July 18, 2008

RE: Proposed Regulations 20.2032-1(f) (Alternate Valuation)

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (“RPTE Section”). They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Business Planning Group, which includes the Committee on Estate Planning and Administration for Business Owners, Farmers and Ranchers and the Committee on Business Investment Entities, Partnerships, LLCs, and Corporations, of the Trust and Estate Division of the RPTE Section. Principal responsibility was exercised by William S. Forsberg of Leonard, Street and Deinard, Minneapolis, Minnesota, vice-chair of the Business Planning Group, and the principal authors of these comments were William S. Forsberg and Douglas W. Stein of Smith, Gambrell & Russell, LLP, Atlanta, Georgia. Also participating in the preparation of the comments were Hugh F. Drake of Brown, Hay & Stephens, LLP, Springfield, Illinois; Steven B. Gorin of Thompson Coburn LLP, St. Louis, Missouri; Lisa M. Rico of McCarter & English, LLP, Boston, Massachusetts; Darren Wallace of Day Pitney LLP Stamford, Connecticut; and Daniel McCarthy of The Blum Firm, P.C., Fort Worth, Texas (the “Task Force”). These comments were reviewed by Louis A. Mezzullo on behalf of the RPTE Section’s Committee on Governmental Submissions.

Although members of the RPTE Section who participated in preparing these comments and recommendations have clients who would be affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or to otherwise influence the development or the outcome of, the specific subject matter of these comments.
We thank you for your consideration and are available to discuss any matters relating to this project. Questions should be addressed to William S. Forsberg, Leonard, Street and Deinard, 150 South Fifth Street, Suite 2300, Minneapolis, MN 55402, Phone: 612-335-1413, Fax: 612-335-1657, william.forsberg@leonard.com.

Sincerely,

Kathleen M. Martin
Chair, Section of Real Property, Trust and Estate Law

cc: Steve R. Akers, Chair-Elect, ABA Section of Real Property, Trust and Estate Law
Armando Lasa-Ferrer, ABA Secretary
Thomas M. Susman, ABA Governmental Affairs
COMMENTS OF THE
REAL PROPERTY, TRUST AND ESTATE LAW SECTION
OF THE
AMERICAN BAR ASSOCIATION
Proposed Regulations 20.2032-1(f) (Alternate Valuation)
July 24, 2008

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law ("RPTE Section"). They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

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Background

Section 2001 imposes an estate tax on the transfer of a decedent’s taxable estate. Section 2031(a) values the decedent’s property as of the decedent’s date of death. Section 2032(a) provides that an executor may elect to value all of the property included in the decedent’s gross estate as late as six months after the decedent’s death. Any property that is sold, exchanged, or otherwise disposed of during the six month period after the date of the decedent’s death must be valued as of the date the property is sold, exchanged or otherwise disposed. Any interest or estate which is affected by the mere lapse of time is valued at its date of death value with adjustments for any difference in its value as of the later date that is not due to the mere lapse of time. Section 2032(c) provides that no election is allowed unless it will

1 The term “Section” throughout this letter refers to a section of the Internal Revenue Code of 1986, as amended, (the “Code”), unless otherwise indicated.
decrease the value of the decedent’s gross estate and the sum of the decedent’s federal estate and
generation skipping transfer taxes. Section 2032(d) provides that the election is made on the
decedent’s federal estate tax return, and, once made, is irrevocable.

held that valuation discounts attributable to certain transfer restrictions on newly issued closely
held stock resulting from a post-death tax-free reorganization of the Kohler Company ("Kohler
Stock") approximately two months after the decedent’s death can be taken into account in
valuing the Kohler Stock on the alternate valuation date. The Tax Court held that the alternate
valuation date was not the date of the tax-free reorganization but six months after the decedent’s
death.

On March 3, 2008, the Internal Revenue Service (the “Service”) nonacquiesced to the

On April 25, 2008, the Service issued proposed regulations to amend Section 20.2032-1
of the Treasury Regulations by restructuring paragraph (f) of that section to clarify that the
alternate valuation election 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. The term “market conditions” is defined in
the proposed regulations as “events outside 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.”

Written and electronic comments to the proposed regulations under Section 2032 and
requests for a public hearing must be received by July 24, 2008.

**Comments and Recommendations**

The Task Force supports the goals stated in the proposed regulations under Section 2032.
We believe the proposed regulations are an important and necessary step in achieving fairness in
carrying out Congressional intent. We commend the Service for taking the necessary steps to
curtail certain abusive post-mortem transactions that artificially reduce value for the sole purpose
of reducing estate taxes. We also acknowledge the difficult task that the drafters of the proposed
regulations confronted. For estates comprised of primarily publicly traded marketable securities
alternate valuation is much easier. However, alternate valuation under Section 2032 applies to
all property and property interests, including closely held business interests, which can be very
difficult to value. It is with this background in mind that we offer our comments and present our
questions for review and consideration. Again, we are thankful for and pleased with the
opportunity to make these comments.

The following is a summary of the manner of presentation of our specific comments:

I. Legislative and case law history of Section 2032;
II. General comments regarding the *Kohler* opinion;
III. General comments regarding the proposed regulations under Section 2032;
IV. Comments and discussion of existing law and reason for issuance of proposed regulations under Section 2032 with the Task Force’s position;
V. Comments, discussion, and explanation of the term “market conditions” in the proposed regulations;
VI. Comments, discussion, and explanation of the term “other person whose property is being valued” in the proposed regulations;
VII. Comments and discussion regarding control premiums in the proposed regulations;
VIII. Comments and discussion regarding the “sale” of estate assets versus the “distribution” of estate assets during the alternate valuation period;
IX. Comments and discussion of the definition of “post-death events” to include “distributions of cash or other property to the estate from such entity” in the proposed regulations; and
X. Task Force examples of post-death events that cause a decrease in the fair market value of a closely held business and should qualify for alternate valuation under Section 2032.

I. Legislative and case law history of Section 2032

Predecessors to Section 2032

The predecessor to Section 2032, Section 302(j) of the Revenue Act of 1926, as amended, was enacted in 1935 in response to the Great Depression. Prior to the enactment of Section 302(j), a decedent's gross estate was valued in all cases as of the decedent's date of death. With the dramatic decline of the stock market between 1929 and 1934, property valued as of the decedent's date of death was, in many cases, worth far less by the time estate taxes were paid. In point of fact, the value of many estates was entirely consumed by estate taxes.2 In response to this inequity, Congress amended the Revenue Act of 1926 to give executors the option of electing to value property on the date one year after the decedent's death.3 At the time, this election was called “optional valuation.”

The purpose of the amendment was to address this “shrinkage in value” problem and to prevent estate taxes from consuming the decedent’s entire estate. Without the ability to elect a later valuation date after values dropped, high estate tax rates could completely absorb the estate’s assets.4 The legislative history of this amendment indicates that Congress intended to provide relief for post-death decreases in the value of estate property resulting from market forces.5 While the stock market crash of 1929 was the impetus for the enactment of optional valuation, the policy reason for the amendment was primarily to ensure equitable treatment of estates when the value of property in the gross estate drops dramatically after the decedent's

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5 See 79 Cong. Rec. 14632 (Aug. 19-26, 1935) (statements of Rep. Hill), Congressman Samuel Hill, D-WA was a member of the House Ways & Means Committee and served in Congress from September 25, 1936, until his resignation, effective June 25, 1936.
death. The provision was intended to be equitable in its effects and to prevent the danger of complete confiscation of estates due to a sudden decline in market values. Congress's continued commitment to the equitable purpose of optional valuation is evident in the Congressional record relating to later re-enactments of Section 2032. For instance, the 1984 Conference Reports state that the purpose of the provision is to provide "relief for estate tax purposes where the value of property decreased after death so that estate taxes are not inordinate." Declining market conditions, in fact market conditions as a whole, are not cited as the reason for the existence of the provision.

Section 2032 and Amendments

Section 302(j) was recodified by Section 811(j) of the Code of 1939, and Section 2032 recodified Section 811(j) in 1954. "Optional valuation" was renamed "alternate valuation," but neither amendment substantially changed the purpose or effect of the provision.

There have been two significant amendments to Section 2032. A 1970 amendment changed the one year alternate valuation period to six months. Prior to the amendment in 1970, the time for filing and paying estate taxes was fifteen months after the death of the decedent. Congress reduced the time period for filing and paying estate taxes to nine months to reduce the delay in the Government’s receipt of taxes and speed up the distribution of property to beneficiaries. The alternate valuation period was shortened to match the reduced time for filing the decedent’s estate tax return and paying estate taxes.

The second significant change to Section 2032 occurred in 1984 when subsection (c) was added, which limited the election to situations where the value of the gross estate and the estate tax were reduced by the alternate valuation election. Prior to the 1984 amendment, some taxpayers elected alternate valuation when the value of the estate had increased during the alternate valuation period so that the estate could receive an increase in the income tax basis of estate assets. In many of these cases, even though alternate valuation increased the value of the gross estate, no increase in estate tax occurred because of the corresponding increase in the unlimited marital deduction.

Case Law and Rulings Interpreting Section 2032

In Flanders v. United States, 347 F. Supp. 95 (N.D. Cal. 1972) the court examined the legislative history of Section 2032. The Flanders court stated that Congress intended that the "character" of the decedent’s property should be fixed as of the decedent’s date of death. Alternate valuation merely allowed the estate to revalue the decedent’s property on the alternate valuation date to take into account significant changes in value due to market conditions.

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9 See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 112-22, JCS-41-84 (1984). An increased income tax basis in estate property allowed a beneficiary to reduce his or her capital gain on the subsequent sale of the property to a third party.
*Flanders* court held that any “voluntary” change (by the executor) to the property, or any change that “artificially reduces” value should be ignored for alternate valuation purposes.

In *Flanders*, the executor elected the alternate valuation date and sought to discount the value of real property included in the estate due to a California land conservation agreement entered into during the alternate valuation period. The court held that the agreement effected a change in the character of the land which should not have been taken into account for purposes of alternate valuation. Since the character of the land was fixed at the decedent's date of death, the post-death conservation agreement was ignored, and the land was valued under the market conditions that existed on the alternate valuation date. The *Flanders* court held that “voluntary” post-mortem changes in the property should not be considered unless they resulted in a sale or other disposition between the date of death and the alternate valuation date. In such instances, the valuation date would be the date of such sale or other disposition. Any “artificial” reductions in fair market value should be ignored.

In *Hull’s Estate v. Commissioner*, 38 T.C. 512 (1962), the executor of the estate of a decedent, who was a partner in a law firm, entered into a post-death settlement agreement with decedent’s law firm relating to the estate’s share of the firm’s income. The court held that the terms of the settlement agreement should be taken into account when valuing the estate’s partnership interest on the alternate valuation date since the settlement agreement was “entered into at arm’s length between parties with clearly adverse interests,” and because the terms were a “known fact” on the alternate valuation date.

In *Maass v. Higgins*, 312 U.S. 443 (1941), the court decided that the valuation method used to value property on the alternate valuation date must be the same method used to value property on the decedent’s date of death. Considering whether dividends and interest accruing during the alternate valuation period should be included in the estate, the court held that the valuation method used on the alternate valuation date was not intended to be different from the valuation method used at the decedent’s death. The Service argued that interest and dividends paid out during the alternate valuation period must be added to the value of the gross estate on the alternate valuation date. But the court recognized that the usual method for valuing bonds was to add the amount of “accrued” (but unpaid) interest to the market value of the bond. To include interest “paid” on the bonds during the alternate valuation period ignored the character of such payments and contradicted general business practices.

A different result was reached in a case where oil and gas was extracted from property and sold during the alternate valuation period. The court in *Estate of Johnston v. United States*, 779 F. 2d 1123 (5th Cir. 1986), held that oil and gas production should be distinguished from income produced by stocks and bonds. They recognized that separation of oil and gas from the underlying property was essentially a change in form from in-place reserves to money. They found that, unlike payment of dividends and interest on stocks and bonds, separation of oil and gas from a well depletes the property and should be included when valuing the decedent's estate on the alternate valuation date. The quantity of oil and gas in reserve at the decedent's death must be valued under market conditions on the alternate valuation date.
In both *Maass* and *Johnston*, the courts focused on which party's arguments were “unreal and artificial and which comports with our common understanding.”

The Service in Priv. Ltr. Rul. 93-49-003 (Sept. 3, 1993) stated that the recording of forged deeds after death does not affect the alternate valuation of property for estate tax purposes under Section 2032(a). In the ruling the estate owned ten parcels of real estate as of decedent’s death and reported their full value on the decedent’s estate tax return. Two days after decedent’s death, the decedent’s brother forged and recorded two warranty deeds, putting a cloud on title to the parcels. The estate elected alternate valuation, claiming the real estate was now worth only thirty percent of its date-of-death “actual” value because of the cloud on title. Citing *Flanders* and *Estate of Holl v. Commissioner*, 967 F. 2d 1437 (10th Cir. 1992), the ruling noted that Congress intended that the character of the property is to be valued as it existed on the date of death, although it could be valued at “market conditions” existing on the alternate valuation date. The ruling stated that the alternate valuation election should only be available to estates where “unfavorable market conditions (as distinguished from voluntary acts changing the character of the property)” lessen the fair market value of property. In the ruling, the action of the decedent’s brother to record and claim an interest in the estate’s property had no effect on the value of the property for purposes of alternate valuation. The value of the properties as “commodities in the open market was not affected by the brother’s action.”

**Kohler v. Commissioner**

In *Kohler v. Commissioner*, 92 T.C.M. 48 (2006), the Tax Court considered whether transfer restrictions and purchase options placed on stock during the alternate valuation period could be taken into account when the stock was valued for estate tax purposes. The stock in question was stock in Kohler Company (“Kohler”), a privately held family business with substantial assets. Family members, charities, and trusts for the benefit of family members held 96% of the Kohler Stock.

Kohler began the process of reorganizing the company before the decedent’s death in 1996. The purpose of the reorganization was 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. The reorganization replaced the old shares of common stock with new classes of stock that had various voting rights and dividend preferences. Old common stock shares were traded for either cash, or a combination of voting and nonvoting

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10 *Holl* involved the valuation of substantial oil and gas holdings valued at nearly $9 million at decedent’s death. The estate valued these oil and gas interests on the alternate valuation date at approximately $3.1 million. Between date of death and the alternate valuation date the estate received $980,698 of net income from the sale of oil and gas. The estate gave an “in-place” value to the oil and gas sold on the alternate valuation date of approximately $686,489. The Tax Court determined in 95 T.C. 566 (1990) that the value of the oil and gas should be its sales price of $930,839. On appeal, the U.S. Court of Appeals (10th Cir.) held that the Tax Court erred in its application of the law when it used the sales price on the alternate valuation date. The court held that the Tax Court should have used the pre-change in-place value of the reserves reduced to possession and sold during the interim period from the date of death to the alternate valuation date. Citing *Flanders*, the court noted that the legislative history of Section 2032 showed an intent to consider the character of the property to be valued “as it existed on the date of death” although it could be valued at market conditions existing on the alternate valuation date.
stock. All shares were subject to transfer restrictions and a purchase option. Non-family members did not have a right to exchange their stock for stock, but received cash for each share. The reorganization qualified as a tax-free reorganization under Section 368(a).

Decedent shareholder died on March 4, 1998. The executor elected to value the gross estate on the alternate valuation date. Kohler’s reorganization was completed on May 11, 1998, during the estate’s alternate valuation period. The estate’s appraisers valued the decedent’s stock at $50 million on date of death and $47 million on the alternate valuation date. The Service’s appraiser valued the decedent’s stock at $144 million on the alternate valuation date.

The estate held a minority interest in Kohler and could not have blocked the reorganization, nor did it have the ability to control or change management or the board of directors, or to amend the Kohler Articles of Incorporation.

The Service argued that either the pre-reorganization stock should be valued on the alternate valuation date or that the post-reorganization stock should be valued without the transfer restrictions. The Tax Court held that the Kohler Stock should be valued at its fair market value on the alternate valuation date.11

The Tax Court’s analysis focused on Treas. Reg. Section 20.2032-1(c)(1), which states that a tax-free reorganization under Section 368(a) is not treated as a distribution, exchange, sale or other disposition for purposes of Section 2032(a). The Service argued that the reorganization was a change in form akin to the restrictive land-use agreement entered into by the executor in Flanders and should be ignored for valuation purposes. The Tax Court disagreed, holding that the plain meaning of the statute, as adopted in the regulations, excepted tax-free reorganizations from treatment as a disposition of property for purposes of Section 2032 and that the stock should be valued as of the alternate valuation date.

II. General comments regarding the Kohler opinion

The Service nonacquiesced to the Tax Court’s opinion in Kohler v. Commissioner, 92 T.C.M. 48, action on dec. (Mar. 3, 2008) and has issued the proposed regulations in response to Kohler. The facts presented in Example 1 of the proposed regulations are similar to the facts in the Kohler case, but with a few differences.

In Example 1, a closely held business stock is owned by a decedent and is valued at $50X at the date of death. Two months after decedent’s death, his estate participates in a tax-free reorganization under Section 368(a). In Kohler, the estate held a minority interest in Kohler Stock and could not have blocked the reorganization, nor did it have the ability to control or change management or the board of directors, or to amend the Kohler Articles of Incorporation. In Kohler, the estate’s only choice was to participate in the reorganization, a reorganization that was started prior to decedent’s death, or to exercise its dissenters’ rights. The facts in Example 1 appear to be slightly different from the Kohler facts. Example 1 states that decedent’s estate

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11 Fair market value is defined as the price at which property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or sell and both having knowledge of relevant facts. Treas. Reg. Section 20.2031-1(b).
“opted” to exchange its stock for new stock in the reorganized company that was subject to certain transfer restrictions. The word “opt” suggests a choice. We respectfully request that Example 1 be clarified to include the percentage of ownership the decedent had in the closely held business stock as well as the level of involvement and participation by the estate in the reorganization. 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.

The facts in Example 1 vary slightly from the facts in *Kohler* in one other way. In Example 1 the value\(^{12}\) of the stock did not change during the alternate valuation period. In *Kohler* the value of the stock did change during the alternate valuation period, presumably because of market conditions.

### III. General comments regarding the proposed regulations under Section 2032

In general, we agree with the approach taken to value the property or property interests identified in the examples in the proposed regulations. However, in most cases we believe that generally accepted valuation principles should determine value, unless the decedent (or the decedent’s executor or trustee) has taken action to artificially reduce such value.

### IV. Comments and discussion of existing law and reason for issuance of proposed regulations under Section 2032 with the Task Force’s position

The proposed regulations identify a number of post-death transactions that artificially reduce value. Below are our comments on the examples in the proposed regulations.

1. **Proposed Regulations—Examples 1 and 2: Anti-Kohler Examples**

Example 1 under the proposed regulations involves a post-death tax-free reorganization where the value of the stock owned by the decedent (“Old Stock”) as of date of death and the “value” of the new stock received by the estate in the reorganization (“New Stock”) as of the alternate valuation date are the same. In Example 1 the “value” of New Stock and Old Stock are the same after the reorganization, so discounts for lack of control and marketability cannot be applied to New Stock on the alternate valuation date. However, the terms “value,” and “fair market value” are used interchangeably. We believe that the proposed regulations contemplate two concepts: 1) “fair market value,” as that term is used and defined by law, and 2) “fair market value before the application of applicable discounts” (e.g., discounts for lack of marketability and control). It would be helpful, and we respectfully suggest, that the term “value” wherever used be defined and clarified in the proposed regulations.

We respectfully recommend that only the “artificial” use and application of valuation discounts should be disallowed. Please consider these facts. The fair market value of Old Stock before the application of valuation discounts was $70X. Valuation discounts for lack of control

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\(^{12}\) In the proposed regulations, the terms “value” and “fair market value” are used interchangeably. It would be helpful to know if the terms are intended to have the same meaning.
and marketability of $20X were applied, resulting in Old Stock having a fair market value on date of death of $50X. During the alternate valuation period a tax-free reorganization occurred and New Stock with a fair market value of $50X was issued to the estate in exchange for Old Stock having the same fair market value. Six months after death, on the alternate valuation date, the fair market value of New Stock before the application of valuation discounts was $60X. Valuation discounts for lack of control and marketability of $15X were applied, resulting in New Stock having a fair market value of $45X on the alternate valuation date. We respectfully suggest that the discounts taken on the alternate valuation date should be allowed. They were applied based on sound and generally accepted business valuation principles and methodology. This would also be true if the discounts applied on the alternate valuation date were higher than those applied on date of death.13

In Kohler, the pre-reorganization stock and the post-reorganization stock owned by the estate had the same fair market value on the date of the reorganization. Discounts for lack of control and lack of marketability were applied to the pre-reorganization stock, the post-reorganization stock, and the stock owned by the estate on the alternate valuation date.14 The Tax Court allowed alternate valuation because the fair market value of the estate’s stock was higher on the reorganization date than it was on the alternate valuation date.15 It is also noted that the estate in Kohler owned a minority interest in the company (12.85% of the outstanding stock of the company), and could not have blocked or approved the reorganization on its own. Finally, certain non-family member shareholders exercised their dissenters’ rights in the reorganization and litigated with the company to achieve a higher price for their shares.16 We respectfully suggest that the Kohler reorganization was “outside the control of the decedent (or the decedent’s executor or trustee),” and that no artificial reduction in value occurred.

We agree with the intent of the proposed regulations and suggest that if discounts are applied by the appraiser that artificially reduce fair market value, then they should have no affect on property value on the alternate valuation date. Also, we believe the new appraiser penalties under Section 6695A, the new preparer penalties under Section 6694, and the aiding and abetting penalties under Section 6701 should apply to remedy such action by the appraiser and executor.

13 In the above example, higher discounts for lack of marketability might be appropriate if the company had substantial real estate holdings that become contaminated during the alternate valuation period resulting in the underlying real estate and thus the company stock being less marketable.
14 See Kohler v. Comm’r, 92 T.C. M. 48, n. 7 (2006) (“We note that the fair market value of the post-reorganization stock must generally equal the fair market value of the pre-reorganization stock for the reorganization to be tax free,”) citing Rev. Rul. 74-269, 1974-1 C.B. 87; Rev. Proc. 86-43, sec. 7.01(1), 1986-2 C.B. 722 (prerequisite 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 the other consideration received will be approximately equal to the fair market value of the target stock surrendered in the exchange); Rev. Proc. 81-60, sec. 4.03(2)(d), 1981-2 C.B. 680, 682 (prerequisite to advance ruling that a Type E reorganization 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).
15 It should be noted that there are tax-free transactions that do not look at value before and after for qualification under the Code. For example, the tax-free incorporation of a corporation under Section 351 or the tax-free formation of a partnership under Section 721 do not look at before and after value of contributed property to qualify for income tax–free treatment.
2. Proposed Regulations Example 3—Post-death formation of family limited partnerships with estate assets

In Example 3, the estate, in conjunction with family members, formed four limited partnerships with estate assets. The estate owned a 25% limited partnership interest (i.e., a minority interest) in each partnership and claimed discounts for lack of control and marketability on the alternate valuation date. Discounts for lack of control and marketability could not be taken into account in determining the value of the partnership interests on the alternate valuation date. We agree with the conclusion reached in Example 3. Action taken by and under the control of the executor that artificially reduces value should not affect property value on the alternate valuation date. We commend the Service for including this example in the proposed regulations. Such action is clearly contrary to the Congressional intent underlying Section 2032, and if not curtailed could lead to endless lawsuits by beneficiaries against executors for failing to form such entities post death.

If, however, an executor simply “invests” in a private partnership during the alternate valuation period with unrelated partners and is not in control of the partnership we respectfully suggest that a different result might be appropriate. Please consider the following facts: During the alternate valuation period, an executor transfers $500,000 (“Cash Investment Amount”) to a limited partnership created and controlled by unrelated non-family members in exchange for a 10% limited partnership interest (“LP Interest”). Treas. Reg. Section 20.2032-1(c)(1) provides that the term “otherwise disposed of” does not include tax-free transfers of assets to newly formed entities. Therefore, the alternate valuation date will be six months after death assuming there has been no sale, exchange or other disposition of the LP Interest during the alternate valuation period. The estate retains an appraiser to value its LP interest on the alternate valuation date. The appraiser uses generally accepted valuation principles and applies discounts for lack of control and marketability. Will the appraiser’s report be used to value the LP Interest on the alternate valuation date? We respectfully suggest that it might. If the executor’s sole motive was to make a prudent business investment and to carry out his fiduciary duty, then we believe the appraiser’s report should be considered when valuing the LP Interest on the alternate valuation date. The difficulty is that Section 2032 is not limited in its scope to easily valued assets such as publicly traded securities, but includes a wide range of property and property interests, some of which are hard to value, such as the one in the above example.

3. Proposed Regulations Example 4—Post-death distribution of minority interests in a limited liability company when the estate owned 100% of the limited liability company membership interests on date of death

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17 See Treas. Reg. Section 20.2032-1(c)(1). The term “otherwise disposed of” does not include a transfer of assets to a corporation in exchange for its stock in a transaction with respect to which no gain or loss would be recognizable for income tax purposes under section 351.” This regulation would likely be applicable to transfers to a partnership or limited liability company under Code Section 721 as well.

18 In the example, when the estate acquired the LP Interest, discounts for lack of control and marketability were undoubtedly inherent in the investment price but based on the offering, although no formal valuation was performed.
In Example 4, the estate owned 100% of the units of a limited liability company (the “LLC”). Post-death, the estate makes a series of distributions of minority interests in the LLC to estate residuary beneficiaries and values the interests on the distribution dates applying discounts for lack of control and lack of marketability. The proposed regulations state that these discounts cannot be taken into account in determining the value of the LLC interests on the alternate valuation date (i.e., date of distribution). We agree with the conclusion reached in Example 4.

4. Proposed Regulations Example 5—Post-death funding of testamentary trusts with fractional interests in real estate

In Example 5, the estate owned 100% of Blackacre (i.e., an interest in real estate). Post death, the executor distributed an undivided 70% interest in Blackacre to a trust for the surviving spouse and an undivided 30% interest in Blackacre to trusts for children. The proposed regulations state that each interest is to be valued as a percentage of the whole (i.e., apparently without any fractional interest or partition discounts) on the distribution date. We agree with the conclusion reached in Example 5.

V. Comments, discussion, and explanation of the term “market conditions” in the proposed regulations

We respectfully request that you consider the following comments relating to the term “market conditions.”

First, we respectfully disagree that the election to use alternate valuation should be limited to situations where there has been a decrease in the fair market value of estate property due solely to market conditions. Further, we respectfully disagree with the definition of “market conditions” as “events outside the control of the decedent (or the decedent’s executor or trustee) that affect the fair market value of the property being valued.” We believe that this definition may be too broad in its application and could capture and make suspect some actions of the decedent (or the decedent’s executor or trustee) that were not intended by the proposed regulations.

Second, we respectfully recommend the following language as an alternative definition of “market conditions”:

“The term market conditions is defined as all events and forces\(^{19}\) that affect the fair market value\(^{20}\) of estate property, excluding, however, events arising solely from action that is controlled and initiated\(^{21}\) by the decedent (or the decedent’s executor or trustee).”

\(^{19}\) We chose not to use the term “market forces” as that term is too narrow and does not take into account forces that are not per se market driven but nonetheless affect value (e.g., a natural disaster).

\(^{20}\) We chose to use the term “fair market value” because it is used and defined in the Treasury Regulations.

\(^{21}\) The term “controlled and initiated” is used because we believe that only certain executor action should be questioned. There may be situations where the executor must act in reaction to market forces or other events. For example, an estate may own a minority interest in a closely held company but the majority shareholders who control the company vote to reorganize the company. In this situation, the estate’s options are limited. Even if the estate voted against the reorganization, it most likely would still go through. Here the executor did not...
trustee), that is not negotiated at arm’s length,\textsuperscript{22} that is independent of and not in reaction to market force events,\textsuperscript{23} and\textsuperscript{24} that artificially\textsuperscript{25} reduces the fair market value of the property being valued on the alternate valuation date.”

Below are our comments relative to our recommended definition of the term market conditions:

First, we respectfully suggest that the term “market conditions” should include “all” events and “forces” that affect the fair market value of property.

Second, we respectfully suggest that the term “market conditions” should only exclude action of the executor if such action was the only cause of the valuation reduction. If the executor’s action was in “reaction” to a market force or other triggering event that preceded the executor’s action, then we suggest that the executor’s subsequent action should not necessarily be suspect.

Third, we respectfully suggest that the term market conditions should only exclude those actions of the executor that are initiated and controlled by the executor and that were not negotiated at arm’s length. If the executor reacted to an event that was out of the executor’s control (e.g., executor as majority shareholder and board member of a closely held commuter airline company decides to lay off a significant number of company personnel because of an unprecedented spike in fuel costs) or arose from an arm’s length negotiation that affects fair market value (e.g., a post-death arm’s length–negotiated key employee contract that significantly affected company operations), then we suggest that the executor’s action should not necessarily be suspect.

Fourth, we respectfully suggest that the term “market conditions” should only exclude actions of the executor if such action has the effect of artificially reducing value. It is our view that the use of discounts should only be disallowed when their application results in an artificial reduction in value.

VI. Comments, discussion, and explanation of the term “other person whose property is being valued” in the proposed regulations

The proposed regulations define market conditions as “events outside the control of the decedent (or the decedent’s executor or trustee) or other person whose property is being valued”

\textsuperscript{22} The term “not negotiated at arm’s length” is used because the Task Force believes, and the Service and Tax Court implicitly recognize, that transactions negotiated at arm’s length are more likely to be accurate and a true reflection of fair market value. Also, the court in\textit{Hull’s Estate v. Comm’r}, 38 T.C. 512 (1962) viewed events precipitated by an arm’s length negotiation as a credible indication of fair market value. See Example 11 infra.

\textsuperscript{23} The term “market force event” is used because it appears in the case law and legislative history of Section 2032.

\textsuperscript{24} The term “and” is used in the conjunctive, requiring that all elements listed be satisfied.

\textsuperscript{25} The term “artificial” is used because it was cited in\textit{Flanders} and is defined in Merriam-Webster Online Dictionary as “produced by a human; lacking in natural or spontaneous quality”, which is the opposite of how a true market force works.
(emphasis added). The property interest, or person who has an interest in such property interest, intended to be subject to this provision is not clear from the literal language (i.e., the italicized language) of the proposed regulations. We believe this was intended to include those persons who are in possession of property, or property interests, on the alternate valuation date that were included in the decedent’s gross estate and possess such property because it passed to them either by operation of law outside of probate (e.g., property held in joint tenancy with right of survivorship, or property subject to a pay on death designation) or was property that was transferred by the decedent by gift during life that is included in the decedent’s transfer tax base as an adjusted taxable gift. It would be helpful if the proposed regulations could clarify the language “or other person whose property is being valued.”

VII. Comments and discussion regarding control premiums in the proposed regulations

We are unclear whether the proposed regulations preclude “premiums” or certain asset value enhancers (e.g., control premium) when valuing closely held business interests on the alternate valuation date. There are situations where a control premium may not be warranted when valuing stock on date of death, but will be warranted when valuing the same stock on the alternate valuation date.

For example, assume an estate holds a 40% non-controlling interest in a closely held business, and two family members (e.g., decedent’s son and daughter) each hold a 30% non-controlling minority interest in the same company. No one shareholder is in control of the business at decedent’s death. Assume that decedent’s will provides for distribution of the residue of the estate equally between the two children. During the alternate valuation period the company redeems the daughter’s shares, so that the estate now owns 57% of the company. The estate’s shares were valued on the decedent’s death without a control premium, because the estate held a minority interest in the company. After the redemption, the estate has a controlling interest in the company. What will the value of the estate’s shares be on the alternate valuation date? Assume further that the only other estate assets were marketable securities that decreased significantly in value as of the alternate valuation date, and that the estate as a whole decreased in value from date of death and otherwise qualified for alternate valuation. Will the estate’s shares be valued on the alternate valuation date with or without a control premium? The answer to that question could significantly affect the amount of estate tax owed by the estate. It would be helpful if the proposed regulations could state whether or not “premiums” are included or precluded when valuing property or property interests on the alternate valuation date.

VIII. Comments and discussion regarding “sale” of estate assets versus “distribution” of estate assets during the alternate valuation period

The proposed regulations define post-death events other than market conditions to include only “distributions” of fractional interests in estate property. They do not discuss or mention “sales” of property by the estate in the text of the proposed regulations or in the examples. We respectfully point out that one could effectively accomplish with a “sale” what the proposed regulations are trying to prohibit with a “distribution.” For example, Estate owns sixty shares of stock in a closely held company with a fair market value of $3,000,000 on date of death which constitutes the entire gross estate. The decedent’s will provides that the
decedent’s residuary estate will pass to her three sons in equal shares. Instead of the executor making a “distribution” of twenty shares to each son during the alternate valuation period (where a discount for lack of control would not be allowed under the proposed regulations), what if the executor “sold” twenty shares to each beneficiary at fair market value with a discount for lack of control and then elected alternate valuation. Thereafter, the estate distributes the sales proceeds equally among the estate beneficiaries. Each estate beneficiary would then be in the same cash and financial position as they were before the sale, but the estate will have paid less estate tax because the stock is valued on the alternate valuation date at fair market value with discounts. If the sons buy the stock in the same proportion as their beneficial interest, then we believe the Service will properly view this as abusive and contrary to the spirit of the proposed regulations. However, if the sons buy the stock in different proportions at an arm’s length price we believe this would not be abusive and would qualify for alternate valuation even if the stock sold includes valuation discounts.

It would be helpful if the proposed regulations could include examples of a “sale” of estate assets at fair market value that are both permissible and not permissible.

IX. Comments and discussion of the definition of “post-death events” to include “distributions of cash or other property to the estate from such entity” in the proposed regulations

Section 2032(a)(1) and the regulations thereunder provide that property distributed, sold, exchanged, or otherwise distributed will be valued on the date of distribution, sale, exchange or other disposition. Treas. Reg. Section 20.2032-1(d)(4) provides that ordinary stock dividends out of post-death earnings and profits are “excluded property” (i.e., that they are not taken into consideration when valuing the entity on the alternate valuation date unless the dividend would result in the stock at the subsequent valuation date not reasonably representing the same included property of the gross estate as existed at the date of the decedent’s death).

The proposed regulations, however, state that an interest affected by a post-death event other than market conditions is included in the gross estate at date of death values. A “post-death event” is defined to include a “distribution of cash or other property to the estate from such entity.” The Task Force believes that the proposed regulations should clarify that Treas. Reg. Section 20.2032-1(d) controls if and to the extent that Treas. Reg. Section 20.2032-1(f) conflicts with it.

X. Task force examples of post-death events that cause a decrease in the fair market value of a closely held business that will qualify for alternate valuation under Section 2032

Below are four categories of examples affecting the value of closely held businesses after the death of the decedent that are not addressed in the proposed regulations.

26 The Task Force acknowledges that the proposed regulations are not limited in their reach to “distributions” of property. The caveat language in the proposed regulations that “post-death events includes, but is not limited to . . . and the language of “events outside of the control of the decedent (or the decedent’s executor or trustee)” suggest that this type of planning might not be allowed.
1. **Category 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. **Category 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. **Category 3.** Action taken by the executor of an estate that is negotiated at arm’s length; and,

4. **Category 4.** Post-death distributions from pass-through entities.

**Category 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

**Discussion of Issue Raised by Task Force**

We respectfully suggest that the proposed regulations should address the consequences of actions taken by the executor that is preceded by and in response to post-death events that are specific to the business being valued, such as the loss of a key employee, the loss of a key customer, the loss of a key supplier or key creditor, or the threat of a major lawsuit. Even if the executor might have been able to avoid the events, they have such independent significance that the executor’s action or inaction relating to the default should not preclude use of alternate valuation. The following example illustrates the issue raised.

**Example 1**

**Loss of key employee (termination of employment; threat of departure; threat of competition):** A closely held business was in transition at the time of decedent’s death. The decedent, a key person herself, was mentoring and transitioning the business to other key employees (possibly a key manager who developed a good relationship with a key customer). The transition process may not have been completed at decedent’s death. No employment agreement or covenant not to compete was in place. Most of these facts were known and taken into account when the date of death valuation was done. However, sometimes after death, but before the end of the alternate valuation period when things are in theory “settling down,” the key employee starts “making noise” (possibly because the key employee does not like or want to work for the new owners, the decedent’s children or spouse, or maybe the decedent’s death was sudden and unexpected, and there was a vacuum in ownership and management was worried about the key employee). The key employee becomes uncomfortable and threatens to quit and start a competing business, and/or demands a long term employment contract with stock or other equity options, and/or a higher base salary, and/or a performance bonus with a lucrative deferred compensation package. With the decedent gone, the estate is put in an unequal bargaining position, so it acquiesces and submits to the key employee’s demands-demands that hopefully will result in a long term benefit to the company, but cause a short term decrease in the value of
the business. The actions taken by the executor were in response to a market force event and were not taken to artificially reduce the fair market value of the business. These events were not known by, reasonably foreseeable by, or under the control of the decedent or the decedent’s executor. These events should therefore be taken into account when valuing the decedent’s stock on the alternate valuation date.

Task Force Recommendation

We respectfully suggest that executor action taken in response to a post-death triggering event that is specific to the closely held business interest being valued and that was not foreseen or foreseeable at decedent’s death, such as the loss of a key employee, key customer, key supplier, or key creditor, the threat of a major lawsuit, or a dramatic increase in material or fuel costs, is not action taken to artificially reduce the value of the decedent’s business interest and should not necessarily be suspect when valuing the decedent’s business interest on the alternate valuation date. We respectfully suggest that it should not matter if the executor is a majority shareholder, controls the entity, or sits on or controls the board or is the managing partner of the entity.

Category 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

Discussion of Issue Raised by Task Force

We respectfully suggest that the proposed regulations should address the issue of post-death affirmative action taken by an executor/shareholder/board member of a closely held business, in response to and preceded by an unforeseen and uncontrollable event, such as a natural disaster.

Example 2

Action taken by executor/shareholder/board member of closely held business in response to a hurricane: Six months after the decedent’s death the decedent’s closely held company, located in New Orleans, was devastated by Hurricane Katrina. The physical plant was destroyed, production was completely shut down, employees had to be temporarily let go, and the company’s business interruption and casualty insurance was inadequate. This single event had a significant detrimental effect on the value of the decedent’s business. The executor of decedent’s estate, who was also the sole shareholder, together with action of the board, made a decision to liquidate and dissolve the company. The liquidation and dissolution proceeding was not completed as of the alternate valuation date. The event that destroyed the business was not known by, reasonably foreseeable by, or under the control of the decedent or the decedent’s executor. However, affirmative steps had to be taken by the executor, as shareholder and board member in response to the natural disaster. Section 2054 and the regulations thereunder allow an estate to deduct losses from casualties or theft incurred during settlement of the estate arising from fires, storms, shipwrecks, or other casualties, but very little guidance is provided with regard to losses incurred by and within a business. Does Section 2054 allow the estate a
deduction, or is the estate’s only recourse alternate valuation? If the latter, will the affirmative action taken by the executor to liquidate the company preclude alternate valuation under the proposed regulations, or cause the stock to be valued on a going concern basis on the alternate valuation date, rather than at liquidation value?

**Task Force Recommendation**

We respectfully suggest that post-death action taken by an executor of an estate that owns a closely held business interest, including action to liquidate, dissolve or sell the business, which action is in response to and precipitated by an unforeseen and uncontrollable post-death event that is not specific to the business, such as a natural disaster or act of terrorism, is not action taken to artificially reduce the value of the decedent’s business interest and should not necessarily be suspect when valuing the decedent’s business interest on the alternate valuation date. We respectfully suggest that it should not matter if the executor is a majority shareholder, controls the entity, or sits on or controls the board or is the managing partner of the entity.

**Category 3**

Action taken by the executor of an estate that is negotiated at arm’s length.

**Discussion of Issue Raised by Task Force**

We respectfully suggest that the proposed regulations should address the issue of post-death actions taken by an executor/shareholder/board member of a closely held business, in a transaction that is negotiated at arm’s length.

**Example 3**

*Action taken by executor negotiated at arm’s length (hiring new president; compensation package includes stock; estate retains control):* The decedent was sole director and president of a closely held company and owned 75% of the company’s voting stock. At decedent’s death a vacuum in management occurred so the estate sought to hire a new president to run the company. The prospective president is represented by separate counsel. The estate and the president negotiated at arm’s length a compensation package that includes stock and stock options in the company and required the executor to further capitalize the business. The estate and the prospective president settled on the president acquiring 10% of the estate’s voting stock currently with an option to acquire a controlling interest in the company if certain performance and financial goals and objectives are reached over then next two years. This left the estate owning 65% of the voting shares on the alternate valuation date subject, however, to the president’s option to acquire a controlling interest if the performance and financial goals and objectives are met. We suggest that the estate’s stock should be valued on the alternate valuation date subject to the president’s stock option to acquire a controlling interest using generally accepted valuations principles, which would include discounts for lack marketability. The president’s first option to acquire the company stock restricts the estate’s ability to sell the stock and may result in discounts for lack of marketability at a level that is higher than those taken on date of death.
**Task Force Recommendation**

We respectfully suggest that post-death action taken by an executor of an estate that owns an interest in a closely held business in a transaction that is negotiated at arm’s length should stand on its own merits, and the business interest should be valued using generally accepted valuation principles, including appropriate discounts for lack of control and marketability. We respectfully suggest that it should not matter if the executor is a majority shareholder, controls the entity, or sits on or controls the board or is the managing partner of the entity.

**Category 4**

*Post-death distributions from pass-thru entitles*

**Discussion of Issue Raised by Task Force**

We respectfully suggest that the proposed regulations should address the issue of post-death distributions from pass through entities, such as S corporations or partnerships where there has been a historic pattern in the ordinary course of business of making cash distributions, and where such distributions do not constituted “all” of the entities earnings and profits earned prior to the decedent’s death. Treas. Reg. Section 20.2032-1(d) (4) provides in pertinent part that:

> Ordinary dividends out of earnings and profits (whether in cash, shares of the corporation, or other property) declared to stockholders of record after the date of the decedent’s death are “excluded property” and are not to be valued under the alternate valuation method. If, however, dividends are declared to stockholders of record after the date of decedent’s death with the effect that the shares of stock at the subsequent valuation date do not reasonably represent (emphasis added) the same “included property” of the gross estate as existed at the date of the decedent’s death, the dividends are “included property”, except to the extent they are out of earnings of the corporation after the date of the decedent’s death”. Similarly, if a corporation, in which the decedent owned a substantial interest and which possessed at the date of the decedent’s death accumulated earnings and profits equal to its paid-in-capital, distributed all of its accumulated earnings and profits as a cash dividend to shareholders of record during the alternate valuation period, the amount of the dividends received on stock includible in the gross estate will be included in the gross estate under the alternate valuation method.

**Example 4**

**Post-death distributions from S corporation in ordinary course-historic pattern:** Decedent died January 1 when the decedent’s S corporation had substantial undistributed earnings from the prior year (its distribution for its shareholders’ fourth quarter estimated tax payments, plus its normal distribution of profits that it determines when it files its tax return). The company had a pattern of making these distributions each year and declared and paid them on April 1 of the year following the year of decedent’s death. Will these distributions be “included property” or “excluded property” for purposes of alternate valuation? Do these distributions constitute “ordinary dividends out of earnings and profits declared to shareholders of record” after the decedent’s death? The decedent’s S corporation shares are the same shares as owned by the estate on the alternate valuation date. Does the answer change depending on whether it is an operating business or a holding company (assume no C corporation accumulated earnings and profits)? Does the answer change based on whether these distributions are part of a pattern
established during decedent's life, and were not made in contemplation of death? Does it matter if the only factor affecting the value of the decedent’s S corporation stock on the alternate valuation date is the S corporation distributions? What if the distributions where not identified by the appraiser as a reason for the decrease in the decedent’s stock on the alternate valuation date? Would it matter if the executor was also the majority shareholder and controlled the board?

**Task Force Recommendation**

We respectfully suggest that post-death distributions from pass through entities declared and paid out of earnings and profits from such entities, where there has been a clear historic pattern and record in the ordinary course of business of making such distributions, should not constitute “included property” on the alternate valuation date. We respectfully suggest that it should not matter if the executor is a majority shareholder, controls the entity, or sits on or controls the board or is the managing partner of the entity.

**Conclusion**

The proposed regulations under Section 2032 were well drafted and go a long way toward achieving fairness. We again commend the Service for taking the necessary steps in the proposed regulations to curtail certain abusive post-mortem transactions. We appreciate your consideration of our comments and welcome the opportunity to discuss them further with you. If you would like to discuss these comments, please contact the following:

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