CCH
a Wolters Kluwer business

Estate Planning Review

Volume 35, No. 3 March 19, 2009

THE ESTATE TAX: WHERE ARE WE?

As the new Administration plunges ahead on a myriad of different fronts, we examine some of the possible avenues for transfer tax reform this year. The President's budget outline give us some clue, but there are also a number of other ideas that have a good chance of being considered.

The first few weeks have been busy ones for the new Obama Administration. Already we have seen passage of the $787 billion American Recovery and Reinvestment Act of 2009 (P.L. 111-5), which includes almost $300 billion in tax relief. The President and his team are preparing to tackle a laundry list of tough subjects from health care and Social Security reform to budget and tax policies.

With the end of the first quarter of 2009 quickly approaching, it is not too soon to ask, what about the future of the estate tax? Under provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the estate tax is supposed to be repealed for one year (2010) and then return to pre-EGTRRA law pursuant to a sunset provision. The generation-skipping transfer tax and stepped-up basis would also go away for one year, although the gift tax would remain in force. However, few people still believe that the one-year repeal is going to happen. With the Democrats holding the White House and healthy majorities in both houses of Congress, most observers think that 2009 will see legislation to continue the estate tax in some form.

At least one clue may be found in "A New Era of Responsibility Renewing America's Promise." That is the title of the Administration's budget summary, which was released on February 26. Buried in a footnote on page 121 of that document is the following language: "in continuing the 2001 and 2003 tax cuts, the estate tax is maintained at its 2009 parameters." This news should come as no surprise to anyone who was following then Senator Obama's campaign for President. During the campaign, Mr. Obama's website and tax summaries indicated his support for continuation of the estate tax with a $3.5 million lifetime exclusion amount and a 45-percent maximum rate.

Assuming that to be the basic framework for the estate tax going forward, what other proposals can we anticipate to be considered as part of any transfer tax legislation this year? A good place to begin to answer that question would be to look at the testimony heard before the Senate Finance Committee at a series of hearings on the estate tax that took place in November of 2007 and in March and April of 2008. One of these hearings concentrated on possible alternatives to the current transfer tax system. Although a number of the proposals were well researched and contained many positive attributes, it seems doubtful that Congress would attempt to confront these types of radical changes to the existing system outside of a debate on the broader question of overall tax reform—a debate that seems unlikely to take place this year in light of all the other priorities the Administration is currently wrestling with.

On the other hand, other proposals that were presented at the Senate Finance Committee hearings would seem to be more likely candidates for consideration in any legislative package being assembled in 2009. Here is an outline of several of these proposals.

"Reunification" of estate and gift tax exclusions—Since 2004 we have been faced with the rather odd situation of the previously unified estate and gift tax system in fact not being unified. While the applicable exclusion amount for transfers at death continued to increase until reaching its present level of $3.5 million, the exclusion amount for lifetime transfers

INSIDE

The Estate Tax: Where are We? 17
Planning Techniques and Tips: Alternate Valuation 19

has remained static at $1 million. Although a return to a unified system would seem to be a logical tradeoff to halting the repeal of the estate tax, this is one proposal that may wither under the pressure of budget constraints. Granted, not everyone has faith in the budget scoring that is used in connection with tax proposals, but the reality is that the numbers alone may doom the prospects for this idea.

Restoration of the pre-EGTRRA state death tax credit—Many estate planners, and for that matter, many revenue hungry state governments, would be happy to see the Code Sec. 2011 state death tax credit restored to law. But, similar to the situation concerning the gift tax applicable exclusion amount, budget considerations will have a negative impact on this proposal's chances. As you may recall, the phase down and eventual elimination of the state death tax credit arose in the late stages of negotiations on EGTRRA, fueled significantly by the possibility of being able to pass at least some of the cost of repeal of the federal estate tax on to the states. Unfortunately, the same mindset will most likely prevail again making the chances of enactment slim.

Portability of deceased spouse's unused credit amount—Although this proposal may also face risks due to the potential revenue loss, it does have several points in its favor. The first of which is undoubtedly simplicity. Certainly no one believes that portability would completely eliminate the need for trusts, but for many couples, particularly those who have been married only once and who are in the lower echelons of exposure to the estate tax (e.g., estates of between $3.5 and $7 million), this suggestion could prove to be beneficial. Supported by the American College of Trust and Estate Counsel (ACTEC), this proposal has at least a fighting chance of survival.

However, before finalization of any legislation, there are also several related issues that would need to be addressed with respect to portability. For one, the iteration of this proposal that appeared in the "Estate Tax and Extension of Tax Relief Act of 2006" (H.R. 5970) allowed the exclusion amount to be portable for purposes of estate and gift taxes, but not with respect to the generation-skipping transfer tax. H.R. 5970 also required that an election be made by the decedent's executor and that the decedent's estate had to file an estate tax return to take advantage of the portability provision. In testimony before the Senate Finance Committee in April 2008, a representative of ACTEC suggested that the proposal be revised to include the GST exemption and that an election not be required, as well as to allow for the possibility of attaching a special schedule to the deceased spouse's income tax return as a means of alerting the IRS to the portability issue rather than having to file an estate tax return.

Elimination of Crummey withdrawal rights—Referred to as nothing more than a legal fiction by some critics, the elimination or restriction of *Crummey* withdrawal rights is once again receiving scrutiny. It surfaced more than once during the Clinton years, but never made it into any serious legislative vehicles. With tax revenues a major concern in coming years it may see the light of day. However, it will face the opposition of a well organized life insurance lobby.

Elimination of nonbusiness valuation discounts—Unless you have not been paying attention for the last decade or so, it is painfully obvious that the IRS does not like valuation discounts taken in connection with transfers of interests in family limited partnerships and limited liability companies. The IRS has been on a relatively successful run in litigating cases in this realm (most recently in *T. Hurford Est.*, 96 TCM 422, CCH Dec. 57,610(M), TC Memo 2008-278), although one could argue that many of their successes have been "bad facts" cases. Similar to the situation with *Crummey* withdrawal rights, the valuation discount issue has been proposed before. A bill submitted earlier this year by Rep. Earl Pomeroy (H.R. 436) may serve as a stepping off point for any pending legislation on this subject.

Several other proposals are cited in a 2008 Congressional Research Service Report, "Estate and Gift Taxes: Economic Issues," (RL30600; March 24, 2008). The proposals include: (1) imposing consistent valuation rules for income and estate tax purposes; (2) elimination of stepped-up basis on a surviving spouse's share of community property; and (3) elimination of the exception for a retained interest in a qualified personal residence trust. As Congress begins to convert President Obama's budget framework into actual legislation in the coming weeks, we will soon see if any of these proposals will survive. ✦

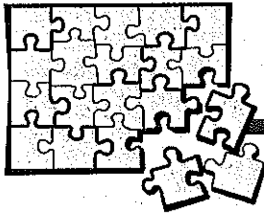
Estate Planning Review

Consulting Editor
Sidney Kess, J.D., LL.M., C.P.A.

Portfolio Managing Editor
Karen A. Notaro, J.D., LL.M.

Editors
Bruno Graziano, J.D., M.S.A.
Laura A. Tierney, J.D.
Alicia C. Ernst, J.D.
Michael G. Sem, J.D.
Scharema Hannibal

ESTATE PLANNING REVIEW (ISSN 0098-2873), published monthly by CCH, a Wolters Kluwer business, 4025 W. Peterson Ave., Chicago, Illinois 60646 **POSTMASTER:** SEND ADDRESS CHANGES TO ESTATE PLANNING REVIEW, 4025 W. PETERSON AVE., CHICAGO, IL 60646. Printed in U.S.A.
© 2009 CCH. All Rights Reserved.



PLANNING TECHNIQUES AND TIPS

Alternate Valuation

Sidney Kess & Martin M. Shenkman

OBJECTIVE

The current economic crisis has made the use of the alternate valuation date (AVD) morph from a once-in-a-blue moon election to what could become the norm for estate tax valuations. As a result, practitioners will have to bone-up on this once esoteric technique and its myriad implications. Making use of the AVD election is complex because of the interplay of a host of different tax consequences. The potentially varying impact on beneficiaries challenges fiduciaries and creates a need for professional guidance as to whether or not they should make the AVD election. The decision is significant because the executor can be held personally liable if making the AVD election could have reduced taxes (*Lohm Est.*, Pa. Sup. Ct., 269 A.2d 451 (1970)).

However, it is not only executors who should worry. "There is a catalog of considerations in determining whether to implement an AVD election. And while the current decline in portfolio values, like the original impetus for the predecessor to Code Sec. 2032, would suggest that these elections may be the norm in these rough times, the decision is anything but easy. Practitioners are going to need a map for this minefield. The election will rarely be a win-win across the board—and with winners and losers, the specter of malpractice will certainly hang over those guiding the executor," cautions Hugh F. Drake, Esq., Brown, Hay & Stephens, LLP, Springfield, IL.

Finally, the recent issuance of controversial proposed AVD regulations (NPRM REG-112196-07) makes the already significant challenges of advising fiduciaries even more daunting for practitioners. After summarizing the basic requirements affecting the use of the AVD, this article will explore each of the issues identified above and endeavor to provide practical guidance to practitioners.

TECHNIQUES

Assets are generally valued at the date of the decedent's death. However, if the assets have declined in value and there is a reduction in the estate and generation-skipping transfer (GST) tax due, then the fiduciary can make an election to use the AVD to value assets at the date six months following the decedent's death (Code Sec. 2032). The simplicity ends with this general concept. There are many exceptions and special rules.

- The six-month period is measured in terms of months. If there is no day in the sixth month which corresponds numerically, then the last day of the month is used.
- The election is made by the executor on the estate tax return and is irrevocable (Code Sec. 2032(d)(1)). The estate tax return must be filed within one year of the due date, including extensions for the election to be valid (Code Sec. 2032(d)(2)).
- Estates are not static. Property distributed, sold, exchanged, or otherwise disposed of within six months after the decedent's death is valued as of the date of the distribution, sale, exchange, or other disposition (Code Sec. 2032(a)). A transaction that is a mere change in form of the assets and not a sale, exchange, or other disposition of those interests should be valued at the AVD (Reg. §20.2032-1(c)). In *H. Kohler, Jr. et al.*, 92 TCM 48, CCH Dec. 56,573(M), TC Memo. 2006-152 (Nonacq.), the court held that a corporate reorganization was a conversion and a mere change in form of assets rather than a disposition. This pro-taxpayer holding was the catalyst for the proposed regulations, discussed below.
- A special valuation rule applies to certain assets such as patents, life estates, remainders, and reversions. These assets, which are affected by a mere lapse in time, are valued as of the date of death, not a later date of disposition or the AVD. There is, however, an adjustment to the valuation to reflect any difference in value that is not due to the mere lapse of time (Reg. §20.2032-1(f)).
- If the AVD is used, the value of an asset on the AVD becomes the beneficiary's basis for that property instead of the fair market value at the

date of death (Code Sec. 1014(a)(2)). Thus, the estate tax savings from electing the AVD may be offset by an increased income tax liability when the beneficiary subsequently disposes of the inherited property. Further, if it is anticipated that income tax rates will rise significantly (a distinct possibility as time progresses), the AVD may provide more of a time-value-of-money benefit (tax savings earlier) then a rate arbitrage (higher estate tax rate versus lower income tax rate).

EXAMPLES

1. *The AVD and Code Sec. 6166.* An estate is comprised of a family business valued as of the date of death at $7 million, securities valued at $10 million, and a house valued at $4 million. The business on the date of death constitutes one-third of the estate's value, calculated as follows: $7,000,000/($7,000,000 + $10,000,000 + $4,000,000), which is insufficient to qualify for the deferral of estate tax payments. On the AVD, the business has declined in value to $6 million and the securities to $4 million, while the house has increased to $5 million. The value of the business now comprises 40 percent of the estate, calculated as follows: $6,000,000/($6,000,000 + $4,000,000 + $5,000,000), which is sufficient to qualify for estate tax deferral under Code Sec. 6166. Thus, use of the AVD can have the added benefit of enabling the estate to qualify for additional estate tax benefits (or lose them, depending on the facts).
2. *Beneficiary Conflicts.* In the above example, the decedent was survived by three children, each of whom received a separate asset: the business, the securities, and the house. The use of the AVD benefited the children receiving the business and securities, but penalized the child receiving the house. How can an executor make the election in such a situation? How can the executor avoid making the election?
3. *Absorption Discount and Proposed Regulations.* An estate owns a large parcel of property, which can be subdivided into lots and sold. However, because the size of the parcel represents a large volume of property in the particular region, an absorption discount would apply to reflect the period of time over which the parcels would sell, similar to the situation in *J. Z. Astleford*, 95 TCM 1497, CCH Dec. 57,435(M), TC Memo. 2008-128. If the executor subdivides the property for sale, should that act be ignored under the new proposed regulations (discussed below) as an enhancement of post-death value since it is in the executor's control? What if the executor lists 10 percent of the parcels for sale in order to raise funds for the estate while attempting to avoid flooding the market? Is that act of restricting/limiting sales a control by the executor that should be ignored? What if the executor lists all the lots at one time thereby flooding the market and reducing values? What if the executor has a report prepared by an independent real estate consultant that determines that the approach that would maximize the value to the estate would be to immediately list all of the parcels? The decision is market driven but within the control of the executor. Yet the proposed regulations would ignore the impact on value.

   If the executor does not endeavor to maximize value to the estate, he/she will be violating his fiduciary duty. Are the proposed regulations creating potential conflicts for the executor? Would flooding the market reduce the tax valuation? Would flooding the market be contrary to the executor's fiduciary duties? The reality is that the determination of how many parcels to sell is really governed by the market and the executor has to follow the market conditions to maximize value for the estate or risk violating the fiduciary duties owed to the estate. The proposed regulations interpret the actions by the executor as preventing the consideration of the value; however, as a fiduciary, the executor's actions are, in fact, dictated by the market.

SIGNIFICANT DEVELOPMENTS

The objective of the proposed regulations, issued in response to *Kohler* (Reg. §20.2032-1(f)(1)) was to prevent executors from taking actions that could lower the value of an estate asset and then electing the AVD. More specifically, the IRS endeavored to enjoin the consideration of non-market forces. Unfortunately, the application of this seemingly simple objective results in considerable confusion and potential unfairness.

The concept underlying the proposed regulations seems to conflict with the purpose and history of the provisions."The definition of 'market conditions' and the history of 2032, is important to consider," suggests Hugh Drake. "The Service goes to great lengths to establish the historical underpinnings of 2032 as being rooted in the Great Depression. With the decline of the stock market between 1929 and 1934, many estates were entirely consumed by estate taxes. The purpose of the Congressional action was to prevent taxes from wiping out an estate—be it in publicly traded stocks or in a closely held business suffering in a staggering economy. Declining market conditions, as defined, are not cited as the reasons for the existence of the provision. This history does not support denying the AVD election in situations where the executor/trustee had some role in the short term drop in value, which is

©2009 CCH. All Rights Reserved.

what the proposed regulations do," notes Drake. "The definition of 'market conditions' in the proposed regulations is simply much too broad, as applied, in making suspect some actions by a personal representative that perhaps were not intended," Drake comments.

The proposed regulations provide that the AVD election permits the property included in the gross estate to be valued as of the AVD to the extent that the change in value during the alternate valuation period is the result of market conditions. The term "market conditions" is defined as events outside of the control of the decedent (or the decedent's executor or trustee). To eliminate changes in value due to "post-death events" other than market conditions, any asset affected by post-death events other than market conditions is included in the decedent's gross estate at its value as of the date of the decedent's death, adjusted for any change in value that is due to market conditions. "Ignoring changes in value due to post-death events other than market conditions cuts both ways," notes Carol A. Cantrell, CPA, JD, CFP, shareholder in Briggs & Veselka, Co., in Bellaire, Texas. "Some events have a positive impact on value, but some have a negative impact. For example, an executor who subdivides a parcel into lots to enhance value presumably would ignore the post-death increase in value because the increase was under his control. But, then the IRS would probably argue that the land should have been valued on the date of death at its highest and best use anyway."

The term "post-death events" includes, but is not limited to, a reorganization of an entity (for example, corporation, partnership, or limited liability company) in which the estate holds an interest, a distribution of cash or other property to the estate from such entity, or one or more distributions by the estate of a fractional interest in such entity. Thus, a restructure of a corporation as in *Kohler*, or the distribution of fractional interests in a controlled limited partnership or limited liability company will not be permitted to generate discounts as of the AVD that did not exist in valuing the asset at the date of death.

The proposed regulations are particularly problematic for, and unfair to, family and closely held businesses. The definition of "market conditions" under the proposed regulations suggests a complete prohibition of an executor doing anything post death that affects the value of the entity, even in the ordinary course of business. "This is the reason that the American Bar Association Real Property, Trust and Estate Law section submitted written comments suggesting that actions of an executor that are a reaction to market forces, or that are negotiated at arm's length, should not preclude an AVD election," explains Drake. The executor should not be hindered from allowing the operations of a business to continue in a manner that is in the business' best interest. "The business judgment rule should still govern the executor's actions post-death," insists Drake.

Family dysfunction is an issue that is ignored by the proposed regulations. The restrictions may in fact be foisted on the minority by the majority, with real economic detriment to the minority, and with no control on their part (*Kiriakides v. Atlas Food Systems & Services, Inc.*, 541 S.E.2d 257 (S.C. 2001)).

It also appears that the proposed regulations ignore events that may be critical to determining value and that are not reasonably controllable by the decedent or the fiduciary. Assume that the decedent owned one-third of a closely held business and was one of two key executives and founders of the business. The decedent's death did not have a significant impact on the business because a younger partner remained active. Post death, the younger partner quits the business and retires. The value of the business plummets. The departure of the unrelated partner cannot be controlled by the decedent's fiduciary. But is it a market force that the regulations permit to be considered? The business value may decline dramatically as a result of non-market, but non-controlled, circumstances. Change the facts slightly, so that the partner is the executor of the decedent's estate. If the partner/executor resigns, clearly his or her resignation is within the control of the executor. However, it does not appear to be a market force that the proposed regulations permit to be recognized. But the executor cannot be forced to work. The assumptions the proposed regulations require are problematic. "The proposed regulations require us to speculate on the value of a hypothetical asset — one that existed on the date of death, but no longer does, and adjust it for what it might have been worth six months later if the events that changed its form had not occurred. This may not even be possible in some cases. It then becomes an arbitrary wild speculative guess, subject, of course to differing opinions, as most predictions are," laments Cantrell.

The bottom line is more complexity. "Determining whether an estate qualifies for the AVD election is no longer a simple process of measuring the value at date of death and six months hence. Each asset must now be cleansed of the impact of post-death events under the control of the executor," notes Cantrell.

PITFALL AND TRAPS

1. *How will an AVD election affect different estate beneficiaries?* The election must apply to all es-

tate assets, no partial application is permitted (Reg. §20.2032-1(b)(2)). What happens if some assets go up and some decline in value? If there are bequests of different assets to different beneficiaries, the AVD election could potentially be advantageous to one beneficiary and detrimental to another. This conflict could prove problematic in administering the estate, and especially for the fiduciary having to make the Shakespearean call: "To AVD, or not to AVD: that is the question: Whether 'tis nobler in the estate administration to suffer the slings and arrows of outraged beneficiaries... ." As illustrated in Example 2 above, overall, the estate tax will be reduced, but the child receiving the residence will pay more tax as a result of the AVD election. In many estates, the residuary beneficiaries bear the burden of the estate tax. If in the above scenario, that child was the residuary beneficiary, he/she would realize the entire estate tax savings from the AVD election, but the child receiving the business would suffer the detriment of a lower income tax basis for the family business. This could put the fiduciary in a direct conflict in making the AVD election decision. Finally, the second child's intended holding period would affect this analysis. If he/she were planning on selling the business shortly after death, the present value of the income tax increase would be substantial, especially if capital gains rates rise. However, if instead that child planned on working for the foreseeable future in the business, the possible increase in income tax cost on sale resulting from the AVD election may be inconsequential.

2. *The impact of the AVD election on other estate tax elections must be considered.* Electing the AVD can positively or adversely affect the availability of a number of estate tax special valuation and tax deferral provisions by changing the threshold required to qualify for these advantageous provisions. Practitioners will have to evaluate the impact of the AVD election and any of the other available special rules to determine whether the overall impact to the estate is positive or negative. Three of these special provisions are discussed below.

   a. Code Sec. 303 permits redemption of stock to pay death taxes if the value of the corporate stock exceeds 35 percent of the gross estate reduced by deductions permitted under Code Secs. 2053 and 2054.
   b. Code Sec. 2032A requires that 25 percent or more of the adjusted value of the gross estate must constitute qualifying real property interests.
   c. If the value of an interest in a closely held business that is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States exceeds 35 percent of the adjusted gross estate, the executor may elect to pay part or all of the tax imposed by Code Sec. 2001 in two or more (but not exceeding ten) equal installments (Code Sec. 6166(a)(1)). In the AVD election regulations the phrase, "any property distributed, sold, exchanged, or otherwise disposed..." is identical to that used in Code Sec. 6166 (see IRS Letter Ruling 200043031). So, the test as to whether estate tax deferral and alternate valuation can apply in this context was the same. It is not clear whether the proposed regulations change the interpretation of this phrase for Code Sec. 2032, but not Code Sec. 6166 purposes.

3. *Assets Sold or Exchanged.* Valuing assets for the AVD election is complex because many estates sell assets and reinvest in new assets during administration. This can be essential to comply with the Uniform Prudent Investor Act. Such compliance could arguably be complicated by the need to consider the estate tax impact of an asset sale in addition to the pure investment reasons to diversify, etc.
4. *IRAs.* It is not clear what happens with property in an IRA on the alternate valuation date. How does Code Sec. 2032 apply to an IRA inherited by a child or other beneficiary? A transfer from the decedent's IRA to an inherited IRA should not be considered a Code Sec. 2032 distribution or disposition, according to most commentators. Instead, this should be treated as a mere transition of an account, similar to a joint account where the transfer to the surviving joint owner is not deemed to be a disposition under Code Sec. 2032. In Rev. Rul. 59-213, 1959-1 CB 244, the IRS stated: "The term "otherwise disposed of" is construed as not applicable to a transfer of jointly owned property which is subject to an unrestricted power of disposition retained therein by the surviving joint tenant, since, in effect, the joint tenant or tenant by the entirety is not relinquishing any authority or power of ownership over the property." A similar IRA succession issue arises if, prior to the September 30th beneficiary determination date in the year following the year of death, the beneficiaries who inherit the IRA split the account into separate IRAs so that each designated beneficiary can use his or her own life expectancy to calculate required minimum distributions (e.g., siblings with significant differences in age). Is the division of an IRA among named beneficiaries a "disposition" that freezes the value for purposes of the AVD elec-

©2009 CCH. All Rights Reserved.

tion? Finally, is an IRA a single asset or a bundle of separate assets (analogous to a brokerage account)? There seems to be little actual guidance on these potentially significant IRA issues.

PRACTICE POINTERS

1. *Qualifying for AVD election.* In order to elect the AVD, there has to be a reduction in estate tax. On the death of the first spouse, when under a typical estate plan no tax is incurred, the AVD will not be feasible. First, why would an estate wish to elect the AVD in such a situation? Perhaps, an executor would seek to elect the AVD to pack more assets into a bypass trust to avoid tax on the later death of the surviving spouse. How can this requirement of Code Sec. 2032 be met? If the will or revocable trust provides for a maximum funding of the bypass up to the amount that can pass free of federal estate tax (with the remainder to a marital qualified terminable interest property (QTIP) trust), no tax will be incurred and the AVD election will not be available. The surviving spouse might opt to disclaim sufficient assets to trigger an estate tax, thus qualifying the estate for the AVD election. If the disclaimed assets pass to someone other than the spouse, the necessary tax will be incurred and the AVD election available (assuming the asset disclaimed is one that declined in value). Alternatively, the fiduciary might make a partial QTIP election for the marital trust, perhaps opting for only 99 percent of the trust to qualify, thereby triggering a tax and qualifying the estate for the AVD election. This latter approach may be superior in that the partial QTIP election is not subject to the stringent nine-month deadline that a qualifying disclaimer requires.
2. *Closely Held Business and the AVD.* Executors contemplating an AVD election in an estate consisting largely of closely held business interests have to be very careful in the steps they take until it is clear how the IRS is going to approach the AVD into the future. "If an executor is compelled to take action during the alternate valuation period that could affect value, make sure to identify the business reasons for the action in the minutes of shareholder and board of directors meetings. If the action was the result of an arm's length negotiation, make sure to document all of the interchanges between the parties including identifying the business reasons for the actions. These may be the only means of proving why it was necessary or advisable to take the action and why it should not preclude an AVD election," recommends Drake.
3. *Post-Appraisal Events.* Closely related to the AVD election is the issue as to whether or not the appraisal as of the date of death (or the AVD, for that matter) was correctly done. Every appraisal is based on assumptions as to future economic conditions. What if those assumptions, as with the current economic recession, prove far too optimistic? Can the appraiser re-evaluate the assumptions used as of either valuation date to consider post valuation (after the date of death or AVD) factors? What can be done? Can a new appraisal be completed with better assumptions?

   "The answer is not clear-cut," according to Jay B. Abrams, ASA, CPA, MBA, Abrams Valuation Group, Inc., North Hollywood, California. There are two conflicting principles involved, according to Abrams. The first and most basic principle, based on the definition of "fair market value," is that the valuation must be done based on what is known or reasonably knowable on the valuation date. This stems from "each being reasonably informed of the relevant facts." So, it is quite reasonable to value the World Trade Center on 9/10/01 at, say, $1 billion, it was not knowable that the WTC would be wiped out the next day. If at both estate valuation dates it was already known that the economy was in a shambles, the only question is the degree of shambles. "While there may be a case to be made that the valuation assumptions were too optimistic, such an argument is not a slam dunk," cautions Abrams. The second principle, which is largely contrary to the first principle, is that the tax law may allow consideration of some degree of subsequent information or events in order to provide evidence as to whether the assumptions used in the valuation were reasonable. An expectation that specific future events might occur may influence an asset's value and the courts have occasionally permitted the use of hindsight to confirm the appropriateness of these expectations and their impact as of the valuation date. A subsequent sale of an asset can be used as evidence of the asset's fair market value on the valuation date. The Tax Court ruled that an actual sale made at arm's length, in the normal course of business, within a reasonable time before or after the valuation date, is the best criterion to value an asset (*H. Noble Est.*, 89 TCM 649, CCH Dec. 55,903(M), TC Memo 2005-2). In *Noble Est.*, bank stock was sold in an arm's-length transaction more than a year after death and that value was held determinative.
4. *Re-Appraising with Different Methodologies.* Apart from considering post-valuation date events, Abrams notes that different valuation methodologies may be better at addressing the impact of the economic tur-

moil. "The Monte Carlo Simulation (MCS) presents another possible approach that should be useful, even if subsequent events are not allowed. MCS is likely to do a better job of modeling the downside of a very squishy economy than a discounted cash flow (DCF), the latter of which is a static model, frozen in time. MCS is a more sophisticated version of the multi-scenario analysis sometimes used in appraisals. It is a technique wherein we assign probability distributions to different assumptions of the DCF. For example, instead of assuming that sales will grow at a specific percentage, we could model, for example, that, worst case, sales will decline 50 percent in year one, most likely, they will decline ten percent, and, best case, they will increase by three percent. The appraiser may have used a forecast of a sales decline in year one of seven percent, but this seven percent does not capture the terrible possibilities that MCS can capture. The MCS process is to define every one of several assumptions that are really probability distributions and not known, fixed numbers. A DCF valuation model is run 50,000 or 100,000 times using random number generators to simulate the probability distribution for each assumption. Each run is its own DCF, but instead of running just one fixed DCF, we run 100,000 of them. In MCS, value is no longer just a simple fixed number, but it is a probability distribution. For example, MCS may show that there is a ten-percent probability that the fair market value of the company is between $1 million and $2 million, a 30-percent probability that it is between $2 million and $3 million, etc. We still come to a weighted average and that is what we say is the fair market value of the company. However, it is more realistic in the sense that we show that fair market value is really a probability distribution. MCS is more realistic to measure value as a probability distribution."

SUMMARY

Objectives

- ▼ As a result of current economic conditions, fiduciaries should consider using the AVD and should obtain the advice of counsel.

Technique

- ▼ The AVD can be used only if there a decline in the value of estate assets and the decline in value causes a reduction in the estate and GST tax liability.
- ▼ The fiduciary must observe all statutory and regulatory requirements and carefully weigh the costs and benefits.

Example

- ▼ The executor must consider the consequences of electing the AVD, such as qualifying for the estate tax deferral provision and the effect on beneficiaries.
- ▼ Under recently issued proposed regulations, an executor's duty to maximize the value of estate assets may be affected by the directive that actions within the executor's control will be ignored for AVD purposes.

Significant Developments

- ▼ The proposed regulations restrict the availability of the AVD election to those circumstances where "market conditions," defined as events outside of the control of the decedent or the decedent's executor or trustee, caused the decline in the value of the property.
- ▼ The proposed regulations could cause problems for estates with family or closely held businesses or where family dysfunction is an issue.

Pitfalls & Traps

- ▼ Consider the impact the AVD will have on different estate beneficiaries and on other estate tax elections.
- ▼ Balance the need to comply with the prudent investor rules with the impact the AVD election could have on the sale of an asset.
- ▼ Lack of guidance on the interplay of IRAs and the AVD election.

Practice Pointers

- ▼ Where a spouse survives the decedent, it may be beneficial to make a partial QTIP election, triggering some estate tax liability but allowing the estate to qualify for the AVD election.
- ▼ Where a closely held business is involved, document the business reasons for any action that may have an effect on value during the AVD period.
- ▼ During a period of economic uncertainty, the executor may be permitted to consider post-death events that were unforeseen at time of the appraisal or the possibility of employing different valuation methodologies.

©2009 CCH. All Rights Reserved.