes in form, such as tax-free reorganizations.[154] By not addressing the distribution section of the existing regulations, the proposed regulations simultaneously include and exclude tax-free reorganizations of the sort mentioned in *Kohler* from the alternate valuation date.[155]

To summarize, if the IRS, after receiving comments regarding the proposed regulation's vagueness, its failure to achieve stated goals, its

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[148] S. REP. NO. 91-1444, at 574 (1970) (shortening alternate valuation period to six months to reflect shorter estate period to file estate tax return); STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 1121–22 (1984) (adding subsection (c) to section 2032 to prevent taxpayers from utilizing alternate valuation election to increase basis in estate's property without increasing tax liabilities).

[149] I.R.C. § 2032(a)(1).

[150] Prop. Treas. Reg. § 20.2032-1(f)(3)(i), 73 Fed. Reg. 22,300 (Apr. 25, 2008).

[151] Treas. Reg. § 20.2032-1(b)(1) (2004) ("[I]t is the purpose of section 2032 to permit a reduction in the amount of tax that would otherwise be payable if the gross estate has suffered a shrinkage in its aggregate value in the 6 months . . . following the decedent's death . . . .").

[152] Martin & Honson, *supra* note 75.

[153] Prop. Treas. Reg. § 20.2032-1(f)(3)(i), 73 Fed. Reg. at 22,302.

[154] Treas. Reg. § 20.2032-1(c)(1) (2010).

[155] Hoops, *supra* note 111 (finding that inconsistency affects transactions under sections 351, 368(a), and 355).

overly broad scope, and its unworkable application, does not seriously question its approach, then the fact that the regulations are inconsistent with the statute and existing regulations should make it abundantly clear that the proposed regulations should not be promulgated as is. All of these problems indicate that the approach taken by the IRS is not the correct one.

VI. POSSIBLE SOLUTIONS: WAYS TO FIX OR CHANGE THE PROPOSED REGULATIONS

Fortunately for the IRS, the commenters on the proposed regulations have offered a variety of suggestions for improving the regulations from their current state. The overwhelming majority of commenters believe that a non-abuse position should be taken instead of a control/market conditions standard.[156] Other options suggested by commenters include: encouraging Congress to change the "currently valid use of section 2032 to obtain entity valuation discounts" instead of proposing possibly invalid regulations to do so;[157] amending the current regulation sections regarding dispositions instead of creating the "market conditions" rule;[158] including further examples of how closely held businesses are affected by the regulations;[159] and, as mentioned earlier, clarifying the various terms in the proposed regulations.[160]

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[156] *See* Wendy C. Gerzog, *The New Regs on Alternate Date Valuation*, 120 TAX NOTES 797 (2008) (stating that voluntary valuation depressions are not included in proposed regulations); Hoops, *supra* note 111 (urging that proposed regulations be limited to preventing actions where decedent's executor makes voluntary change to assets in estate that affects their value); Johnson, *supra* note 21 (offering another alternative test in lieu of control standard); Martin, *supra* note 21(suggesting that "only the 'artificial' use and application of valuation discounts should be disallowed"); Martin & Honson, *supra* note 75 (suggesting that proposed regulations control test is unworkable, that regulations disallow only "tax motivated changes," and elaborating alternative test).

[157] Borteck, *supra* note 21, at 331.

[158] Wilkins, *supra* note 21.

[159] Martin, *supra* note 21 (proposing four categories to be addressed in the proposed regulations: "1. Action taken by the executor of an estate during the alternate valuation period that is preceded by and in reaction to a post-death market force event that is specific to the business being valued but that affects fair market value; . . . 2. Action taken by the executor of an estate during the alternate valuation period that is preceded by and in reaction to a post-death market force event that is not specific to the business being valued but that affects fair market value; . . . 3. Action taken by the executor of an estate that is negotiated at arm's length; and, . . . 4. Post-death distributions from pass-through entities.").

[160] *See* Borteck, *supra* note 21, at 328 (criticizing the uncertain meaning of "market conditions"); Johnson, *supra* note 21(desiring clarification of term "outside the control of"); Martin, *supra* note 21 (wanting to change term "market conditions" and desiring clarification of term "or other person whose property is being valued"); Wilkins, *supra* note 21 (requesting clarification of term "outside of the control of" and clarification of term "post-death events").

As discussed in Part IV, the courts have already created an anti-abuse standard on their own. If the IRS feels that it needs to create regulations, then it should do so, but it should shift the focus from the proposed regulations to a more workable standard. One commenter suggested a more workable test to include in the regulations:

> [T]he regulation should be aimed at disregarding the effect on fair market value of any volitional, affirmative act initiated by the estate during the alternate valuation period (1) a purpose of which is decreasing the fair market value of an asset held by the estate for federal estate tax purposes as of the alternate valuation date, (2) that actually has the effect of decreasing the fair market value of the asset for federal estate tax purposes as of the alternate valuation date, and (3) that does not have a legitimate and substantial non-tax purpose.[161]

To put it more simply, one commenter suggested that the IRS should disallow only the "'artificial' use and application of valuation discounts."[162] This test would be more workable than the confusing control standard. Additionally, this test would lead to a reduction in the abuses of the alternate valuation date election like in *Flanders*, where an estate's trustee limited the use of the land for the sole purpose of reducing tax liabilities. Eliminating these abuses appears to have been the goal of the IRS in promulgating the proposed regulations.

The most effective solution appears to be to amend the current regulations section on dispositions to include what the IRS now deems "post-death events." By making reorganizations and distributions of fractionalized entity interests dispositions, the IRS would eliminate inconsistencies with the statute as well as much of the confusion caused by the "market conditions" standard. In addition, to further clarify, more examples of how the new dispositions would be treated should be included. With these changes, the proposed regulations would not encounter as much resistance upon promulgation.

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[161] Martin & Honson, *supra* note 75; *see also* Johnson, *supra* note 21 ("[T]he final regulations [should] 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.").

[162] Martin, *supra* note 21 (suggesting "that if discounts are applied by appraiser that artificially reduce fair market value, then they should have no effect on property value on alternate valuation date," and arguing that Kohler Co. reorganization was not artificial).

VII. CONCLUSION

Alternate valuation has a distinctive and clear purpose: to aid an estate that declines in value after decedent's date of death to spare them tax liabilities that the estate cannot afford. While some abuse of section 2032 has no doubt occurred, what the proposed regulations try to accomplish will eliminate the savings of a valid tax reduction technique, such as post-mortem entity discounts. Not only are the proposed regulations unworkable in their complexity, confusing in their application, and frustrating to the purpose of the alternate valuation date, but they are inconsistent with section 2032, which makes them invalid as they are written. Without a lot of work, these proposed regulations cannot be made final. Either the IRS needs to embrace the trend followed by courts and suggested by commenters of disallowing only tax-motivated changes, as opposed to the current convoluted market conditions standard, or be prepared to spend a lot of time explaining and defining "market conditions," "post-death events," "outside the control of," and any number of other confusing terms in the proposed regulations. If the proposed regulations are made final as they now stand, estate planning and tax savings will quickly become a lot more complicated. Although the regulations attempt to serve a valid purpose in stopping abuse of the alternate valuation date, the approach the proposed regulations take is not the right one. IRS regulations are intended to reduce complication and increase clarification. They have achieved neither here.