

**CHOOSE YOUR EXPERTS CAREFULLY:  
EVALUATING THE PROPOSED REGULATIONS  
ON THE ALTERNATE VALUATION DATE IN  
LIGHT OF *KOHLER***

I.	INTRODUCTION .....	167
II.	LEGISLATIVE HISTORY OF THE ALTERNATE VALUATION DATE .....	168
	A. <i>History of the Estate Tax</i> .....	168
	B. <i>History of the Alternate Valuation Date</i> .....	169
	C. <i>Alternate Valuation Date</i> .....	170
	1. Section 2032 .....	170
	2. Treas. Reg. § 20.2032-1.....	172
III.	CASE LAW AND RULINGS INTERPRETING I.R.C. § 2032 .....	172
	A. <i>Maass v. Higgins</i> .....	173
	B. <i>Hull’s Estate v. Commissioner</i> .....	173
	C. <i>Flanders v. United States</i> .....	174
	D. <i>Estate of Johnston v. United States</i> .....	175
	E. <i>Estate of Holl v. Commissioner</i> .....	176
	F. <i>I.R.S. Private Letter Ruling 93-49-003</i> .....	176
	G. <i>Kohler v. Commissioner</i> .....	177
	1. Facts of the Case .....	177
	2. Date of Disposition.....	180
	3. The Service’s Arguments .....	180
	4. The Character of the Stock.....	180
	5. Transfer Restrictions and the Purchase Option....	181
	6. The Service’s Witness .....	181
	7. The Estate’s Witnesses .....	183
	8. Value of the Stock .....	185
	H. <i>The Proposed Regulations</i> .....	185
IV.	COMMENTS ON THE PROPOSED REGULATIONS.....	186
	A. <i>Kohler was Correctly Decided</i> .....	187
	B. <i>Criticisms of Example 1</i> .....	188
	C. <i>Criticism of the Definition of “Market Conditions”</i> .....	189
	D. <i>The Ambiguities of a Reorganization Under § 2032</i> ...	191
	E. <i>Safeguards Against Abuses Involving</i> <i>Reorganizations</i> .....	191
	F. <i>Implementing the Proposed Regulations</i> .....	192
V.	EVALUATING THE PROPOSED REGULATIONS.....	193

2010]	<i>ALTERNATE DATE VALUATION</i>	167
	A. <i>Expert Testimony in Kohler</i> .....	193
	B. <i>The Proposed Regulations Will Increase Uncertainty</i> .....	194
VI.	CONCLUSION.....	195

I. INTRODUCTION

Under 26 U.S.C 2032, an executor may elect an alternate valuation date for the gross estate as late as six months after death for estate tax purposes.<sup>1</sup> Congress created this election in the 1930's when, due to the rapid decline in the U.S. stock market, many estates lost much of their value shortly after the decedent's death.<sup>2</sup>

Although § 2032 disallows changes due merely to the lapse of time, in *Kohler v. Commissioner* ("Kohler") the U.S. Tax Court held in favor of the taxpayer who elected an alternate valuation date following a reorganization of a corporation that comprised the bulk of the decedent's estate.<sup>3</sup>

The Internal Revenue Service (the "Service") argued the reorganization was a voluntary act under the control of the executor of the estate and was thus not due to market conditions.<sup>4</sup> After declining to acquiesce in the holding,<sup>5</sup> the Service proposed regulations ("Proposed Regulations") aimed at clarifying the meaning of "market conditions" to prevent estates from taking advantage of the holding in *Kohler*.<sup>6</sup>

The current economic environment bears an uncanny resemblance to the conditions that existed when Congress originally passed the alternate valuation date election, potentially making the election an important tool in the current volatile market.<sup>7</sup> This paper evaluates the position taken by the

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1. I.R.C. § 2032(a) (2006).  
 2. Election to Value on Alternate Valuation Date, 73 Fed. Reg. 22,300, 22,301 (Apr. 25, 2008) (to be codified at 26 C.F.R. pt. 20) [hereinafter Proposed Regulations].  
 3. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 54 (2006), *nonacq. in result*, 2008-9 I.R.B. 483.  
 4. *Id.*  
 5. I.R.S. Action on Decision 2008-1 (Mar. 5, 2008).  
 6. Proposed Regulations, *supra* note 2, at 22,302.  
 7. The alternate valuation date election was created by Congress in 1935. H.R. REP. NO. 74-1885, at 4 (1935) (Conf. Rep.), *reprinted in* 1939-1 (Part 2) C.B. 660, 663-64. The Dow Jones Industrial Average declined by 33.8% in 2008, the third worst performance on record and surpassed only by the declines in 1907 and 1931. Mark Hulbert, *2008 by the Numbers*, MARKET WATCH, Dec. 31, 2008, <http://www.marketwatch.com/news/story/reviewstockmarket2008/story.aspx?guid={C804E9C8-2C7C-4E33-84E6-9A056024E3AE}>; *see also* Tim Paradis, *Street Looks to '09 With Relief After Terrible '08*, ABC NEWS, Dec. 31, 2008, <http://abcnews.go.com/Business/wireStory?id=6554107>.

Service in the Proposed Regulations and makes two arguments: 1) because the court found the estate's expert to be more credible than the Service's expert, the Proposed Regulations would not have substantially changed the outcome in *Kohler* and 2) the Proposed Regulations fail to adequately define "market conditions," thus increasing uncertainty in the application of the alternate valuation election.

## II. LEGISLATIVE HISTORY OF THE ALTERNATE VALUATION DATE

### A. *History of the Estate Tax*

Congress passed the current U.S. estate tax in 1916 to help defray the costs of World War I.<sup>8</sup> The statute's reach was limited: it only reached property owned by the decedent at death, transferred by the decedent in contemplation of death, or with possession or enjoyment postponed until death.<sup>9</sup> Taxpayers could easily avoid it by making lifetime gifts.<sup>10</sup> To remedy this problem, Congress enacted a gift tax in 1924.<sup>11</sup> Although this tax was repealed the following year, Congress reinstated the gift tax in 1932 and it has been in effect since.<sup>12</sup> The two taxes were unified in 1976 so the estate tax is (1) a tax on the sum of the decedent's taxable estate and all taxable gifts made by the decedent, less (2) a tax on the taxable gifts.<sup>13</sup>

The 1976 amendment, as well as the 1981 amendment, significantly reduced the impact of the estate tax. Before 1976, the estate tax exemption was \$60,000 with a maximum rate of 77% on estates in excess of \$10 million.<sup>14</sup> The 1976 amendment provided an effective gift and estate tax exemption of \$175,000 with a maximum rate of 70% on estates in excess of \$5 million.<sup>15</sup> The 1981 amendment effectively raised the unified exemption to

8. S. REP. NO. 64-793, at 1 (1916) (Conf. Rep.). Congress enacted a tax ranging from one to ten percent on estates above \$600,000 (in 1916 dollars), the equivalent of \$11,300,000 in 2008 dollars. *See id.*; *see also* JAMES B. LEWIS, *THE ESTATE TAX* 656-57 (4th ed. 1979).

9. Revenue Act of Sept. 8, 1916, ch. 463, § 202, 39 Stat. 756, 777-78.

10. PAUL W. PINKERTON & JEFFERSON H. MILLSAPS, *INHERITANCE AND ESTATE TAXES* § 128 (1926).

11. *Id.*; *see also* DARIEN B. JACOBSON, BRIAN G. RAUB & BARRY W. JOHNSON, *THE ESTATE TAX: NINETY YEARS AND COUNTING* 118, 122 n.17 (2007), <http://www.irs.gov/pub/irs-soi/ninetyestate.pdf>.

12. Theodore S. Sims, *Timing Under a Unified Wealth Transfer Tax*, 51 U. CHI. L. REV. 34, 34 (1984).

13. *Id.* at 34-35, 35 n.4.

14. JACOBSON, *supra* note 11, at 122.

15. *Id.*

\$600,000 and reduced the maximum rate to 50% on estates in excess of \$2.5 million.<sup>16</sup>

Congress passed legislation in 2001 increasing the effective exemption from \$675,000 with a maximum 55% rate in 2001 to \$3.5 million in 2009 with a maximum 45% rate in 2007.<sup>17</sup> The legislation repeals the estate tax for decedents dying in 2010.<sup>18</sup> After 2010, the 2001 legislation will no longer be effective, and unless Congress passes new legislation, the estate tax will revert to pre-2001 exemption and rates.<sup>19</sup>

### B. *History of the Alternate Valuation Date*

The alternate valuation date provision was introduced by Congress as “§ 302(j) of the Revenue Act of 1926, as added by § 202(a) of the Revenue Act of 1935.”<sup>20</sup> Congress enacted the alternate valuation election in response to “hardships which were experienced after 1929 when market values decreased very materially between the period from the date of death and the date of distribution to the beneficiaries.”<sup>21</sup> The legislation provided an election to use a date that was one year after the date of the decedent’s death to value estate property.<sup>22</sup> Property that was sold or disposed of was to be valued on the date of its sale or disposition during the alternate valuation period.<sup>23</sup> Changes in value due to the mere lapse of time were not to be taken into account.<sup>24</sup> Section 302(j), the alternate valuation date provision, was codified as § 811(j) in the Internal Revenue Code.<sup>25</sup>

In *Maass v. Higgins*, the U.S. Supreme Court addressed whether rents, dividends, and interest received and accrued during the alternate valuation period are includible in the decedent’s gross estate under § 811(j).<sup>26</sup> In that case, the Court

16. Harry L. Gutman, *Federal Wealth Transfer Taxes After the Economic Recovery Tax Act of 1981*, 35 NAT’L TAX J. 253, 253, 264 n.5 (1982).

17. Jonathan G. Blattmachr & Lauren Y. Detzel, *Estate Planning Changes in the 2001 Tax Act—More Than You Can Count*, 95 J. TAX’N 74, 74-75, 90 n.3 (2001).

18. I.R.C. §§ 2210(a), 2664 (2006); see also M.C. Mirow & Bruce A. McGovern, *An Obituary of the Federal Estate Tax*, 43 ARIZ. L. REV. 625, 625 n.1 (2001).

19. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150 (2001). See generally Revenue Act of 1935, 49 Stat. 1014 (1935) (current version at I.R.C. § 2032(a)).

20. Proposed Regulations, *supra* note 2, at 22,301.

21. 79 CONG. REC. 14,632 (statement of Mr. Samuel B. Hill) (1935).

22. Proposed Regulations, *supra* note 2, at 22,301.

23. *Id.*

24. *Id.*

25. *Id.*

26. *Maass v. Higgins*, 312 U.S. 443, 444 (1941).

stated, “Congress enacted [302(j)] in the light of the fact that, due to such shrinkages, many estates were almost obliterated by the necessity of paying a tax on the value of the assets at the date of decedent’s death.”<sup>27</sup>

### C. *Alternate Valuation Date*

#### 1. Section 2032

Section 811(j) was recodified as § 2032 in 1954.<sup>28</sup> In considering proposals to amend the section, Congress noted, “[t]he option to value property [on the alternate valuation date] initially was provided . . . because by the time estate taxes were paid, property values had dropped substantially, sometimes to such an extent that the proceeds of the sale would not pay the estate tax due.”<sup>29</sup>

Under § 2032, an executor may elect an alternate valuation date for the property included in the gross estate.<sup>30</sup> If the executor elects the alternate valuation date, property retained in the gross estate “shall be valued as of the date six months after the date of death.”<sup>31</sup> Property disposed of within six months of the decedent’s death, through sale, distribution, or exchange, shall be valued as of the date of disposition.<sup>32</sup>

The election encompasses “all the property included in the gross estate . . .”<sup>33</sup> If taking advantage of the election, the executor must apply the alternate valuation date to all property in the estate.<sup>34</sup> The property comprising the gross estate is determined at the date of death according to § 2033(a).<sup>35</sup> Alternate valuation shall apply to property included in the gross estate that changes form between the date of death and the alternate valuation date.<sup>36</sup> Property accrued after the date of death is not subject to alternate valuation.<sup>37</sup>

27. *Id.* at 446.

28. Proposed Regulations, *supra* note 2, at 22,301.

29. *Id.* (citing H.R. REP. NO. 83-1337, at 90 (1954) (second alteration in original) (internal quotations omitted)).

30. I.R.C. § 2032(a) (2006). The alternate valuation election is made by the executor on the estate tax return, but the right to elect is forfeited if the return is filed more than one year after it is due (taking extensions into account). § 2032(d)(1)-(2).

31. I.R.C. § 2032(a)(2).

32. I.R.C. § 2032(a)(1).

33. I.R.C. § 2032(a).

34. Treas. Reg. § 20.2032-1(b)(1) (as amended in 2005).

35. Treas. Reg. § 20.2033-1(a) (1963); I.R.C. § 2033(a).

36. *Id.*

37. *Id.*

The section prevents a potential double tax benefit by disallowing any deduction that is given effect by electing the alternate valuation date.<sup>38</sup> For example, an estate tax loss deduction cannot be claimed if the property is sold during the alternate valuation period and the proceeds from the sale are included in the gross estate.<sup>39</sup> If the alternate valuation date is elected, charitable and marital deductions shall be valued as of the date of death with adjustment for changes in value as of six months after the date of death.<sup>40</sup>

The executor may not make the election unless the election will decrease the value of the gross estate as well as the estate tax imposed as a result of the alternate valuation date.<sup>41</sup> This provision was added in 1984 to prevent an executor from electing the alternate valuation date when the value of the gross estate has increased, but the increase in estate tax liability is offset by the increased basis of estate assets for income tax purposes.<sup>42</sup>

The statute disallows changes in value due to “mere lapse of time.”<sup>43</sup> Property that changes in value due to a mere lapse of time must be valued as of the date of death.<sup>44</sup> The rationale for this provision is that Congress intended the alternative valuation election to protect estates against unexpected changes in value, not changes in value that could have been anticipated by a prudent executor.<sup>45</sup> Interests encompassed by this provision include patents, estates for the life of persons other than the decedent, remainders, and reversions.<sup>46</sup> However, “obligations for the payment of money, whether or not interest-bearing” are excluded from the scope of the provision.<sup>47</sup> If an interest experiences a change in value that is due to both market conditions as well as a lapse in time, the effects of each must be segregated and only the change in value due to market conditions

38. I.R.C. § 2032(b) (2006).

39. 34A Am. Jur. 2d *Federal Taxation* ¶ 143,929 (2009).

40. *Id.*

41. I.R.C. § 2032(c).

42. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494; see STAFF OF JOINT COMM. ON TAX’N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 at 1121 (Comm. Print 1984) (“Because the purpose of the alternate valuation date provision was to provide estate tax relief and not to be a general method of avoiding income taxes, Congress believed that the election to use the alternate valuation date should be restricted to cases where there are estate tax consequences.”).

43. I.R.C. § 2032(a)(3).

44. *Id.*

45. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 135.7.4 (2d ed. 1989).

46. Treas. Reg. § 20.2032-1(f) (as amended in 2005).

47. *Id.*

may be taken into account when determining the alternate valuation.<sup>48</sup>

## 2. Treas. Reg. § 20.2032-1

The Service promulgated § 20.2032 of the estate tax regulations in 1958.<sup>49</sup> The regulation provides examples emphasizing that the rule only allows changes in the value of the estate due to market conditions, and not changes due to a mere lapse of time.<sup>50</sup> However, the case law on § 2032 shows the general principles, when applied to real world controversies, are still subject to disparate constructions.

### III. CASE LAW AND RULINGS INTERPRETING I.R.C. § 2032

The cases interpreting the language of § 2032 involve controversies over whether certain post-death events may be taken into consideration when valuing the decedent's estate on the alternate valuation date.<sup>51</sup> The trials tend to be fact intensive, sometimes involving conflicting estimates of value presented by experts for each side.<sup>52</sup>

Some clear principles have emerged from the cases, but this area of law is still subject to uncertainty. For example, "[t]wo judicial decisions have interpreted the language of § 2032 and its legislative history differently in determining whether post-death events other than market conditions may be taken into account under the alternate valuation method."<sup>53</sup> In *Flanders v. United States*,<sup>54</sup> the court held that a reduction in value due to "a voluntary act by [a] trustee, instead of as a result of market

48. See *id.*; see also Proposed Regulations, *supra* note 2, at 22,301; I.R.C. § 2032(a)(3) (2006).

49. Proposed Regulations, *supra* note 2, at 22,301.

50. *Id.*

51. See, e.g., *Maass v. Higgins*, 312 U.S. 443, 444 (1941) (the estate received post-death income that accrued subsequent to the decedent's death); *Estate of Hull v. Comm'r*, 38 T.C. 512, 516 (1962) (decedent's heirs entered into a compromise agreement with respect to the share of the decedent's partnership interest); *Flanders v. United States*, 347 F. Supp. 95, 95 (N.D. Cal. 1972) (a trustee agreed to restrict use of estate property in return for a reduction in assessed value); *Estate of Johnston v. United States*, 779 F.2d 1123, 1124 (5th Cir. 1986) (oil and gas was extracted and sold from decedent's property between date of death and the alternate valuation date); *Estate of Holl v. Comm'r*, 967 F.2d 1437, 1438 (10th Cir. 1992) (oil and gas was extracted and sold from decedent's property between the date of death and the alternate valuation date); *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 51 (2006) (the estate was a stockholder in a closely held corporation that engaged in a voluntary reorganization between the date of death and the alternate valuation date).

52. See, e.g., *Kohler*, 92 T.C.M. (CCH) at 53.

53. Proposed Regulations, *supra* note 2, at 22,301.

54. *Flanders*, 347 F. Supp. at 95.

conditions, could not be taken into consideration.”<sup>55</sup> Despite the holding in *Flanders*, the *Kohler* court held a reduction in value due to a post-death reorganization of a company should be taken into account.<sup>56</sup> The leading cases provide the general principles behind the application of § 2032 and illustrate the fact-intensive nature of each controversy.

#### A. *Maass v. Higgins*

In *Maass v. Higgins*,<sup>57</sup> the estates received post-death payments of income (dividends, interest, and rent) that accrued subsequent to the decedents' deaths.<sup>58</sup> According to standard business practices, the estates argued that the valuation should include income accrued prior to death, but not income accrued and paid after death.<sup>59</sup> Pursuant to the applicable regulation,<sup>60</sup> the Service argued that the payments must be included in the gross estate on the alternate valuation date.<sup>61</sup> The Court held in favor of petitioners, deciding the valuation method used on the alternate valuation date should be the same valuation method used on the date of death.<sup>62</sup>

#### B. *Hull's Estate v. Commissioner*

The decedent Hull was the senior partner in a successful law firm.<sup>63</sup> At the time of Hull's unexpected demise on February 2, 1957, the firm was in the process of modifying the terms of its partnership agreement.<sup>64</sup> The modification, executed by the remaining partners immediately after Hull's death, had the effect of reducing the share of income received by a deceased partner's estate.<sup>65</sup> The estate and the firm quickly reached a

55. Proposed Regulations, *supra* note 2, at 22,301; *see also Flanders*, 347 F. Supp. at 99.

56. Proposed Regulations, *supra* note 2, at 22,301; *see also Kohler*, 92 T.C.M. (CCH) at 54.

57. *Maass v. Higgins*, 312 U.S. 443 (1941).

58. *Id.* at 444.

59. *Id.* at 447.

60. *Id.* at 446 (“The regulation required that if, during the year subsequent to death, rents, royalties, interest, or dividends were received by the decedent's estate, such portion thereof as had not accrued, or was not attributable to a period prior to death, should be returned in full and reckoned as part of the gross estate in any case where the executor elected . . . to value the assets as of one year after the decedent's death or as of the date of disposition of any asset.” (citing Art. 11 of Regulations 80 (1937 Ed.))).

61. *Id.* at 446-47.

62. *Id.* at 448.

63. *Estate of Hull v. Comm'r*, 38 T.C. 512, 514 (1962).

64. *Id.* at 513, 515.

65. *See id.* at 515.



settlement regarding the estate's share of the firm's income.<sup>66</sup> The question before the court was whether the terms of the settlement should be considered for the purposes of alternate valuation date, or whether the estate should be valued based on the partnership agreement that existed on the date of death.<sup>67</sup>

The court held that the terms of the settlement agreement should be taken into account when valuing the estate's partnership interest on the alternate valuation date.<sup>68</sup> The court doubted the executors of the estate could have forced payment under the terms of the partnership agreement that existed at the date of death.<sup>69</sup> The payment under the settlement was a compromise agreement that was smaller than the payment prescribed in the original partnership agreement, but larger than the payment prescribed under the new agreement.<sup>70</sup> The court was satisfied that the agreement was "entered into at arm's length between parties with clearly adverse interests."<sup>71</sup> Furthermore, the court held "all evidence of value" known as of the alternate valuation date, including the terms of the settlement, should be considered.<sup>72</sup>

### C. *Flanders v. United States*

A few months after the death of the decedent, the trustee controlling the decedent's undivided one-half interest in the property entered into a Land Conservation Agreement.<sup>73</sup> In exchange for restricting the property to agricultural uses for ten years, the trustee was allowed to reduce the assessed value of the land for purposes of paying property taxes.<sup>74</sup> The estate elected to use the alternate valuation date for estate tax purposes and reported the value of the decedent's interest in the land as \$25,000.<sup>75</sup> This amount "represented one-half of the value of the ranch after the land use restriction was placed upon it" less a lack of marketability discount.<sup>76</sup>

The district court held the reduction in value of property included in the decedent's estate as a result of a voluntary act by

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66. *Id.* at 516.

67. *Id.* at 523.

68. *Id.*

69. *Estate of Hull v. Comm'r*, 38 T.C. 512, 524 (1962).

70. *Id.* at 523.

71. *Id.*

72. *Id.* at 524.

73. *Flanders v. United States*, 347 F. Supp. 95, 96 (N.D. Cal. 1972).

74. *Id.*

75. *Id.*

76. *Id.* at 96-97.

the trustee, instead of a result of market conditions, could not be taken into consideration in valuing the property under the alternative valuation method.<sup>77</sup> The court stated, “Congress [clearly] intended that the character of the property be established for valuation purposes at the date of death.”<sup>78</sup> The option to select an alternate valuation date is “to allow an estate to pay a lesser tax if unfavorable market conditions . . . result in a lessening of its fair market value.”<sup>79</sup> The court distinguished a voluntary act that changes the character of the property from unfavorable market conditions.<sup>80</sup>

#### D. Estate of Johnston v. United States

In *Estate of Johnston v. United States*, the estate received royalty income from minerals extracted during the alternate valuation period.<sup>81</sup> The question was whether the income received after death should be included in the gross estate at the time of death or severed from the taxable gross estate.<sup>82</sup> The Service argued that royalty payments are merely a change in form, from minerals in the ground, to money.<sup>83</sup> Because the in-place reserves were a part of the estate on the date of death, and the contents of the decedent’s gross estate are fixed at death, the payments simply represent reserves in the form of money and should be included in the estate.<sup>84</sup> The estate relied on *Maass*, arguing mineral royalties are not unlike financial dividends that accrue after the date of death, and therefore, are not a part of the estate at death.<sup>85</sup>

The court rejected the estate’s argument, distinguishing *Maass* because oil and gas, unlike dividends, are in existence as a part of the estate at the date of death.<sup>86</sup> In both *Maass* and *Johnston*, the courts evaluated the parties’ arguments by deciding which were “unreal and artificial” and which “comport[] with our common understanding.”<sup>87</sup>

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77. *Id.* at 99.

78. *Id.*

79. *Flanders v. United States*, 347 F. Supp. 95, 99 (N.D. Cal. 1972).

80. *Id.*

81. *Estate of Johnston v. United States*, 779 F.2d 1123, 1124 (5th Cir. 1986).

82. *Id.* at 1126.

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.* at 1126-27.

87. *See Estate of Johnston v. United States*, 779 F.2d 1123, 1126-28 (5th Cir. 1986).

## E. Estate of Holl v. Commissioner

At the time of his death, Holl had substantial holdings in oil and gas properties.<sup>88</sup> The estate valued the mineral interests at \$9 million on the date of his death and \$3.1 million on the alternate valuation date.<sup>89</sup> Between the date of his death and the alternate valuation date, the estate received \$980,698.47 in net income on the sale of oil and gas produced during the alternate valuation period.<sup>90</sup> “The estate gave an in-place value to this oil and gas of \$686,488.93,” but the Service argued the in-place value was \$930,839.76.<sup>91</sup> At trial, the tax court found in favor of the Service, adopting a value primarily reflecting the sales price.<sup>92</sup>

On appeal, the Tenth Circuit held the tax court erred in focusing on the sales price and instead should have applied a valuation analysis to the “pre-change” (in-place) minerals reduced to possession and sold during the alternate valuation period.<sup>93</sup> Citing *Flanders*, the court noted the legislative intent was for the character of the property to be fixed at the date of death, although market conditions could be considered on the alternate valuation date.<sup>94</sup>

## F. I.R.S. Private Letter Ruling 93-49-003

In a 1993 Private Letter Ruling, the Service addressed the question whether the recording of forged deeds after death affects the alternate valuation of property.<sup>95</sup> Two days after decedent's death on June 16, 1990, the decedent's brother forged and recorded two warranty deeds purporting to convey ten parcels of decedent's property.<sup>96</sup> The decedent's executrix, electing to value the estate's assets on the alternate valuation date, valued the parcels at only 30% of their appraised fair market value.<sup>97</sup> The estate argued the forged deeds placed a cloud on the title and diminished the value of the property.<sup>98</sup>

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88. Estate of Holl v. Comm'r, 967 F.2d 1437, 1437 (10th Cir. 1992).

89. *Id.*

90. *Id.*

91. *Id.* at 1437-38.

92. *Id.*

93. *Id.* at 1439.

94. Estate of Holl v. Comm'r, 967 F.2d 1437, 1439 (10th Cir. 1992); *Flanders v. United States*, 347 F. Supp. 95, 98 (N.D. Cal. 1972).

95. I.R.S. Priv. Ltr. Rul. 93-49-003 (Sept. 3, 1993).

96. *Id.*

97. *Id.*

98. *Id.*

The Service, citing *Flanders* and *Holl*, noted Congress's intent for the statute was for the character of property to be "valued as it existed on the date of death although it could be valued at market conditions existing at the elected valuation date."<sup>99</sup> As the *Flanders* court distinguished market conditions from "voluntary acts,"<sup>100</sup> the Service determined the actions by the decedent's brother had "no affect on the value of the property for purposes of the alternate valuation determination."<sup>101</sup>

#### G. Kohler v. Commissioner

The main controversies in *Kohler* were essentially questions of fact: at what date should the estate be valued, and what was the value of the estate on that date?<sup>102</sup> The nature of this controversy led the court to conduct a fact-intensive inquiry to resolve the case.<sup>103</sup>

##### 1. Facts of the Case

Frederic C. Kohler, the decedent in question, possessed a substantial estate at death, including a minority interest in Kohler Co.<sup>104</sup> Founded in 1873, Kohler Co. (the "Company") is a closely-held entity best known for manufacturing kitchen and bath fixtures.<sup>105</sup> At his death, Frederic owned 975 shares of the Company's common stock, or approximately 12.85% of all outstanding shares.<sup>106</sup> Despite his significant ownership stake, Frederic was not an employee of the Company, nor did he participate in management of the Company.<sup>107</sup> In fact, Frederic suffered from schizophrenia, was adjudged incompetent, and had been under guardianship his entire adult life.<sup>108</sup> Frederic was diagnosed with carcinoma in 1997 and died unexpectedly of a heart attack on March 4, 1998.<sup>109</sup>

Although Frederic never participated in the management of the Company, his closest relatives stood in a position to control both the Company as well as Frederic's estate (the "Estate"): not

99. *Id.*

100. *Id.*

101. I.R.S. Priv. Ltr. Rul. 93-49-003 (Sept. 3, 1993).

102. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 52-54 (2006).

103. *See id.* at 53.

104. *Id.* at 50.

105. *See* History of Kohler, <http://www.kohler.com/corp/about/history.html> (last visited Oct. 2, 2009).

106. *Kohler*, 92 T.C.M. (CCH) at 50.

107. *Id.*

108. *Id.*

109. *Id.*

only had Frederic's brother Herbert served as chairman, chief executive, and president of the Company since the 1970's, but he also served as Frederic's guardian.<sup>110</sup> Furthermore, Herbert's wife, Natalie, served as both general counsel of the Company as well as the personal representative of the Estate.<sup>111</sup>

Kohler is a privately-held family business and has been since its inception.<sup>112</sup> Because of numerous drawbacks inherent in managing a public company, Herbert had always intended to maintain the Company's status as a private company.<sup>113</sup> Although shares were never traded in public markets, shares were occasionally sold in private transactions; for example, thirty-six trades of Kohler stock took place between December 1993 and March 1998.<sup>114</sup> Due to the limited market for Kohler shares, dividends were the primary means by which shareholders earned a return on their investment.<sup>115</sup> The Company had a stated policy of paying a seven to ten percent annual dividend to shareholders.<sup>116</sup>

The Company used two types of projections to plan for its business, a management plan and an operations plan.<sup>117</sup> The management plan, reflecting the realistic expectations of the Company's management, was used internally for capital, acquisition, and tax planning, and externally to provide information to potential business partners.<sup>118</sup> The operations plan was an aspirational plan of what could be achieved in a perfect environment.<sup>119</sup>

As of 1998, the Kohler family held approximately 96% of the stock and outside shareholders held approximately 4% of the stock.<sup>120</sup> That year, the family and management decided to undergo a reorganization in order to achieve a number of desirable goals: remove the outside shareholders, facilitate estate planning for shareholders, and prepare for future generations of the family to take control of the Company.<sup>121</sup> The Company

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110. *Id.*

111. *Id.*

112. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 50 (2006).

113. *Id.*

114. *Id.*

115. *Id.* at 50-51.

116. *Id.* at 50.

117. *Id.* at 51.

118. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 51 (2006).

119. *Id.*

120. *Id.*

121. *Id.*

retained a law firm to assist in the reorganization in early 1996 and completed the reorganization on May 11, 1998.<sup>122</sup>

Under the reorganization, nonfamily shareholders were required to accept \$52,700 cash or exercise dissenters' rights, thus consolidating the shares within the Kohler family.<sup>123</sup> Family members had the right to receive either \$52,700 cash or "new" shares of voting and non-voting common stock that were subject to transfer restrictions and a purchase option.<sup>124</sup> These restrictions ensured that all of the shares of Kohler would remain under the control of the family.<sup>125</sup>

The Estate elected to receive new shares in the Company and as a result, owned 14.45% of the outstanding shares after reorganization.<sup>126</sup> Frederic's share of the Company after reorganization was not sufficient to give the Estate power to change the management, the board of directors, or the Company's article of incorporation.<sup>127</sup>

Natalie, acting as the personal representative of the Estate, retained Robert Schweihs ("Schweihs") to value the Kohler stock in the Estate.<sup>128</sup> Schweihs reported the fair market value of the Kohler stock on the date Frederic died was \$50.11 million and the value as of September 4, 1998 was \$47.01 million.<sup>129</sup> Natalie elected to value the Estate as of September 4, 1998, the alternate valuation date, and reported a value of \$47,009,625 for the Kohler stock on the Estate's tax return.<sup>130</sup>

After examining the Estate's return, as well as numerous documents provided by the Estate, the Service issued a deficiency notice in excess of \$100 million that determined the value of Kohler stock held by the Estate on the alternate valuation date was \$144.5 million.<sup>131</sup> The Estate filed a petition to contest the deficiency notice.<sup>132</sup>

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122. *Id.*

123. *Id.* Some non-family shareholders exercised dissenters' rights and settled with Kohler for amounts greater than \$52,700 per share. *Id.*

124. Kohler v. Comm'r, 92 T.C.M. (CCH) 48, 51 (2006).

125. *Id.*

126. *Id.* The Estate owned a larger stake after reorganization because non-family shares had been cashed out. *Id.*

127. *Id.*

128. *Id.* at 51-52. Schweihs' professional credentials impressed the court. He was accredited as a senior appraiser by the American Society of Appraisers, authored several books on the subject, lectured regularly, and had been an active appraiser since the 1980's. *Id.* at 56-57.

129. *Id.* at 52.

130. Kohler v. Comm'r, 92 T.C.M. (CCH) 48, 52 (2006).

131. *Id.*

132. *Id.*

## 2. Date of Disposition

At trial, the court held the Kohler stock was treated as disposed of on the alternate valuation date six months after Frederic's death rather than the date of reorganization.<sup>133</sup> If an estate elects the alternate valuation date, property "distributed, sold, exchanged, or otherwise disposed of" within six months of death is valued as of the date of disposition.<sup>134</sup> Stock received in exchange for stock of the same corporation under a tax-free reorganization is not treated as "distributed, exchanged, sold, or otherwise disposed of" for the purposes of § 2032(a).<sup>135</sup>

## 3. The Service's Arguments

Although a determination of deficiency is generally presumed to be correct, usually placing the burden of proof on the taxpayer, in this case the court shifted the burden of proof to the Service.<sup>136</sup> The Service argued that the *pre-reorganization* stock should be valued on the alternate valuation date or, in the alternative, that the transfer restrictions and purchase options should not be disregarded for valuation purposes.<sup>137</sup> The court rejected both arguments.<sup>138</sup>

## 4. The Character of the Stock

The Service argued that in accordance with regulation § 20.2032-1(d), the pre-reorganization stock (rather than the post-reorganization stock) should be valued on the alternate valuation date.<sup>139</sup> This regulation requires that certain types of property, such as dividends and leased property, remain in the estate even if it changes form prior to the alternate valuation date.<sup>140</sup> The court rejected this argument because the regulation does not explicitly address stock received in a tax-free reorganization and thus does not provide sufficient authority to disregard the exchange.<sup>141</sup>

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133. *Id.* at 53-54.

134. *Id.* at 53 (citing I.R.C. § 2032(a)(1) (2002)).

135. *Id.* at 53-54 (citing Treas. Reg. § 20.2032-1(c)(1) (as amended in 2005)).

136. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 52 (2006). The court shifted the burden of proof to the I.R.S. because the Estate presented credible evidence and cooperated with the Service's reasonable requests. *Id.*

137. *Id.* at 53-54. In a motion to amend his answer, the Service also argued the stock should be valued at the date of death, but the court disallowed the motion because doing so at a late date would have prejudiced the Estate. *Id.* at 53.

138. *See id.*

139. *Id.* at 53-54.

140. Treas. Reg. § 20.2032-1(d) (2009).

141. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 54 (2006).

### 5. Transfer Restrictions and the Purchase Option

Analogizing the Company's reorganization to the land conservation agreement in *Flanders*, the Service further argued the valuation of the post-reorganization Kohler stock held on the alternate valuation date should disregard the transfer restrictions and purchase option.<sup>142</sup>

The *Kohler* court distinguished *Flanders* by finding there was no ambiguity in § 2032 regarding the effect of a tax-free reorganization on the election of an alternate valuation date; therefore, the court found no need to consider legislative history.<sup>143</sup> In fact, the court found the regulation specifying that "otherwise disposed of" does not include tax-free reorganizations to be consistent with the legislative history relied on in *Flanders*.<sup>144</sup> The court said "[t]he legislative history describes the general purpose of the statute, not the specific meaning of 'otherwise disposed of' in the context of tax-free reorganizations."<sup>145</sup> Consequently, the court held the valuation of the post-reorganization stock shall include the transfer restrictions and purchase option.<sup>146</sup>

### 6. The Service's Witness

After resolving many of the Service's arguments, the court narrowed the issue to determining the fair market value of the post-reorganization Kohler stock on the alternate valuation date.<sup>147</sup> "The determination of fair market value is a question of fact, and the trier of fact must weigh all relevant evidence of value and draw appropriate inferences."<sup>148</sup> Consequently, the court weighed the evidence of value presented by the parties, which amounted to competing valuations presented by experts for each side.<sup>149</sup> The Service presented one expert witness and the Estate presented two expert witnesses.<sup>150</sup>

The court had "several significant concerns" with the report of the Service's expert witness, Dr. Scott Hakala ("Hakala"), and therefore attacked Hakala's report and placed "no weight" on his

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142. *Id.*

143. *Id.*

144. *Id.* (citing I.R.C. § 2032).

145. *Id.* at 54.

146. *Id.*

147. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 54 (2006).

148. *Id.*

149. *Id.* at 55.

150. *Id.* at 55-56.



testimony.<sup>151</sup> The court's concerns included the report's lack of certification and the fact that the report did not conform to Uniform Standards of Professional Appraisal Practice ("USPAP") standards.<sup>152</sup> The report initially overvalued the Estate's stock by \$11 million.<sup>153</sup> Describing this error as "not a minor mistake," the court said "[w]hen we doubt the judgment of an expert witness on one point, we become reluctant to accept the expert's conclusions on other points."<sup>154</sup>

The court was disappointed that Hakala only spent two and a half hours meeting with the Kohler management and felt he did not sufficiently understand Kohler's business.<sup>155</sup> Hakala rejected the Company's expense projection and invented his own expense structure for his analysis, but did not discuss it with the Company's management to determine whether it was realistic.<sup>156</sup> Hakala weighted the operations plan model 80% and the management plan model 20%, despite the manager's admonitions that the operations plan represented projections only achievable under perfect conditions and that the management plan presented realistic projections.<sup>157</sup>

Furthermore, although Hakala used the discounted cash flow ("DCF")<sup>158</sup> method and the guideline company method,<sup>159</sup> he did not include a dividend-based method for valuing the stock.<sup>160</sup>

151. *Id.* at 56.

152. *Id.* The Uniform Standards of Professional Appraisal Practice are the generally accepted standards for professional appraisal practice in North America. Explanation of USPAP, [http://www.appraisalfoundation.org/s\\_appraisal/sec.asp?CID=68 &DID=97](http://www.appraisalfoundation.org/s_appraisal/sec.asp?CID=68 &DID=97) (last visited Oct. 2, 2008).

153. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 56 (2006).

154. *Id.* (citing *Brewer Quality Homes, Inc. v. Comm'r*, 86 T.C.M. (CCH) 29 (2003), *aff'd* 122 F. App'x 88 (5th Cir. 2004)).

155. *Id.*

156. *Id.*

157. *Id.*

158. "The discounted cash flow method estimates value on the basis of future return flows over an investment horizon using empirical market data, macroeconomic and industry evidence, and the underlying fundamental trends for the subject company [and] then applies a present value discount rate . . . which results in an estimation of the net present value of a series of cash flows." SHANNON P. PRATT & ALINA V. NICULITA, *VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES* 516 (5th ed. 2008).

159. Under the guideline company method, public companies similar to the subject company are selected, data about the company are analyzed, and the value of the subject company is estimated by applying "market-derived pricing multiples to the subject franchise's parameters." ROBERT F. REILLY & ROBERT P. SCHWEIS, *HANDBOOK OF ADVANCED BUSINESS VALUATION* 386 (2000). The data used to derive the multiples are generally taken from the guideline company's income statement and balance sheet and include variables such as net sales, gross cash flow, revenues, and book value. *See* PRATT, *supra* note 158, at 265-66.

160. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 56 (2006).

Because periodic dividends were the primary means of obtaining a return on the Kohler stock, the court believed it was important to consider dividends in the valuation.<sup>161</sup>

### 7. The Estate's Witnesses

In contrast to its harsh treatment of the Service's expert witness, the court found the Estate's expert witnesses to be "thoughtful and credible" and thus gave "significant weight" to their testimony.<sup>162</sup> The Estate presented Schweihs as an expert to testify about the methods he used to determine the valuation as reported on the Estate's tax return.<sup>163</sup> The Estate also presented a second expert, Mr. Grabowski ("Grabowski"), who conducted an independent valuation.<sup>164</sup>

Schweihs used four methods to value the Kohler stock.<sup>165</sup> Under an income approach,<sup>166</sup> Schweihs used the DCF method,<sup>167</sup> and two dividend-based methods (the discounted dividend method<sup>168</sup> and the dividend capitalization method<sup>169</sup>).<sup>170</sup> The court observed that "[u]nder the market approach, Mr. Schweihs used the capital market method, also known as the guideline company method."<sup>171</sup> Unlike Hakala, he considered the significance of dividends to shareholders; he believed the dividend-based methods were important because dividends were the best, and possibly only, means by which a minority shareholder would receive a return on the investment.<sup>172</sup>

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161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.* at 56-57.

165. *Id.* at 57.

166. An income approach is "a general way of determining a value indication for a[n] . . . asset by using . . . methods that convert anticipated economic benefits into a present single amount." PRATT, *supra* note 158, at 1072. The valuation takes into account the useful life of the asset, the rate of return on the investment, the type of asset and the intended use of the asset. REILLY, *supra* note 159, at 252.

167. *See supra* note 158 and accompanying text.

168. The discounting method is used to convert expected future income to an estimate of present value. PRATT, *supra* note 158, at 240. Dividends are one of many types of economic income that can be analyzed in this model. *Id.* at 176.

169. The capitalization method is used to convert some measure of economic income (which can be expected, current, historical, or normalized income) to an estimate of present value. *Id.* at 240.

170. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 57 (2006).

171. *Id.* The market approach seeks similar assets in the marketplace in order to determine the value of an asset. REILLY, *supra* note 159, at 252. For a description of the guideline company method, see *supra* note 158 and accompanying text.

172. *Kohler*, 92 T.C.M. (CCH) at 57.

In accord with the court's holding that the transfer restriction and purchase option shall be taken into account in the valuation, Schweihs applied a lack of marketability discount to each method: a 45% discount to the values he determined under the DCF and capital market method, and a 10% discount to the dividend methods.<sup>173</sup> He also applied a 26% discount for lack of control to the DCF method.<sup>174</sup> To calculate a final valuation, Schweihs weighted the DCF and capital market methods 20% each and weighted the dividend-based methods 30% each.<sup>175</sup>

Schweihs' final estimate for the fair market value of the Kohler stock on the alternate valuation date was \$47.010 million.<sup>176</sup> In addition to valuing the post-reorganization Kohler stock on the alternate value date, Schweihs also valued the pre-organization shares on the date of Frederic's death and determined the shares were worth \$50.115 million on the earlier date.<sup>177</sup>

The Estate's second expert, Grabowski, also used four methods to value the Kohler stock: the DCF method, the discounted dividend method, the adjusted discounted dividend method, and the guideline publicly traded company method.<sup>178</sup> Grabowski found that all of these methods resulted in similar valuations.<sup>179</sup> After assessing "the strengths and weaknesses of each method, [Grabowski] ultimately decided that the adjusted discounted dividend method was the most appropriate because it reflected the actual cash flows a shareholder could expect to receive . . . and reflected the remote possibility that Kohler would be sold or undergo an initial public offering."<sup>180</sup>

Grabowski applied a 35% discount for lack of marketability (to reflect the closely held nature of the Company and the number of shares in the Estate) and a 25% discount for lack of control.<sup>181</sup> After adjusting the value for these discounts, he

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173. *Id.*

174. *Id.*

175. *Id.*

176. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 57 (2006). Considering the Estate's and the Service's valuations differed by almost \$100 million, the difference between Schweihs' pre- and post-reorganization values is relatively minor (\$3.105 million) and supported the court's observation that ". . . the fair market value of the post-reorganization stock must generally equal the fair market value of the pre-reorganization stock for the reorganization to be tax free." *Id.* at 54 n.7.

177. *Id.* at 57.

178. *Id.* For descriptions of valuation methods, *see supra* notes 158-59, 166, 168-69, and 171.

179. *Kohler*, 92 T.C.M. (CCH) at 57.

180. *Id.*

181. *Id.* at 58.

determined the fair market value of the stock on the alternate valuation date was \$63,385,000.<sup>182</sup>

#### 8. Value of the Stock

The court found the valuation methods used by the Estate's experts to reflect the true nature of a privately held company like Kohler.<sup>183</sup> Because the court gave no weight to the Service's evidence, but found the Estate's evidence to be more credible, the court concluded the fair market value of the Kohler stock on the alternate valuation date was \$47,009,625.<sup>184</sup>

The Service refused to acquiesce to *Kohler*, arguing "the court erred in focusing on whether a disposition had occurred rather than on whether it should take into account a change in the character of the property that had occurred during the alternate valuation period."<sup>185</sup> According to the Service, regulation § 20.2032-1(c)(1) addresses *when* to value property, not the character of the property itself.<sup>186</sup> *Flanders* stands as authority that character of property is established at the date of death and voluntary acts that change the character of the property should not be considered for alternate valuation date purposes.<sup>187</sup>

#### H. The Proposed Regulations

Seeking to prevent estates from taking advantage of *Kohler* in the future, the Service proposed changes to Treas. Reg. § 20.2032-1 in April 2008.<sup>188</sup> The Proposed Regulations define "market conditions" as "events outside of the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued."<sup>189</sup> The regulation also states that changes in value due to post-death events "other than market conditions" may not be taken into consideration in determining the value of an estate.<sup>190</sup> The regulations require that a property interest affected by a post-death event, including (but not limited to) a reorganization, must be valued as of the date of death, not

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182. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 58 (2006).

183. *Id.*

184. *Id.*

185. I.R.S. Action on Decision 2008-1 (Mar. 3, 2008).

186. *Id.*

187. *Id.*

188. Proposed Regulations, *supra* note 2, at 22,301-02.

189. *Id.* at 22,302.

190. *Id.*

the alternate valuation date.<sup>191</sup> After ascertaining the value of the interest at death, adjustments may be made for changes in market conditions between the time of death and the alternate valuation date.<sup>192</sup>

The Proposed Regulations provide five examples of allowable valuations, including two examples based on the facts of *Kohler*.<sup>193</sup> Under Example 1, D's estate owned stock in a closely-held corporation.<sup>194</sup> The stock, valued at \$50X, was not subject to transfer restrictions.<sup>195</sup> Two months after D's death, the estate participated in a reorganization and received new stock of equal value, but subject to transfer restrictions.<sup>196</sup> The value of the stock was discounted by \$20X due to discounts for lack of marketability and lack of control, resulting in a value on the alternative valuation date of \$30X.<sup>197</sup> Under the Proposed Regulations, because the decline in value is due to events within the control of the executor of the estate, the reduction is not due to market conditions.<sup>198</sup> The value of the property interest is the same as on the date of death, and the estate may not claim a discount.<sup>199</sup>

Example 2 uses the same facts as Example 1, but provides that the value of the stock declined due to market conditions from \$50X to \$40X between the date of death and the alternate valuation date.<sup>200</sup> In this scenario, this \$10X decline due to market conditions may be included in the alternate date valuation, but again, the discounts for lack of marketability and lack of control are prohibited.<sup>201</sup>

#### IV. COMMENTS ON THE PROPOSED REGULATIONS

The Proposed Regulations quickly drew the attention of practitioners in the areas of estate planning and taxation.<sup>202</sup>

191. *Id.*

192. *Id.*

193. *Id.* at 22,302-03.

194. Proposed Regulations, *supra* note 2, at 22,302.

195. *Id.*

196. *Id.* at 22,302-03.

197. *Id.* at 22,303.

198. *Id.*

199. *Id.*

200. Proposed Regulations, *supra* note 2, at 22,303.

201. *Id.*

202. W. Bjarne Johnson, *Trust and Estate Lawyers Recommend Changes to Proposed Regs on Alternate Valuation Method Election*, TAX NOTES TODAY, July 22, 2008, available at 2008 LEXIS TNT 156-14 [hereinafter *Estate Lawyers*]; see also Kathleen M. Martin, *ABA Members Comment on Proposed Regs on Alternate Valuation Method Election for Estates*, TAX NOTES TODAY, July 18, 2008, available at 2008 LEXIS TNT 144-14

Prominent professional organizations, including the American College of Trust and Estate Counsel (“Estate Lawyers”),<sup>203</sup> the American Bar Association Section of Real Property, Trust and Estate Law (“ABA Members”),<sup>204</sup> and the American Bar Association Section of Taxation (“Tax Section”),<sup>205</sup> (collectively “the Commenters”) provided substantive and thorough comments on the Proposed Regulations.

The Commenters acknowledge that in light of *Kohler*, § 2032 in its current form is subject to abuse.<sup>206</sup> Therefore, the current regulations should be modified or clarified.<sup>207</sup> However, the Commenters are uniformly concerned that the Proposed Regulations will overreach in certain situations, with the potential to penalize estates acting in good faith.<sup>208</sup> These criticisms are discussed below.

#### A. *Kohler was Correctly Decided*

The Commenters appear to agree that because the *Kohler* reorganization was not abusive of the regulations, *Kohler* was correctly decided.<sup>209</sup> While the Service was justified in preventing post-death actions which only served to reduce

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[hereinafter *ABA Members*]; William J. Wilkins, *ABA Tax Section Members Comment on Proposed Regs on Alternate Valuation Method Election*, TAX NOTES TODAY, Aug. 8, 2008, available at 2008 LEXIS TNT 156-15 [hereinafter *Tax Section*].

203. *Estate Lawyers*, *supra* note 202, at 2.

204. *ABA Members*, *supra* note 202, at 4.

205. *Tax Section*, *supra* note 202, at 13.

206. *Estate Lawyers*, *supra* note 202, at 2; *see also ABA Members*, *supra* note 202, at 4; *Tax Section*, *supra* note 202, at 13 (“Clearly, deliberate manipulations of the value of property interests by the persons who stand to derive a tax benefit from a lower value must not be permitted . . .”).

207. *Estate Lawyers*, *supra* note 202, at 2; *see also ABA Members*, *supra* note 202, at 4; *Tax Section*, *supra* note 202, at 13 (“Clearly, deliberate manipulations of the value of property interests by the persons who stand to derive a tax benefit from a lower value must not be permitted . . .”).

208. *See Estate Lawyers*, *supra* note 202, at 2-3; *see ABA Members*, *supra* note 202, at 4 (“However, alternate valuation under Section 2032 applies to all property and property interests . . . which can be very difficult to value.”). *Cf. Tax Section*, *supra* note 202, at 13 (arguing that the proposed regulations may *underreach* as well as overreach, failing to prevent the deliberate manipulation of property value by persons not covered by the “market control” definition).

209. *Estate Lawyers*, *supra* note 202, at 3 (“[T]he facts in *Kohler* do not appear to be abusive.”); *see Tax Section*, *supra* note 202, at 18 (“[I]f the estate does *not* have the option of retaining unrestricted stock through the alternate valuation date . . . [then] the reorganization itself should be considered a “market condition” (and therefore not ignored).”); *see also ABA Members*, *supra* note 202, at 11 (“We respectfully suggest that the *Kohler* reorganization was ‘outside the control of . . . the decedent’s executor’ . . . and that no artificial reduction in value occurred.”).

transfer taxes without serving any legitimate business interest, the reorganization in *Kohler* did “not appear to be abusive.”<sup>210</sup>

Although the reorganization was completed between the death of the decedent and the alternate valuation date, the reorganization had actually commenced two years before. Frederic’s death was sudden and unforeseen to the managers of Kohler, and there was no evidence that the execution of the reorganization was deliberately timed to coincide with his death.<sup>211</sup> The Company planned the reorganization for legitimate business reasons unrelated to Frederic’s Estate.<sup>212</sup> The Estate held a minority share of the Company and could not have prevented the reorganization.<sup>213</sup> The Estate Lawyers point out “a prudent fiduciary may very well have preferred the stock of a closely held business to other investment options which would have been available if one of the cash options had been elected.”<sup>214</sup>

#### B. Criticisms of Example 1

Example 1 of the Proposed Regulations presents a set of facts similar to *Kohler*.<sup>215</sup> The result of the analysis in the Example is that transfer restrictions resulting from a post-death reorganization may not be included in an alternate date valuation.<sup>216</sup> This would seem to directly repudiate the holding in *Kohler*, but the Commenters note problems with Example 1.<sup>217</sup> It is unclear exactly how the Service applies the “control” test to the fact pattern.<sup>218</sup> Depending on how a few key words in the Example are constructed, the facts in Example 1 may be slightly different than those in *Kohler*.<sup>219</sup>

The type and amount of control exerted by the estate over the post-death events described in the Example is ambiguous.<sup>220</sup> In the Example, the estate “participated” in a tax-free

210. *Estate Lawyers*, *supra* note 202, at 3.

211. See *Kohler v. Comm’r*, 92 T.C.M. (CCH) 48, 50-51 (2006) (“He died unexpectedly of a heart attack on March 4, 1998, at age 54 . . . .”); *Tax Section*, *supra* note 202, at 10-11.

212. *Estate Lawyers*, *supra* note 202, at 3.

213. *Kohler*, 92 T.C.M. (CCH) at 51; *Estate Lawyers*, *supra* note 202, at 3.

214. *Estate Lawyers*, *supra* note 202, at 3.

215. *ABA Members*, *supra* note 202, at 7-9; *Tax Section*, *supra* note 202, at 15-16, 18-20.

216. Proposed Regulations, *supra* note 2, at 22,302-03.

217. See *ABA Members*, *supra* note 202, at 7-8; *Estate Lawyers*, *supra* note 202.

218. See *ABA Members*, *supra* note 202, at 7-8; See discussion *supra* Part III.H.

219. *Estate Lawyers*, *supra* note 202, at 2.

220. *Tax Section*, *supra* note 202, at 15-16, 19 (“In *Example I*, it is unclear whether the reorganization *itself* is outside the control of the decedent’s estate . . . .”).

reorganization and “opted” to exchange old stock for new stock subject to transfer restrictions.<sup>221</sup> The words used in the Example could imply that the estate initiated and controlled the reorganization.<sup>222</sup> In *Kohler*, the Estate’s minority stake in the Company was not sufficient by itself to either initiate or block the reorganization.<sup>223</sup> If this is the construction intended by the Service, then the facts of the Example can be distinguished from *Kohler*,<sup>224</sup> and the Proposed Regulations, if applied to *Kohler*, would not have changed the outcome.<sup>225</sup> If the words in the Example imply that the estate initiated and controlled the reorganization, then the ABA Members agree that no discounts for lack of marketability and control should be allowed.<sup>226</sup>

Alternately, the words used in the Example could imply the estate was merely a minority shareholder that had a choice among accepting new shares, accepting cash, or exercising dissenters’ rights.<sup>227</sup> This construction parallels the facts of *Kohler*.<sup>228</sup> If these words mean that an option to accept post-reorganization shares, cash, or exercise dissenters’ rights is sufficient to show the estate had control to cause the transfer restrictions to be imposed on the estate, and a decline in value due to the transfer restrictions is thus not due to market conditions, then the Estate Lawyers argue the regulation “goes much further than is necessary.”<sup>229</sup>

### C. Criticism of the Definition of “Market Conditions”

The Commenters are uniformly critical of the definition of “market conditions” in the Proposed Regulations. The Tax Section thinks it unwise to base the definition of “market conditions” on the identity of some party deemed to control a post-death event rather than on the existing market for the property interest,<sup>230</sup> and indeed, most of the criticism focused on the notion of “control.”

The Estate Lawyers point out that the phrase “outside of the control” is not defined in the Proposed Regulations, and in other

221. See Proposed Regulations, *supra* note 2, at 22,302-03.

222. *ABA Members*, *supra* note 202, at 7-8.

223. *Kohler v. Comm’r*, 92 T.C.M. (CCH) 48, 51 (2006).

224. *ABA Members*, *supra* note 202, at 7-9.

225. *Tax Section*, *supra* note 202, at 19.

226. See *ABA Members*, *supra* note 202, at 8.

227. See *Estate Lawyers*, *supra* note 202, at 4; *Tax Section*, *supra* note 202, at 19.

228. *ABA Members*, *supra* note 202, at 7-8.

229. *Estate Lawyers*, *supra* note 202, at 4; *ABA Members*, *supra* note 202, at 7-8.

230. *Tax Section*, *supra* note 202, at 14-15.



190 *HOUSTON BUSINESS AND TAX LAW JOURNAL* [Vol. X

contexts “a ‘control’ standard is ‘so vague and amorphous as to be impossible of ascertainment in many instances.’”<sup>231</sup> Consequently, the Estate Lawyers are concerned the Service will interpret the phrase more broadly than intended by the regulation.<sup>232</sup>

The Estate Lawyers fear the regulations will be interpreted such that the mere ability to sell stock in a closely held company will satisfy the control standard, preventing declines in value due to legitimate business events from being considered in valuation on the alternate valuation date.<sup>233</sup> To address this concern, the Estate Lawyers propose any change in value resulting from a post-death event should be considered as resulting from market conditions as long as the estate does not have the unilateral power to cause the event or block it from happening.<sup>234</sup> The ABA Members express similar concerns and propose a definition that would only exclude from market conditions value-changing actions by the estate over which the estate has near complete control.<sup>235</sup>

If the “outside the control” is retained, the Tax Section argues the regulation should include a numerical measurement of control in terms of the estate’s ownership stake in the property,<sup>236</sup> such as the “at least 50%” threshold of Chapter 14 of the Internal Revenue Code.<sup>237</sup>

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231. *Estate Lawyers, supra* note 202, at 2 (quoting *United States v. Byrum*, 408 U.S. 125, n.10 (1972)).

232. *Estate Lawyers, supra* note 202, at 3.

233. *Id.*

234. *Id.* at 5-6. As an alternative, they proposed the following: “[A] change in value not resulting from market conditions as a change in value attributable to an event, other than a corporate or other entity reorganization, that (1) the estate was a party by reason of the estate’s volitional affirmative act or consent, (2) would not have occurred, at least with respect to the estate, but for the volitional affirmative act or consent of the estate, and (3) in the case of an interest in an entity or a distribution from an entity, is not the result of (a) management decisions in the ordinary course of the business or activities of that entity, (b) a distribution by the entity not in excess of the net income of the entity earned in the alternate valuation period following the decedent’s death, or (c) a legitimate and substantial business (including investment) purpose other than carrying out the dispositive terms of the decedent’s will, revocable trust, or other controlling instrument.” *Id.*

235. *ABA Members, supra* note 202, at 11-12. “The term market conditions is defined as all events and forces that affect the fair market value of estate property, excluding however, events arising solely from action that is controlled and initiated by the decedent (or the decedent’s executor or trustee), that is not negotiated at arm’s length, that is independent of and not in reaction to market force events, and artificially reduces the fair market value of the property being valued on the alternate valuation date.” *Id.*

236. *Tax Section, supra* note 202, at 15-16.

237. *See, e.g., I.R.C. §§ 2701(b)(2), 2704(c)(1)* (2006).

#### D. *The Ambiguities of a Reorganization Under § 2032*

The Tax Section highlights a problematic ambiguity in the *Kohler* decision. The court noted “the fair market value of the post-reorganization stock must generally equal the fair market value of the pre-reorganization stock for the reorganization to be tax free.”<sup>238</sup> “Therefore, any decline in value after the reorganization, should not be attributable to the reorganization itself.”<sup>239</sup> However, if the post-reorganization stock is subject to new restrictions that may decrease its value, the stock must have had some aspect that increased in value, or indeed, the reorganization itself resulted in a decline in value.<sup>240</sup> Because of the potential to take advantage of this ambiguity, the Tax Section proposes amending Treas. Reg. § 20.2032-1(c)(1) to treat a reorganization as a disposition, thus valuing the stock on the reorganization date for the purposes of alternate date valuation.<sup>241</sup>

#### E. *Safeguards Against Abuses Involving Reorganizations*

The catalyst post-death action in *Kohler* was a reorganization of a closely held company.<sup>242</sup> The Service implied that this reorganization was an event that caused a reduction in the value of the estate’s stock, but that the reorganization was not caused by a market condition.<sup>243</sup> The Commenters argue that a reorganization with a valid business purpose should be considered a market condition.<sup>244</sup> Safeguards already exist to prevent abuses involving reorganizations.<sup>245</sup> Fundamentally, non-acquisitive reorganizations, such as the one in *Kohler*, must be supported by a valid business purpose.<sup>246</sup> Furthermore, if a post-death reorganization is considered abusive, the Service can rely on § 2703 to exclude options and transfer restrictions from

238. *Kohler v. Comm’r*, 92 T.C.M. (CCH) 48, 54 n.7 (2006). Despite the court’s note and the parties’ stipulation to this fact, the Tax Section argues that this is not always a requirement. See *Tax Section*, *supra* note 202, at 12-13.

239. *Tax Section*, *supra* note 202, at 11.

240. *Id.* at 11-12.

241. *Id.* at 12.

242. See *Kohler*, 92 T.C.M. (CCH) at 51.

243. See Proposed Regulations, *supra* note 2, at 22,302. “The proposed regulations will amend § 20.2032-1 by restructuring paragraph (f) of this section to clarify that the election to use the alternate valuation method under section 2032 is available to estates that experience a reduction in the value of the gross estate following the date of the decedent’s death due to market conditions, but not due to other post-death events.” *Id.*

244. See *Estate Lawyers*, *supra* note 202, at 3.

245. *Id.*

246. Treas. Reg. § 1.368-2(g) (2008); *Kohler*, 92 T.C.M. (CCH) at 51.

being considered for the purposes of valuation.<sup>247</sup> Under § 2703, in order for an option or transfer restriction to be considered for valuation, an event must be a valid business arrangement,<sup>248</sup> not a device to transfer property to members of the decedent's family for less than adequate and full consideration,<sup>249</sup> and must be "comparable to similar arrangements entered into by persons in an arm's length transaction."<sup>250</sup> Lastly, the Service has the authority to assess penalties against appraisers,<sup>251</sup> tax return preparers,<sup>252</sup> and executors<sup>253</sup> for aiding and abetting a fraudulent return.<sup>254</sup>

#### F. *Implementing the Proposed Regulations*

As a practical matter, problems with enforcement may arise because the regulations do not distinguish between publicly traded companies and closely-held companies.<sup>255</sup> The Estate Lawyers argue the Service may abuse the regulation by applying it to estates holding marketable securities, although these estates are less likely to pose a concern under the regulation.<sup>256</sup> The availability of an open market in which to sell securities "may make it more likely that any changes in the value of such marketable securities resulting from a reorganization of a public company are within the 'control' of the estate, which could sell the securities at any time."<sup>257</sup> If the changes in market value are within the control of the estate, thus not regarded as changes due to market conditions under the regulation, then any reduction in value due to the reorganization could not be taken into account in valuing the estate on the alternate valuation date.<sup>258</sup> The Estate Lawyers, finding this an "anomalous result" recommended "any change in value caused by a post-mortem reorganization of a company whose shares are publicly traded should be presumed to be caused by market conditions."<sup>259</sup> Finally, the Commenters are concerned the regulations may have an adverse impact on the

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247. *Estate Lawyers*, *supra* note 202, at 4.

248. I.R.C § 2703(b)(1) (2006).

249. I.R.C § 2703(b)(2).

250. I.R.C § 2703(b)(3).

251. I.R.C § 6695A (2006 & Supp. 2009).

252. I.R.C § 6694 (2006 & Supp. 2009).

253. I.R.C § 6701 (2006).

254. *ABA Members*, *supra* note 202, at 9.

255. *Estate Lawyers*, *supra* note 202, at 5.

256. *Id.*

257. *Id.*

258. *Id.*

259. *Id.*

conduct of business in closely held corporations: if the Service were to enforce the regulations in an overbroad manner, prohibiting estates from taking advantage of the congressionally mandated alternate valuation date election, businesses may fail to adopt what would otherwise be considered prudent business decisions in order to avoid the adverse tax consequences.<sup>260</sup>

## V. EVALUATING THE PROPOSED REGULATIONS

### A. *Expert Testimony in Kohler*

Although the Service introduced the Proposed Regulations in response to the court's holding on valuation discounts, the most significant aspect of the case was the court's acceptance of the testimony of the Estate's expert, Schweihs, over the Service's expert, Hakala.<sup>261</sup> The Service introduced the proposed changes to Treas. Reg. § 20.2032-1 in response to the court's holding that the post-reorganization stock valued on the alternate valuation date shall include discounts for transfer restrictions and a purchase option.<sup>262</sup> The Service's position was that the discounts, because they were due to a post-death event in the control of the Estate, should not be included in the alternate date valuation.<sup>263</sup> Even if the court had held for the Service on this question, as long as the court found the Estate's experts more credible, the outcome would have favored the Estate.

If the Service had prevailed in persuading the court to disregard the valuation discounts due to the post-death reorganization, but the court still found Schweihs to be more credible than Hakala, the court would have accepted Schweihs' valuation but ignored the discounts he applied. The range of Schweihs' valuations was substantially less than Hakala's: Schweihs estimated the value of the Company's stock pre-reorganization to be approximately \$50 million.<sup>264</sup> While his post-reorganization estimate of \$47 million<sup>265</sup> includes the valuation discounts, Schweihs' testimony does not provide any evidence that his valuation without the discounts would fall within close proximity to Hakala's estimate of \$156 million. Even if it were, the Company could simply chose to not elect the

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260. *Tax Section*, *supra* note 202, at 19; *see also Estate Lawyers*, *supra* note 202, at 4-5.

261. *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 56 (2006).

262. *Id.* at 54.

263. *Id.*

264. *Id.* at 57.

265. *Id.*

alternate valuation date and report the valuation at the date of death, or \$50 million. The Service was seeking an Estate valuation in the neighborhood of \$150 million, but as long as the court preferred Hakala's testimony, the estimate probably would not have exceeded \$50 million.

Applying the Proposed Regulations to the facts of *Kohler* shows the battle of the experts was more significant to the outcome of the case than the holding on valuation discounts. This suggests the Proposed Regulations will not result in a substantive change in the requirements for alternate valuation, but rather an indication of the Service's litigation posture on the question of valuation discounts.

#### B. *The Proposed Regulations Will Increase Uncertainty*

Because "control" is not defined in the Proposed Regulations and thus is subject to multiple interpretations with regard to post-death events, the Proposed Regulations will increase uncertainty in the application of the alternate valuation date election. The stated goal of the Proposed Regulations is "to clarify that the election to use the alternate valuation method under § 2032 is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market conditions, but not due to other post-death events."<sup>266</sup> Rather than defining "market events" in terms of the existing market for the property interests, the definition in the Proposed Regulations relies on a determination of whether an estate may or may not control events that affect the fair market value of the property interest.<sup>267</sup> Yet, although the Proposed Regulations rely on the notion of control, they do not define the term. Consequently, the effect of the Proposed Regulations on common post-death events is subject to uncertainty. If the Proposed Regulations are implemented, controversies will arise over the question of control.

The ABA Members acknowledge the great difficulty in drafting these regulations.<sup>268</sup> The type of post-death events that may affect the value of an estate's property interest is virtually unlimited. In any given case, the question of how the value of a property interest is affected by a post-death event is a fact question. Because of this, the resolution of each case depends on a careful analysis of the facts of the case. Expert testimony is

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266. Proposed Regulations, *supra* note 2, at 22,302.

267. *Id.*

268. *ABA Members*, *supra* note 202, at 4.

critical to determine the basic facts of alternate valuation cases, the most important being the valuation of a particular property interest at a particular time, and the effects of a particular event on said property interest. The experts' testimony in *Kohler* had a greater influence on the outcome of the case than did the holding that was the subject of the Proposed Regulations. For this reason, litigants in future alternate valuation controversies would be well advised to carefully select their expert appraisers.

#### VI. CONCLUSION

Because of the significant role played by expert testimony in *Kohler*, the regulations appear to miss the mark. In their current form, the Proposed Regulations will only serve to increase uncertainty in application of the alternate valuation election. The Service should take note of the comments provided by the Estate Lawyers, the ABA Members, and the Tax Section, and clarify the definition of control in the final regulation. If the Service ultimately promulgates the regulations, the rules on taking valuation discounts due to post-death events will only be muddled, and particular controversies will have to be decided in court.

*Brian E. Surratt*

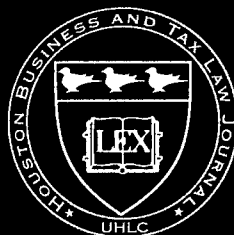


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EXCESSIVE EXECUTIVE COMPENSATION:  
PRIOR FEDERAL ATTEMPTS TO CURB PERCEIVED ABUSES  
*Kathryn J. Kennedy*

EXECUTIVE COMPENSATION: MUCH TO DO ABOUT...  
*James R. Raborn*

DEFERRED COMPENSATION FOR THE EMPLOYEES OF  
TAX INDIFFERENT PRIVATE EQUITY FUNDS  
*Shane M. Tucker*



