

POINTS TO REMEMBER

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WHAT HAS THE FIFTH CIRCUIT DUNN?

by Leandra Lederman,
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Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002), a recent estate tax decision, is as notable for its angry tone as for its content. In *Dunn*, the Court of Appeals for the Fifth Circuit harshly criticized the government's approach to trying and appealing a case involving valuation of a closely held corporation. In reversing and remanding, the court even instructed the Tax Court to "entertain" any claim that the taxpayer-estate might make for attorney's fees and costs. To succeed on such a claim, the estate would have to show that the Service's position was not substantially justified.

Valuation is notoriously inexact and experts often disagree, as was true in *Dunn*. It may, therefore, seem surprising that the Court of Appeals expressed sympathy for an argument that the Service's position lacked justification. The anger reflected in the *Dunn* decision apparently was caused by five things: (1) the mailing of the notice of deficiency approximately two and a half years after the estate filed its return; (2) the Service's increase in its valuation in an amend-

ed answer filed in Tax Court; (3) the Service's assertion of a valuation based entirely on asset value without a sizeable reduction for associated tax liabilities; (4) the Service's use of its trial expert solely to criticize the taxpayer's valuation, rather than to support its own; and (5) the government's argument on appeal that the court should affirm the Tax Court decision (which reflected a lower valuation than the Service had claimed in its amended answer). In fact, the Service was well within its rights on the procedural issues involved.

First, the Court of Appeals' statement that the estate's valuation "by virtue of the Commissioner's eleventh-hour deficiency notice, could not effectively be revised downward . . ." is plainly wrong. Although the court correctly pointed out that the limitations period on refund claims generally expires three years from when the return was due or two years from when the tax was paid (section 6511(a)), it further stated:

When the IRS presents a deficiency notice in close proximity to the expiration of I.R.C. § 6501's 3-year time bar, it creates a tactical advantage for itself: Once the statute of limitation expires, the taxpayer can no longer claim a refund even if he then concludes that he was too conservative in his original valuation. . . . Consequently, by holding off the filing of a notice of deficiency until more than two years following payment of tax or three years following the filing of the return, the IRS is able to manufacture an advantage with no downside risk: The taxpayer is precluded from claiming a refund except for any taxes paid with the deficiency notice, and the Commissioner is able to assert an excessive value and then use it for leverage in negotiations or at trial.

Fortunately for taxpayers, the Service has no such advantage. When the Service mails a notice of deficiency within the three-year statute of limitations on assessment, the taxpayer always will be able to pursue a refund of amounts paid (or deemed paid)

with the return, even if the taxpayer receives the notice more than three years after the return was due, if the taxpayer petitions the Tax Court, which the *Dunn* estate did. That is because, if the taxpayer has not previously filed a refund claim, section 6512(b)(3)(B) will deem the date of the mailing of the notice of deficiency to be the date a refund claim was filed. Because the notice will have been mailed within three years of the due date of the return, the taxpayer's deemed refund claim will be timely under the three-year rule and will therefore benefit from a three-year look-back period with respect to the limitation on the amount of refund imposed by sections 6512(b)(3) and 6511(b)(2)(A). Thus, the court's additional assertion that the timing of the notice of deficiency reflects the lack of "a bona fide disagreement over the value of Dunn Equipment" is patently incorrect. Instead, the Service likely needed much of the three-year statutory period to consider the complex issues raised in the case.

In addition, the estate had almost four months remaining after the November 11, 1994 notice of deficiency to file a claim with the Service for refund of the taxes it had already paid (*see* sections 6075(a), 6511, 7503). Moreover, the estate did lower its initial valuation. On its return, the estate valued the decedent's stock at \$1,635,465, based 50–50 on assets and earnings-based values. However, in Tax Court, the estate argued that the value should be \$1,582,185. Furthermore, the Court of Appeals, in remanding to the Tax Court, essentially determined an even lower valuation; it set forth a specific formula that yields a value of approximately \$977,183, as explained below.

It is true that the Service increased its valuation after the case was docketed in Tax Court. In its notice of deficiency, the Service asserted a value of \$2,229,043. In an amended answer, the Service increased its valu-

ation to \$4,430,238, using the net asset value of the corporation, with a discount for lack of marketability and lack of supermajority. However, the Service paid a procedural price; it always bears the burden of proving an increased deficiency, as both the Tax Court and Court of Appeals pointed out. *See* Tax Court Rule 142(a)(1). Particularly given that context, the Service's decision to have its expert critique the estate's valuation but not support the Service's own valuation was probably a tactical error.

The Tax Court held that the decedent's stock was worth \$2,738,558, weighing the asset-based value 65 percent and the earnings-based value 35 percent. *See* Estate of Dunn v. Commissioner, T.C. Memo. 2000-12. The Service did not appeal but the estate did. As appellee, the Service did not return to its \$4,430,238 valuation but instead argued that the Tax Court's holding was correct. Oddly, that tactic angered the Court of Appeals, and the court's ire influenced its decision. Referencing "[t]he Commissioner's abrupt change of position on appeal," the court stated, "[w]e keep this duplicity in mind as we proceed to examine the Tax Court's valuation methodology." The court's misunderstanding of the workings of statutes of limitations on refund claims may also have colored its view; its statement about duplicity immediately follows a lengthy paragraph, quoted in part above, that incorrectly describes the interaction of the statutory period with the statute of limitations on assessment.

This is not the first time that a Court of Appeals has penalized the Service for reconsidering its valuation of a closely held business during the course of litigation. In a trio of cases decided last year, the Court of Appeals for the Ninth Circuit required the Service to bear the burden of proof when it decreased its deficiency subsequent to issuing a notice of deficiency. *See* Estate of Mitchell v. Commissioner, 250 F.3d 696 (9th Cir. 2001); Estate of Simplot v. Commissioner, 249 F.3d 1191 (9th Cir. 2001); Morrissey v. Commissioner, 243 F.3d

1145 (9th Cir. 2001). The message conveyed by these decisions and *Dunn* may be that the Service should carefully determine its valuation methodology, relying on qualified experts, and apply that methodology meticulously. However, the message that the Service might receive is that, at least in valuation cases, it should not deviate from the amount it asserts in the notice of deficiency, even to support a lower valuation.

Ironically, despite the Ninth Circuit's criticism, on remand, the Tax Court upheld its initial valuation in *Mitchell* and reentered its original decision. *See* Estate of Mitchell v. Commissioner, T.C. Memo. 2002-98. (The estate has appealed; *see* docket sheet for docket 21805-93 at www.ustaxcourt.gov). The Tax Court cannot do the same in *Dunn* because the appellate decision left it little discretion. The Fifth Circuit held that the Tax Court must (1) assign a weight of 85 percent to the value that the Tax Court had determined to be \$1,321,740 using the earnings-based approach, and a weight of 15 percent to the value that the court determines using the asset-based approach after reducing the market value of the assets by 34 percent of their taxable built-in gain, (2) calculate the estate's 62.96 percent share of that value, and (3) discount the resulting amount by 22.5 percent. The Tax Court had determined that the aggregate value of the corporation's assets was \$8,278,342 and that the built-in gains amounted to \$7,109,000. Applying the formula to those numbers results in a value of \$977,183.43.

The Service may end up owing more than a refund in *Dunn*. The Court of Appeals directed the Tax Court to consider a claim for attorney's fees, if asserted, "if perchance the re-valuation of the Decedent's block of . . . stock should reduce the net worth of the Estate to a sum below the \$2 million cap on entitlement to relief . . ." By effectively locking the Tax Court into a valuation well below that number, the Court of Appeals may have eased the way for a fee award, if the Tax Court finds that the

estate's "net worth" is the value of its assets on the date of the decedent's death.¹ Yet, the Fifth Circuit's misunderstanding of tax procedure hardly lends credence to its suggestion that the Service's position was not substantially justified.

SUBSEQUENTLY IMPOSED RESTRICTIONS: THE SERVICE SPEAKS ON SECTION 83

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In a letter ruling released this spring, PLR 200212005 (November 8, 2001), the Service provided a curiously simple answer to a historically troublesome question: Does section 83 apply to a taxpayer who owns outright shares which subsequently become subject to a substantial risk of forfeiture as a result of an arms-length negotiated financing or third-party investment?

THE CONCERN

In general, section 83(a) requires a taxpayer to include in gross income the fair market value of any property received (less the amount, if any, paid for such property) in connection with the performance of services. Thus, if an employee receives stock from her employer as part of her compensation, she will be taxed on the fair market value of such stock on the date of receipt. The result is different, however, if the employee's ability to transfer or keep the stock is conditioned upon her continued employment for a period of time. This is because the income inclusion and the corresponding fair

¹ Cf. Estate of Woll by Woll v. United States, 44 F.3d 464 (7th Cir. 1994) (apparently using fair market value); Estate of Rao v. United States, 987 F. Supp. 249 (S.D.N.Y. 1997) (same); but cf. Wilkes v. United States, 2000 U.S. Dist. LEXIS 12430 (M.D. Fla. 2000) (parties agreed that net worth meant "cost"; court determined that decedent's acquisition cost was relevant measure), *aff'd*, 289 F.3d 684 (11th Cir. 2002) (declining to consider government's argument, first raised on appeal, that net worth should be based on fair market value of estate's property on date of decedent's death); Estate of Lute v. United States, 19 F. Supp. 2d 104, 1061 (D. Neb. 1998) (using "acquisition cost of real estate" to arrive at a figure under \$2 million and much lower than that advanced by government).