COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

NEW RULEMAKING APPROACHES TO IMPROVE FEDERAL TAX ADMINISTRATION THROUGH USE OF PRECISIONAL SUBSTITUTIONS THAT AVOID VALUATION UNCERTAINTIES

*Richard J. Kovach**

TABLE OF CONTENTS

I. INTRODUCTION 79
II. THE NEW VALUATION APPROACHES OF THE AMERICAN JOBS CREATION ACT OT 2004 83
III. PRECISIONAL SUBSTITUTIONS CONSTITUTE A LONG TRADITION UNDER THE INTERNAL REVENUE CODE 87
IV. IDEAS FOR FURTHER REDUCING CHARITABLE CONTRIBUTION VALUATION PROBLEMS 91
V. EXPANSION OF PRECISIONAL SUBSTITUTION VALUATION TECHNIQUES BEYOND CHARITABLE CONTRIBUTIONS 96
VI. POTENTIAL VARIATIONS IN PRECISIONAL SUBSTITUTION TECHNIQUES 99
VII. TOWARD THE GOAL OF MITIGATING COMPLEXITY IN THE FEDERAL TAXATION SYSTEM 103
VIII. CONCLUSION 107

I. INTRODUCTION

Valuation difficulties undermine public faith in the fairness and integrity of our federal taxation systems.[1] Valuation

* McDowell Professor of Law, The University of Akron School of Law. A.B. 1970, Oberlin College; J.D. 1974, Harvard Law School.

1. In MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 89-107 (W.W. Norton & Co. 1997), Professor Graetz devotes a chapter to the question, "Have we Become a Nation of Tax Cheaters?" He laments that tax compliance has become an increasingly difficult problem and states: "A fair, straight-forward, simple tax system will command greater support both politically and at filing time than one riddled with inequities and weighted down with complexities." *Id.* at 106-07. In reaching this conclusion, Professor Graetz acknowledges the important role of "appraisers who are often paid to estimate values that have important tax consequences" in hindering tax

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

problems also generate enormous tax planning and compliance costs for businesses and individuals.[2] Each year taxpayers spend untold time and treasure attempting to work out the revenue consequences of various rules that require valuations for properties having no readily ascertainable market values.[3]

Even a relatively simple tax rule, like the income recognition edict that covers compensation for services whether realized in cash or in kind,[4] generates much analytical complexity depending, for example, on whether the taxpayer receives for services stock in a closely held corporation rather than shares in a publicly traded entity. If compensation is paid in publicly traded shares, the tax result to the recipient is almost as easily determined as if the payment were made in cash.[5] Paying compensation in closely held shares could result not only in the taxpayer having to employ the expensive services of a specialty valuation expert but lead to an expensive and time consuming litigation as well. The litigation, in turn, could lead to tax deficiency payments, interest and penalty impositions,[6] and considerable costs to the government. In the end, a judge or jury might do no better than simply to mediate between the taxpayer's and government's dueling valuation experts.[7]

---

compliance. *Id.* at 105.

2. In recent years, an entire services industry has developed in response to tax valuation problems, as evidenced by the variety of valuation service providers who typically attend the vendors' booths at a large national conference like the Philip E. Heckerling Institute on Estate Planning sponsored annually by the University of Miami. *See* Univ. of Miami School of Law, 40th Annual Heckerling Institute on Estate Planning, http://www.law.miami.edu/heckerling/ (last visited Aug. 27, 2005).

3. Aside from the compensation-in-kind example given in the next paragraph, common tax valuation problems include a wide variety of determinations as set forth in a partial listing *infra* notes 11-19 and accompanying text. Of course, the many contested audits and litigations resulting from these determinations involve a considerable expense for both taxpayers *and* the federal government. *See, e.g.,* Hearst Corp. v. United States, 28 Fed. Cl. 202, 212 (Fed. Cl. 1993) (discussing the issue of the correct amount for a tax deduction for a charitable contribution in property other than money).

4. Treas. Reg. § 1.61-2(d)(1) (as amended in 2003).

5. *See* Treas. Reg. § 20.2031-2(b)(1) (as amended in 1992) (regarding fair market value determinations for stocks having a market on a stock exchange).

6. I.R.C. § 6662(h) (West 2005) specifically enhances the imposition of accuracy-related penalties pertaining to underpayments of tax to the extent an underpayment results from "gross valuation misstatements." § 6662(b)(3)(e) preliminarily sets a valuation misstatement standard equal to 200 percent or more of the amount "determined to be the correct amount" of an income tax valuation. By tailoring penalty provisions to the specific problem of valuation misstatements, Congress has acknowledged the widespread tax compliance difficulties associated with valuation determinations.

7. One kind of valuation dispute that involves particularly wide differences in the opinions of experts arises under I.R.C. § 162(a)(1) when closely held corporations struggle to determine the value of services performed by a controlling shareholder in order to distinguish deductible compensatory payments from nondeductible dividend payments. *See* Menard, Inc. v. Comm'r, T.C.M. (RIA) 204-207 (2004), *available at*

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

The genesis for this and many other potential tax valuation controversies is the shopworn valuation standard, developed for estate tax purposes, that seeks to establish values through an imaginary process that conjures up a hypothetical sales transaction:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price.[8]

This valuation standard invites controversy. How does one determine the results of negotiations between imagined "willing" buyers and sellers? If it were possible to do so with any accuracy, real life negotiations in property transactions would largely be unnecessary, since the values of various properties could be fixed beforehand by simple reference to the imaginary process incorporated into the valuation standard.[9] Price adjustments would result only to the extent of "forced" sale or purchase circumstances, ostensibly the only avenues for subjective inputs into the valuation process.

Of course, the entire valuation process under this regulatory standard is subjective to the extent that even valuation experts can exhibit multiples of difference when expressing opinions about the valuation of particular properties.[10] The variations of opinion that potentially result from the vague "willing buyer and

---

http://www.ustaxcourt.gov/InOpHistoric/MENARDV.TCM.WPD.pdf. A recent case in the U.S. Tax Court illustrates voluminous, complex, and expensive expert testimony leading to greatly disparate opinions on the value of services rendered by an owner-executive of a prosperous corporation operating a chain of home improvement stores. *Id.* The taxpayer's expert sought to justify a deductible compensation of $20,642,485 for the taxable year in question, while the government's expert supported the Internal Revenue Service's position that the value of the executive's services was no more than $1,380,876. *Id.* After a complicated analysis of the expert's methodologies, Judge Marvel concluded that a maximum reasonable (deductible) compensation could not exceed $7,066,912. *Id.* As discussed *infra* throughout this article, this kind of dispute and result suggests the need for a structural "precisional substitute," or set of rules for automatically determining valuation figures without resort to the dramatic fiction that either experts or a court can find the "true" value of something.

8. Treas. Reg. § 20.2031-1(b) (as amended in 1965).

9. If this valuation standard really worked, estate tax auditors, in particular, could earn a great deal of money through consulting endeavors based on their unerring familiarity with the intentions of hypothetical buyers and sellers.

10. *See, e.g.*, Jerman v. O'Leary, 701 P.2d 1205, 1208-09 (Ariz. Ct. App. 1985) (appraisers for one 25-acre parcel of desert real estate adjacent to a mobile home park expressed opinions ranging from $100,000 to $1,213,000 upon valuing the property in the course of a litigation involving a limited partnership that sold the parcel to its general partners).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

seller" standard wreak havoc in the federal taxation system in many ways:

—Contributors of property to charities have difficulty knowing how much to deduct.[11]

—Those who make inter vivos or testamentary gifts cannot accurately address their transfer tax implications.[12]

—Both payers and payees have trouble determining the tax effects of compensatory payments.[13]

—Taxpayers must struggle with basis determinations that affect the amount of gain or loss they recognize on property dispositions.[14]

—Business owners cannot easily determine depreciation allowances for assets converted from personal use or acquired in bulk transactions.[15]

—Distributees of qualified retirement plans must often guess the amount to recognize from distributions in kind.[16]

—Recipients of properties in taxable exchanges frequently cannot determine their proceeds realized with reasonable certainty for purposes of computing gains and losses.[17]

—Charities and insiders who deal with them can face substantial penalties for valuation errors leading to excess benefit transactions.[18]

---

11. *See* Treas. Reg. § 1.170A-1(c)(1) (as amended in 2005) (requiring that the amount of the charitable contribution deduction taken correlates to the fair market value of the property donated at the time of the contribution).

12. *See* Treas. Reg. § 25.2503-1 (as amended in 1983) (defining the term "taxable gifts" for gift tax purposes); Treas. Reg. § 20.2031-1(a)-(b) (defining a decedent's gross estate for estate tax purposes).

13. *See supra* note 4 and accompanying text (respecting the income tax consequence to payees); Treas. Reg. § 1.162-9 (1960) (respecting the deductibility to an employer of a compensatory bonus paid in kind to an employee).

14. A taxpayer selling property acquired from a decedent must generally determine a basis in the property by finding the fair market value of the property at the date of the decedent's death as required by I.R.C. § 1014(a)(1) (West 2005). Similarly, a donee might have to find the fair market value of gifted property in order to determine basis upon a disposition for a loss under I.R.C. § 1015(a) (West 2005).

15. *See* Treas. Reg. § 1.167(g)-1 (as amended in 1964) (requiring possible use of a property's fair market value on the date of conversion from personal use as the basis of the property for depreciation purposes); Treas. Reg. § 1.167(a)-5 (as amended in 1986) (requiring apportionment of basis according to relative fair market values when a purchaser acquires multiple properties for a lump sum).

16. *See* Treas. Reg. § 1.402(a)-1(a)(1)(iii) (as amended in 2005) (providing generally that a distributee under a qualified retirement plan must take into account property received at its fair market value).

17. *See* Treas. Reg. § 1.1001-1(a) (as amended in 1996) (stating that the amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received).

18. *See* I.R.C. § 4958 (2000); Treas. Reg. § 53.4958-4(b)(1)(i), (ii) (as amended in 2002) (stating that if an economic benefit provided by a tax-exempt organization to a

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

—Many other taxpayers face complexities, tax adjustments, and potential penalties regarding a variety of tax allocations based on fair market valuations involving more esoteric tax rules.[19]

Indeed, one could say without exaggeration that valuation difficulties have become the nemesis of federal taxation planning and compliance. Fortunately, new (but sparingly applied) valuation approaches initiated in the American Jobs Creation Act of 2004 point the way to structural remedies for ubiquitous valuation problems.[20] After describing these new approaches, this article will discuss how widespread extensions of these ideas could vastly improve our federal taxation system.

II. THE NEW VALUATION APPROACHES OF THE AMERICAN JOBS CREATION ACT OT 2004

The Internal Revenue Service and Congress became mindful that many taxpayers were improperly valuing used vehicles contributed to charities and thus taking charitable contribution deductions excessively.[21] Consequently, the 2004 Act amended I.R.C. Section 170(f) by adding a new paragraph to mitigate the perceived abuses.[22]

If a taxpayer contributes a motor vehicle, boat, or airplane having a claimed value exceeding $500, the charitable contribution deduction shall not exceed the gross proceeds the charity receives if it sells the contributed property without any significant intervening use or material improvement of the

---

disqualified person exceeds the fair market value, determined under the willing buyer and seller standard, of the consideration the disqualified person gives back, the excess value is taxed under I.R.C. § 4958).

19. *See, e.g.,* Treas. Reg. § 1.358-2(b)(2) (as amended in 1995) (upon an incorporation involving a non-recognition exchange of business assets for two or more classes of stock issued to the transferor, the basis of the property transferred must be allocated among all of the stock received in proportion to the fair market value of the stock of each class). If the transferor guesses wrongly about the proportionate values of the classes of stock received, a later sale or disposition of shares will produce an inaccurate determination of gain or loss to be recognized under I.R.C. § 1001 (2000).

20. *See generally* I.R.C. § 170(e)(1)(B)(iii), (f)(12), and (m) (West 2005) as added to the Internal Revenue Code by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

21. *See* I.R.S. News Release IR-2004-84 (June 29, 2004) (announcing the release of two new publications on automobile donations to curb this special valuation problem: IRS Publication 4302, "A Charity's Guide to Car Donations" and IRS Publication 4303, "A Donor's Guide to Car Donations." Taxpayers were warned to deduct only the fair market value of their vehicles, which might be less than "blue book" value).

22. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 884, 118 Stat. 1418, 1632 (2004).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

item.[23] Frequently, a charitable donee will simply take possession of a contribution in kind and convert it to cash as conveniently as possible by selling it. This practice is most common when the item has a ready market for disposition, as exists for motor vehicles, boats, and airplanes. The economic reality of the subsequent sale sets the amount of the donor's charitable contribution deduction, and the charitable donee must provide a contemporaneous written acknowledgement certifying that the vehicle was sold in an arm's length transaction between unrelated parties.[24] This acknowledgement must also identify the gross proceeds from the charity's sale and provide a statement to the donor that the deductible amount may not exceed the amount of the gross sale proceeds.[25]

This methodology for establishing charitable contribution deductions prevents the donor from having to guess the precise fair market value of the donated item at the date of transfer. The donee's information respecting the economic value it derived from the contributed property is directly linked to the donor's tax reporting consequence. This system has limitations. It covers only motor vehicles, boats, and airplanes.[26] Also, the valuation rule does not apply if the donee organization keeps the donated property for its own use (no value-establishing sale occurs) or the donee materially improves the donated item (adding value in a way that might unfairly increase the donor's deduction upon sale of the property).[27]

Congress took a slightly different approach in the American Jobs Creation Act of 2004 with respect to charitable contributions of intellectual properties such as patents, copyrights, trademarks, trade names, trade secrets, know-how, software, and similar items.[28] Again, the donor's reporting consequence is

---

23. I.R.C. § 170(f)(12)(A)(ii) (West 2005).

24. I.R.C. § 170(f)(12)(B)(iii)(I).

25. I.R.C. § 170(f)(12)(B)(iii)(II), (III).

26. *See* I.R.C. § 170(f)(12).

27. *See* I.R.C. § 170(f)(12)(A)(ii). A donee could sell a vehicle for a nominal price to assist the transportation needs of its charitable beneficiaries and thus produce an unfair and unreliable sales price indicator of fair market value for deduction purposes. *See id.* Consequently, I.R.C. § 170(f)(12)(F) authorizes the Secretary of the Treasury to issue future regulations to exempt from valuation determinations sales by the donee in *direct* furtherance of the organization's charitable purposes. (By selling a vehicle simply to raise cash to be used for the charitable mission, the donee *indirectly* furthers its purposes.)

28. H.R. REP. NO. 108-548, pt. 1, at 352 (2004). With respect to the addition of new I.R.C. § 170(m) the report states: "The Committee believes that the value of certain intellectual property . . . contributed to a charity often is highly speculative. Some donated intellectual property may prove to be worthless . . . . Although in theory, such intellectual property may promise significant monetary benefits, the benefits generally will not materialize if the charity does not make the appropriate investments, have the

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

linked to economic value realized by the charitable donee subsequent to the donation. For intellectual property donations, however, gross sales proceeds are not the financial benchmark. Instead, the donor's contribution deduction is ultimately predicated upon the amount of income the donee organization obtains from the donated property over a ten-year period following the date of contribution.[29]

Intellectual property donations afford the donor a base contribution deduction equal to the donor's basis in the donated property.[30] The donor takes this base contribution deduction for the year of the contribution.[31] Additionally, the donor can take deductions respecting the contribution in future taxable years, depending on the timing and amounts of income produced by the property, and its legal life, while in the possession of the donee organization.[32]

These additional deductions must in the aggregate exceed the donor's original deduction corresponding with the property's basis in the donor's hands in order to give the donor an extra tax benefit,[33] effectively providing a potential substitution of income-based deductions for the original basis-determined deduction. As a further limitation on the efficacy of income-based deductions, the additional contribution deduction scheme provides a sliding scale table of percentages that reduce the amount of annual income counted from 100% in the first and second taxable years of the donor to only 10% in the eleventh and twelfth taxable years.[34] Presumably, these percentage limitations, along with

---

right personnel and equipment, or even have sufficient sustained interest to exploit the intellectual property . . . ." Thus, Congress explicitly recognized the practical limitations of the willing buyer and seller valuation standard. *Id.* at 352-53.

29. I.R.C. § 170(m)(1), (5) (West 2005).

30. *See* I.R.C. § 170(e)(1)(B)(iii) (providing for a reduction in the amount of a charitable contribution deduction by the amount of gain latent in an intellectual property). If contributed intellectual properties are worth less than basis at the date of donation, Treas. Reg. § 1.170A-1(c)(1) (as amended in 2005) would limit deduction amounts to fair market values. This means that despite the new approach of the American Jobs Creation Act of 2004, which eliminates valuation uncertainties for donations of intellectual properties clearly worth more than basis, resorting to the highly imperfect willing buyer and seller standard is still necessary for determining fair market value for items having an arguable value less than basis.

31. I.R.C. § 170(a)(1).

32. I.R.C. § 170(m)(1), (3)-(6).

33. I.R.C. § 170(m)(2).

34. I.R.C. § 170(m)(1), (7). As mentioned *supra* in note 30, contributions of intellectual properties worth less than basis still produce a classical valuation problem. This problem could have been eliminated if the new deduction scheme had deferred all deductibility until the donee realized income from the donated property. As a possible concession to taxpayers in view of their losing any kind of immediate deduction upon making an intellectual property contribution, the I.R.C. § 170(m)(7) table might have

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

the ten-year limitation on income received or accrued by the donee,[35] prevent the total deductions taken by the donor from exceeding a reasonable approximation of the intellectual property's actual initial value.[36]

This intellectual property contribution deduction scheme is a good substitute for the prior fair market value guessing approach used by donors; but again, this new approach unduly applies to only a single category of donated properties.[37] Unlike the new approach applied to motor vehicles, boats, and airplanes, the deduction scheme applicable to intellectual property donations does attempt to provide valuation convenience when the property donated is directly used by the donee organization instead of merely licensed to produce a cash income stream:

"The Secretary may issue regulations or other guidance . . . providing for the determination of an amount to be treated as net income of the donee which is properly allocable to qualified intellectual property in the case of a donee who uses such property to further a purpose or function constituting the basis of the donee's exemption under section 501 . . . and does not possess a right to receive any payment from a third party with respect to such property."[38]

Exactly how could the Treasury Department make determinations of amounts "to be treated as net income of the donee" when the intellectual property donated is directly used by the donee organization and it involves no payment rights from any third party? The answer to this question leads to a vastly more important question: How can the conceptual approaches to avoiding valuation difficulties introduced in the American Jobs Creation Act of 2004 lead to broader applications that could tame the valuation nemesis not only within the charitable contribution deduction rules but over a wider range of tax rules as well? The answer to this question will follow a brief consideration of how

---

provided more generous "applicable percentages" or allowed for a longer period of taxable years. Thus, although the new scheme represents a small step toward avoiding valuation difficulties, it obviously does not reflect any overarching Congressional policy to provide precisional substitutions for the complete elimination of the unsatisfactory willing buyer and seller standard of valuation, as advocated *infra* throughout this article.

35. I.R.C. § 170(m)(5) (West 2005).

36. As discussed *infra* in Part II of this article, "reasonable approximations" of value fit well into a long tradition of federal tax rule-making involving precisional substitutions when truly accurate determinations are not practical.

37. As discussed in *supra* notes 30 and 34, the category of donated assets not subject to a traditional valuation analysis is further restricted to intellectual properties clearly having an intrinsic value greater than the donor's basis at the date of donation.

38. I.R.C. § 170(m)(10)(D)(ii). *Cf.* I.R.C. § 170(f)(12)(F) (merely authorizing regulations exempting the use of proceeds from sales by the donee organization in direct furtherance of its charitable purpose).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

economic precision frequently gives way to administrative convenience under the Internal Revenue Code.

III. PRECISIONAL SUBSTITUTIONS CONSTITUTE A LONG TRADITION UNDER THE INTERNAL REVENUE CODE

Nobody knows for sure exactly how long an asset purchased for a business will remain useful. The asset can wear out or become obsolete long before, or long after, the purchaser of the asset might estimate its period of business utility. Rather than permit taxpayers who purchase business assets to initiate depreciation deductions for these assets based on some hypothetically determined estimate of useful life, the Internal Revenue Code simply assigns a categorical useful life for each kind of business asset purchased.[39] Taxpayers who purchase assets of a particular kind take their depreciation allowances over designated periods of time, regardless of actual experience, variations in the quality of similar assets, or varying circumstances of obsolescence.[40]

When a taxpayer retires a business asset, perhaps to replace it with a newer and even better similar asset, any residual salvage value inherent in the retired asset is ignored.[41] This is so even though the retired asset might have a substantial salvage value that belies the total depreciation deductions taken over an expired recovery period designated in the Internal Revenue Code for that type of asset.[42]

In effect, the Internal Revenue Code contains a set of crafted rules that recognize simultaneously the impracticability of guessing precise patterns of economic depreciation for business assets and the need to provide taxpayers with predictable tax benefits and limitations regardless of economic reality. This system works well and results in relatively little controversy considering the untold millions of business assets subject to depreciation allowances at any particular time.[43]

---

39. *See generally* I.R.C. § 168(e) (West 2005).

40. I.R.C. § 168(a) states: "Except as otherwise provided in this section, the depreciation deduction provided by section 167(a) for any tangible property *shall be determined* by using [the methods, recovery periods, and conventions further set out]." (Emphasis added).

41. I.R.C. § 168(b)(4).

42. For example, a business vehicle fully depreciated as "5-year property" under I.R.C. § 168(c) frequently has substantial residual value after the recovery period has expired. Moreover, buildings frequently are worth *more* after they have been fully depreciated than when first acquired and placed into remunerative service.

43. *See* I.R.C. § 168. Note that the depreciation system is so relatively workable, understandable, and free from controversy that compliance and reporting is

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

As a form of gross adjustment in recognition of the possibilities for mismatching depreciation allowances given with actual economic results, the depreciation system incorporates special "recapture" rules that convert to ordinary income the more favorably taxed capital gain that might otherwise arise upon the disposition of an asset that has been excessively depreciated for tax purposes in relation to its residual value.[44] As a result of "recapture" rules, designated useful lives, non-recognition of salvage value, and other relatively well understood technical adjustments,[45] the federal income taxation depreciation system substitutes an artificial, technically defined precision for true economic precision. For the most part, this substitution is satisfactory to both the Internal Revenue Service and taxpayers.[46]

Similarly, the Internal Revenue Code and administrative promulgations embody a number of other precisional substitutions that have worked well for many years. Consider the following:

—Actuarial tables use factors embodying fluctuating interest rates and mortality data that permit transferors of split-interest gifts in trust to value simultaneously their retained interests and, for example, charitable remainders that result in a charitable contribution deduction.[47] Although such arrangements effectively give the transferor a fixed deduction, in fact the charitable beneficiary can easily end up getting substantially more or less economic value than the amount deducted, since the actuarial factors employed do not reflect

overwhelmingly handled by either taxpayers themselves or accountants having no legal training. By contrast, valuation determinations frequently necessitate the services of attorneys and professional appraisers.

44. *See generally* I.R.C. §§ 1245 and 1250 (providing ordinary income recognition upon the disposition of certain assets).

45. *See, e.g.,* I.R.C. § 168(d) (West 2005) (providing "conventions" that treat all applicable assets placed in service during a taxable year as placed in service on a precise date regardless of dates actual service commenced).

46. *See id.* At least professional tax advisers can understand the system with relative clarity and certainty, even if the technical details of the precisional substitution are beyond the understanding of taxpayers who do not have the time or capacity to gain familiarity with the applicable rules. The distinction between the understandings of tax professionals and laypersons goes to a separate policy issue as to whether Congress and the Treasury Department should create precisional substitutions in the federal tax scheme that are understandable to the average taxpayer to an extent that precludes the need for professional assistance.

47. *See generally* I.R.C. § 664 (defining and regulating charitable remainder trusts); I.R.C. § 7520 (authorizing tables for the valuation of any annuity, interest for life or a term of years, or remainder or reversionary interest). *See also* Treas. Reg. § 1.7520-1(b) (as amended in 2000) (elaborating upon the designation of interest rate and mortality components for split-interest valuation tables).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

actual mortality experience or investment performances over the life of the trust.[48]

—"Applicable federal rates," based on average market yields on the United States' outstanding marketable obligations with varying periods to maturity,[49] permit taxpayers and the Internal Revenue Service to determine with presumed precision original issue discount includible in income respecting certain debt instruments.[50] These rates also determine imputed interest on certain deferred payments.[51] Although the market for U.S. Treasury obligations is distinct from the markets for nongovernmental debts and deferred payments, interest rate determinations from the former market are nonetheless conveniently applied to prevent tax characterization disputes involving private obligations.[52]

—As an administrative convenience aside from the precisional substitution scheme for depreciation allowances, taxpayers can elect to deduct business-use automobile expenses, which mostly reflect depreciation of a vehicle, on a per-mile-driven basis subject to fixed annual rates published by the Internal Revenue Service.[53] Similarly, a taxpayer can take charitable contribution deductions on a per-mile-driven basis for the use of an automobile involving charitable purposes.[54] These per-mile-driven deduction allowances do not reflect cost variations associated with the many kinds of automobiles nor the

---

48. *See* Treas. Reg. § 1.7520-1(b) (basing actuarial factors on U.S. census mortality information). Thus, a poor investment performance for trust assets and an unexpectedly long life span for the beneficiary of a life income interest could work in concert to make a charitable remainder worthless despite a sizeable charitable contribution deduction predicated upon the artificial precision of the applicable valuation tables.

49. I.R.C. § 1274(d)(1)(C)(i) (2000). *See generally* I.R.C. § 1274(d) (defining Federal short-, mid-, and long-term rates for debt instruments with varying periods to maturity).

50. *See* I.R.C. §§ 1272-1274 (2000). Section 1272 pertains to including original issue discount in income, section 1273 explains how to calculate the original issue discount, and section 1274 explains how to determine issue price for debt instruments issued for property.

51. I.R.C. § 483 (2000). Section 483 applies to interest and unstated interest on any contracts for sale or exchange of property. *Id.* It also provides for reporting accountability respecting unstated interest under any contract for the sale or exchange of property. *Id.*

52. Additionally, the "applicable federal rate" precisional substitution serves to make certain determinations for qualified retirement plans, including computations of accumulated plan contributions under minimum vesting rules. *See* 2005 CCH Pension Plan Guide, Vol. 1, ¶ 54 at p. 1977.

53. *See* Rev. Proc. 2004-64, 2004-49 I.R.B. 898 (setting out the standard mileage rates for employees or self-employed persons to use when computing deductible costs of operating passenger automobiles for business purposes).

54. I.R.C. § 170(i) (2000) (fixing the standard mileage rate for charitable use of a personally owned passenger automobile at 14 cents per mile).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

actual cost experiences of individual taxpayers.[55]

—Taxpayers who incur expenses for business travel can take advantage of "federal per diem rates," annually published by the Internal Revenue Service, when deducting costs for lodging, meals, and incidental purchases.[56] Once again, administrative norms substitute for actual expenses, frequently cumbersome to document, as a concession to practicability over economic precision.[57]

—Sometimes federal tax rules permit amortization or depreciation of otherwise non-depreciable assets having indefinite useful lives simply to encourage particular activities via tax benefits totally detached from economic reality. Thus, a taxpayer obtaining goodwill in a business acquisition can write it off over a fifteen-year period regardless of how long the economic benefit of the goodwill lasts.[58] As a further example, certain creators of intellectual properties can amortize their creative expenses over a mere three-year period, even though the properties they create might have far longer economic utility.[59]

—Just as some tax rules ignore economic reality with a view toward encouraging certain activities, other tax rules ignore economic reality in ways that limit certain activities, like retirement savings.[60] Thus, the commonly accepted economic proposition that retirement benefits should be proportionate to the level of earnings of a worker yields to an artificial limitation that compensation taken into account under a qualified

---

55. Using the standard mileage rate for deducting business expenses for a passenger automobile is optional, but the standard mileage rate method allows the taxpayer to avoid the substantiation requirements of I.R.C. § 274(d). In addition, the Internal Revenue Service has authority to set mileage allowances deemed equivalent to the substantiation otherwise required. *See* Treas. Reg. § 1.274-5(g) (as amended in 2003). Like other precisional substitutions, the convenience of a "one size fits all" standard outweighs the potential inaccuracies in individual cases that might favor either the taxpayer or the Treasury.

56. *See* Rev. Proc. 2004-60, 2004-42 I.R.B. 682 (providing rules for deeming substantiated the amount of certain reimbursed traveling expenses of employees as well as optional rules for determining the amount of deductible meals and incidental expenses while traveling away from home).

57. These administrative norms create a kind of artificial precision that takes the place of precision in fact, regardless of potential distortions relative to economic reality. Whether taxpayers travel roughly or in high luxury, their tax consequences respecting employer reimbursements are fixed identically.

58. *See generally* I.R.C. § 197 (2000) (authorizing amortization of goodwill and certain other intangibles having indeterminate useful lives).

59. *See* Rev. Proc. 2000-50, 2000-2 C.B. 601 (providing guidelines on the tax treatment of the costs of computer software).

60. *See generally* I.R.C. §§ 408, 401(a) (2000) (setting out the numerous qualification features for individual retirement accounts and employer sponsored retirement savings plans).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

retirement plan cannot exceed $200,000 (adjusted for inflation).[61]

These and other abrogations of economic precision accommodate administration of the Internal Revenue Code in ways that suggest precision in the determination of fair market values for tax purposes need not be as problematic as currently is the case. All that is needed are appropriate technical devices that implement precisional substitutions for actual determinations of fair market value under the various applicable federal tax rules that involve valuation issues.

IV. IDEAS FOR FURTHER REDUCING CHARITABLE CONTRIBUTION VALUATION PROBLEMS

The American Jobs Creation Act of 2004 makes a good start towards the goal of reducing valuation disputes involving charitable contribution deductions but falls far short of the full potential of precisional substitutions for eliminating fair market value determinations. Using sales proceeds or income realized from a contribution in kind subsequent to the date of donation eliminates the need for precise determinations of fair market value at the date of transfer from a donor.[62] These valuation substitutions could work as well for a wide variety of contributions in kind other than vehicles and intellectual properties like patents.

Shares of stock in closely held corporations,[63] other equity interests in business entities,[64] collectibles,[65] oil, gas, and other

61. *See* I.R.C. § 401(a)(5)(B) (allowing contributions and benefits under qualified retirement savings plans to bear a uniform relationship to the compensations of plan participants). *Cf.* § 401(a)(17) (stating that a qualified plan cannot take into account the compensation of any employee in excess of $200,000).

62. *See* discussion *supra* Part I.

63. Aside from possible dividend payments, shares of stock frequently convert into sale or redemption proceeds that provide a basis for deferred valuation.

64. As a basis for deferred valuation, the income streams from partnership and limited liability company interests can be highly variable not just because of business exigencies but because of the power of partners or LLC members to block sales or redemptions and retain profits instead of distributing them to a nonparticipating interest holder. *See, e.g.*, UNIF. P'SHIP ACT § 18(g), 6–II U.L.A. 101 (2001) (no person can become a member of a partnership without the consent of all partners) and § 27(1) (a mere assignee of a partnership interest has no right to interfere in the management of a partnership business). *See also* UNIF. LTD. LIAB. CO. ACT § 502, 6A U.L.A. 604–05 (2003) (stating that transfer of a distributional interest in a limited liability company does not entitle the transferee to become a member or exercise any rights of a member).

65. Collectibles such as art, antiques, memorabilia, coins, etc., frequently have a sufficiently active market, via internet sites such as eBay, to permit data analyses leading to "educated guesses" for valuation. *See 'I thought this could be a small, quite profitable company,'* FINANCIAL TIMES, Aug. 5, 2005, *available at* 2005 WLNR 12331577 (eBay brings price and information efficiency to markets where such efficiencies did not exist); Corey Levitan, *Collecting*, DAILY BREEZE, Feb. 24, 2005, at B1, *available at* 2005 WLNR

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

mineral interests,[66] improved or undeveloped real estate,[67] intangibles other than currently covered intellectual properties,[68] contract rights,[69] choses in action,[70] and other kinds of valuable assets[71] might constitute charitable contributions that a recipient organization uses, sells, or keeps for appreciation or income production. Many of these assets are at least as difficult to value as the intellectual properties addressed in the American Jobs Creation Act of 2004 and certainly more difficult to value than the motor vehicles, boats and airplanes covered by the new rules.[72]

A charitable recipient has a limited number of choices respecting a contribution in kind:

—The charity can immediately sell a donated asset, assuming the organization can readily find a cash buyer. A

3116413 (eBay can be and is used as a free price guide). Collectibles rarely produce a continuing income stream to serve as a basis for deferred valuation, but extensive data from numerous sales and auctions no doubt could theoretically enable the Treasury to concoct classification schemes for designated items as precisional substitutions for individual valuations. At present, a taxpayer can request an IRS "Statement of Value" for artwork valued at more than $50,000, thus precluding controversy over valuation. *See* Rev. Proc. 96-15, 1996-1 C.B. 627 (outlining procedures, and establishing a $2500 fee, for Statement of Value requests).

66. These, of course, frequently produce royalties or sales that could serve as a basis for deferred valuations.

67. The basis for deferred valuation could be rents and later sales. Additionally, a precisional substitution for immediate valuation could result from local property tax values subject, perhaps, to adjustments reflecting pending appeals of a local assessor's opinion and outdated appraisals for jurisdictions in which assessors do not make annual updates.

68. Consider, for example, donations of governmental licenses, permits, and similar rights. In theory at least, these could be valued in the same way as patents and similar properties are now valued under the American Jobs Creation Act of 2004. *See* discussion *supra* Part I.

69. Consider a contribution of the right to receive deferred payments from an arguably insolvent payor. No doubt deferred valuation based on actual payments collected subsequent to the donation, or a subsequent sale of the rights, would be superior to any attempt at immediate valuation.

70. If assignable at all, a chose in action would seem to be a most appropriate candidate for a "wait-and-see" deferred valuation for obvious reasons.

71. In any event, section 170(f)(3) of the Internal Revenue Code prohibits a charitable contribution deduction for certain partial interests in property. I.R.C. § 170(f)(3) (2000).

72. Note that the Internal Revenue Service had specifically rejected "blue book" valuations for automobiles. *See supra* note 21. Notwithstanding, Congress could have authorized a "blue book" precisional substitution for vehicle valuations by granting authority to the Treasury Department to specify which book values could be used and whether or how the authorized values would be reduced by designated factors reflecting the Internal Revenue Service's audit experiences that previously resulted in rejection of "blue book" values. There are many reasonable ways to formulate fair precisional substitutions for "willing buyer and seller" valuations. Indeed, the Internal Revenue Service could implement many methods administratively without the necessity for additional legislation. *Cf. supra* notes 52-56 and accompanying text.

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

special permutation of this possibility involves the organization's finding a party who will exchange the asset contributed for some other valuable asset.[73]

—The organization could keep an income producing asset and benefit from its income realizations over some period of time.[74]

—The charitable recipient might use a donated asset directly in fulfillment of the organization's exempt purpose, as when an art museum displays a donated painting.[75]

—The charitable donee might simply keep indefinitely an asset that produces no income, neither finding a buyer for it nor being able to use it in fulfillment of an exempt purpose. Organizations sometimes feel obligated to accept even unwanted assets, which are not necessarily valueless, in order to foster good relationships with particular donors or the donating public in general.[76]

The American Jobs Creation Act of 2004 shows the way for creating valuation substitutes for the first two of the above possibilities. Expanding the new law's sale or income concepts to additional categories of assets would create only relatively minor issues pertaining to political considerations that induce disparate treatment[77] or technical adjustments reflecting economic differences between classes of assets. For example, the definition of no "significant intervening use or material improvement,"[78] a condition for limiting a deduction to the gross sale proceeds of a

---

73. This should shift a deferred valuation inquiry to the asset received in the exchange, which might itself produce an income stream, be sold eventually in a cash transaction, or be useful to the organization in the accomplishment of its exempt purpose. *See* I.R.C. § 170(a)(3) (2000).

74. Ultimately, the organization might sell, exchange, or dedicate the asset to an exempt purpose use, creating possibilities for ending or converting a deferred valuation process.

75. *See* discussion of Rev. Proc. 96-15, *supra* note 65, respecting valuation possibilities for valuable collectibles.

76. Ask a law school development officer what the school hypothetically would do with an outdated and redundant set of law books received as a first donation from a wealthy attorney. The possibility for later substantial gifts, perhaps in cash, would likely cause the law school to accept the books with enthusiasm and gratitude, even if shelf space in the library was dear. Sometimes gifts like unneeded law books eventually get re-donated. For example, the law school might give the books to another law school in a poor country or a law library in an impecunious county.

77. For example, donors of oil and gas interests might get higher deferred valuations based on larger percentages of income produced by a donation than donors of commercial real estate, if Congress found it politically expedient to favor oil and gas production over commercial real estate development. *Cf.* I.R.C. § 170(m)(7) (West Supp. 2005) (setting applicable percentages of income realized from donated intellectual properties).

78. I.R.C. § 170(f)(12)(A)(ii).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

donated vehicle, might logically vary in hypothetical regulations according to the characteristics of a particular class of assets.[79] Similarly, different classes of assets might justify varying periods of applicable income productivity and sliding scale income percentages than now exists for intellectual property deductions under the American Jobs Creation Act of 2004.[80]

The second two possibilities listed above present more substantial technical issues. Donated property used by the donee organization in furtherance of its exempt purpose, or simply stored away property, produces no proceeds of sale or income stream with which to craft a scheme for deferred deductibility. For intellectual properties covered by the American Jobs Creation Act of 2004, future Treasury regulations will work out the details for income equivalency determinations.[81] The practical possibilities for designating these income equivalencies call upon the ingenuity frequently needed when tax rules incorporate precisional substitutions.

Consider, for example, the donation of a copyright to a religious organization exempt from taxation under I.R.C. Section 501(c)(3). If the recipient uses the copyright to publish a religious tract for gratis distribution to the members of the organization, no income stream will result but the donated copyright will help fulfill the organization's exempt purpose. Treasury regulations could define an imputed income stream for the asset, used to calculate a contribution deduction for the donor, in a number of ways.

The imputed income stream might derive from a "cost-plus" concept that takes into account the organization's periodic publication costs increased by a percentage calculated to mimic an author's royalty.[82] Working in reverse, regulations might start with the number of copies distributed annually, assign a fair market value per copy according to the size and quality of the publication,[83] further assign a hypothetical author's royalty

79. Thus, "significant intervening use or improvement" might have a different meaning respecting real estate donations than for gifts of vehicles, since leaving real estate unused has different legal and economic consequences compared to leaving automobiles untouched on a lot until they are sold.

80. Comparing a real estate donation to a gift of a patent, one could observe the former might, because of its relative permanence, "keep on giving," in the sense of protracted income production, much longer than the latter. This characteristic of real estate could alone justify a much different table of years and sliding scale income percentages than provided for intellectual properties in I.R.C. § 170(m)(7).

81. *See supra* note 37 and accompanying text.

82. The percentage increase might even take into account a hypothetical "publisher's profit" gleaned from industry data.

83. The value per copy figure could reflect whether the work is a hardbound or

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

as a percentage of imputed sales, then discount the result by a substantial factor to reflect the fact that earned sales are not the same as free distributions.[84] Or, the regulations could simply assign an imputed royalty as a fixed amount per copy distributed.[85] Similar rules could apply to patents, trademarks, and other donated intellectual properties.[86]

Respecting donations other than intellectual properties, rule makers could create a system of classifications that qualitatively grade particular assets, thereby creating ranges of imputed income depending on an asset's characteristics.[87] Thus, if a donor gives a sculpture to an art museum that will put the piece on display, the sculptor's status in the art world, determined from a list prepared and updated by an independently selected art advisory panel,[88] might place the piece within a designated imputed income range. Further, the size, importance within the creator's body of work, and condition of the piece could determine the piece's place in the designated imputed income range.[89] Extremely famous, valuable, and well-known works might go directly to an art advisory panel for a kind of arbitrated value determination.[90] On the other hand, donations of creative works that simply end up in storage space of a museum should fall into a classification producing only a nominal annual imputed income.[91]

---

paperback volume, the number of pages it contains, whether it includes photos, artwork, or illustrations, etc.

84. As with all precisional substitutions under the Internal Revenue Code, the numbers used need not comport with individualized economic reality and can be based on national norms derived from applicable industry data. *See generally supra* Part II.

85. For example, the designated royalty might be ten cents to fifty cents per copy distributed, depending on the quality and size of the publication.

86. Consider the donation of a patent for an automated collection kettle transferred to the Salvation Army. Imputed royalties from the patent could set the amounts and pattern of deferred charitable contribution deductions granted to the donor.

87. *Cf.* Treas. Reg. § 1.167(a)-11 (as amended in 1995) (defining asset classification schemes for depreciation purposes; although classification schemes appear technically complicated, professionals who master them can make determinations that avoid controversy to an extent not now possible for valuation determinations under the willing buyer and seller standard).

88. *See supra* note 64 (discussing valuation of collectibles).

89. If this sounds administratively fussy, consider the potential virtues of letting the fuss occur in gross by administrative fiat *before* taxpayers take deductions, not individually via litigation or audit *afterwards*. Many precisional substitutions under the Internal Revenue Code require a certain amount of technical fussiness in order to achieve compliance and planning certainty. *See generally supra* notes 45-56 and accompanying text.

90. *Cf.* Rev. Proc. 96-15, 1996-1 C.B. 627 (setting out the rationale and procedure for obtaining a Statement of Value for art for income, estate, and gift tax purposes).

91. By manipulating designated imputed incomes over a large enough range, a deferred valuation scheme could encourage donors to seek their donees selectively for the

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

Indeed, perhaps all donations of property left fallow in the hands of an organization should produce at best only nominal deductions, and donations thrown away by the donee organization should yield no deduction at all.[92] If property not used by a donee organization is re-transferred to another Section 501(c)(3) entity, the donor's deduction could be deferred until the second organization establishes a use for the donated item.[93] Deferral and potential denial of tax benefits would encourage efficiency in the disposition of contributions in kind, alerting both donors and donees to the fact that deductions might vary substantially if donated property neither produces a cash return nor finds an actual use with a donee.[94] In circumstances under which the donee can neither find a use for a donation nor a transferee having a use, the value designated for a contribution in kind should be set at or close to zero, despite the donor's basis in the item.[95]

V. EXPANSION OF PRECISIONAL SUBSTITUTION VALUATION TECHNIQUES BEYOND CHARITABLE CONTRIBUTIONS

Regardless of the precise fair market value of an asset at the moment a tax-altering transaction occurs, true economic realizations from the transaction often manifest haphazardly over a period of time.[96] This economic fact of life underscores the principle of deferred recognition frequently applied under the

---

most efficient enhancement of the exempt purposes donors seek to support. Consequently, a donor might get a better set of deferred deductions by donating a work put on display in a small museum in a relatively unimportant city than by gifting the piece to a prominent museum that consigns the donation to a storage locker in its basement.

92. Eventually, of course, fallow contributions would tend to cease, and donees like the hypothetical law school, *supra* note 76, would best assist certain donors not by accepting items they cannot use but rather by having contacts with similar organizations that can use these kinds of donations.

93. Or, as suggested previously, *supra* note 92, the organization having first contact with a donor could extend its exempt purposes to include assisting by referral similar organizations having direct uses for unneeded items. Thus, donations of certain items could be made just once without the necessity for re-transfer.

94. In effect, the system would encourage donors to focus on the value of a contribution in kind *to the donee* and not on some notion of universal value as embodied in the willing buyer and seller valuation standard.

95. *See supra* note 30 (discussing charitable contribution deductions for assets having values less than basis at the time of donation). Donors in these circumstances would want to consider the economic and tax consequences of selling an item instead of donating it. *See generally* I.R.C. § 1001 (2000) (determining the amount of and recognition of gain or loss upon a sale or other disposition of property).

96. This observation is implicit in the American Jobs Creation Act of 2004's emphasis on linking charitable contribution deductions for donors to later sales or income realizations of donees as discussed in *supra* Part I of this article.

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

Internal Revenue Code in a variety of circumstances. Thus, an employer's mere unsecured promise to pay compensation in the future delays both the employee's recognition of income and the employer's deduction until the promise to pay materializes concretely.[97] Deferred recognition also applies when the parties to a transaction are closely enough related that the economic benefits involved effectively remain within a designated unit of shared identity, as with donors and donees,[98] shareholders and their newly formed or reformed corporations,[99] or spouses who transfer properties between themselves incident to a divorce.[100]

As the American Jobs Creation Act of 2004 illustrates, the principle of deferred recognition readily assists in the formulation of an artificially precise substitute for determining economically precise fair market values at the time certain properties pass to a charitable donee.[101] The operative feature of these precisional substitutions involves a "wait and see" approach that ignores immediately presumed economic consequences in the property transfer while considering easily determined future returns, whether from a later sale, use, or income realization, that benefit the donee more concretely than a mere change of ownership in the property contributed.[102]

Precisional substitutions based on deferred economic realizations could serve as well to eliminate difficult valuation issues that now complicate a number of other property dispositions having federal tax consequences.[103] Perhaps foremost among these are inter vivos and testamentary

---

97. Respecting deferral of income recognition, *see* Rev. Rul. 60-31, 1960-1 C.B. 174 (discussing the application of the doctrine of constructive receipt to certain deferred compensation arrangements). An employer's deduction for deferred compensation is also deferred under I.R.C. § 404(a)(5) (2000).

98. *See* I.R.C. § 1015 (2000) (generally transferring a donor's basis in property to a donee).

99. *See* I.R.C. § 358(a)(1) (giving a shareholder a basis in newly issued stock subject to the non-recognition rule of I.R.C. § 351 equal to the basis of property given in exchange for the stock, subject to possible adjustments).

100. *See* I.R.C. § 1041(b) (setting the basis of property for a transferee equal to a transferor's basis for transfers incident to a divorce).

101. *See generally supra* Part I of this article (describing the Act's approach for allowing charitable contribution deductions resulting from donations of vehicles and certain intellectual properties).

102. *See supra* note 28 (setting out the Congressional lamentation regarding the speculative inaccuracies involved with date of transfer valuations of certain properties). Note also the "wait and see" approach implicit in Treas. Reg. § 25.2511-2(f) (as amended in 1999), which defers gift taxation until later income is realized from property transferred subject to powers that prevent a completed gift at the date of original transfer.

103. *See supra* notes 12-19 and accompanying text (setting out a partial listing of these property dispositions).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

dispositions involving the gift and estate taxes.[104]

Precisional substitutions for date of transfer valuations already exist in a limited manner under the estate tax,[105] but no generalized precisional substitution permits uniform avoidance of contentious fair market value determinations across the full range of transfer tax applications.[106] Accordingly, deferring transfer tax valuations in relation to later sales, income realizations, and uses of assets that support imputed income determinations would introduce a great deal of certainty into primary planning and compliance activities of the federal transfer tax scheme.[107] Deferring revenue collection under a revised transfer tax approach should present no great inconvenience, given potential attainment of valuation certainty, since even present law contemplates deferred tax collections both as a result of the litigation process[108] and statutory mechanisms that some taxpayers have used for years to pay transfer taxes in installments.[109]

Likewise, deferred revenue collections resulting from precisional substitutions that avoid valuation controversies could accommodate other tax determinations currently tainted by the necessity of finding fair market values for transferred assets. Compensatory transfers would result in predictable and consistent income recognitions for payees and business deductions for payers.[110] Taxpayers could more readily determine the basis of assets for purposes of calculating depreciation, as well as gains and losses upon later

104. *See generally* I.R.C. §§ 2001-2009 (2000) (Subtitle B, Chapter 11, the Estate Tax); §§ 2501-2524 (2000) (Subtitle B, Chapter 12, the Gift Tax).

105. *See generally* I.R.C § 2032A (departing from the regular valuation standard by allowing valuation of qualified real property according to specialized uses) and, most significantly, § 2032(a)(1) (permitting valuation of property included in a gross estate as of the property's date of sale, exchange, or other disposition within six months after the decedent's death).

106. As indicated at *supra* notes 47 and 48, workable precisional substitutions do exist for valuing some partial interest transfers using I.R.C. § 7520 actuarial factors. *See* Treas. Reg. § 20.2031-7(d) (as amended in 2000) (involving actuarial valuations for estate tax purposes). Of course, this form of precisional substitution does not itself simplify the initial valuation of corpus in a split interest arrangement.

107. Note that the unworkable willing buyer and seller valuation standard originally appeared in the estate tax regulations nearly fifty years ago. Treas. Reg. § 20.2031-1(b) (as amended in 1965) (created on June 24, 1958 by T.D. 6296, 1958-2 C.B. 432).

108. Tax assessments and collections are suspended pending disposition of litigation in the U.S. Tax Court. I.R.C. § 6503(a)(1) (2000).

109. *See generally* I.R.C. § 6166 (providing years of extensions for payment of estate tax respecting estates consisting largely of an interest in a closely held business).

110. *See* Treasury Regulations cited *supra* notes 4, 13 respecting the income tax consequences of compensatory payments in kind.

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

dispositions.[111] Indeed, any transfer of assets involving federal tax consequences predicated upon fair market value determinations would proceed in a much less complicated manner.[112]

VI. POTENTIAL VARIATIONS IN PRECISIONAL SUBSTITUTION TECHNIQUES

Using a later sale of an asset by a transferee as the basis for a deferred valuation in lieu of a date of transfer valuation might invoke certain technical problems, or even potential abuses.[113] One obvious controlling mechanism in this regard would consist of variable limitations on when the transferee's sale would have to occur subsequent to the subject transfer.[114] Congress might grant technical authority to the Treasury Department to vary the period for sale by the transferee according to categories of assets selected in relation to such factors as potential for abuse,[115] inherent characteristics,[116] and context of the original transfer.[117] Of course, statutory or regulatory limitations on related party sales would prevent value manipulation just as similar rules have worked in the past to prevent other artificial tax results.[118]

Other controlling mechanisms pertaining to transferee sales might involve fixing the valuation at only a percentage of the

111. *See* Treasury Regulations cited *supra* note 15 respecting the fair market value basis determinations for depreciated assets.

112. *See* discussion *supra* note 19 for an example pertaining to basis allocations upon an incorporation.

113. *See* discussion *infra* note 118 regarding collusive dispositions.

114. New § 170(f)(12) places no time limit on when the value-determining sale of a vehicle must occur for charitable contribution deduction purposes. *See* I.R.C. § 170(f)(12) (West Supp. 2005).

115. For example, waiting too long to sell inherited real estate in a gradually deteriorating neighborhood might inordinately result in under-valuation in a situation involving the heir's occupancy of the property prior to sale.

116. Some assets take longer to sell than others. For example, in a high priced home in a declining real estate market, the contents of an expensive home can often sell much faster than the home itself.

117. Perhaps a shorter period for a subsequent sale of real estate should apply when a transferee receives property located near his or her tax home than when property is situated hundreds or thousands of miles away.

118. Collusive dispositions involving related parties are extensively regulated under the Internal Revenue Code. *See generally* I.R.C. § 267 (2000) (denying loss recognitions); I.R.C. § 1239 (converting capital gain into ordinary income for certain related party dispositions); I.R.C. § 4958 (regulating excess benefit transactions involving exempt organizations and disqualified persons). No doubt Congress or the Treasury Department could create appropriate technical mechanisms to prevent collusively created deferred valuation data. The collusion problem currently involves misstatements of valuation based on raw opinion held by experts who contentiously advocate positions that cannot be proved or disproved objectively.

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

subsequent sale proceeds,[119] introducing special adjustments to integrate, mitigate, or coordinate multiple tax effects of particular transactions,[120] and interjecting special reporting requirements into the precisional substitution scheme.[121] Eventually, tax regulators could fine tune the transferee sale approach to produce deferred valuation results that are equitable, workable, and certain.[122]

Correspondingly, assets not sold by transferees but kept for production of an income stream could inspire a flexible array of regulatory devices that rationally determine tax consequences without the need for "snapshot" fair market value determinations under the willing buyer and seller standard. Just as new I.R.C. Section 170(m) allows for a charitable contribution deduction based on a technically adjusted income stream produced by a donated intellectual property,[123] income based precisional

119. *Cf.* I.R.C. § 170(m)(7) (West Supp. 2005) (using a sliding scale of "applicable percentages" for determining income-based additional deductions for charitable contributions of certain intellectual properties). Applying applicable percentages, which might range above or below 100%, to subsequent sale proceeds might reflect regulatory judgments about the overall reliability of subsequent sales for setting valuations as of prior transactional dates.

120. Consider a potential estate tax valuation based on the sale of an inherited asset. Under I.R.C. § 1014(a)(1), and absent any application of I.R.C. §§ 2032 or 2032A, the fair market value of the asset at the date of the decedent's death determines the beneficiary's basis for purposes of computing gain or loss to the beneficiary as required under I.R.C. § 1001. Basing the estate tax consequence on the proceeds of a later sale would have the simultaneous effect of eliminating gain recognition to the selling beneficiary. This effect, now possible under I.R.C. § 2032(a)(1), would apply more generally if deferred valuation based on a subsequent sale became a broader precisional substitution for the date of death valuation standard now in general use. Consequently, the repeal of I.R.C. § 1014 after 2009 as authorized by I.R.C. § 1014(f) might find support as a permanent change despite the "sunset" provision of Economic Growth & Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901(a)(2), 115 Stat. 38 (2001), which reinstates prior law after 2010. *See generally* Fed. Tax. Coordinator 2d (RIA) ¶ P-4060 (2005) (discussing the "modified carryover" basis system for property acquired from decedents dying after December 31, 2009). Permanently implementing a carryover basis system would tend to foster a greater incidence of gain recognition than would otherwise result from a deferred valuation system, and Congress might view that permanent implementation as an appropriate revenue offset against putative deferred estate tax collections associated with substituted valuation rules.

121. For example, the new charitable contribution deduction rules applicable to donations of vehicles require a donee to provide a donor with a contemporaneous written acknowledgement containing specified information that a donee must also provide to the Internal Revenue Service. I.R.C. § 170(f)(12)(A)(i), (B), (D) (West Supp. 2005).

122. Current federal tax rules for depreciating remuneratively used assets have been successfully implemented to an extent that they could serve as a model for a standard of equitableness, workability, and certainty under a revised set of valuation rules. *See supra* note 43 and accompanying text (commenting on the relatively low level of controversy generated by the depreciation rules).

123. *See supra* notes 32-36 and accompanying text (discussing the income-based deductions allowed under I.R.C. § 170(m)).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

substitutions could solve other valuation problems arising under the Internal Revenue Code. Again, customizing regulatory limitations could result in a more effective valuation scheme. For example, the period of years (or months) over which income streams would affect tax consequences might vary greatly according to asset classifications,[124] how the transferee derives income from the asset transferred,[125] and the extent to which the income stream is burdened by costs and expenses.[126] Furthermore, percentage limitations on income realized in particular years might reflect "front loading,"[127] "back loading,"[128] or customized patterns that account for intrinsic characteristics of the asset transferred.[129]

As expected, the most technically difficult precisional substitution for valuation determinations would involve transferred assets that are either put to use by the transferee directly or simply held and not used.[130] Once again, assigning token values or administratively ignoring the tax consequence of an asset transfer that results in no sale, income stream realization, or productive use for the transferee might constitute an appropriate regulatory response. If an employer transfers a stylish set of office furniture to a retiring employee for personal use, and the employee simply stores the furniture in his attic for decades, perhaps no or little tax benefit to the employer (deduction) nor substantial income recognition to the employee should result even if the furniture had substantial intrinsic value

---

124. *Cf.* I.R.C. § 168(e) (2000) (classifying various properties under the Accelerated Cost Recovery System).

125. Some income produced by an asset does not represent the highest and best use of the asset. For example, leasing land to a church for recreational purposes might produce a substantially different income stream than leasing the same land to an agricultural business for a farming use or leasing it to a developer in connection with a commercial real estate project.

126. Thus, royalties from the licensing of an intellectual property might involve fewer expenses to produce income than rents from the leasing of real estate. Gross income is often a less reliable indicator of an asset's value than net income, just as gross sales of a business do not per se suggest profitability.

127. I.R.C. § 170(m)(7) (West Supp. 2005) illustrates "front loading," since the applicable percentages gradually decline over the designated period of income production.

128. Basing a deferred valuation tax consequence on increasing percentages of annual income produced by an asset might effectively defer the tax consequences of a transaction to future dates that correspond with an asset's maturing utility. For example, valuation of shares of stock in a start-up company could better relate to dividends or earnings from years beyond the period of struggle often associated with new ventures.

129. Depending on industry data available regarding the income productivity patterns of various classes of assets, the applicable percentages of annual income used to find deferred values might fluctuate over an assigned period of years.

130. *See generally supra* notes 81-91 and accompanying text (discussing income equivalency possibilities for donations in kind under new I.R.C. § 170(m)).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

when transferred.[131]

Transferred collectibles might fall under a different set of precisional substitution rules that artificially account for the potential investment characteristics obvious from the nature of these assets. Tax rule makers could create classification schemes for collectibles based on auction data, recorded dealer transactions, insurance information, and other objective indicators of like kind values.[132] Because the Internal Revenue Service could publish current information pertaining to these indicators, taxpayers about to transfer or receive a painting, coin collection, or other collectibles would know ahead of time their potential tax consequences, just as taxpayers who acquire business assets know precisely what their options are for recognizing amortization or depreciation deductions.[133]

In special cases involving unusually valuable assets for which reliable objective data might not exist for valuation classification purposes, the valuation approach could switch from an administrative classification scheme to a procedural scheme. One interesting possibility for a procedural resolution to high profile valuation difficulties would involve a mandatory "baseball arbitration."[134] Under this approach, an appointed arbitrator could select only one of two appraisal figures submitted by the taxpayer and the Internal Revenue Service.[135] Because the

---

131. Under a deferred valuation scheme, deductions and income recognition would be delayed until the item transferred was sold, produced income, or was put into use. Absent any of these events needed to support a deferred valuation result, a transferred asset would effectively have no tax recognition consequences to the transferor or transferee. The system of deferral would likely need a time limit in which a deferred recognition event must occur. In the example given, if the employee were to sell the furniture after this time limit had expired, the employer would have lost all possibility for deferred deductions, and the employee would recognize full gain upon the sale, since the employee would not have established a "tax cost" basis in the furniture. *See generally*, Standard Federal Tax Reports ¶ 29,335.03 (CCH 2005) (referring to various authorities supporting the establishment of basis according to required income inclusions).

132. A deferred valuation scheme could coexist with direct valuations. Differences in assets could justify differences in approach. Thus, a valuation system need not abandon direct valuation methods that have always produced reliable and uncontroversial results. *Cf.* the valuation of stocks and bonds under Treas. Reg. Section 20.2031-2(b) (as amended in 1992) (involving recognized market quotations for publicly held securities). Conceivably, direct valuation, involving precisional substitution rules that focus on markets for collectibles rather than deferred valuation events, could offer an optimum approach for avoiding valuation uncertainties respecting certain collectibles.

133. *See supra* Part II of this article up to note 46.

134. A recent Senate Finance Committee discussion draft proposed a mandatory "baseball arbitration" as a means to resolve valuation disputes involving tax-exempt organizations. *See* Staff Discussion Draft at 18, *available at* http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf (last visited Sept. 12, 2005).

135. As mentioned in *supra* note 132, consistency of approach in a valuation scheme

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

arbitrator would not be allowed to "split the difference" between the two figures, each side to a valuation dispute would have an incentive to submit a reasonable proposal. Accordingly, exaggerated proposals would unlikely prevail, since the arbitrator would have a duty to select the most reasonable number while rejecting altogether the less reasonable proposal.[136]

VII. TOWARD THE GOAL OF MITIGATING COMPLEXITY IN THE FEDERAL TAXATION SYSTEM

Regardless of any possible schematic expansion of the valuation principles introduced by the American Jobs Creation Act of 2004, those who write tax laws, regulations, and administrative interpretations should continuously strive to eliminate valuation problems, small and large, in order to promote simplicity, fairness, and certainty throughout the federal tax system. Various possibilities exist for implementing this overarching policy goal.

For example, a mitigable tax problem involving valuation difficulties arises when an individual who owns a home tries to sell it just following the bursting of a housing market "bubble."[137] As housing prices increase dramatically during the growth phase of the "bubble," buyers and sellers alike get used to what seems like a never ending rise in housing prices. Accordingly, a person who pays top dollar at the peak of the cycle of price increases succumbs to psychological pressure to pay a lot now in order to avoid paying even more in the near future. If, say as a result of a work reassignment, a peak price buyer is forced to sell a home after prices have started to fall, the psychological pressure will shift to loss avoidance.

Housing inventories in "burst bubble" communities quickly grow larger as disbelieving sellers, faced with transactional costs as well as a declining real estate market, hold on to their

---

is less important than finding ways to reduce or eliminate valuation uncertainty. By analogy here, the IRS and taxpayers would take the roles of team owners and players under the "baseball arbitration" concept.

136. Ancillary procedural rules could either postpone the tax recognition consequences of a completed transfer or provide for an expedited arbitration for proposed transfers. A taxpayer preferring to arbitrate subsequent to an irrevocable transfer would thus merit some risk of valuation uncertainty.

137. Of late, various financial news sources too numerous to cite seem to concentrate on the possibilities for over-inflated housing prices resulting in downward adjustments for areas like Southern California, Washington, D.C., and New York City. Consider whether the prices we hear about for these areas could be sustained if simultaneously the economy went into a recession and mortgage interest rates went up a few percentage points.

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

properties as long as they can in the hope that someone will come along with an offer that reflects old market expectations.[138] In order to facilitate "holding on" as long as possible, frequently hapless sellers will consider leasing their homes until the market improves.

Once an owner decides to lease, he or she will simultaneously become a landlord (with all the headaches that status entails), a frustrated would-be seller, and a consumer of tax advice, good or bad.[139] Tax issues immediately arise, including questions about establishing the subject property's basis,[140] determining annual depreciation allowances,[141] taking operational deductions,[142] and working with operating loss limitation rules, including those applicable to passive activities.[143] These issues could lead to audit exposure for a period of years if the taxpayer-owner does not follow all the appropriate rules. But one tax rule in particular will compound the owner's already considerable economic risk with a special kind of tax compliance risk: the owner will have to guess the property's fair market value at the precise date when the owner converted it from a personal use asset to a remunerative asset held out for lease.[144]

The fair market value at the date of conversion is necessary both to determine proper depreciation allowances[145] and to determine potential loss recognition when the owner eventually does find a buyer for the home.[146] In each instance, the cost of the home will not serve as its basis if the fair market value upon

---

138. Presumably, the sellers of loss-posture personal residences eventually learn about the strictures of I.R.C. §§ 165(c), 262(a) (2000), which normally block loss recognition and thus remove any expected tax silver lining in the dark economic cloud.

139. Perhaps the source for the tax knowledge mentioned in *supra* note 138 will also provide the owner with information pertaining to the tax advantages of converting a personal residence into a deduction generating rental unit.

140. The taxpayer will need an adjusted basis number ultimately to determine the I.R.C. § 1001 recognition consequences upon a later sale of the house.

141. *See* I.R.C. § 167(c)(1) (West 2005) (stating that basis for depreciation purposes is the adjusted basis used for determining gain on the sale or other disposition of a property).

142. *See generally* I.R.C. § 212 (allowing deductions for the ordinary and necessary expenses involved with the production of income).

143. *See generally* I.R.C. § 469 (detailing passive activity loss limitations).

144. *See infra* notes 145 and 146.

145. *See* Treas. Reg. § 1.167(g)-1 (as amended in 1964) (stating that fair market value on the date of conversion, if less than adjusted basis at that time, is the basis for computing depreciation in the case of converted property).

146. *See* Treas. Reg. § 1.165-9(b)(2) (as amended in 1964) (stating that a property's adjusted basis for determining loss recognition shall be the lesser of the fair market value at the time of conversion or the otherwise determined adjusted basis of the converted property).

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

conversion to rental status is lower.[147]

Frequently, the headaches associated with holding the property and renting it while the burst market "bubble" becomes apparent will lead the owner to "unload" the property after many frustrating months for a price far below the peak market price the owner paid. Sometimes the owner will work out a deal with the property's current renter in order to economize on transactional costs and take advantage of many renters' desire to own their own home. Having converted the home to a remunerative use prior to selling it, the owner will attempt to report a transactional loss using as high a basis as feasible.[148] Of course, an examining revenue agent will find the owner's distress sale price to be a good indicator of the property's basis as of the date of conversion.[149] If so, the Internal Revenue Service will likely deny most or all of the owner's claimed loss.[150]

In any event, the loss recognition issue directly relates to the fair market value of the property at the date of its conversion from personal use, and that value is not necessarily the same as the eventual sale price obtained later. If the tax system made clear that a subsequent sale would set the conversion date value,[151] the taxpayer would know not to claim a controversial

---

147. *Id.*

148. This means the owner will want to view the property's fair market value at the date of conversion to rental status as being considerably higher than the ultimate disposition price. *See supra* note 146.

149. The revenue agent might ignore arguments to the effect that most of the property's decline in value occurred subsequent to the date of conversion, effectively using the uncontroverted disposition price as an *informal* precisional substitution for the date of conversion value.

150. The owner must also face possible downward adjustments in the date of conversion basis pertaining to depreciation deductions allowed during the rental period, as required by I.R.C. § 1016(a)(2)(A) (West 2005). Thus, the owner's loss recognition potential will be limited both by a basis adjustment rule that works very precisely and a basis determining rule involving the uncertainties of the willing buyer and seller valuation standard.

151. Note that a precisional substitution using subsequent sale proceeds would also eliminate controversy about when the date of conversion occurred, at least with respect to the loss recognition issue. As for the issue of determining basis for depreciation purposes, certainty of result could occur from rules that involve precisional substitutions that favor either the taxpayer or the Treasury. For example, a rule could permit the taxpayer to use cost as the basis for depreciation. A much different rule could use disposition price as the basis for depreciation allowances *deferred* in recognition until the date of disposition. Rulemakers could, if necessary, account for any inequities resulting from use of a valuation avoiding rule with simple technical adjustments that would not abrogate the desired goal of certainty and workability. Thus, a rule favoring taxpayers could allow some percentage of cost to serve as a basis for depreciation, and a rule favoring the Treasury could grant some kind of bonus depreciation adjustment to compensate for the deferral of deductions. It should not take inordinate imagination to create equitable rules that avoid valuation disputes.

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

loss.[152] But even if the tax rules did not follow the American Jobs Creation Act of 2004 approach involving donated vehicles,[153] rule makers could still help tax enforcers and taxpayers alike by using a precisional substitution that avoids the awkward problem of determining a precise fair market value at a particular date.[154]

For example, the rules could set the conversion value according to a temporal apportionment using three dates – the date of the owner's original purchase, the conversion date, and the date of the owner's distress sale.[155] Accordingly, if the taxpayer purchased a residence for $250,000 in month one of year one, converted it to rental use in month nine of year two, and sold the home for $175,000 in month seven of year three, the deemed basis upon conversion would be $200,000.[156] In this instance, a taxpayer or tax enforcer could prorate the market value decline of $75,000 over a thirty-month period, assigning two-thirds of the decline to the pre-conversion period and one-third to the period subsequent to conversion.[157]

Other precisional substitutions might work just as well to alleviate the need to find a true fair market value at a particular date. As a concession to taxpayers, the date of conversion basis could be set at a relatively high fixed percentage of the owner's original cost of the property.[158] As a concession to revenue collection, the loss recognition rules could simply disallow any loss recognition whatsoever in cases involving remunerative uses that do not last for an arbitrary period, such as three years.[159] In

---

152. Avoiding valuation controversies obviously helps both the Treasury and the taxpayer. The former would benefit from enhanced compliance, and the latter would avoid the potential cost and risk of relying detrimentally on overly aggressive valuation professionals.

153. *See generally supra* Part I of this article.

154. *See supra* note 151 (discussing precisional substitution possibilities for determining a conversion basis for depreciation purposes).

155. The otherwise controvertible value would be fixed in relation to the two uncontroverted sale prices.

156. This example will not address the possible need to supply a mid-month convention (*cf.* I.R.C. § 168(d)(4)(B) (2000)) or particularize dates, the intent being to work with an overall period of thirty months, split into twenty month and ten month segments.

157. *Cf.* the sensible "weighted average" technique employed in Treas. Reg. Section 20.2031-2(b)(1) as amended in 1992) for determining the value of marketed stocks and bonds when no sales occur on the valuation date.

158. *See supra* note 151 discussing this possibility in the context of setting basis for depreciation purposes. In theory, rule makers could formulate a different basis determination rule for loss recognition purposes or create one rule for both purposes, as long as the rule or rules appropriately eliminated valuation controversies in each case.

159. Thus, de minimum remunerative conversions would not, in effect, fulfill the I.R.C. § 165(c)(2) (2000) "transaction entered into for profit" standard as a result of substantial prior personal use of a residence.

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

keeping with the utility of collectible data for structuring tax rules, the basis at the date of conversion could derive from a housing cost index decline resulting from a comparison of index numbers for the date of original purchase and the date of conversion. By this means, the basis determination rule need not depend on the privately determined input consisting of the seller's ultimate distress sale price.[160]

No doubt many possibilities exist for finding a workable precisional substitution for actual fair market value in the little tax problem just described. Moreover, our tax rule makers could work out technical substitutions appropriate for all tax issues involving the elusive concept of fair market value.[161]

VIII. CONCLUSION

The "willing buyer and seller" definition of fair market value is not at all useful.[162] It has fostered controversy, invited tax cheating, resulted in untold expensive litigations, and weakened our federal tax system in many ways.[163] The American Jobs Creation Act of 2004 points the way, very modestly, toward precisional substitutions that could readily take the place of fair market value determinations for the majority, if not all, tax planning and compliance issues based on fluctuating asset values.[164]

Precisional substitutions, technically formulated to avoid awkward economic reality determinations, have been used successfully for many years in the federal taxation system.[165]

160. Under current law, one could argue that using the seller's distress sale price as an indicator of fair market value at the date of conversion violates the "neither being under any compulsion to buy or sell" portion of the willing buyer and seller standard of valuation. *See supra* note 8 and accompanying text. The "no compulsion" concept could support a precisional substitution valuation standard that thus ignores the distress sale price altogether.

161. *See supra* notes 11-19 and accompanying text (non-exhaustively listing a variety of tax problems involving valuation difficulties).

162. Perhaps the willing buyer and seller standard is actually *less than* useful, since in spawning a cumbersome appraisal industry, it has created the vexatious ancillary problem of how to regulate valuation professionals. In reaction to this problem, Congress had to grant authority to the Secretary of the Treasury both to deny certain appraisers from presenting evidence or testimony in administrative proceedings before the Internal Revenue Service and to deny the probative effect of appraisals submitted by these errant appraisers. *See* Deficit Reduction Act of 1984, 31 U.S.C. § 330(c) (2000).

163. *See supra* note 1 (asserting the connection between tax cheating and the use of professional appraisers by taxpayers).

164. *See supra* note 132 (discussing the possibility that some fair market value determinations work well enough to avoid substantial controversy and thus would need no precisional substitutions).

165. *See generally supra* Part II of this article (discussing the long tradition of using

COPYRIGHT © 2005 HOUSTON BUSINESS AND TAX LAW JOURNAL. ALL RIGHTS RESERVED.

Congress, the Treasury Department, and the Internal Revenue Service should as soon as practicable adopt an overarching policy to formulate precisional substitutions for fair market value determinations whenever possible. By exercising this rule making mentality across the board, those who create and operate our federal tax system would greatly promote the fairness, predictability, and workability so necessary to support a system based predominantly on voluntary compliance.[166]

---

precisional substitutions to facilitate federal tax determinations).

166. The average taxpayer might never find our federal tax system comfortably understandable, but at least professional tax advisers should view the system as comprehensible and thus reasonably workable. To achieve the minimum goal of professional comprehensibility, tax rule makers must eliminate obtrusive factual uncertainties like those resulting from having to find the precise fair market value, on a stated date, of infrequently traded assets.