August 8, 2008

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Under Section 2032 Relating to the Alternate Valuation Date Election

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations under section 2032 relating to the alternate valuation date election. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William J. Wilkins
Chair-Elect, Section of Taxation

Enclosure

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
    Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
The following comments (“Comments”) concerning proposed regulations relating to the alternate valuation date election are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Joseph Barry Schimmel of the Section’s Estate and Gift Taxes Committee (the “Committee”). Substantive contributions were made by Benjamin Carter, Hannah Mensch and Paul E. Van Horn. The Comments were reviewed by Martin A. Hall, Chair of the Committee. The Comments were further reviewed by Barbara A. Sloan, of the Section’s Committee on Government Submissions, and John P. Barrie, the Section’s Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal estate tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: August 8, 2008
EXECUTIVE SUMMARY

These Comments are submitted in response to the request for comments contained in the preamble to Proposed Regulation section 20.2032-1 (the “Proposed Regulations”), published on April 24, 2008. The Proposed Regulations were issued largely in response to the Tax Court memorandum opinion in Kohler v. Commissioner, and would restructure Regulations section 20.2032-1(f), to provide that the alternate valuation method under section 2032 is available only to estates that experience a reduction in the value of the gross estate due to market conditions, but not due to other post-death events.

The Section acknowledges the concerns of the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) with the Tax Court’s analysis in Kohler, which concerns were discussed more fully in the action on decision document. Nonetheless, we have serious concerns with respect to the approach taken by Treasury and the Service in the Proposed Regulations, and question whether Treasury has the authority to adopt a general anti-abuse rule in the context of section 2032 (as the Proposed Regulations appear to do). We also are concerned that the Proposed Regulations appear to conflict with long-standing guidance that was not addressed in the preamble to the Proposed Regulations.

Central to the opinion in Kohler was Regulation section 20.2032-1(c)(1), which provides that “transactions which are mere changes in form” are not taken account of in determining whether a disposition of property has occurred under section 2032(a). We believe that the Proposed Regulations focus on the wrong portion of the Regulations, and that the amendments should, for the most part, be made to Regulations section 20.2032-1(c)(1).

Specifically, we recommend that Treasury and the Service reconsider whether they have authority to establish an anti-abuse rule under section 2032. Assuming such authority does exist, we further recommend that Treasury and the Service:

• Amend Regulation section 20.2032-1(c)(1) to provide that a tax-free disposition of property may be treated as a disposition; and

• Amend Regulation section 20.2032-1(c)(1) to provide that a partial disposition of an interest in property may be treated as a disposition of the entire interest.

1 Unless otherwise indicated, all references to a “section” are to the Internal Revenue Code of 1986, as amended (the “Code”), and all references to “Regulations” are to the Treasury Regulations promulgated thereunder.
3 T.C. Memo. 2006-152; 92 T.C.M. (CCH) 48; action on decision 2008-001 (March 4, 2008).
4 Id.
5 The Real Property, Probate, Trust and Estate Law Section of the American Bar Association (“RPTE”) recently submitted extensive comments on the Proposed Regulations, AMERICAN BAR ASSOCIATION, SECTION OF REAL PROPERTY, TRUST AND ESTATE LAW, PROPOSED REGULATIONS 20.2032-1(F) (ALTERNATE VALUATION) (July 24, 2008), available at 2008 TNT 144-14 (July 25, 2008). As discussed below, we share RPTE’s support for the goals stated in the preamble to the Proposed Regulations, and echo many of their comments and recommendations.
In the event that Treasury and the Service decide to retain the framework of the Proposed Regulations, we recommend:

- The term “outside of the control of” be clarified with respect to who may exercise control;
- The term “outside of the control of” be clarified with respect to how control should be determined;
- The term “post-death events” be clarified to exclude certain events that, although within the control of an executor, trustee or other person, may appropriately be treated as market conditions;
- The hypothetical valuation method required in the Proposed Regulations be clarified;
- Regulation section 20.2032-1(f)(1) be amended to be consistent with Regulation section 20.2031-7; and
- Regulation section 20.2032-1(f)(2) be amended to be consistent with the Proposed Regulations.
DISCUSSION

Section 2031(a) provides that the value of the gross estate of a decedent be determined as of the time of the decedent’s death. Section 2032(a) provides that if certain conditions are met the value of the gross estate instead may be determined, if the executor so elects, by valuing all of the property included in the gross estate pursuant to the following alternate valuation method:

- In the case of property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent’s death, such property must be valued as of the date of distribution, sale, exchange, or other disposition.\(^7\)

- In the case of property not distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent’s death, such property must be valued as of the date that is 6 months after the decedent’s death.\(^8\)

- Any interest or estate which is affected by the mere lapse of time is included at its value as of the date of death (instead of the later date) with adjustment for any difference in its value as of the later date that is not due to the mere lapse of time.\(^9\)

Historically, the Regulations have limited themselves to the foregoing three rules – i.e., if an interest or estate in property is affected by the mere lapse of time, it is included at its value as of the date of death; if not, then such property is valued as of the earlier of the date of distribution, sale, exchange, or other disposition, or the date that is 6 months after the decedent’s death.\(^10\)

The Proposed Regulations were issued in response to the Tax Court’s analysis in Kohler and would create a fourth rule, which can be summarized as follows:

- Any interest or estate in property which is affected by a specified event other than the mere lapse of time is not included; instead, the value of a hypothetical interest or estate in property which would have existed in the absence of the specified event is included.

We acknowledge that the Regulations currently may not eliminate the potential for abuse of the alternate valuation method. However, as discussed below, by attempting to create a rule not contemplated by Congress, the Proposed Regulations create a special valuation rule that will not be administrable, and which in many cases will cause additional confusion.

\(^7\) Section 2032(a)(1).
\(^8\) Section 2032(a)(2).
\(^9\) Section 2032(a)(3).
\(^10\) See Part II, infra.
I. ABUSIVE TRANSACTIONS

The Proposed Regulations attempt to address two categories of abusive transactions. The first category can generally be described as post-mortem changes in the legal form of property interest; the second category relate to timing of post-mortem distributions.

Post-Mortem Changes in Legal Form

The Proposed Regulations provide three examples that are intended to illustrate abusive changes in legal form.

Example 1 of the Proposed Regulations presents a fact situation similar to that in Kohler. Specifically, a corporation in which the decedent owned stock undergoes a tax-free reorganization following the date of the decedent’s death but prior to the alternate valuation date. As part of the reorganization, the new stock is subject to transfer restrictions that ordinarily would support valuation discounts in determining the fair market value of the stock. Example 2 of the Proposed Regulations represents a minor variation of Example 1, and does not require separate discussion.

Example 3 of the Proposed Regulations presents a fact situation that, although dissimilar to any reported case, will be very familiar to estate planners. In Example 3, the estate, in conjunction with family members, formed four limited partnerships with estate assets. The estate received a 25% interest in each limited partnership, and claimed discounts for lack of control and marketability on the alternate valuation date. Example 3 provides that the discounts for lack of control and lack of marketability could not be taken into account in valuing the partnership interests on the alternate valuation date.

The common thread among the three examples is obvious; there has been a change in the legal form of the estate assets, perhaps for the purpose of exploiting the alternate valuation method. The Proposed Regulations are written far more broadly; as discussed both below and in the RPTE Comments, they would capture many situations that do not involve changes in legal form. However, the preamble to the Proposed Regulations fails to suggest any abusive situations not involving changes in legal form that needed to be addressed by the Proposed Regulations.

Timing of Post-Mortem Distributions

The Proposed Regulations provide two examples that are intended to illustrate abusive timing of post-mortem distributions.

In Example 4 of the Proposed Regulations, the estate owned 100% of the units of a limited liability company (the “LLC”). During the alternate valuation period, the estate made a

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14 Part V, infra.
series of distributions of minority interests in the LLC, each to a different beneficiary, in accordance with the decedent’s will. On the alternate valuation date, the estate continued to hold a minority interest in the LLC. Example 4 provides that the lack of control and marketability discounts may not be taken into account either in valuing the LLC interests distributed by the estate prior to the alternate valuation date or in valuing the LLC interests remaining in the estate on the alternate valuation date.

Example 5 of the Proposed Regulations provides that the lack of control and marketability discounts may not be taken into account either in valuing the LLC interests distributed by the estate prior to the alternate valuation date or in valuing the LLC interests remaining in the estate on the alternate valuation date.

Example 5 of the Proposed Regulations provides a variation on Example 4. The estate owns an interest in real property, which the decedent has devised 70% to one trust, and 30% to another trust. The estate makes the distributions to the two trusts on different dates. Example 5 provides that the value of each interest in real property distributed must be valued as a percentage of the whole, without any discounts.

The two examples each illustrate the same general rule – an estate will not be permitted, through the distributions of fractional interests in an asset, to exploit the alternate valuation date. It would not seem that the simultaneous distribution of undivided interests in an asset (e.g., to the decedent’s children as a joint tenancy with rights of survivorship) would represent an abusive situation – however, neither does it seem likely that any court would permit discounts to apply to such a distribution.

Statutory Authority for an Anti-Abuse Rule

Congress regularly grants to Treasury the authority to promulgate anti-abuse rules, particularly in complicated areas of the Code. Congress specifically uses the word “abuse” in grants of regulatory authority in more than 20 different sections of the Code. In dozens more, Congress uses softer terms, such as “avoidance,” with the same intention.
In the transfer tax area, Congress has been relatively proactive in enacting specific anti-avoidance provisions (rather than granting the authority to Treasury). For example (and as discussed more fully in the RPTE Comments), Congress enacted section 2032(c), requiring that the alternate valuation election must decrease both the value of the gross estate and the estate tax due, in order to put an end to abuses in the use of the alternate valuation method. Tax Reform Act of 1986, P.L. 99-514, sec. 1432(c)(1). Chapters 13 and 14 of the Code were each enacted as anti-avoidance provisions. In fact, Chapter 14 was enacted to address a problem very similar to that addressed by the Proposed Regulations, creating special valuation rules to disregard certain events.

Section 2032 does not grant to Treasury any explicit authority to issue anti-abuse regulations. The Proposed Regulations appear to have been promulgated under the Treasury’s general authority under section 7805 to issue interpretative regulations. As discussed below, we believe that regulations can be promulgated under section 2032(a) to address the Kohler decision, as well as the situations specifically discussed in Examples 1 through 5, without the need to create a special alternate valuation rule. However, to the extent that a special rule is required, we believe that such a rule should be specifically authorized by Congress.

II. HISTORY OF SECTION 2032(a) REGULATIONS

The preamble to the Proposed Regulations provides a useful narrative history of section 2032, and a discussion of two cases in which the courts considered whether post-death events other than market conditions may be taken into account under the alternate valuation method – Flanders v. United States and Kohler. The RPTE Comments expand upon the history of section 2032, and add a more complete discussion of cases and rulings. We will not attempt to replicate the historical matters discussed in either the Proposed Regulations or the RPTE Comments. However, certain points need to be expanded upon, particularly with respect to the history of the regulations under section 2032.

foreign ownership).

24 Id.
25 The preamble states that the Proposed Regulations “clarify” that the election to use the alternate valuation method is available to estates that experience a reduction in value of the gross estate due to market conditions, but not to other post-death events. 73 Fed. Reg. at 22,302 (April 24, 2008).
26 See Part IV, infra.
28 Supra.
Prior and Current Regulations

Aside from providing the primary justification for Treasury’s proposal, the opinion in Flanders provides an excellent history of section 2032 and the Regulations thereunder, from which much of the following discussion is derived.

1937 Regulations

The original alternate valuation date legislation was enacted in 1935. Subsequent to its enactment, Treasury issued an interpretative regulation (the “1937 regulations”), which stated in part:

The property to be valued as of one year after the date of decedent’s death, or as of some intermediate date, is the property included in the gross estate on the date of the decedent’s death. As property and its value are separate and distinct, the former denoting legal rights, the latter the monetary measure of such rights, and as subdivision (j) treats the two separately, it will be necessary in every case first to determine what property constituted the gross estate at decedent’s death.

Another portion of the 1937 regulations provided that income received between the date of death and the alternate valuation date was includible in the gross estate. That portion of the regulations was struck down in Maass v. Higgins. In Maass, the Supreme Court held that “If Congress intended . . . that a different method should apply at the end of the [alternate valuation] period than that applicable as of the date of death, it would have been a simple matter so to state.”

1941 Regulations

After the Maass decision, the regulations were amended (the “1941 regulations”) to read in pertinent part:

In valuing the gross estate under the optional valuation method, all of the property interests existing at the date of death which are a part of the gross estate . . . constitute the property to be valued as of one year after the date of the decedent’s death, or as of the date of the decedent’s death, or as of some intermediate date. Such property is hereinafter referred to as “included property.” “Included property” as of the date of the decedent’s death remains “included property” for the purpose of valuing the gross estate under the optional valuation method even though it is changed in form during the optional valuation period by being actually received or disposed of, in whole or in part, by the estate.

29 Notably, although only the opinion of a single federal district court, this decision receives more discussion in the preamble than does the legislative history to section 2032, the Supreme Court decision in Maass v. Higgins, 312 U.S. 443 (1941), the Kohler decision, or any of the other cases or revenue rulings interpreting section 2032.


31 Article 11 of Regulations 80 (1937 Ed.) (emphasis added).

32 312 U.S. 443 (1941).

Current Regulations

Both the 1937 regulations and the 1941 regulations focused on the idea that “included property” is determined as of the date of death – an idea not inconsistent with the Proposed Regulations. However, the current Regulations do not contain any such language.

Market Conditions and Other Causes

The preamble cites the example in Regulation section 20.2032-1(f)(1) for the proposition that “only changes in the value of the decedent’s gross estate due to market conditions, and not changes to the value due to a mere lapse of time, are to be considered . . . .”\(^{34}\) However, the example illustrates no such rule. In the example, the decedent or his estate was entitled to receive property upon the death of his eldest brother. At the date of the decedent’s death, the property was worth $50,000, and the eldest brother was age 31. Under the then-applicable tables, the factor for valuing the decedent’s remainder interest was .04746. At the alternate valuation date, the property was worth only $40,000, “because of economic conditions.” The example states that, although the eldest brother may then be age 32, the same remainder factor will be used. Thus, the example illustrates (and attempts to illustrate) only how to properly account for changes in value due to the “mere lapse of time”; the example’s reference to economic conditions was not intended to be limiting.

The preamble fails to cite the example in Regulation section 20.2032-1(f)(2), which does not restrict itself to “economic” or “market” conditions. In the example, the decedent owned a patent which, on the date of the decedent’s death, had an unexpired term of ten years.\(^ {35}\) Six months after the decedent’s death, the patent was sold, “because of lapse of time and other causes,” for $60,000. The example states that the alternate value is determined by dividing $60,000 by 0.95, to reflect that only 95% of the original life of the patent was remaining. The example clearly requires only that changes due to the lapse of time be taken into account.

Distributed, Sold, Exchanged, or Otherwise Disposed Of

Regulation section 20.2032-1(c)(1) provides the interpretive definition of “distributed, sold, exchanged, or otherwise disposed of,” which section 2032(a) uses to set the alternate valuation date for property distributed, sold, exchanged or otherwise disposed of within 6 months after the decedent’s death.\(^ {36}\)

Subparagraph (1) is intended to apply to “all possible ways by which property ceases to form a part of the gross estate.”\(^ {37}\) It does not, however, extend to transactions which are “mere changes in form.”\(^ {38}\) Specifically included as “mere changes in form” are contributions of assets to a corporation under section 351, and exchanges of stock or securities for other stock or

\(^ {34}\) 73 Fed. Reg. 22,301(April 24, 2008).
\(^ {35}\) The example states that the value at the date of death was $78,000, but the example indicates that this value is irrelevant.
\(^ {36}\) See Reg. § 20.2032-1(c)(1).
\(^ {37}\) Id.
\(^ {38}\) Id.
securities in a transaction described in sections 368(a) or 355 with respect to which no gain or loss is recognizable for income tax purposes under sections 354 or 355. Although not specifically mentioned in the Regulations, other “mere changes in form” include contributions to a revocable trust,\(^{39}\) and, presumably, contributions of assets to a partnership under section 721.

 Explicitly excluded from the term “mere changes in form” are complete or partial liquidations of a corporation under section 331; presumably, the term would also exclude certain non-recognition exchanges such as like-kind exchanges under section 1031 and involuntary conversions under section 1033.

 The Regulations provide no guidance as to how the term should apply to certain other non-recognition events, such as exchanges of annuities and life insurance policies under section 1035, assets-over partnership mergers under section 708, and liquidations of disregarded entities. In some cases, the application of the rule makes little sense – for example, a split-up under section 368(a)(1)(D) satisfies the definition of “mere change in form,” while the taxable distribution of a corporation’s assets to its sole shareholder does not.\(^{40}\)

 As entity structures have become more complicated, so have subchapters C and K of the Code. Regulation section 20.2032-1(c)(1) has simply failed to keep pace. What is, and what is not, a “mere change in form” cries out for elaboration. However, the Proposed Regulations would not amend Regulation section 20.2032-1(c).

### III. OBSERVATIONS CONCERNING KOHLER V. COMMISSIONER

The Kohler Company (the “Company”) is a privately held company (perhaps known best for its kitchen and bath supplies), owned primarily by family members of the Company’s founder, John Michael Kohler, charities established by family members, and trusts for the benefit of family members. One of the founder’s grandchildren, Frederic C. Kohler (the “decedent”), died unexpectedly on March 4, 1998. On his death the decedent owned approximately 12.85% of the outstanding stock of the Company, all of which passed to his estate.

 Approximately two years before the decedent’s death, in early 1996, the Company’s management decided to take action to achieve two main goals: (i) remove all outside shareholders (who owned approximately 4% of the Company’s stock); and (ii) facilitate estate planning for Kohler family members. Management determined that a recapitalization best met its goals, and began the process of restructuring the Company via a tax-free reorganization under section 368(a).\(^{41}\) The transaction was completed and became effective on May 11, 1998, two months after the decedent’s death. There is no indication that the timing of the transaction had

\(^{39}\) See Rev. Rul. 59-213, 1959-1 C.B. 244.

\(^{40}\) Inexplicably, the receipt of a single dollar of “boot” from a tax-free reorganization will result in the entire reorganization being deemed a disposition. See Rev. Rul. 77-221, 1977-1 C.B. (271) (boot received in exchange described in section 368(a)(1)(A) is taxable under section 356; because gain or loss is recognizable under section 354, the transaction is, as a whole, an “exchange” for purposes of section 2032). At best, this is a trap for the unwary; under the Proposed Regulations, cash distributed as a dividend will merely be disregarded, Prop. Reg. § 20.2032-1(f)(3)(i), while cash in a tax-free exchange would continue to result in a deemed disposition.

\(^{41}\) The opinion in Kohler does not indicate the specific form of reorganization used under section 368(a); the term “recapitalization” is not intended to imply any particular form of reorganization for tax purposes.
any relation to the decedent’s death. After the recapitalization was complete, all of the new shares in the Company were subject to transfer restrictions and a purchase option to ensure that family shareholders would continue to own all of the shares of the Company. The estate accepted restricted shares in the recapitalization, which resulted in it owning 14.45% of outstanding stock of the Company after the transaction.

The decedent's estate did not have the ability to approve or block the reorganization on its own. Had it not desired to accept the restricted shares, the estate would have had the option of accepting a cash-out of $52,700 per share ($51,382,500 for the estate’s interest), or exercising dissenter’s rights. Certain nonfamily shareholders (who did not have the right to accept restricted shares) exercised their dissenters’ rights; some of these shareholders also claimed that management breached their fiduciary duties. Ultimately, these claims were all settled for varying prices, up to $135,000 per share; however, apparently some shareholders accepted the $52,700 cash-out, without litigation.

The estate hired a well-known appraisal company to value the stock, and the firm determined that the stock's value was approximately $50,000,000 on the date of death, and $47 million on the alternate valuation date. The $47 million valuation reflected a discount for lack of marketability due to the added restrictions and purchase option.

The Service issued a deficiency notice to the estate claiming that the decedent's stock was actually worth $144.5 million (almost $100 million more than the estate’s appraisal) on the alternate valuation date. The estate filed a petition with the Tax Court to contest the deficiency notice.

What stock to value?

In the Tax Court trial, the Service put forth two alternative arguments regarding whether the estate’s stock should be valued pre- or post-reorganization: (i) pre-reorganization stock should be used to determine valuation; and (ii) post-reorganization stock should be valued, but without regard to the transfer restrictions and purchase option.42

42 The text of the Proposed Regulations state that interests in entities should be valued pre-reorganization. See Prop. Reg. § 20.2032-1(f)(3)(i). However, the facts of Examples 1 and 2 both assume that the value of stock does not change during a reorganization; the examples both accept that post-reorganization stock should therefore be valued, but without regard to transfer restrictions.

The ambivalence of the Proposed Regulations may result from Kohler opinion, which stated, “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.” Kohler, supra, at n.7. This statement was not actually necessary to the decision, as the parties had stipulated that the fair market value of the pre-reorganization and post-reorganization stock were equal.

In fact, subchapter C of the Code does not require that pre-reorganization and post-reorganization stock be of equal value. The Kohler decision cites to Rev. Rul. 74-269, 1974-1 C.B. 87 (which explicitly holds that if one party to a reorganization receives stock having a value in excess of the value of the stock surrendered, the excess “will be treated as having been used to make gifts, pay compensation, satisfy obligations of any kind, or for whatever purpose the facts indicate”), and to Rev. Proc. 81-60, sec. 4.03(2)(d), 1981-2 C.B. 680, 682 (which does not treat equal value as a prerequisite, but requires an explanation if values are not equal, and which references section 356(f), which provides that a reorganization may also result in a gift or compensation).
Pre-reorganization stock

The Service argued that pre-reorganization stock was the appropriate property interest to be valued as of the alternate valuation date. In support of its position the Service cited Regulation section 20.2032-1(d), which provides that, for certain types of property interests (such as interest-bearing obligations and leased property), the post-death earnings from such property are not included in the value of the property interests on the alternate valuation date. Equating the creation of new property interests in the Kohler stock to the creation of post-death earnings under Regulation section 20.2032-1(d), the Service argued that the Kohler stock should be valued as it existed on the date of death, without taking account of the new property interests.

The Tax Court determined that Regulation section 20.2032-1(d) did not support the Service’s argument because a tax-free reorganization of corporate stock was not one of the specific property interests contemplated by the Regulations. The court found no authority to treat the tax-free exchange as a change in form or to disregard the exchange for valuation purposes.

Unrestricted post-reorganization stock

The Service’s argument that post-reorganization stock should be valued without regard to the transfer restrictions and purchase option was based on Flanders and the legislative history of section 2032, which (the Service argued) indicated that the alternate valuation date method was intended only to address changes caused by declines in the market and not changes in the character of the property.

The court found that there was no ambiguity under section 2032, and therefore no need to consider legislative history. Moreover, the court determined that while section 2032 requires an estate asset to be valued when “distributed, sold, exchanged or otherwise disposed of,” Regulation section 20.2032-1(c)(1) plainly specifies that tax-free reorganizations under section 368(a) do not constitute dispositions for such purposes. Ultimately, the Tax Court held that the post-reorganization stock should be valued on the alternate valuation date, taking into account the transfer restrictions and the purchase option.

IV. RECOMMENDED AMENDMENTS TO REGULATIONS SECTION 20.2032-1(c)(1)

Under the current Regulations, corporate reorganizations pursuant to section 368(a) such as the one presented in the facts of Kohler are not considered dispositions for the purposes of the alternate valuation rule.\(^{43}\) It is clear from the Kohler decision that the court was impressed by the language of the Regulations. The Tax Court in Kohler stated that one requirement of such a reorganization is that the value of the stock prior to the reorganization must equal the value of the stock after the reorganization,\(^{44}\) therefore, any decline in value thereafter should be

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\(^{43}\) Reg. § 20.2032-1(c)(1).

\(^{44}\) See Kohler, supra, at fn.7.
attributable not to the reorganization itself (except to the extent the reorganization causes the company to be affected differently by market conditions).\textsuperscript{45}

To the extent a share of stock of the reorganized company has a restriction that may decrease value, either such share must also have had an aspect added that increased value, or the value of a share of stock before and after the reorganization must not have been equal. In such a circumstance, there would appear to be a potential for manipulation of value for alternate valuation date purposes. It may make more sense to treat a reorganization as a disposition as of the reorganization date for alternate valuation date purposes, rather than following the process under the Proposed Regulations.

We recommend that Treasury consider withdrawing the proposed amendments to Regulation section 20.2032-1(f). Instead, we recommend that Treasury propose amendments to Regulation section 20.2032-1(c)(1), to treat certain transactions currently considered “mere changes in form” as included in “distributed, sold, exchanged, or otherwise disposed of.” While such an amendment may disadvantage taxpayers in certain instances, the approach has the potential for a simpler and more efficient administration of the tax laws than that taken by the Proposed Regulations.

We recommend that Treasury further propose amendments to Regulation section 20.2032-1(c)(1), to clarify that when interests in an entity or other asset are held in the estate, all interests that would be aggregated for purposes of section 2031 shall also be aggregated for purposes of section 2032. Any distribution of an interest in an entity or other asset for purposes of section 2032 would be deemed a distribution of all interests in the entity or other asset. Again, while such an amendment may disadvantage taxpayers in certain instances, the approach has the potential for a simpler and more efficient administration of the tax laws than that taken by the Proposed Regulations.

This proposal would reach the “correct” result under all five examples in the Proposed Regulations, while avoiding the gray areas required by the definition of “market conditions.” We believe that this proposal requires only minor changes to the existing Regulations, and is well within Treasury’s authority to issue interpretive regulations under section 2032(a)(1). If Treasury does not believe that its authority would extend so far, then we suggest that the appropriate response would be to pursue a statutory change similar to Chapter 14 of the Code.

V. THE PROPOSED REGULATIONS

We believe that if our recommendations with respect to Regulation section 20.2032-1(c)(1) were adopted, then there would be little need to adopt the proposed amendments to Regulation section 20.2032-1(f). However, in the event that Treasury is unwilling to deviate from its current path, we offer the following additional comments regarding the Proposed Regulations.

\textsuperscript{45} However, as discussed more fully at fn. 42 above, subchapter C of the Code does not require that pre-reorganization and post-reorganization stock be of equal value. As discussed in Rev. Rul. 74-269, stock values may not be equal, although the excess “will be treated as having been used to make gifts, pay compensation, satisfy obligations of any kind, or for whatever purpose the facts indicate.”
Post-Death Market Conditions

The Proposed Regulations provide, in part, that the alternate valuation method applies “to the extent that the change in value during the alternate valuation period is the result of market conditions.”\(^{46}\) They further provide 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.”\(^ {47}\) Accordingly, the definition of “market conditions” is critical in determining whether the value of a property interest may be valued as of the alternate valuation date.

The definition of “market conditions,” rather than being based on the existing market for the property interest, is dependent solely on the identity of the party who is deemed to control the post-death event: “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.”\(^ {48}\)

Clearly, deliberate manipulations of the value of property interests by the persons who stand to derive a tax benefit from a lower value must not be permitted for this purpose. However, we are concerned that basing the definition on the identity of the party who is deemed to control the event leaves two questions that are not addressed in adequate detail by the Proposed Regulations: (i) which parties are those whose control will render a post-death event to fail to be considered a market condition and (ii) the parameters of the phrase “outside of the control of . . . .”

Who may exercise “control”?\(^ {49}\)

The existing Regulations, which address whether property has been “distributed, sold, exchanged, or otherwise disposed of,” provide that property may be “sold, exchanged, or otherwise disposed of,” by the executor, by a trustee or other lifetime donee, by an heir or devisee to whom title to property passes directly under local law, by a surviving joint tenant or tenant by the entirety, or by any other person.\(^ {49}\)

The Proposed Regulations would create a new rule that expands the class of actors who may exercise control. Any person (including an executor or trustee) in possession of property that is being valued may exercise the control necessary to trigger a loss of the opportunity to use the alternate valuation date. We fear the new rule is inadequate to the task, because it excludes actors who should be included, and includes some who in many situations should be excluded.

For example, a spouse or family member of the decedent who is free to act in a non-fiduciary capacity (and perhaps even in bad faith) may be able to exercise control without being


\(^{49}\) Reg. § 20.2032-1(c)(3). The term “any other person,” when read in pari materia, would appear to refer to “any other person in possession of property constituting a part of the gross estate.”
Indeed, in the Kohler case, the Kohler family and management decided on the reorganization. The executor of the decedent’s estate could not exercise control either to force or to block the reorganization. The executor had only three options: (i) accept the terms of the reorganization (although they resulted in a diminution of value), (ii) accept the cash-out, or (iii) exercise dissenter’s rights. Assuming that the reorganization would have been the “default” rule (e.g., if no executor were appointed), we believe that the Proposed Regulations would, if applicable to the Kohler case, have had no effect at all.

As another example, the new rule would not apply either to a “trust protector” or to the holder of a limited power of appointment, although either person may be in a position to exercise control over a decedent’s estate or trust.

On the other hand, there are situations in which a person may be able to exercise control, and yet such person’s actions should be disregarded because they are not acting in the interests of the estate and may even be acting adversely to the estate’s interest. The Code (and, in particular, the provisions relating to trusts and estates) recognizes that one person’s interests may be adverse to another. For example, although will and trust reformations are presumed by the Service to be non-adversarial, proof of ongoing litigation or other hostility between beneficiaries is often sufficient to overcome the presumption.

How should “control” be measured?

The Proposed Regulations provide little guidance with respect to the measurement of “control.” Examples 1 and 2, which generally follow the Kohler scenario, appear to assume complete control (over the exchange of stock for stock, if not over the reorganization itself). Example 3, which addresses the formation of family limited partnerships by the decedent’s executor, and Examples 4 and 5, which involve distributions, also appear to assume complete control by the executor. However, there are clearly many situations in which an executor or other person may have a vote – may even have a “swing vote” – yet cannot exercise any independent control. Chapter 14 of the Code uses “at least 50%” as the threshold for control. It seems unfair and arbitrary to penalize beneficiaries of an estate for an event that is genuinely outside of the executor’s control merely because the executor possesses the right to vote an insignificant number of shares. If the “outside of the control of” definition is retained, we recommend that a numerical threshold for “control” be adopted. Given the similarity between the concerns addressed by the Proposed Regulations and those addressed under Chapter 14, the Code contains anti-abuse rules for situations in which a person does not own property, but yet is deemed to have constructive ownership. Examples include the constructive stock ownership rules under section 318, and the partnership loss disallowance rules under section 707(b)(1). The Proposed Regulations make no attempt at implementing constructive ownership rules, although there would seem to be situations (aside from the Kohler-type) in which family members may be able to affect the value of the estate’s property.

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51 See Sections 2701(b)(2), 2704(c)(1).

52 See, e.g., sections 304(c) (at least 50%), 318(a)(3)(C) (greater than 50%), 355(g)(2)(B) (at least 20%), 382(g) (greater than 50%), 1239 (greater than 50%), 1504(a)(2) (at least 80%), 1563(a)(1) (at least 80%).
14, we believe that the threshold for control set forth in Chapter 14 should be considered as an appropriate threshold for measuring control in this context.

Events not “outside of the control of”

The Proposed Regulations would require ignoring all post-death events that fail the outside of the control of definition, whether such events would decrease or increase the value of the property interest. The basic problem with the “market conditions” test is that many events cannot be considered “market conditions,” and yet are clearly non-abusive. The RPTE Comments discuss the terms “post-death event” and “market conditions” at length, and provide extensive treatment of several categories of post-death events not adequately addressed by the Proposed Regulations.

The RPTE Comments clearly illustrate that there are many events and forces which, although within the control of the executor or trustee, arise from events outside of the control of the executor or trustee. The RPTE Comments provide examples of actions taken to prevent the loss of key employees, actions taken in response to a hurricane, and actions negotiated at arms length. Additional examples may include actions taken to quell labor unrest, and actions taken in response to increases in health insurance premiums or other costs. While the RPTE Comments provide an excellent attempt at defining events and forces that should be excluded from the Regulations, we believe that there are very few (if any) events beyond those set forth in the Examples which should be treated differently depending on whether they are within the control of the executor or trustee. The following are some additional examples of events that, although within the control of the executor or trustee, should be considered “market conditions.”

Events occurring in the ordinary course of business.

In many cases, several members of a family may work together in the family business, or may be engaged in “friendly” competition with one another. An individual may serve as executor or trustee for a deceased parent or sibling, while simultaneously being employed by the decedent’s company or by a competing business.

When an executor or trustee is involved in operating the family business, dozens of individual decisions may be made every day which the Proposed Regulations would require to be ignored. The patent example under Regulation section 20.2032-1(f)(2) (which the Proposed Regulations would retain) suggests the types of events that may be involved, and is illustrated perfectly (although coincidentally) by Kohler. A search of the patent database of the U.S. Patent and Trademark Office reveals that since March 4, 1998 (the date of Frederic Kohler’s death), 31 design patents have been issued that identify Herbert V. Kohler, Jr. as an inventor (in addition to more than 100 prior to that date). It would be reasonable to assume that many of these patents had a negative effect on the value of preceding patents. However, it would be unreasonable to ignore the existence of post-death patents for alternate valuation purposes.

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53 RPTE Comments, supra, Part V.
54 RPTE Comments, supra, Part X.
55 In the Kohler case, Herbert V. Kohler, Jr., was both executor of his brother’s estate, and an employee of the company.
Blockage discounts

It has long been recognized that the size of a block of stock owned by an estate may depress the value of those shares of stock owned by the estate below the value of the existing market price for an individual share. The theory of a “blockage discount” is based on the idea that the market for the stock is too thin to absorb a sale of all the shares of the estate at the market price within a reasonable time. Indeed, Regulation section 20.2031-2(e) explicitly recognizes the theory of blockage discount by stating that where the taxpayer shows that “the block of stock to be valued is so large in relation the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations.”

In the context of valuing a decedent’s block of stock for the alternate valuation date, the theory of a blockage discount is equally applicable. However, it is the size of the block of stock remaining in the estate on the alternate valuation date that is the consideration for blockage discount. In other words, an executor’s sale of a portion of the block of stock during the alternate valuation period may reduce or eliminate the blockage discount applicable to the block of stock remaining in the estate at the alternate valuation date.

Under the Proposed Regulations, however, this result is called into question. Because the executor’s sale of the stock during the alternate valuation date is an event clearly within the control of the executor, such a sale does not come within the definition of “market conditions.” The sale of a portion of the block of stock by the executor during the alternate valuation period would thus be classified as a “post-death event” other than market conditions, and would consequently be ignored in determining the value of the block of stock remaining in the estate at the alternate valuation date. Such a result would conflict with the case law cited above and seems questionable from the perspectives of logic, consistent application of the tax law and tax policy. Yet, the Proposed Regulations appear to require this questionable result.

Restricted stock

As in the case of blockage discounts, federal securities law may also affect the valuation of securities by restricting their sale. Revenue Ruling 77-287 explains the various types of restrictions applicable under federal securities laws, and provides guidelines for establishing the value of restricted stock.

As the ruling discusses, some restrictions apply under Rule 144 of the Securities and Exchange Commission, for the protection of prospective investors. Under Rule 144, the buyer

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56 See, e.g., Helvering v. Safe Deposit & Trust Co. of Baltimore, 95 F.2d 806 (4th Cir. 1943).
57 See, e.g., Estate of Van Horne v. Commissioner, 78 T.C. 728 (1982), aff’d, 720 F.2d 1114 (9th Cir. 1983).
58 “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.” Prop. Reg. § 20.2032-1(f)(1).
60 17 C.F.R. 230.144 (“Rule 144”).
of unregistered stock from an issuer in a private transaction must wait one year before selling the unregistered shares to the public. In a private transaction, the buyer may also require the issuer and its affiliates to agree to certain restrictions; for example, the issuer may agree not to issue additional shares, or may give the buyer the option to require registration at the issuer’s expense.

An executor or trustee may consummate an initial public offering that was initiated during the decedent’s lifetime; if so, the initial public offering may affect the valuation of the estate’s stock. Or, a decedent’s gross estate may include Rule 144 stock acquired during the decedent’s lifetime; if so, the executor or trustee may take other actions during the alternate valuation period that would affect the marketability (and consequently the valuation) of the estate’s stock. Under the Proposed Regulations, it may be necessary to ignore securities registrations, transfers of securities (whether registered or unregistered), or Rule 144. Particularly in the case of arms-length transfers to unrelated purchasers, there seems no reason to do so.

Livestock and crops

In other circumstances, such as where the property being valued is livestock or crops, the application of the Proposed Regulations is similarly questionable. Where a decedent’s estate owns livestock and crops, the value of such property interests may appreciate (i.e., grow) in the 6 month period from the date of death to the alternate valuation date. In that case, assuming the executor effectively elects to use the alternate valuation date, the higher value of the livestock and crops as of the alternate valuation date is used in determining the value of the gross estate for estate tax purposes.

For example, in Revenue Ruling 58-436,61 the Service ruled that the appreciation in the value of cattle and other property after the decedent’s death and during the alternate valuation period is not property earned or accrued and, therefore, the appreciated property is not “excluded property” but is includible in the gross estate at the fair market value on the applicable valuation date. If, under the Proposed Regulations, the growth in the crops and the livestock during the alternate valuation period were considered in the control of the decedent's executor or trustee, such a change in value would be a post-death event other than “market conditions.”62 Accordingly, the change in value would be “ignored in determining the value of the decedent’s gross estate under the alternate valuation method.” We are concerned that this result may not have been anticipated and is inconsistent with existing law.

Evaluation of Example 1

Example 1 of the Proposed Regulations63 presents a fact situation similar to that in Kohler.64 Specifically, a corporation in which the decedent owned stock undergoes a tax-free


62 Decisions to feed or water cattle, or to fertilize or irrigate crops, are within the control of the executor or trustee, and would appear to be beyond the term “market conditions” in any event.


64 Prop. Reg. § 20.2032-1(f)(3)(ii), Example 2, represents a minor variation of Example 1, and does not require separate discussion.
reorganization following the date of the decedent’s death but prior to the alternate valuation date. As part of the reorganization, the new stock is subject to transfer restrictions that ordinarily would support valuation discounts in determining the fair market value of the stock.

Applying the definition of “market conditions”

Example 1 assumes that the reorganization is a post-death event that causes a change in value for reasons other than market conditions. Proposed Regulation section 20.2032-1(f)(1) defines a change in market conditions as “events outside of the control of the decedent (or the decedent’s executor or trustee) . . . .”

In Example 1, it is unclear whether the reorganization itself is outside of the control of the decedent’s estate; in Kohler, clearly only the estate’s response to the reorganization was subject to the executor’s control. Example 1 requires clarification of the estate’s level of participation in the reorganization.

Example 1 states that the estate “opted to exchange its stock for stock subject to transfer restrictions”; we infer that the estate’s other options were to exercise dissenters’ rights (if to the extent permitted under local law) or, if permitted under the reorganization (as was the case in Kohler), to sell its stock back to the company. The estate may control whether to accept cash, to accept restricted stock, or to exercise dissenter’s rights; however, the estate does not have the option of retaining unrestricted stock through the alternate valuation date. Therefore, the reorganization itself should be considered a “market condition” (and therefore not ignored).

The hypothetical valuation approach

As illustrated in Example 1, the approach taken by the Proposed Regulations requires the valuation of a hypothetical asset on the alternate valuation date. Example 1 assumes that determining the alternate valuation date value of the stock would merely require the appraiser to ignore valuation discounts that otherwise would obtain from the transfer restrictions imposed on the stock from the reorganization. However, in effect, the Proposed Regulations require the valuation of the pre-reorganization stock, as if such stock were still in existence in its pre-reorganization form on the alternate valuation date. We believe that, in practice, such a valuation method would be difficult to implement.

If the form of a property interest changes after death (e.g., through the reorganization of an entity), the Proposed Regulations require that the post-reorganization form be ignored; instead, the property in the “pre-reorganization form” must be valued, but under the market conditions in existence at the alternate valuation date. Any such valuation will necessarily be hypothetical. An arms-length sale to a third-party – perhaps the best indication of fair market value – cannot possibly occur, because the post-restructuring property is no longer deemed to exist.

The vast majority of reorganizations are made for valid business reasons. Market conditions might yield changes in value had a particular reorganization not taken place; however, the reorganization may itself be in reaction to market conditions, and may be expected to

In the Kohler decision, for example, there was no indication that the reorganization was made for tax reasons.
increase shareholder value. An appraiser would have no accurate method to measure those changes in the facts under Example 1 or in many other situations.

If the hypothetical valuation approach is retained, we recommend that the Regulations, when finalized, provide examples clarifying how the approach would be applied.

Policy considerations

Many tax-free reorganizations offer significant non-tax benefits to the corporation or its shareholders. Although Example 1 assumes that the value of the stock did not change during the alternative valuation period, a shareholder might well be expected to sacrifice control for ownership in a more efficiently-run business. The approach applied in Example 1 could discourage shareholders from making prudent business decisions for the management of the corporation and for their long term investment goals, because such decisions might result in adverse estate tax consequences to the estate of a deceased shareholder.

VI. ADDITIONAL RECOMMENDED AMENDMENTS

The current Regulations set forth two examples applying the “mere lapse of time” rule under section 2032(a)(3). The Proposed Regulations indicate that these examples would be retained. We recommend that each of the examples be revised as follows.

Valuation of Life Estates and Remainder Interests

Regulation section 20.2032-1(f)(1) requires that the values of life estates, remainders, and similar interests are to be obtained by applying the methods prescribed in Regulation section 20.2031-7. The Regulations provide the example of a decedent whose estate was entitled to receive certain property upon the death of the decedent’s brother. Under the example, the actuarial increase in the value of the estate’s remainder interest (due to the increase in the brother’s age over the 6 month period) would be disregarded, and only changes in the value of the property itself would be taken into account.

In the example, the estate’s remainder interest is valued using the actuarial tables in effect through 1989, and an assumed 10% interest rate. This valuation method is inconsistent with the methods currently prescribed under Regulation section 20.2031-7. We recommend that the example be revised so as to be consistent with the valuation method currently prescribed.

Valuation of Patents

Regulation section 20.2032-1(f)(2) illustrates the alternate valuation of a patent. In the example, the decedent’s estate owned a patent which, on the date of the decedent’s death, had an unexpired term of 10 years, and a value of $78,000. The example states that, as of the alternate valuation date, the patent was sold for $60,000, “because of lapse of time and other causes.” The example provides that the alternate value would be obtained by dividing $60,000 by 0.95.


67 As Reg. §§ 20.2032-1(f)(2)(i) and (ii), respectively. See Prop. Reg., Par. 2, 1-2.
Under the Proposed Regulations the example would be accurate only if the “other causes” satisfied the definition of “market conditions.” To the extent that the “other causes” were not “outside of the control of” the executor, the appraiser would need to determine the hypothetical sales price of the patent as of the alternate valuation date, ignoring the “other causes.”