



Alternate Valuation Date Prop. Regs.: Effects on Practitioners and Clients

It is clear that the new Proposed Regulations would significantly restrict the use of discounts in valuing property on the alternate valuation date. Nevertheless, the ultimate implications of the changes made by the Prop. Regs. remain uncertain.

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On 4/24/08, the IRS issued Proposed Regulations to modify Reg. 20.2032-1.¹ Generally, Section 2032 is a relief provision that may be elected when the value of an estate's property decreases after the decedent's date of death.² The provision was included in the Revenue Act of 1935³ as a direct result of the 1929 stock market crash. The concept of an alternate valuation date was designed to address "the danger of complete confiscation of estates due to a sudden decline in market values."⁴ Since its enactment, the alternate valuation election has become a valuable estate planning tool that is routinely used to reduce estate taxes.

The Proposed Regulations would make the Section 2032 election available 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." And although the IRS has indicated that these Proposed Regulations were issued, at least in part,

to deal with its disagreement with the Tax Court opinion in *Kohler*,⁵ the implications of such Proposed Regulations extend far beyond the facts of one case. As a result, all estate planning practitioners and clients should pay attention to the details of this proposed rule change. This article will discuss the history of the Proposed Regulations and explain these new provisions and their potential consequences.

Background

Generally, the federal estate tax is calculated based on the date of death value of the decedent's assets.⁶ If the value of the decedent's gross estate declines in the six months following the decedent's death and if electing to use the alternate valuation date for estate tax purposes would reduce the taxes due, the executor

may elect to use it to value the assets of the estate for estate tax purposes. Assuming an executor makes a proper election under Section 2032,⁷ all property included in the gross estate at the decedent's death will be valued as of the date six months after death,⁸ with two exceptions: (1) property sold, exchanged, or otherwise disposed of within six months following a decedent's death is valued on the date of disposition;⁹ and (2) property interests that are affected by the mere lapse of time are valued as of the date of death, adjusted only for changes in value as of the alternate valuation date not due to lapse of time.¹⁰

Two important Regulations explain these exceptions. First, Reg. 20.2032-1(c) provides the definition of "distributed, sold, exchanged or otherwise disposed of" and clarifies who may "distribute" and sell, exchange or otherwise dispose of property. Second, the current Reg. 20.2032-1(f) addresses the "mere lapse of time" rule and provides two

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illustrations of the rule as it relates to (1) life estates, remainders, similar interests, and (2) patents.

Judicial decisions

In evaluating the application of Section 2032, courts have differed in determining whether certain post-death events may be taken into account in determining alternate valuation. As indicated in the Preamble to REG-112196-07, Prop. Reg. 20.2032-1(f) was issued largely in response to the Tax Court opinion in *Kohler*. The Preamble also pointed out that the Proposed Regulations would resolve the differences between the holding in *Kohler* and another case, *Flanders*.¹¹ An analysis of the relevant facts in *Flanders* and the facts and arguments in the *Kohler* case follows.

Flanders. In *Flanders*, the trustee of a decedent's revocable trust entered into a conservation agreement with the State of California after the decedent's death, but prior to the alternate valuation date. The conservation agreement required that land owned by the decedent (a one-half interest in a cattle ranch) be used for agricultural purposes for ten years, in exchange for the right to reduce the assessed value of the land for purposes of paying property taxes. As a result, the fair market value of the entire property was reduced by 88%. The decedent's estate reported the value of the land after the restriction was added, and claimed that the decedent's interest was further reduced to reflect a lack of marketability discount.¹² The Service determined there was a deficiency, and the decedent's trustee—after paying it—sued for a refund.

The California district court that heard the case concluded that the character of property for valuation purposes was determined as of the date of death, and only a reduction

in value as a result of changes in market conditions, not voluntary acts, could be taken into account on the alternate valuation date. The court stated: "It seems clear that Congress intended that the character of the property be established for valuation purposes at the date of death. The option to select the alternate valuation date is merely to allow an estate to pay a lesser tax if unfavorable market conditions (as distinguished from voluntary acts changing the character of the property) result in a lessening of its fair market value." As a result, the conservation agreement was not considered in valuing the property on the alternate valuation date.

Kohler. *The facts*. The Kohler Company (the "Company") is a privately held company (known best for its kitchen and bath supplies) owned primarily by the descendants of the Company's founder, John Michael Kohler. One of Mr. Kohler's grandchildren, Frederic C. Kohler (the "decedent"), died unexpectedly of a heart attack on 3/4/98. On his death, the decedent owned approximately 12.85% of all outstanding capital stock of the Company, all of which passed to his estate.

Approximately two years before the decedent's death, in early 1996, the Company management decided to take action to achieve two main objectives: (1) to remove all outside shareholders (who owned approximately 4% of the Company stock), and (2) to facilitate estate planning for Kohler family members. The Company determined

that a recapitalization best met its goals. Thus, it began a Section 368(a) tax-free reorganization to restructure the company. This was completed, effective on 5/11/98, two months after the decedent's death. Following the recapitalization, all the Company's new shares were subject to transfer restrictions with a purchase option to ensure that family shareholders would continue to hold all the shares.

The decedent's estate did not have the ability to approve or block the reorganization on its own. However, it did elect to receive new shares in the Company (as opposed to accepting cash for the value of its shares), which resulted in it owning 14.45% of the outstanding stock of the Company after the transaction. The estate hired a well-known appraisal company to value the stock, and the firm determined that the stock's value was approximately \$47 million on the alternate valuation date. This valuation reflected a discount for lack of marketability due to the added restrictions and purchase option. The alternate valuation date value of the stock was approximately \$3 million less than the date of death value.

The IRS 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 then petitioned the Tax Court to contest the notice.

The arguments. *What stock to value*. In the Tax Court trial, the

¹ See 73 Fed. Reg. 22,300 (4/25/08); REG-112196-07.

² The specific requirements for a proper Section 2032 election are discussed below.

³ 74 Pub. L. No. 407 (1935).

⁴ S. Rep't No. 1240, 74th Cong., 1st Sess. 9 (1935).

⁵ TCM 2006-152; (*Nonacq.*), AOD 2008-01 (3/3/08) and NA, IRB 2008-9 (3/3/08), discussed below. See also Preamble to REG-112196-07, citing *Kohler*.

⁶ Section 2031.

⁷ The Section 2032 election is available only if it will decrease both (1) the value of the decedent's estate and (2) the sum (reduced by allowable credits) of the estate tax and generation-skipping transfer tax due on the property included in the decedent's gross estate. (Section 2032(c).)

⁸ Section 2032(a)(2).

⁹ Section 2032(a)(1).

¹⁰ Section 2032(a)(3).

¹¹ 347 F. Supp. 95, 30 AFTR2d 72-5872 (DC Cal., 1972).

Service put forth two arguments regarding whether the estate's stock should be valued pre- or post-reorganization:

The first argument was that the pre-reorganization stock should be used to determine valuation based on Reg. 20.2032-1(d), which addresses the rules for certain date of death interests (such as interest-bearing obligations and leased property). Under Reg. 20.2032-1(d), the changes in form that such property interests may undergo, such as dividends being declared and paid or rent accruing and being paid, are not included for purposes of the alternate valuation date. The IRS argued that, similarly, the post-death changes in the Kohler stock should also be ignored and instead the property interest as of the date of death (the pre-reorganization stock) should be valued.

The Tax Court determined that Reg. 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 changes in form contemplated by the Regulation. The court found no authority to treat the exchange as a change in form or to disregard the exchange for valuation purposes. Furthermore, since both the estate and the IRS stipulated that the reorganization was tax-free, requiring that the value of the stock be the same before and after the transaction, the court questioned why the IRS made such an argument at all.

In the alternative, the IRS argued that the post-reorganization stock

should be valued, but without regard to the transfer restrictions and purchase option. This argument was based on *Flanders* and the legislative history of Section 2032, which the IRS claimed indicated that the alternate valuation date method was intended to address only changes caused by declines in the market and not changes in the character of the property.

Despite the IRS's argument and its focus on the *Flanders* case, the court found that there was no ambiguity under Section 2032, and therefore there was no need to consider legislative history. Moreover, the court determined that the appropriate analysis was whether the reorganization caused the stock to be "distributed, sold, exchanged or otherwise disposed of" under Section 2032. Finding that Reg. 20.2032-1(c)(1) plainly specifies that Section 368(a) tax-free reorganizations do not constitute dispositions for such purposes, the court stated that Reg. 20.2032-1(c)(1) was in fact consistent with the legislative history relied on by the district court in *Flanders*. As a result, the Tax Court held that the post-reorganization stock should be valued on the alternate valuation date, including the transfer restrictions and the purchase option.

Valuation of the stock. Once the court determined that the post-reorganization, discounted stock should be valued, it analyzed the approximately \$100 million difference between the estate's valuation and the Service's valuation of such stock. However, the \$100 million difference in value was a result of the differing valuation methodologies, and not a result of the use of the alternate valuation date.

In analyzing the experts' reports, the Tax Court expressed "significant concerns" with the IRS's expert, who did not properly certify his work or prepare his report

in accordance with appropriate standards, and who spent only 2-1/2 hours with the Company's management before submitting his report (leading the court to state that he "did not understand Kohler's business"). In addition, the Service's expert admitted that he overstated the stock's value by \$11 million prior to the trial. In stark contrast, the court was "impressed" by the methodologies and conclusions of the estate's two experts. The Tax Court opinion details these appraisers' methods and praises their skill in coming to the \$47 million valuation.

The court ultimately determined that it could place no weight on the IRS's expert's conclusions. Instead, the court gave "significant weight" to the valuations of the estate's experts and held that the decedent's stock was worth \$47 million.

In summary, *Kohler* was a considerable loss for the IRS.

The genesis of the Proposed Regulations

The IRS disagreed with and nonacquiesced in *Kohler*.¹³ In issuing its nonacquiescence, the IRS stated that it believed the Tax Court "had erred in focusing on whether a disposition had occurred rather than on whether it should take into account a change in the character of the property that had occurred during the alternate valuation period."¹⁴ Responding to *Kohler* and reconciling the difference between it and *Flanders*, REG-112196-07 contained new Proposed Regulations under Section 2032.

The Proposed Regulations

The Proposed Regulations would amend Reg. 20.2032-1 by restructuring the current paragraph (f) to emphasize that the alternate valuation election under Section 2032 is available to estates that experience a reduction in the value of the

¹² The fair market value of the entire ranch was \$220,000 prior to the conservation easement and \$60,000 after the conservation easement. The decedent's interest was valued to be \$25,000 on the alternate valuation date, which reflected one-half of the value of the ranch after the land use restriction was placed upon it (\$30,000) and after 2% of the value (\$5,000) was deducted for lack of marketability because the decedent owned an undivided interest.

¹³ *Nonacq.*, 2008-9 IRB (3/3/08), AOD 2008-1.

¹⁴ *Id.*

gross estate following the decedent's death due to "market conditions," but not due to "other post-death events."

Under the Proposed Regulations, "market conditions" is specifically 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." Changes in value (1) due to mere lapse of time or (2) due to post-death events other than market conditions, will be ignored in determining the value of the decedent's gross estate under the alternate valuation method.¹⁵

While the explanation of the "mere lapse of time" rules (as discussed above) remains the same as under the current Regulation,¹⁶ the Proposed Regulations expand on what "other post-death events" means. "Post-death events" is defined to include, but not be 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."¹⁷ As a result, any interest or asset held by a decedent that is affected by changes due to the passage of time or such other events will be included in the gross estate under the alternate valuation method at its value as of the date of the decedent's death, with adjustment only for any change in value due to market conditions.

The Proposed Regulations then provide five examples to illustrate the application of the new "post-death events" rule. The examples address the following situations:

1. *Tax-free reorganization.* Example 1 is similar to the facts

of *Kohler*; the decedent owns unrestricted stock in a closely held corporation that participates in a tax-free reorganization within six months of the decedent's death, and the estate chooses to receive new restricted shares. Although the example provides that the value of the stock does not change, valuation discounts for lack of marketability and lack of control are applied in determining the stock's value on the alternate valuation date. The example states that because "the claimed reduction in value is not attributable to market conditions, the discounts may not be taken into account in determining the value of the stock" on the alternate valuation date.¹⁸

2. *Changes due to market conditions.* Example 2 has the same facts as Example 1, except that there is a decline in the stock's value due to market conditions. The example concludes that such decline will be recognized, despite the estate still being denied other valuation discounts.¹⁹

3. *Transfer of estate assets to limited partnerships.* In Example 3, discounts for lack of marketability and lack of control on the alternate valuation date are ignored when two months after the decedent's death, the decedent's executor and other family members form four limited partnerships and the estate contributes the estate's property to the partnerships in exchange for a 25% interest in each.²⁰ In addition, the example notes that the result would be the same for a transfer made to a limited partnership formed prior to decedent's death.

4. *Distribution of partial interests in an LLC.* In Example 4, a decedent owns 100% of the units of a limited liability company ("LLC") and, pursuant to the will, during the six months following death the estate makes six distributions (each on a different date to

a different individual) of a 10% interest in the LLC.²¹ All discounts for lack of control and lack of marketability are denied and the value of each 10% distribution is determined by taking 10% of the value on the distribution date of the units (100%) owned by the estate at the decedent's death. Similarly, the value of the units held by the estate on the alternate valuation date is 40% of the value on the alternate valuation date of all the units (100%) owned by the estate at the decedent's death. However, changes in market conditions will be taken into account.

5. *Distribution of partial interests in real property.* Where real property is distributed pursuant to decedent's will, 70% to Trust A and 30% to Trust B on different dates during the six months after decedent's death (and there is no change in value of the property), Example 5 states that the 70% interest is determined by taking 70% of the value of all (100%) of the property as of the distribution date, and the 30% interest is similarly determined.²² Again, changes in market conditions will be taken into account in such calculation.

If the Proposed Regulations are adopted, they would be applicable to decedents dying on or after 4/25/08. Comments requested by the IRS were due 7/24/08.

Analysis of the new Proposed Regulations

What the Proposed Regulations do. The greatest change in alternate valuation under the Proposed Regulations is that a clear distinction is drawn between changes in market conditions and "other post-

¹⁵ Prop. Reg. 20.2032-1(f)(1).

¹⁶ See Prop. Reg. 20.2032-1(f)(2), which is the re-designated section for current Reg. 20.2032-1(f)(1).

¹⁷ Prop. Reg. 20.2032-1(f)(3).

¹⁸ Prop. Reg. 20.2032-1(f)(3)(ii), Example 1.

death events” that cause a reduction in the value of a decedent’s estate. The proposed rule change would codify this difference and limit the use of the alternate valuation method solely to “events outside of the control of the decedent (or the decedent’s executor or trustee)”²³ that reduce the value of the property.

Clearly, the IRS is concerned about certain postmortem planning techniques that it considers abusive, particularly when used to obtain discounts using the alternate valuation method. It seems as though more use was being made of these practices. For example, a recent article pointed out how to achieve estate tax savings without lifetime planning by using “a post-mortem formation of a pass through entity combined with alternate valuation.”²⁴ The Service wanted to attack such techniques, like those discussed in that article and those detailed in the examples under the Proposed Regulations, to ensure that the alternate valuation date could not be used to obtain estate tax savings.

Undoubtedly, post-death discounts resulting from events like (1) tax-free reorganizations, (2) creation of or distribution of estate assets to limited partnerships, (3) distributions of LLC interests to achieve minority status, and (4) distribution of fractional realty interests, would be ignored for alternate valuation purposes under the Proposed Regulations. Furthermore, besides these specific examples in the Proposed Regulations, all decreases in asset value on the alternate valuation date will now be

subject to additional scrutiny regarding the circumstances justifying the decrease. Ultimately, the Proposed Regulations will limit the ability of an estate fiduciary to use the alternate valuation election, whether or not “questionable” techniques were used.

What the Proposed Regulations do not do. In attempting to limit the alternate valuation method to reductions in value due to market conditions, the Proposed Regulations have left several issues open.

Most importantly, the test used to determine if an event is considered a “market condition” is whether an event is “outside of the control of the decedent (or the decedent’s executor or trustee) or other person whose property is being valued.” First, it is not clear what in fact would be considered “outside of the control” of an executor or a trustee. It could be said that *no* event after the decedent’s death is outside the control of the executor/trustee, as a fiduciary is responsible for every aspect of the estate.

Example 1 of the Proposed Regulations states that the decedent’s estate “participated” in a tax-free reorganization and “opted” to exchange its stock for stock subject to transfer restrictions. As a result, the example explains, no discounts for lack of marketability or control would be allowed. However, if *Kohler* were analyzed under this rationale, the decedent’s estate had *no* control over whether or not the reorganization occurred and *was required* to either “opt” to receive new restricted shares or cash out. It is difficult to see how this test would be applied (even in the very case that prompted the issuance of the Proposed Regulations). Additionally, it is unclear what is meant by “other person whose property is being valued”

Practice Notes

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and how this will affect the market conditions test. As a result, clarification and further explanation of the entire definition of “market conditions” seem necessary to have the Proposed Regulations work as the IRS intended.

Finally, the Proposed Regs. do not limit the new provisions to postmortem events that decrease asset values. As a result, it appears that any action taken by an executor/trustee that increases the value of assets in an estate would, under the Proposed Regulations, not be taken into account. It is difficult to believe that this is what the Service intended; thus, clarification may be expected on this point.

Conclusion

It is clear that the Proposed Regulations significantly restrict the use of discounts in valuing property on the alternate valuation date. Furthermore, while the Proposed Regulations seem to be issued with an eye to limiting certain “engineered” discounts, the Prop. Regs. limit the use of the alternate valuation date in some instances where the discounts are warranted under the stated purpose of the Section 2032 alternate valuation rules. It seems likely that the Proposed Regulations will be amended, at least in part, to clarify certain aspects. Therefore, while taxpayers and practitioners need to be aware of the proposed changes, the ultimate implications of these changes remain uncertain. ■

¹⁹ Prop. Reg. 20.2032-1(f)(3)(ii), Example 2.

²⁰ Prop. Reg. 20.2032-1(f)(3)(ii), Example 3.

²¹ Prop. Reg. 20.2032-1(f)(3)(ii), Example 4.

²² Prop. Reg. 20.2032-1(f)(3)(ii), Example 5.

²³ Prop. Reg. 20.2032-1(f)(1).

²⁴ See Easton, “Post-Mortem Estate Planning: Alternate Valuation Treatment of Assets Transferred to FLPs,” 108 J. Tax’n 307 (May 2008).