3 taxes – gift
– estate
– gst

Chapter 18

A BRIEF INTRODUCTION TO WEALTH TRANSFER TAXATION

life = gift
death - estate

The Internal Revenue Code imposes a wealth transfer tax on the gratuitous disposition by United States citizens or residents of property located anywhere in the world *and* on the gratuitous disposition of the United States situs property of nonresident noncitizens. Like the federal estate tax, most states also levy a tax on the transfer of property at death,[1] either "estate" taxes (a single tax determined by the amount of the estate of the decedent) or "inheritance" taxes[2] (separate taxes imposed on each benefit conferred on a devisee, legatee, or heir, the amount of tax usually being determined by the size of the gift and the relationship to the decedent of the person who receives it).

who does it apply to

Few states impose a gift tax,[3] notwithstanding that the tendency of taxpayers would be to make inter vivos gifts if there is a heavy tax on transfers at death but no tax on transfers during life. The low number of states with gift taxes probably reflects the fact that state wealth transfer tax rates are relatively low and probably do not often influence the transfer planning of individual citizens. In addition, the federal gift tax adequately deters most gifting that otherwise would be made solely for tax minimization purposes. The federal gift tax buttresses the estate tax, and most individuals are disinclined to make gifts regardless of clear tax advantages of transferring property during life rather than waiting until death. See Chapter 12.

1. All states impose a sponge or pick up tax that originally was meant to equal the §2011 state death tax credit that was repealed in 2001 effective after 2004. The label sponge or pick up tax reflects that the states were taking the full amount they could collect without costing their citizens added taxes. Every state imposed a state death tax that was keyed to the amount of this credit, which effectively shifted revenue from the federal government to the taxing state. In 2003 only Ohio and Oklahoma imposed estate taxes exceeding the amount of the §2011 state death tax credit. Following repeal of §2011 many states began to "decouple" their tax from the federal regime, such that now it is impossible to predict or easily summarize the impact of state death taxes. *See* Schoenblum, MULTISTATE GUIDE TO ESTATE PLANNING Table 10.02 (2001). *And see* §2058, which is a federal deduction for state estate taxes that are imposed after 2004. Because credits (§2011) and deductions (§2058) have very different effects, that change was not a mere relabelling or a sleight-of-hand, and it visited a huge revenue shift from the states back to the federal government.

2. Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Nebraska, New Hampshire, New Jersey, North Carolina, Pennsylvania, South Dakota (repealed in 2000 with respect to intangibles and nonresidents), and Tennessee still impose inheritance taxes. See Schoenblum, MULTISTATE GUIDE TO ESTATE PLANNING Table 10.01 (2001), which also lists Connecticut (which phased out on a schedule, complete after 2004) and Montana (the legislature voted in 2000 to repeal their tax).

3. Only Connecticut, Louisiana, North Carolina, and Tennessee impose a gift tax. See Schoenblum, MULTISTATE GUIDE TO ESTATE PLANNING Table 10.04 (2001), which also lists New York (the legislature voted in 2000 to repeal the gift tax).

Congress enacted the generation-skipping transfer tax (GST, as Chapter 13 of the Internal Revenue Code) to prevent individuals from planning their estates to avoid all wealth transfer tax in the estates of their children or more remote descendants through the use of trusts that bestow benefits but do not grant sufficient enjoyment or control to require estate tax inclusion. The GST had its own credit under §2604 for state generation-skipping taxes, and several states adopted their own sponge or pick up tax version of this impost.[4] That credit also was repealed, effective in 2005.

This Chapter is a brief overview of the three federal transfer taxes (gift, estate, and generation-skipping transfers) and state death taxation, in that order.

It may be useful to remember throughout that payment of federal estate or gift tax is avoided to the extent the §2010 *unified credit* is available. (The GST also has an exception but it operates in a different manner, as discussed at page 36.) A credit is like money in the bank: you owe the tax but Congress says you need not pay it because you have this credit on deposit. So you pay only when your tax exceeds that amount. The credit is equal to the tax on the first chunk of wealth transferred in a taxable manner (the applicable exclusion amount). For example, in 2005 when the applicable exclusion amount is \$1.5 million, the estate tax unified credit is \$555,800. That also is the tax on an estate of \$1.5 million. (For reasons too complex to explain now, the applicable exclusion amount for gift tax purposes is just \$1 million and the unified credit for gifts is \$345,800.)

So, for example, an estate of \$20 million would incur a lot more tax than \$555,800 but that estate would not pay the first \$555,800 of its tax liability. An estate of just \$1.5 million would not pay any of the tax on that amount, making that smaller estate "nontaxable" in street lingo. Actually, *every* estate is taxable, but most estates don't generate a tax large enough to consume the entire credit, so most do not require an actual payment to the government. We just *say* that those smaller estates are exempt or nontaxable. Indeed, as an administrative convenience, a *gross* estate (note that this is *not* the smaller *taxable* estate) that is below the applicable exclusion amount need not even file a return. Over 99% of the decedent population in 2004 was nontaxable due to the unified credit. Yes, you got that right: The wealth transfer tax applies to less than 1% of the decedent population in America. So, why have your elected representatives made such a big deal over "repeal of the death tax"?

4. Like state death taxes that took advantage of the §2011 credit, these state taxes merely diverted a portion of the federal generation-skipping transfer tax to the state and therefore cost their citizens nothing. Schoenblum, MULTISTATE GUIDE TO ESTATE PLANNING Table 10.03 (2001), reported that over half the states adopted a GST pick up tax. It was expected that most states would follow suit, as they all had in imposing a death tax taking advantage of the §2011 credit. Like §2011, however, this §2604 credit also was repealed in 2001, although unlike §2011 repeal was effective in 2005 all at once — it was not phased out. It is not clear how states will respond post repeal.

There is a quirk in this unified rate system, attributable to the fact that the estate and gift taxes were not unified until 1976 but this integrated gift tax computation regime existed beginning in 1932. Thus, taxable gifts made before 1977 must be reflected in determining the applicable tax for taxable gifts but not for determining the estate tax for any decedent.

To illustrate, assume that Donor made taxable gifts before 1977 totaling $150,000 and a taxable gift after 1976 of $100,000. The gift tax on the $100,000 gift would be computed by determining the gift tax under the unified rate schedule on a gift of $250,000 and then subtracting the gift tax under the same schedule on a gift of $150,000; the difference is the gift tax on the post 1976 taxable gift of $100,000. Donor's estate tax, however, would be determined without regard to the gift made before 1977. Thus, if Donor's taxable estate were $700,000 at death, it would be added to the taxable gift made after 1976 of $100,000 but not to the taxable gift made before 1977 of $150,000. The tax on only $800,000 would be computed, and the tax on that amount would be paid to the extent it exceeds the tax on the $100,000 taxable gift made after 1976.

The tax computed under the unified rate schedule need not be paid until the aggregate tax incurred during life and at death exceeds the unified credit granted by §§2010 and 2505. In this example the tax would be satisfied by applying the unified credit and no tax payment actually would be remitted.

The Federal Estate Tax

As noted in Chapter 11, the federal estate tax is an obligation of the residue of the decedent's probate estate and must be paid by the "executor" of the estate,[8] which distinguishes the tax from an inheritance tax like that imposed by some states on recipients of a decedent's property.

The federal estate tax is imposed on a decedent's taxable estate and requires answers to three basic questions:

(1) What property is includible in the decedent's "gross estate"?

(2) What amounts are deductible from the gross estate in determining the "taxable estate"?

(3) How much tax is imposed on the taxable estate?

The Gross Estate

A decedent's gross estate includes "the value of all property to the extent of the interest therein of the decedent at the time of . . . death." §2033. Property a person owns at death is includible in the decedent's

8. §§2002 and 2205. The term "executor" is defined in §2203 as the fiduciary charged with administration of the decedent's estate or, if there is none, then any person in possession of the decedent's property.

gross estate,[9] but many other types of property or entitlements are includible even though the decedent did not own them in a classic sense. Thus, although §2033 is a general inclusion authority with respect to probate property:

> The word "property" in the statute is not limited in its scope by concepts of property that existed when the estate tax was conceived. When property rights have come into existence since the statute's enactment, the generalized term must be expounded. . . . The economy and many of the elements of life today are different than they were even a generation or less ago. The Congress in its wisdom decided to use a general word like property rather than trying to envision what the ingenuity of man would evolve as something substantial. The tax gatherer is directed to seek out the esoterics of ownership . . . .[10]

Moreover, because Congress intends to tax all transfers of economic benefit upon a decedent's death, regardless of the niceties of property law or the legal forms employed, some property transfers must be reached by special provisions, including some provisions that (in the interest of preventing tax avoidance) reach certain inter vivos transfers notwithstanding that any economic benefit transferred at death is nearly or entirely nonexistent.

(1) Transfers Made Within Three Years of Death In 1981 Congress enacted what now is §2035(a)(2), which requires gross estate inclusion of transfers made within three years of death of property interests that, if retained until death, would cause inclusion in the gross estate under any of §2036, §2037, §2038, or §2042 (all of which are discussed below). This inclusion rule does not apply, however, to the extent the transfer was not a gift because it was made for full and adequate consideration in money or money's worth. §2035(d). In addition, §2035(b) requires inclusion of the amount of any gift tax paid by the decedent (or the decedent's estate) on any gift made by the decedent (or by the decedent's spouse) within three years of death. This "gross up" inclusion rule subjects the dollars used to pay the gift tax to estate tax. This matches the estate tax result at death because the dollars used to pay the decedent's estate tax themselves are part of the estate that is subject to the estate tax. A different approach applies for gift tax purposes: the dollars used to pay gift tax are not themselves subject to the gift tax. See the discussion of this difference in Chapter 12 at page 3.

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9. A few notable exceptions exist by virtue of legislative grace. See, e.g., §2103, which excludes property not situated in the United States that is owned at death by a nonresident noncitizen.

10. First Victoria Nat'l Bank v. United States, 620 F.2d 1096, 1104 (5th Cir. 1980) (holding that "rice history acreage" is "property" for estate tax purposes).

(2) Revocable Transfers The value of property transferred by a decedent during life but subject to a power to alter, amend, revoke or terminate enjoyment is includible in the decedent's gross estate (except to the extent the transfer was for a full and adequate consideration in money or money's worth). This §2038(a)(1) inclusion is consistent with the gift tax rule that a revocable transfer is not a completed gift and therefore is not taxable for gift tax purposes. Because death constitutes termination of the retained power, which completes the transfer for wealth transfer tax purposes, the estate tax is imposed if the power existed any time within three years of the decedent's death. Release of the power within three years of death causes the same result as if the power were retained until death. See §§2038(a)(1) (last clause) and 2035(a)(2), noted above.

(3) Retained Life Estates Even if a transfer is irrevocable and therefore was subject to gift taxation, the transferor may be exposed to §2036(a) estate tax inclusion of the value of the transferred property if the transferor retained enjoyment of the property for life, or retained a power to designate who will enjoy the property and did not relinquish that power more than three years prior to death. These interests and powers are treated for estate tax purposes as if no transfer was made; the transferor's retained enjoyment or control causes the transfer to be regarded as testamentary.

Under §2038 the typical transfer during life is not complete and the gift tax is not imposed. But the §2036 estate tax result may be inconsistent with the gift tax consequences of the transfer. For example, if the donor retained only the right to receive income for life, the gift tax would be imposed on the value of the remainder interest transferred irrevocably during life. Because it was retained, the value of the life estate was not subject to gift tax when the initial transfer was made and it is subject to estate tax in the form of the increase in the transferor's net worth attributable to income received (to the extent that income has not totally been consumed before death). There is nothing inconsistent with this result.

But inclusion of the full value of the transferred property in the transferor's gross estate at death *is* inconsistent with the prior gift taxation, because the remainder taxed during life is exactly the same interest that is subject to estate tax at the time of the transferor's death (the remainder now being the full value of the trust). Because the value of the remainder is being taxed a second time by virtue of the retained life estate, an adjustment is provided under the flush language of §2001(b) to preclude double taxation of the same interest, due to the inconsistent application of the estate and gift tax rules.

With only one deviation the same results apply if the power to alter enjoyment of the income interest triggers §2036(a)(2) inclusion at death. Because the income interest was not retained, it was subject to gift tax at the time the trust was created and that wealth was not received by the transferor. So it is not subject to taxation at death. Thus, in both cases the value of the income interest is taxed only once, the difference here being that it was taxed at the time the trust was created and it was taxed at death in the prior case of retained enjoyment of that interest. In both cases, however, the value of the remainder interest is subjected to tax twice, and again the §2001(b) flush language adjustment is necessary.

For purposes of these rules, §2036(b) regards the transfer of stock in a controlled corporation as a §2036(a)(1) transfer with retained enjoyment if the transferor retains the right to vote the stock. A more appropriate rule would be to treat this as a §2036(a)(2) transfer with retained power to govern the enjoyment, but the result is the same either way: the transfer during life is ignored for estate tax purposes and treated as if it were a testamentary disposition.

(4) Transfers That Take Effect at Death Unquestionably the strangest estate tax inclusion provision is §2037. It applies only if (1) some beneficiary must survive the decedent as a condition to obtaining possession or enjoyment of property the decedent transferred during life, and (2) the decedent retained a reversion in the corpus of that property that was worth at death more than 5% of the value of the property that would revert. To illustrate, a transferor would have to make a transfer such as "to A for life, then reversion to the transferor if living and, if not, to B if living," and even then the value subject to §2037 would be only the value of the transferred property reduced by the value of the life estate in A (because it is not subject to the reversion). A reversionary interest that does not meet these requirements still may be includible in the decedent's gross estate under §2033, although only the value of the reversion would be subject to inclusion in that event rather than the full value of the property subject to the reversion. Notwithstanding that §2037 has been in the estate tax law since its inception, for decades it has been a veritable backwater, and all significant litigation involving its provisions is antiquated. This provision largely is irrelevant given that modern estate planning seldom would call for retention of anything closely resembling the reversion that would trigger §2037.

(5) Annuities The value of an annuity at a decedent's death is includible in the decedent's gross estate under §2039(a) if the decedent was entitled to receive annuity payments for life (including if the decedent had not yet begun to receive such payments but, once they began, they were payable for life). The most common illustrations of this are under a retirement benefit plan if some other beneficiary is entitled to enjoyment of an annuity after the decedent's death, such as under a joint and survivor payout option. Because most retirement benefit annuity payments also constitute income in respect of a decedent for purposes of §691(a), these entitlements that survive a participant's death constitute one of the most heavily taxed forms of wealth and require special attention in the planning process.

(6) Concurrent Interests Property held in joint tenancy with the right of survivorship or as tenants by the entireties (i.e., concurrent

interests with the right of survivorship) are subject to special inclusion rules under §2040, applicable with respect to the estate of all but the last concurrent owner to die. The general inclusion rule applies a consideration furnished test that requires inclusion in the gross estate of a portion of the value of the concurrently owned property that corresponds to the portion of the consideration furnished by the decedent to acquire the property. The presumption is that the decedent furnished the entire consideration, in which case the entire value is includible in the decedent's gross estate. However, any surviving concurrent owner may prove that the decedent did not provide all the consideration, in which case a lesser percentage will be includible. No part of the value will be includible in the decedent's gross estate if it can be proved that the decedent furnished none of the consideration. If, however, the concurrent owners acquired the property by gift from a third party, an equal portion of the value is includible (or such other portion specified by the donor if the gift specified that the owners would not share the property equally).

In 1976 Congress adopted the qualified joint interest rule in §2040(b), applicable only to property acquired after 1976 and held exclusively by spouses who are citizens of the United States. Only half the value of a qualified joint interest is includible in the gross estate of the first spouse to die, regardless of the source of the consideration furnished to acquire the joint interest.

Not subject to §2040 is concurrent ownership that lacks the right of survivorship, such as a tenancy in common or community property. Instead, only the decedent's undivided interest in the property (e.g., half the value of community property) is includible in the decedent's gross estate.

To illustrate the application of §2040(a) with respect to concurrent interests with the right of survivorship among persons who are not spouses, assume Donor devised Blackacre to A and B as joint tenants with the right of survivorship and not as tenants in common. Half the value of Blackacre will be included in the gross estate of the first of A and B to die, and the survivor will become the sole owner of Blackacre pursuant to the right of survivorship. When the survivor dies the full value of Blackacre will be subject to inclusion again, meaning that 150% of the value of Blackacre will be subject to federal estate tax over both estates.

Suppose instead that A had purchased Blackacre and placed the title in the names of A and B as joint tenants with the right of survivorship and not as tenants in common. A would make a taxable gift to B of half the value of Blackacre and still would suffer inclusion of 100% of the value of Blackacre in A's gross estate (because A furnished all the consideration for its acquisition). Any gift tax paid by A will be allowed under §2001(b)(2) as a credit against A's estate tax and, if the tenancy was created after 1976, the gift made upon creation will be purged from A's adjusted taxable gifts by the flush language of §2001(b). Still, the net result will be inclusion of 200% of the value of Blackacre over both estates. If, however, B were to die first, no part of the value of Blackacre would be includible in B's gross estate because A furnished all the consideration for its acquisition, and only 100% of the value of Blackacre will be subjected to federal estate tax over both estates (all in A's estate at the second death). Recall, however, that half the value of Blackacre was subject to gift tax when A created the joint tenancy, so in the aggregate 150% of the value of the property was subject to wealth transfer tax. All things considered, can you think of a worse form of property ownership for tax purposes?

(7) Powers of Appointment are important estate planning tools that provide flexibility in trust dispositions. Under §2041 the holder of the power is treated as the owner of any property that is subject to a general power, meaning that the powerholder may appoint the property to the powerholder, to the powerholder's estate, or to creditors of either. Any other power of appointment is a nongeneral power, which is harmless for estate tax purposes (unless the power is exercised in a manner that triggers the arcane provisions of the so called Delaware Tax Trap of §2041(a)(3), meaning that exercise is effective to extend the duration of a trust for Rule Against Perpetuities purposes). It generally makes no difference whether the power is exercised (unless the power predates 1942). Inclusion of the appointive property usually depends solely on whether the powerholder possesses a general power of appointment.

(8) Life Insurance proceeds are includible in the insured decedent's gross estate if at death the decedent possessed any "incidents of ownership" in the policies or if the proceeds are payable to the insured's estate. Recall Chapter 9.

(9) QTIP Property Property that qualifies for a marital deduction in a decedent's estate under §2056(b)(7) as "qualified terminable interest property" is subject to inclusion in the estate of that decedent's surviving spouse under §2044. This inclusion essentially is a payback for the grant of the marital deduction to the estate of the former decedent. Qualification for the marital deduction causes the property to be treated as if the surviving spouse had a sufficient ownership interest to cause estate tax inclusion, notwithstanding that the surviving spouse never owned the property and, in many cases, cannot govern its ultimate disposition.

The Taxable Estate

The §2051 taxable estate upon which the decedent's estate tax is computed under §2001 is determined by subtracting the total amounts of five deductions from the decedent's §2031 gross estate.

(1) Debts, Expenses, and Taxes. Ordinary and necessary expenses of administering the decedent's estate (including fees paid to the personal representative and to advisors such as an attorney or accountant), claims against the estate and recourse indebtedness for which the decedent was personally liable during life (in either case to the extent supported by full

and adequate consideration in money or money's worth), and taxes that were the decedent's liability during life (i.e., taxes other than wealth transfer taxes or any tax that accrues after death), are deductible under §2053.

(2) Casualty or Theft Losses. Losses incurred during administration of the estate that are not compensated by insurance are deductible under §2054.

(3) Charitable Deduction. The §2055 estate tax charitable deduction mirrors the gift tax charitable deduction.

(4) Marital Deduction. The §2056 estate tax marital deduction also mirrors the gift tax marital deduction, with only one difference of any significance. Although §2056(d) denies the estate tax marital deduction if the decedent's spouse is not a United States citizen, §2056A allows an estate tax marital deduction with respect to a noncitizen surviving spouse if certain "qualified domestic trust" requirements are met. No similar entitlement was granted for gift tax purposes, although §2523(i)(2) expanded the gift tax annual exclusion for gifts to a noncitizen spouse.

(5) *State Death Tax Deduction.* A §2058 state death tax deduction took the place of the §2011 state death tax credit beginning in 2005 and merely serves to reduce the financial impact of an estate incurring an estate or inheritance tax liability to a United States taxing jurisdiction other than the federal government.

Valuation

Among the most challenging tax issues are valuation questions, for both inclusion and deduction purposes and not just in taxable estates. These questions easily can arise in times of estate division or distribution, for annual exclusion lifetime giving, to qualify for federal entitlements, for federal income tax purposes, and for various state tax purposes (including property taxation). Most people focus on valuation in the federal estate tax arena, which can entail questions such as whether to determine the federal estate tax value as of the date of the decedent's death or on the alternate valuation date; and whether to determine the value of an asset under a willing-buyer, willing-seller hypothetical sale, as a going concern, using actual sales of comparable assets, by capitalizing future income, considering book value or asset liquidation,[11] or by some other unique or special evaluation. Setting up the appropriate estate tax valuation may

11. See Knott v. Commissioner, 55 T.C.M. (CCH) 424 (1988), in which a transferred partnership interest was deemed to have a value even though a partnership liability exceeded the net underlying asset value of the partnership, such that the donees would have received nothing if the partnership had been liquidated immediately after the transfer. Going concern value should exceed liquidation value because of the perceived benefits of continuing an existing business rather than taking the assets of that business and starting a new enterprise. One obvious benefit is avoiding costs associated with a start up endeavor. Liquidation value usually is a minimum value because of a perception that owners will liquidate a business that has a lower going concern value. See Estate of Leichter v. Commissioner, 85 T.C.M. (CCH) 991 (2003).

involve inter vivos transfers, and they may implicate gift tax valuation issues of the same or related varieties.

In addition, a slew of adjustments may affect value (such as a control premium or discounts for minority or fractional interests, for lack of marketability,[12] or for other more esoteric factors like blockage,[13] built in income tax liabilities, restrictions imposed by the securities laws, or the existence of only an illicit market for the asset). See Chapter 12 beginning at page 48 regarding these and other types of adjustments. With select assets another option may be to value property not at its highest and best use but instead at its actual use under a §2032A "special use" valuation regime applicable to realty used in farming, ranching, and other closely held businesses. See page 21. And there are other specialized valuation rules that may apply under Code Chapter 14 in the context of estate freezing techniques. See page 19.

Valuation is a particularly imprecise endeavor, referred to by one court as a "gross terminal logical inexactitude." Maris v. Commissioner, 41 T.C.M. (CCH) 127 (1980) (expropriating the words of Winston Churchill). Reliance principally on the willing-buyer, willing-seller hypothetical is especially trying because it begs reality. Reference to results reached in particular cases, to "average" discounts or premiums, or to other specific factors often is a fool's errand (reminiscent of using the manufacturer's statement of average miles per gallon fuel economy for a new car as indicating the performance of a particular used car, without specific regard to facts and circumstances such as the condition of the car or road, weather, speed, load, driver technique, and other variables). In addition, courts show a disturbing proclivity to do their own thing, sometimes differing diametrically in terms of such basic principles as whether to accept one litigant's theory of the case over the other or to strike a compromise between them. Thus, it pays to understand guidelines for valuation and the postmortem options that are available but not to embrace particular results in particular cases as if they were informative of *anything*.

Wrestling with valuation issues premortem usually cannot be very precise even on a case by case basis, because values are certain to fluctuate

12. Several cases deny the lack of marketability discount if using the book value of underlying assets is appropriate, because liquidation would yield the greatest return. See, e.g., Estate of Jephson v. Commissioner, 87 T.C. 297 (1986) (net asset value without discount was used because the decedent's willing buyer could liquidate the business and obtain its unleveraged portfolio of investments); Estate of Luton v. Commissioner, 68 T.C.M. (CCH) 1044 (1994) (there should be no lack of marketability discount in the case of a corporation consisting totally of cash and marketable securities that the corporation easily could liquidate); Estate of Jameson v. Commissioner, 77 T.C.M. (CCH) 1381 (1999), vac'd and rem'd on other grounds, 267 F.3d 366 (5th Cir. 2001) (a marketability discount to a 98% shareholder was severely limited because virtually all the assets in the corporation were marketable).

13. The fact that the market for a particular asset at a particular value is thin is not determinative unless less than all the asset could be sold at that price.

over time (usually in unpredictable and uncontrolled ways) and efforts to be accurate tend to be unnecessarily expensive in terms of appraisal and other costs. Although premortem planning may make certain valuation adjustments viable (such as engineering discounts that may apply later), most premortem valuations need to be no more accurate than appropriate to estimate liquidity needs or to judge the likely application of provisions that depend on includible assets meeting certain threshold value requirements. Usually marital and charitable deduction planning is accomplished with formula provisions that self-adjust to reflect valuation changes, and few dispositive or other provisions turn on precise valuation determinations. So, aside from periodic reviews that verify assumptions about operation of the plan, valuation is largely a postmortem estate administration function that requires individuated determinations and entails a great deal of uncertainty, guesswork, or compromise.

The one and only Code provision addressing the proper valuation of garden variety assets includible in the gross estate is §2031(b), and it essentially is worthless, which may explain why valuation is unquestionably the single most frequently litigated issue for all wealth transfer tax purposes. Curiously, more significant valuation guidance is found in §6662, which collars the valuation endeavor by placing overvaluation and undervaluation penalties on taxpayers who are too aggressive in establishing value for both income and wealth transfer tax purposes. Taxpayers are at a competitive disadvantage in this regard because there is no corresponding provision that imposes restrictions on the government when it challenges taxpayer valuations.

Willing-Buyer, Willing-Seller Valuation

Valuation largely is an application of standards established by regulation, ruling, and judicial guidance, the most classic formulation of which being the statement that "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." Treas. Reg. §20.2031-1(b). The regulation goes on to provide:

> 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. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally

obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public, and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles.

Actual sales of identical or, lacking that, comparable assets usually are the best evidence of the proper value, making valuation easy with respect to assets with a ready market. Only when there is no ready market does difficulty normally arise.

In this regard, for some assets there is reasonably good guidance on how to establish value. For instance, a huge percentage of valuation cases involve interests in land, both developed and investment grade or timber, or closely held businesses, in each case for which there may be no established or regular market. With respect to these less easily valued assets, courts sometimes take pains to stress that evidence of what a willing buyer would offer to pay is only half of the two-sided willing-buyer, willing-seller equation. The Tax Court has stated that fair market value requires a price at which both a willing buyer would purchase and a willing seller would sell. It is not established by satisfaction of half this equation.

Yet this message has been confused on occasion, the Tax Court itself once having said that "the highest price a willing buyer would pay is also the price that a willing seller wants,"[14] suggesting that a focus on the willing buyer is appropriate because it necessarily equates with a willing seller analysis. This, however, actually assumes an *un*willing seller — one who feels obliged to sell and therefore feels compelled to find a willing buyer and then take whatever is the highest amount that hypothetical party will offer. Indeed, if it were right, the converse of the statement also would be true: that a willing buyer will pay as much as the lowest price a willing seller would accept. If this were an accurate reformulation, it would posit that a willing buyer will not walk away from a sale even if the price is too high, which makes the buyer unwilling as well. As you can begin to sense, the willing-buyer, willing-seller hypothesis is not particularly realistic.

An additional factor illustrated by the regulation is that new assets should not be valued in the used asset market, or vice versa. Collectively, this differential in value sometimes is known as the difference between liquidation value and replacement cost, the higher replacement cost value being the controlling precept. This difference has been a topic of significant controversy, as illustrated by Estate of Scull v. Commissioner, 67 T.C.M. (CCH) 2953 (1994), which accepted the government's valuation of property sold at auction as the full amount paid by the buyer,

14. Estate of Newhouse v. Commissioner, 94 T.C. 193, 233 n.23 (1990), nonacq., 1991-1 C.B. 1 and 1991-2 C.B. 1 (does twice indicating disapproval mean the government was doubly offended?).

notwithstanding that the seller received only that amount less the auctioneer's commission (indeed, the auctioneer may receive another commission from the buyer, over and above the hammer price, and a commission from the seller out of the hammer price; the federal estate tax value is not the amount received by the seller, nor the hammer price unreduced by the seller's commission: it is the full amount paid by the buyer — basically including the two commissions, neither of which the seller will realize). This truly highlights the difference between replacement cost and liquidation value, the latter amount being what the seller received but the higher replacement cost being what the buyer paid. It should not be a surprise that the regulations view replacement cost as the proper measure of value for federal estate tax purposes.[15]

Finally, note that for estate tax purposes the destination of the includible property is irrelevant. Whether it passes all to one person or to many, or will be owned by a beneficiary who acquires with it control or some other valuable attribute, valuation looks to what the decedent owned and not how or to whom it is transferred.

Use of Postmortem Facts

Among the more controversial and least definite valuation issues is the effect on the valuation process of facts developed after the valuation date.[16] A fundamental wealth transfer tax notion is that the estate tax employs a snapshot principle: only facts about estate assets that appear in a snapshot taken on the valuation date are relevant, meaning (in theory) that facts developed thereafter should not be relevant. But the reality is that some courts have allowed evidence of value that includes facts that were neither known nor reasonably knowable on the valuation date.

Thus, for example, Estate of Keller v. Commissioner, 41 T.C.M. (CCH) 147, 148 (1980) (valuation of a farm and growing crop, sold and harvested, respectively, postmortem), stated that a "sale of property to an unrelated party shortly after date of death tends to establish such value at date of death." The difficulty with a paradigm allowing some postmortem facts as evidence of value is knowing the parameters of the rule. For example, in First National Bank of Kenosha v. United States, 763 F.2d 891 (7th Cir. 1985), a development company entered into an agreement to purchase includible property 21 months after the decedent's death. This was deemed relevant because no intervening events had drastically altered

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15. If a sale meets the requirements of §2053(a)(2) and Treas. Reg. §20.2053-3(d)(2) (if it was necessary to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution), then the commission paid to the auctioneer would be an allowable deduction that would subject only the net amount actually received by the estate to tax. But assets that are not sold, or sales that do not meet this necessity requirement, do not qualify for this reduction in the net effective amount subject to tax.

16. The issue may arise regardless of whether values are being determined as of the date of death or the alternate valuation date, and whether valuation is under traditional methods or a paradigm such as §2032A special use valuation.

the value of the property. Thus, the agreement was regarded as probative (albeit not necessarily conclusive) evidence of value. Notwithstanding that the buyer never completed the transaction! The court noted that a different result might apply if, for example, minerals were newly discovered or other unknown facts were revealed in the interim.

Even this "postmortem discovery" issue is uncertain, as illustrated by Rubenstein v. United States, 826 F. Supp. 448 (S.D. Fla. 1993), in which the existence of the includible asset was not even known at the valuation date, much less its value. The court held that a cause of action discovered only after the decedent's death was includible in the gross estate and that the best evidence of its value was the amount for which it was settled during the course of estate administration.

Given the result in these cases, Estate of Jung v. Commissioner, 58 T.C.M. (CCH) 1127 (1990), is not surprising. To help determine the estate tax value of the decedent' stock in a closely held corporation, the court honored the government's request for documents relating to a sale of the assets of that business 27 months after the valuation date. The court held that sale of those assets might help determine the earlier value of the stock. Similarly, in Estate of Scanlan v. Commissioner, 72 T.C.M. (CCH) 160 (1996), the court admitted as relevant to its valuation of a decedent's stock evidence of an offer to purchase and a redemption price between 18 and 28 months after the valuation date. These may be extraordinary results, and there are cases that go the other way. Still, it is well to remember that courts consider postmortem developments, and they may be relevant for deduction purposes as well as for inclusion or valuation purposes, with equally uncertain parameters.

Ignoring Options and Agreements that Affect Value

Assets includible in a decedent's gross estate may be subject to an agreement (such as a buy-sell, right of first refusal, put or call, or other option) that could (if respected) affect the value of assets subject to the agreement for federal estate tax purposes. These agreements may be desirable for a number of legitimate reasons (other than their effect on valuation), such as to provide a ready market for a decedent's otherwise illiquid investments, to keep the investment in a family unit, or to permit surviving business owners to avoid having to do business with a deceased partner's surviving spouse or other family members. But Congress was aware that these agreements also were used to freeze the value of subject property at the agreed upon striking price. To combat the possibility of abuse in such circumstances, §2703 addresses the valuation effect of options, rights to acquire or use property, and restrictions on the sale or use of property of any kind.

The primary thrust of §2703(a) is to restrict the ability of buy-sell agreements to establish the estate, gift, or GST value of property at a price that is less than fair market value for federal estate tax valuation purposes, determined without regard to the agreement. If applicable, §2703(a) also totally negates the effect of other restrictions on the sale or use of property in determining value for transfer tax purposes, and it may be deemed to apply with respect to limitations on liquidation of an entity, to leases with option provisions, and to certain easements.

An exception is provided if the option, agreement, right, or restriction meets three requirements: it is "a bona fide business arrangement," with terms that are comparable to those of "similar arrangements entered into by persons in an arm's length transaction," and it is "not a device to transfer . . . property to members of the decedent's family for less than full and adequate consideration." Moreover, all the pre-§2703 rules regarding the validity of agreements to peg values (such as the need to impose lifetime restrictions on transfer) are unaffected by §2703, meaning that even if the foregoing exception applies, the agreement still may fail on one or more of those additional traditional requirements.

Ignoring Rights and Restrictions that Affect Value

Also precluded is the use of voting, liquidation, and other rights or restrictions that have "the effect of reducing the value of the transferred interest [for wealth transfer tax purposes that do] not ultimately reduce the value of such interest to the transferee." §2704(b)(4). Applicable only to corporations and partnerships in which the transferor and family members hold 50% control before and after the transfer, §2704 essentially regards the lapse of a restriction as a taxable transfer of the difference in value measured before and after the lapse. Further, restrictions that are imposed but that do *not* lapse are disregarded for valuation purposes if they will lapse or can be removed by the transferor or by family members after the transfer. In effect, the higher value determined without regard to the right or restriction is the proper value for wealth transfer tax purposes.

Alternate Valuation

The alternate valuation date is six months after the decedent's death *or* any *earlier* date on which the asset is distributed, sold, exchanged, or otherwise disposed of. §2032(a)(1), Treas. Reg. §20.2032-1(c)(2), Rev. Rul. 78-378. Distribution occurs upon expiration of the executor's right to obtain possession of the property to satisfy creditor claims. Assets that are affected by the mere lapse of time — such as a temporal or split interest (life estate, term of years, or remainder), or an annuity — are valued without adjustment for any difference in value (as of the later date) that is due to the time element. §2032(a)(3). See Treas. Reg. §§20.2032-1(a)(3), 20.2032-1(f) (the concept does not, however, apply to obligations for the payment of money, with or without interest, as to which the value changes over time).

Alternate valuation is an all or nothing proposition: the election is made with respect to either every estate asset or none. The estate may not pick and choose assets to value under the normal date of death paradigm and others to value on the alternate valuation date. So postmortem planning requires the personal representative to accelerate the alternate valuation date for rapidly appreciating assets by forcing a distribution or other acceleration event that allows other assets to continue to benefit from the six month alternate valuation date, by drawing the curtain on only those assets that are becoming more valuable. If the entire estate is appreciating, however, alternate valuation will not be viable: among the qualification requirements is that the value of the estate as a whole must be less than if date of death valuation applies. §2032(c)(1).

A second qualification requirement for §2032 alternate valuation is that all taxes payable (*after* all credits are applied) under the estate and GST must be reduced. §2032(c)(2). As illustrated in Chapter 7, typical marital deduction planning reduces the estate tax incurred (after the unified credit) in any sized estate to zero, regardless of the valuation results, which makes qualification difficult and requires special planning to qualify for alternate valuation in such an estate.[17]

Finally, alternate valuation requires a timely election. §2032(d). This actually may be made on a late return filed no more than one year tardy. §2032(d)(2).

Special Use Valuation

The special use valuation election of §2032A provides an option to value certain includible realty at its actual use in farming or ranching or in a closely held trade or business, rather than at normal highest-and-best-use value. So, for example, Blackacre Farm sitting in the path of urban development might be worth $100x for tract housing but is worth only $25x in agricultural production. Special use valuation would allow use of the lower actual use value if the requirements for qualification are met. The actual use value of qualified special use real property is determined by a complex formula. Or the estate may elect to have the value of the qualified special use property determined under a special five factor alternative. This is a complex area, not well suited to any simplified summary description.

Administratively §2032A is cumbersome because it also requires the estate to determine the highest-and-best-use value under the traditional willing-buyer, willing-seller method. This is because the aggregate decrease in value resulting from special use valuation cannot exceed $750,000 (as adjusted for inflation; in 2004 this figure had risen to $850,000). Moreover, the estate must evaluate whether to determine this fair market value on the alternate valuation date; if it does, the special use value also will be determined on the alternate valuation date.

17. Because the estate will pay no estate tax in either event, the benefit of alternate valuation is to reduce the amount of marital deduction needed in the estate of the first spouse to die, which correspondingly reduces the wealth potentially includible in the subsequent estate of the surviving spouse.

As discussed next, the administrative hassles and added cost attributable to the valuation approach, along with recapture tax potential and other less obvious costs of qualification, may persuade the estate that §2032A is not worth pursuing, or that other alternatives for making the estate tax burden more palatable should be considered.

Qualification Requirements

Applicable only to the United States real property of a United States citizen or resident decedent passing to a "qualified heir," §2032A requires that the decedent or members of the decedent's family owned, and used in a qualified manner, property that constituted a significant portion of the decedent's total wealth. As you may well imagine, there are multiple definitional and sub-requirements lurking in all of this. So it probably makes sense to make a quick audit of the basic requirements to determine whether an estate is in the qualification ballpark, before spending substantial resources determining whether qualification would be viable or desirable and whether the respective valuation thresholds are met. In addition, it usually is relatively easy to determine whether the requisite activity requirements have been met, and whether allocation of the qualified use property under the terms of the estate plan (or in the fiduciary's discretion) will permit continued qualification.

This can be an important issue if some beneficiaries intend to be active material participants on the qualified use property and others not, such as children who remained active in the family farm or business and those who moved away. Premortem planning might sever assets or create ownership structures to segregate the qualified use property and allow its distribution to only those who will participate, while maintaining any intended equality with nonparticipants. For this purpose qualified use requires participation by the decedent or members of the decedent's family in activities that constitute farming or a trade or business (other than farming).

The availability of special use valuation in nonfarm trade or business activities is surprising to some. For example, §2032A special use valuation has been used in such diverse cases as a ski resort (in which highest-and-best-use was for condominiums but the actual use was as a slick slope for slip sliding), a vacant lot in a major urban downtown location (in which highest-and-best-use was for a skyscraper but the actual use was a parking lot), and an overland truck terminal located near the intersection of three major interstate highways (for which the highest-and-best-use was for light industrial development but the actual use was a trailer parking lot and a loading dock).

Qualified Use: Material Participation and Recapture

Material participation is required to qualify for special use valuation initially and then to avoid a §2032A(c) recapture of the tax benefit postmortem. It is defined in §2032A(e)(6) as qualified use for at least five years of any eight year period, by the decedent (or a family member of the decedent) during life and thereafter by a qualified heir (or a family member of the heir). This eight year material participation period spans the date of the decedent's death, and the recapture tax might be triggered quickly after death if neither the decedent nor any member of the decedent's family was active for almost a full three years during the eight years just before death. Because it may not be feasible for the qualified heir to make a rapid assumption of qualified use, relief is provided by a special hiatus that permits the qualified heir to delay assumption of material participation for up to two years, with a concomitant extension of the recapture period (which normally runs for a full decade after death). §2032A(c)(7). Other special accommodations are made for decedents who were retired (receiving old age benefits) or were disabled during the eight year period prior to death. §2032A(d)(4). And a relaxed "active management" standard is substituted by §2032A(e)(12) for the more demanding §2032A(c)(7)(B) material participation requisite if the qualified heir is the decedent's surviving spouse or other "eligible qualified heirs."

Ownership and qualified use are essential with respect to both the decedent before death and the qualified heir afterwards, the critical notion being that §2032A is not meant to benefit passive investors versus active participants. The qualified use aspect that most clearly illustrates this is cash leases of otherwise qualified property. Economic risk is the essential element in qualified use, which is negated by a fixed rent cash lease. A crop share lease qualifies, however, because both owner and tenant share the risk of a poor harvest.

A special rule in §2032A(e)(3) regarding residences on the qualified use property allows the home to meet the material participation requirement if it is occupied by the owner, a lessee, or an employee of either, if that occupancy permits the resident to operate or maintain the qualified use property. In some cases it may be wise to exclude such property from the qualified use election to permit a full §1014 basis adjustment with respect to the residence and occupancy by or rental to third parties that will not imperil material participation.

The amount of added recapture tax liability specified in §2032A(c) is the amount by which the decedent's estate tax was reduced. This amount is subject to a limitation that protects the taxpayer from owing more tax than the value of the property that avoided estate tax.

Computing the Estate Tax

The federal estate tax is computed under the §2001 unified rate schedule. The computation involves four basic steps:

(1) the §2051 taxable estate (gross estate minus deductions) is added to the decedent's adjusted taxable gifts made after 1976 (to the extent those gifts are not included in the decedent's gross estate);

(2) a tentative estate tax is computed on this amount under the unified rate schedule;

(3) the tentative tax is reduced by the aggregate gift taxes payable with respect to gifts made by the decedent after 1976; and

(4) the §§2010 through 2014 credits (e.g., the unified, the previously taxed property, and the foreign death tax credits) then are applied against this estate tax liability to reduce the amount of tax actually payable.

Under §2013 a previously taxed property credit is designed to protect against taxation of the same property in more than one estate within a short time. A 100% credit is allowed for the tax previously paid if the prior transferor and the current decedent died within two years of each other; the credit diminishes as the dates of death become more remote and several limitations may preclude the credit from being equal to the entire federal estate tax previously paid. Unfortunately, there is no credit against double taxation in rapid succession if a donor gives property inter vivos to a donee who dies shortly thereafter. There simply is no estate tax credit for gift tax previously paid. Nor is there a credit if the transferor incurs estate tax and the transferee incurs gift tax on an inter vivos transfer within 10 years after the transferor's death. And there is no previous GST credit either.

It may help to visualize the estate tax computation by reviewing the following truncated pro forma illustration.

- To determine the decedent's *gross estate*, add:
  1. §2033 Probate Estate
  2. §2035 Transfers and Gift Taxes Paid Within 3 Years of Death
  3. §§2036 through 2038 Property Transferred Inter Vivos
  4. §2039 Annuities
  5. §2040 Concurrently Owned Property
  6. §2041 General Power of Appointment Property
  7. §2042 Life Insurance Proceeds
  8. <u>§2044 Qualified Terminable Interest Property</u>

  Total Value of Gross Estate

- To determine the decedent's *taxable estate*, subtract:
  1. §2053 Expenses, Debts, Claims, and Taxes
  2. §2054 Losses
  3. §2055 Charitable Deduction
  4. §2056 Marital Deduction
  5. <u>§2058 State Death Tax Deduction</u>

  Total Value of Taxable Estate