

Passing Estate Tax Values Through the Eye of the Needle

By Calvin H. Johnson and Joseph M. Dodge



Calvin H. Johnson



Joseph M. Dodge

Calvin H. Johnson is a professor at the University of Texas School of Law, and Joseph M. Dodge is a professor at Florida State Law School. The authors wish to thank Ronald D. Aucutt and Wendy C. Gerzog for helpful comments without binding them to conclusions with which they disagree.

The taxable estate is the value of assets at the moment of death or other valuation date. Routine estate planning claims discounts of 30 to 60 percent of the value of the property through temporary, self-imposed restrictions or arrangements that will lapse or that heirs can undo.

The wealth transferred to heirs is better measured by ignoring the self-imposed temporary restrictions that reduce value. We should be skeptical that self-imposed restrictions permanently affect the wealth

transferred to heirs; if they do, the law should not encourage it. Section 2704(b) has proved inadequate to prevent this technique.

Under this proposal, value-reducing restrictions or arrangements added by the decedent or on his behalf would be ignored in transfer tax valuation. The lapse of a restriction that originally reduced transfer tax value by a material amount would be a taxable transfer subject to supplemental transfer tax that would be a proxy estate tax.

This proposal is offered as a part of the Shelf Project, which is a collaboration of tax professionals to develop proposals to raise revenue without a VAT or a rate increase. The proposals would improve the fairness, efficiency, and rationality of the tax system. An inventory of the 63 prior shelf projects can be found at http://www.utexas.edu/law/faculty/calvinjohnson/shelf_project_inventory_subject_matter.pdf. Shelf Project proposals follow the format of a congressional taxwriting committee report in explaining current law, what is wrong with it, and how to fix it.

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Property subject to federal transfer tax is valued at the moment of death or other valuation date.¹ The moment-of-transfer valuation principle has led to standard estate planning, even an estate planning industry, the point of which is to subject the transferred property to temporary restrictions or arrangements that destroy a significant fraction of the appraised value of the property at the moment of valuation without reducing the wealth transferred

¹If a taxpayer elects valuation of the estate six months after death, valuation is made as of a specific date six months after death. Similarly, gifts are valued at the moment of completed transfer by gift.

to the natural objects of the transferor's bounty.² The longstanding rule is that valuation for federal estate, gift, and generation-skipping tax purposes is what a willing buyer would pay at the moment of valuation.³ With restrictions, an arm's-length buyer

²Martha Britton Eller, "Which Estates Are Affected by the Estate Tax?: An Examination of the Filing Population for Year-of-Death 2001," IRS Statistics of Income 7 (2005), available at <http://www.irs.gov/pub/irs-soi/01esyod.pdf> (also saying that discounts of \$3.6 billion were claimed on 2001 estates).

³The value of property for estate and other transfer taxes 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

(Footnote continued on next page.)

would be willing to pay less for the property than if the property were unrestricted. Restrictions in family entity arrangements, usually family limited partnerships, that prevent sale or control of the property and its cash flow typically are claimed to reduce the estate tax valuation by 30 to 60 percent.⁴ While the restrictions reduce value at the relevant transfer tax valuation date, they are unlikely to be permanent. These are now-you-see-them, now-you-don't arrangements; that is, the successors will eventually be free from the restrictions (or can undo the value-reducing arrangement without substantial burden) and will end up with the full wealth (and power) inherent in the property without the discount. With the discounts, estate planners can get a camel through the eye of a needle⁵ and end up with a full camel on the other side.⁶

The principle of the proposals here is that property should be valued for federal transfer tax purposes without regard to arrangements or restrictions on property imposed by the transferor (or by another on the transferor's behalf) that, when made, reduce the fair market value of the property. All restrictions and arrangements that reduce value are presumed temporary in the sense that they will lapse or can be reversed by the ultimate beneficiaries to improve the FMV of the property. To the extent that the restrictions and arrangements do reduce value permanently, then the tax law should not give an incentive to the economic waste entailed in the destruction of value. Under these proposals, there would be neither an incentive to manipulate tax value artificially nor to reduce the real economic value of the property. The rules would be objective and applied without regard to the taxpayer's purpose.

A related proposal would provide that the lapse of a significant value-reducing restriction, such as the liquidation or distribution of cash or publicly traded securities from a partnership or other entity, would itself be a taxable event under the transfer tax system unless the restriction had previously been disregarded for transfer tax valuation pur-

knowledge of relevant facts." Reg. sections 20.2031-1(b) (estate tax), 25.2512-1 (gift tax), and 26.2642-2(a)(1) and (b)(1) (generation skipping tax). In transactions subject to the wealth transfer taxes, the transferor is not acting as a greedy seller trying to extract the maximum value from the transaction but is seeking the lowest possible valuation of the property. The willing-buyer, willing-seller test is thus a counterfactual hypothetical.

⁴Eller, *supra* note 2, at 8.

⁵Matthew 19:24 (King James version) ("And again I say unto you, It is easier for a camel to go through the eye of a needle, than for a rich man to enter into the kingdom of God.").

⁶Mitchell M. Gans and Jonathan G. Blattmachr, "Family Limited Partnership Formation: Dueling Data," 35 *Cap. U. L. Rev.* 1 (2006).

poses. The tax would be a supplemental transfer tax but would mimic the estate tax, much as the generation-skipping and gift taxes are supplemental to the estate tax.

Under the proposal, a property owner would be at liberty to impose restrictions or arrangements that reduce the value of his property below the traded market value of the property. The government, however, would cease to give a tax incentive for intentional, typically temporary, economic waste brought about by the transferor. The value-reducing restriction would not be allowed to reduce the government's interest in revenue. Tax avoidance would then never be a motive for imposing a temporary restriction or arrangement.

A. Current Law

1. Allowing self-imposed value reduction. The estate tax is a tax on wealth transmitted from one generation to the next, above an exemption level that for 2011 is \$5 million for individuals and \$10 million per couple. The gift and generation-skipping taxes are supplemental to the estate tax, protecting the estate tax base by ensuring that tax is imposed once a generation and that the estate tax is not avoided by gifts before death.⁷ Valuation of the property subject to tax is made as of the moment of death, the completion of the gift, or the generation-skipping transfer.⁸

Estate planners and wealth management professionals have successfully lowered the appraised value of that taxable property by imposing restrictions or making other arrangements. Typically, for example, the owner of assets above the exemption level will transfer assets to an FLP, a family limited liability company, or a corporation in exchange for equity interests. The assets are often publicly traded securities, cash (or claims to cash), and real estate.⁹

⁷The transfer taxes include the estate tax and the gift and generation-skipping taxes enacted to guard the flanks of the estate tax. IRC chs. 11, 12, and 13.

⁸See, e.g., *Estate of Bright v. United States*, 658 F.2d 999, 1006 (5th Cir. 1981).

⁹See, e.g., *Estate of Korby v. Commissioner*, 471 F.3d 848 (8th Cir. 2006), *Doc 2006-24661*, 2006 TNT 237-8 (cash, stocks, and bonds); *Estate of Thompson v. Commissioner*, 382 F.3d 367, 370 (3d Cir. 2004), *Doc 2004-17577*, 2004 TNT 171-8 (marketable securities and a note receivable); *Estate of Rosen v. Commissioner*, T.C. Memo. 2006-115, *Doc 2006-10518*, 2006 TNT 106-11 (cash and marketable securities); *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, *Doc 2002-11394*, 2002 TNT 95-11 (marketable securities and a note). Real estate is often contributed to an FLP. See, e.g., *Bigelow v. United States*, 503 F.3d 955, 959 (9th Cir. 2007), *Doc 2007-21105*, 2007 TNT 180-9; *Estate of Abraham v. Commissioner*, 408 F.3d 26 (1st Cir. 2005), *Doc 2005-11621*, 2005 TNT 102-11; *Estate of Miller v. Commissioner*, T.C. Memo. 2009-119, *Doc 2009-11967*, 2009 TNT 100-11 (marketable securities); *Estate of Erickson v. Commissioner*, T.C. Memo. 2007-107, *Doc 2007-10663*,

(Footnote continued on next page.)

The entity agreement or arrangement will prevent equity holders from selling, redeeming, or alienating their interests or from liquidating the entity.¹⁰ Equity interests are also typically made the subject of gifts — often of minority interests — and frequently leave the original owner with a minority interest. Sometimes, the restrictions are claimed to affect even a majority owner's control of the assets.¹¹ Typically, the owner of the entity after the restrictions are imposed is not supposed to be able to sell the underlying assets, obtain the cash income from the assets, or decide where to reinvest it.¹²

Although property is generally valued for the transfer taxes according to its "highest and best use,"¹³ courts have accepted valuations of equity interests in family entities well below that standard. In particular, claims for minority interest discounts and discounts for lack of marketability of equity interests typically are 30 to 60 percent of the value of the public market value of the property.¹⁴ Current law apparently allows discounts even when the destruction in value is self-imposed and intentional. Thus, in *Citizens Bank & Trust Co. v. Commissioner*,¹⁵ the court said that "if you own the Mona Lisa and paint (indelibly) a mustache on it before giving the painting to your child, with the result that its value

is greatly reduced, still your gift tax will be computed at the reduced value."¹⁶ The IRS has conceded that the simultaneous gift transfer of five 20 percent interests produces minority discounts.¹⁷ But temporary restrictions on value are distinguishable from irreversible destructions, because they can be reversed after the valuation date. To put it one way, the mustaches are not indelible.

2. Narrow antiabuse rules. Current law provides that some value-reducing restrictions will be ignored, but the provisions to disregard restrictions are narrow and can be avoided by technical estate planning. The principal antiabuse provision is section 2704(b),¹⁸ which disregards any applicable restriction on liquidating the entire entity. A liquidation restriction is applicable if it can lapse by its terms or family members have a right to remove it. However, there is an exception for restrictions imposed by state law,¹⁹ and most state laws governing family entities (especially FLPs) provide such a restriction.²⁰

Section 2704(b) has other escape hatches. It only applies to transfers to members of the transferor's family.²¹ The statutory definition of family member is narrow and unnecessary because any donee or beneficiary of a gift or estate transfer should be included. Also, section 2704(b) only applies to restrictions on liquidating the entire entity. It does not apply to restrictions on redemptions of entity interests and to other value-depressing restrictions. Those are purportedly governed by section

2007 TNT 84-9 (marketable securities and real estate); *Estate of Schutt v. Commissioner*, T.C. Memo. 2005-126, Doc 2005-11675, 2005 TNT 102-12 (timberlands, marketable securities, and cash). See generally Wendy C. Gerzog, "Valuation Discounting Techniques: Terms Gone Awry," 61 *Tax Lawyer* 775, 789-791 (2008) (cataloging cases in which liquid assets of various kinds are given a discount).

¹⁰See generally Joseph M. Dodge et al., *Federal Taxes on Gratuitous Transfers: Law and Planning* 484, n.2 (2011).

¹¹See *Estate of Kelley v. Commissioner*, T.C. Memo. 2005-235, Doc 2005-20660, 2005 TNT 196-9 (restriction applicable to any buyer of even a controlling interest, resulting in a 12 percent discount).

¹²If the owner does or can obtain the use or income from transferred assets, the underlying assets may be included in the transferor's gross estate under section 2036(a). See, e.g., *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005), Doc 2005-15234, 2005 TNT 137-12, *aff'g*, T.C. Memo. 2003-145, Doc 2003-12584, 2003 TNT 98-16 (*Strangi II*). We do not address the role of section 2036(a) in this area, because it can be avoided by prudent planning and execution of the arrangement. See *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005), Doc 2005-5359, 2005 TNT 50-11 (reviewed). Since our proposals herein are based on the proposition that the intentional destruction of value to avoid transfer tax is illegitimate, it follows that any exchange in which that occurs should not be deemed to be a transfer for full and adequate consideration, even if a legitimate and significant nontax reason for the creation of the family entity exists.

¹³See, e.g., *LeFever v. Commissioner*, 100 F.3d 778, 782 (10th Cir. 1996), Doc 96-30063, 96 TNT 223-16 (saying that estate tax value is highest and best use). However, Congress has relaxed that principle in the case of family farms by enacting section 2032A, valuing them according to use as a farm.

¹⁴Eller, *supra* note 2, at 8.

¹⁵839 F.2d 1249, 1254-1255 (7th Cir. 1988).

¹⁶See also *Ahmanson Foundation v. United States*, 674 F.2d 761, 768 (9th Cir. 1981), in which the court said in dicta that if a public figure ordered his executor to shred and burn his papers, the value to be counted would be the value of the ashes. However, the court went on to hold that the creation of fractional interests by an estate transfer would not result in a discount.

¹⁷Rev. Rul. 93-12, 1993-1 C.B. 202.

¹⁸Section 2704(a) is not a serious impediment to discounts. That section causes the lapse of a restriction on liquidation or voting rights to be subject to gift or estate tax. Most family entities are set up so that there are no lapsing voting or liquidation rights. If there is a lapsing liquidation right, it will likely fall within a technical exception found in reg. section 25.2704-1(c)(2), which applies if nobody can liquidate the entity after the lapse and the state law default rule precludes a liquidation. State law default rules for FLPs typically bar liquidations.

¹⁹See section 2704(b)(3)(B).

²⁰The theory, presumably, is that here the restriction is not "self-imposed." However, if one knowingly transfers assets to an entity subject to that type of restriction, the restriction is indeed self-imposed.

²¹Family member means the transferor's spouse, descendants and ancestors of the transferor (and transferor's spouse), the transferor's siblings, and spouses of any of the foregoing. See section 2704(c)(2). That definition also applies under section 2704(a).

2703(a)(2).²² However, section 2703(b) negates the application of section 2703(a) when the restriction results from a bona fide business arrangement comparable to similar arm's-length transactions that don't result in a disguised gift or bequest.²³ Although the government succeeded in applying section 2703(a)(2) in *Holman v. Commissioner*,²⁴ the case bodes ill for the government, because both the Eighth Circuit and the Tax Court viewed the issue of business purpose as a factual one that is relatively easy to meet,²⁵ and the other elements of the section 2703(b) exception would not likely prove to be a major barrier.²⁶ The IRS seems reluctant to use section 2703(a)(2). Besides *Holman*, there are apparently no cases,²⁷ and the regulations under section 2703 give no examples involving standard family entity arrangements.²⁸

In short, there are no serious statutory, regulatory, or judicial obstacles to obtaining valuation

²²Section 2703(a)(2) provides that for valuation purposes, "any restriction on the right to sell or use such property" shall be disregarded. The use reference is to leases, and is of little relevance here. Most family entities have restrictions on sales to outsiders and do not give equity holders a right to sell their interest to the entity. Section 2703(a)(1), which is aimed principally at buy-sell agreements, is outside the scope of this article.

²³Specifically, the exception requires that the restriction be (1) "a bona fide business arrangement"; (2) "not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth"; and (3), at the time the restriction is created, "comparable to similar arrangements entered into by persons in an arms-length transaction."

²⁴601 F.3d 763 (8th Cir. 2010).

²⁵See *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76, Doc 2006-7345, 2006 TNT 74-9 (applying section 2703(b) to restrictions on sale). In a slightly different legal context, the Tax Court has found a business purpose for the creation of a family entity on the basis of investment and family motives. See *Estate of Black v. Commissioner*, 133 T.C. 340 (2009), Doc 2009-27388, 2009 TNT 238-10 (consideration issue under section 2036); *Estate of Schutt v. Commissioner*, *supra* note 9.

²⁶Because family entities typically don't involve disguised transfers at gift or death, and restrictions on sale are normal in the context of closely held business, section 2703 cannot be counted on to prevent restrictions on sale or redemption from depressing value. In any event, section 2703 does nothing to curb lack-of-marketability and minority-interest discounts, despite the fact that placing liquid assets in a family entity destroys liquidity.

²⁷Apart from *Holman*, there appears to be no reported case (not involving a side agreement) involving a restriction contained in the entity's constitutive documents.

²⁸Reg. section 25.2703-1(d) gives only examples involving side agreements, despite the fact that paragraph (a)(3) of the same regulation states that the restriction can be contained in the entity's charter, bylaws, or capital structure.

discounts for interests in family entities on account of self-imposed restrictions that appear to destroy value.²⁹

B. Reasons for Change

Self-imposed restrictions that purport to reduce the value of assets should be disregarded in valuation for the transfer taxes because they cannot be expected to reduce the wealth of the transferor's successors in the long run. Because undoing the arrangement (which was undertaken primarily to avoid tax) will increase value, it is predictable that the arrangement will be undone. Self-imposed temporary restrictions take advantage of the necessity of doing valuations at a moment of death or other valuation date, but they are restrictions that appear and disappear as convenient. Under current law, however, there is no tax-recognized transfer of value when the self-imposed value reduction is removed. Insofar as the restrictions really do permanently destroy economic value, they should be ignored, because it is against public policy to give an incentive to economic waste. If the owner adds restrictions preventing the sale of the stock of a company that makes buggy whips or of Enron stock, we can expect that his successors will cast those restrictions off so that they can sell those terrible investments. But if the prohibition on sale did create economic losses, the transfer tax system should not be complicit in the economic waste.

The proposals here are based on the assumption that self-imposed value-reducing restrictions are temporary arrangements to reduce tax by taking advantage of the moment-of-transfer valuation principle without reducing permanent value. Nevertheless, the disregard of self-imposed value-reducing arrangements would not depend on taxpayer intent to avoid tax nor on what happens in the future. Justice Oliver Wendell Holmes Jr. described the grand pattern of the common law as moving away from moral rules based on subjective intent and toward the adoption of objective rules:

²⁹The Obama administration's 2010 budget proposal contained an expansion of section 2704(b) but this looks to us more like a patch than a cure for the underlying defect in the law, because it disregards only some of the common restrictions while allowing discounts from others. Joint Committee on Taxation, "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal — Part One: Individual Income Tax and Estate and Gift Tax Provisions," JCS-2-09 (Sept. 8, 2009), at 140-142, Doc 2009-20118, 2009 TNT 172-54 (describing disregard of some restrictions, such as on a right of redemption, while allowing others).

“While the law still does and always, in a certain sense, measures legal liability by moral standards, it nonetheless, by the very necessity of its nature, is continually transmuting these moral standards into external or objective ones, from which the actual guilt of the party concerned is wholly eliminated.”³⁰

That there is no bedrock principle that values must be determined precisely at the moment of transfer is demonstrated by the rule allowing the executor to elect to value the estate six months after death in a falling market.³¹ The only bedrock norm is that a wealth transfer tax should reach gratuitous wealth transfers whenever occurring.

1. The destruction of wealth is against public policy. If self-imposed temporary restrictions on estate assets reduced their economic value, the tax law should ignore the restrictions so as to prevent tax incentives to destroy value. The transfer taxes depend heavily on standards drawn from the underlying law of property, estates, and trusts, and those bodies of law contain strong policies against the destruction of wealth. Courts, for instance, have commonly refused to follow directions in a will calling for the burning or razing of the decedent’s house. Thus, a Kentucky court held that a testator could not devise his property to be “burnt or otherwise uselessly destroyed, because such a disposition of it is not only unnatural and unreasonable but against public policy.”³² A Missouri court refused to allow the destruction of a home as instructed by the will because it would harm the neighbors, detrimentally affect the community, and was without any benefit to the dead woman. The court said the destruction was simply intolerable in a “well-ordered society.”³³ A New York Surrogate’s court also refused to follow the instructions that a house should be razed, calling the instruction “a waste,” “of no benefit to anyone,” “repugnant, invalid and against public policy.”³⁴ Discouraging economic losses also underlies the executor’s or

trustee’s legal duty to diversify investments.³⁵ More generally, economic efficiency (wealth maximization) is an important norm throughout all law.³⁶

The destruction of wealth without any correlative social benefit, which results from the use of value-reducing arrangements in estate planning, violates that norm. The remedy proposed here is not to ban family entities or any other private arrangement or restriction, but only to ignore the claimed discounts in transfer tax valuation so as to remove the tax incentive for value reduction.

There are prominent provisions in the federal income tax that disregard self-imposed (or consensual) value-depressing arrangements. Thus, a taxpayer is denied a deduction for casualty losses resulting from the taxpayer’s willful or gross negligence,³⁷ or even for failure to make a casualty insurance claim.³⁸ Losses are supposed to be involuntary events; intentional destruction is not involuntary and should not be the basis of a tax incentive.

Section 83, enacted in 1969, provides that manipulative restrictions to suppress the taxable value of in-kind compensation are ignored. Courts, under prior law, had held that if compensatory stock was subject to a restriction that prevented its sale on a market, it had no FMV.³⁹ They also had held that the release from a no-sale restriction was not a taxable transfer of compensation.⁴⁰ Under the cases, accordingly, an executive was taxable on his compensation neither when stock was transferred nor when the sale restrictions lapsed or were released. Congress responded by mandating that restrictions would be ignored in the valuation of compensatory property, except for restrictions which by their terms never lapse. The example of a restriction that never lapsed was a requirement that the stock be resold to the

³⁰In *The Common Law* 38 (1887).

³¹Section 2032(a)(2). The alternative valuation date election was adopted in reaction to the stock market crash of 1929. By providing the election, Congress decided that it is the wealth ultimately transferred that counted, not the higher value at date of death. See Sen. Rep. No. 1240, 1939-1 C.B. 656 (1935) (also saying shrinkage might mean estate tax amounts to confiscation).

³²*Ford v. Ford’s Ex’r*, 16 S.W. 451, 453 (Ky. App. 1891). See Adam J. Hirsch, “Bequests for Purposes: A Unified Theory,” 56 *Wash & Lee L. Rev.* 33, 72 (1999) for a collection of the cases.

³³*Everyman v. Mercantile Trust Co. Nat’l Assoc.*, 524 S.W.2d 210 (Mo. Ct. App. 1975).

³⁴*Will of Pace*, 93 Misc.2d 969, 976 (N.Y. Surrogate’s Court 1977). See generally Adam J. Hirsch, “Bequests for Purposes: A Unified Theory,” 56 *Wash & Lee L. Rev.* 33 (1999) for a collection of the cases.

³⁵Thus, for example, an executor or trustee is under a duty to invest prudently, which includes a duty to diversify investments. See Uniform Principal and Income Act (1994). A trustee is ultimately not bound even by directions in the governing instrument to the contrary. Federal law imposes the prudent investor standard for the management of qualified retirement plans (see 29 U.S.C. section 1104), and section 4944 imposes an excise tax on imprudent private foundation investments.

³⁶See, e.g., Richard Posner, *Economic Analysis of Law*, section 2.2 at 18 (1977) (arguing that common law bears “the stamp of economic reasoning” to improve economic efficiency); George L. Priest, “The Common Law Process and the Selection of Efficient Rules,” 6 *J. Legal Stud.* 65, 67 (1977) (arguing that efficient case law rules arise from parties’ decisions to litigate inefficient rules); Paul H. Rubin, “Why is the Common Law Efficient?” 6 *J. Legal Stud.* 51 (1977) (accord).

³⁷Reg. section 1.165-7(a)(1)(i) (denial of casualty loss deduction resulting from taxpayer’s willful or gross negligence).

³⁸See section 165(h)(5)(E).

³⁹*Kuchman v. Commissioner*, 18 T.C. 154 (1952).

⁴⁰*Lehman v. Commissioner*, 17 T.C. 652, 654 (1951).

corporation under a formula mimicking FMV, and that restriction was considered not to be tax motivated, as well as being an inherent part of the property.⁴¹

2. Value-reducing restrictions are temporary. Temporary restrictions or arrangements added by the transferor that reduce value when they were added but will lapse or can be removed after death produce estate tax valuations that are lower than what is really transferred. The restrictions are Cheshire Cat-like — now you see them, now you don't. The restrictions are so ephemeral that they should not be recognized for transfer tax valuation purposes. In the case of an entity (especially one holding an investment portfolio), all interested parties would gain by removal of the restrictions, and there is no party that can be expected to object to removal. Hence, it is predictable that the restrictions will be removed, and it is reasonable to base legislation on that assumption.

For an investment holding company, a rule disregarding self-imposed restrictions results in valuation of the underlying portfolio (and allocating that value among the equity interests involved) at the quoted market price. Normally, valuing an investment portfolio would be quite straightforward, even for real estate. The public market quotes for assets provide our best evidence of their fundamental value. If any major investor perceives a divergence between the current market price and the fundamental value of the stock, that investor can drive the quoted market price to a better price almost immediately.⁴² The stock value at its current price reflects the summation of thousands of dollars of research by people who have an economic stake in the accuracy of their work.⁴³ Although self-imposed restrictions on sale and liquidation would reduce the value of a family entity equity interest to a hypothetical willing buyer, there can be no willing buyers (and no sellers able to sell) precisely on account of the restrictions, and therefore application of the willing-buyer, willing-seller test would be counterfactual. A look-through rule lets the parties

avoid having to haggle over purely hypothetical discounts that mean nothing in the world of commerce.

One should be skeptical of many of the purported justifications for family entity arrangements, particularly those that involve investment portfolios. Courts have found value in preventing future diversification of investments⁴⁴ — even though increasing diversification is standard wisdom of financial economics — to reduce the riskiness of one's investment.⁴⁵ Family entities often tie up family capital, when a wise businessman would never do that unnecessarily. Many of the value-reducing restrictions accepted by the courts could have been effected without the FLP.⁴⁶

It is reasonable to conclude in virtually every published court decision that the self-imposed value-restricting arrangements were made primarily for tax avoidance. If one weighed the value of avoiding the 35 percent estate tax on the discount against the nontax value the decedent got from the restrictions, the tax avoidance is more important. Taxpayers implicitly concede that the restrictions reduce the nontax economic value of the property by more than whatever value was purportedly added by the nontax rationales, because taxpayers always claim a net value reduction. Courts that find a sufficient nontax reason to recognize the restrictions are not finding, and could not find, that the nontax reason is more important than the estate tax savings. They are only finding some minimum, possible, hypothetical nontax justification. Congress should not acquiesce in a practice that is systemically infected by a tax-avoidance purpose.

3. Tax on lapse remedy. The disappearance of a restriction or arrangement that created a substantial discount in the transfer tax valuation of the transferred property should be considered a transfer subject to the transfer tax system. That kind of delayed transfer of value is best met by a new supplemental tax that defends the tax base of the

⁴¹Senate Finance Committee Tax Reform Act of 1969, Senate Report No. 91-552, at 121.

⁴²Burton Malkiel, "Is the Stock Market Efficient?" 243 *Science* 1313, 1317 (1989) (answering largely yes); Kenneth A. Froot and Andre F. Perold, "New Trading Practices and Short-Run Market Efficiency," Nat'l Bureau of Econ. Research Working Paper No. 3498 (1990) (arguing that stock prices react fully to news within 15 minutes of publication).

⁴³See Sanford Grossman and Joseph Stiglitz, "On the Impossibility of Informationally Efficient Markets," 70 *Am. Econ. Rev.* 393 (June 1980) (arguing that the markets reach not perfect knowledge, but an "equilibrium degree of disequilibrium").

⁴⁴See *Estate of Black v. Commissioner*, 133 T.C. 340 (2009), Doc 2009-27388, 2009 TNT 238-10 (decedent employee wanted to force the keeping of employer stock); *Estate of Schutt*, T.C. Memo. 2005-126 (assuaging the decedent's worry that his heirs would sell his investments after his death).

⁴⁵See, e.g., Diversification (finance), available at [http://en.wikipedia.org/wiki/Diversification_\(finance\)](http://en.wikipedia.org/wiki/Diversification_(finance)) (last accessed July 5, 2011).

⁴⁶See, e.g., *Estate of Miller*, T.C. Memo. 2009-119 (decedent wanted her assets to be traded according to her husband's investment philosophy and managed by her son); *Estate of Schutt*, T.C. Memo. 2005-126 (decedent wanted to effect buy-and-hold strategy). The first could have been accomplished without a family entity, and the second, if committed to a trust, would have been imprudent.

transfer system, much as gift and generation-skipping trust taxes are supplemental taxes enacted to protect the estate tax base.

Taxing the lapse of a restriction is a common remedy in other areas. A tax on a lapse of a right exists under section 2704(a). Also, section 83(d) provides that a non-lapse restriction on compensatory stock will be taken into account in setting the value of the stock as compensation. Section 83(d)(2), however, provides that if the restriction is canceled for compensatory reasons, the disappearance of the resale restriction is itself taxable compensation under the income tax. In the gift tax, a retained power to revoke, alter, or amend a gift causes the gift to be incomplete and not yet subject to gift tax, but the lapse or release of the power, possibly by reason of the transferor's death, causes the transferred property to be a completed gift or included in the transferor's gross estate. Similarly, the lapse of a retained current enjoyment interest in transferred property by reason of the transferor's death causes the entire property to be included in the transferor's gross estate under section 2036(a)(1).⁴⁷ Under current law, however, self-imposed restrictions embedded in family entity arrangements can lapse or be undone by successors without causing a taxable event. The value reflected in the discount is restored, bypassing the transfer tax both at death and on lapse.

As with section 83, ignoring the restriction or imposing tax on the lapse of the restriction is complementary: Any given arrangement would be subject to one, but not both, of those remedies. In a sense, a tax on the lapse or undoing of a restriction that caused an earlier valuation discount to occur is simply a recapture tax, the precedent for which is found in section 2032A(c). Section 2032A(a) allows an estate tax discount for qualified real property if specific conditions are satisfied for a 10-year period following the decedent's death. Subsection (c) of section 2032A imposes an additional recapture estate tax if the conditions are not adhered to during the 10-year period. But there is no magic in the 10-year period, and there is no need to limit the recapture tax to the amount of the prior discount. Indeed, there is no need to identify a transferor, because an excise tax on the transfer of wealth can

⁴⁷A transfer with a retained current enjoyment interest (such as X irrevocably in trust, income to X for life, remainder to Y) is an arrangement that causes value to shift, commencing at the date of transfer, from X to Y solely with the passage of time, until X's death, when the transfer becomes complete.

be imposed on the transferee and paid out of the property itself, at a rate keyed to the transfer tax rate.⁴⁸

C. Explanation of the Proposal

The proposal would enact a new section 2704A to provide all restrictions and arrangements imposed by the transferor or on his behalf that reduce the value of assets would be ignored in valuation for gift, estate, and generation-skipping trust taxes. It would enact new section 2705 to provide that valuation would look through the entity and include the value of underlying assets in the owner's estate. It would enact a new section 2851 in a new chapter 16 that would impose tax on the lapse or removal of restrictions that had meaningfully decreased value, even if those restrictions were imposed before the effective date of this act.

1. Disregard of self-imposed value-reducing restrictions. The proposal would enact a new section 2704A to provide that restrictions or arrangements added by the transferor or on his behalf that reduced or are claimed to reduce the value of assets subject to the transfer taxes will be disregarded in estate tax valuation.

The term "restrictions or arrangements" is intended to be broad enough to include all aspects or features of the entity or equity interests therein, whether imposed by entity documents, rules of applicable law, or contract, that reduced the FMV of the entity, equity interests therein, or the underlying assets of the entity. The term "restriction or arrangement," however, would not include aspects inherent in the property when the transferor obtained it. The term also would not include the unintentional, irreversible losses from bad business decisions; for example, developing an unsuccessful product, entering into a bad contract, or wasting money, which cannot be reversed by undoing the restriction or arrangement. A restriction would not be disregarded if it enhanced value when adopted or if it was imposed by a contract; negotiated at arm's length with unrelated parties; or involves significant financing, a merger or acquisition, a franchise (or other agreement involving the licensing of intangibles), or arrangement of like significance entered into for the purpose of profit maximization or economic gain.

⁴⁸The generation-skipping tax on taxable terminations and taxable distributions is an excise tax. Sections 2601 and 2611(a)(1) and (2). The excise tax is payable out of the property or by the person receiving a distribution. See section 2603(a)(1) and (2).

It is assumed that any restriction or arrangement that would enhance the value of the property if undone is a temporary restriction ignored under this proposal, but there is no requirement that we look into the future to see that it turns out to be temporary. Thus, the definition of restrictions and arrangements does not require that the restriction lapse by its own terms or be temporary on its face.

2. Look-through rule for family-entity investment portfolios. A new section 2705 would be added to provide a look-through rule for family investment holding entities. Dropping investment assets into a holding company reduces the FMV, and we can assume that after the valuation date the successors receiving the interest will liquidate the holding company or distribute assets to increase the value of the underlying assets to their value free from the discount. Look-through rules already exist for “U.S. shareholders” of controlled foreign corporations with foreign personal holding company income.⁴⁹

New section 2705 would provide that each family member equity holder of a family entity is deemed to be a pro rata owner of the underlying investment assets for transfer tax valuation purposes. That operating rule would have the effect of automatically eliminating both lack-of-marketability *and* minority-interest discounts for publicly traded or other liquid assets. (There is no “natural” minority discount for owning 10 shares of Dell Corp. common stock.) Also, no minority discount would be allowed for being a deemed co-owner of real estate, collectibles, or any other tangible assets, or for similar intangible assets such as notes, annuities, and royalty interests, because the equity holders are not tenants in common, and because the entity has centralized management that can deal with the asset. Investments that lack marketability (or are minority interests) in the hands of the entity (and in the hands of the transferor to the entity) would not lose the discounts if the interest is not itself an investment-holding entity.

The look-through rule of new section 2705 (but not the disregard of value-restricting arrangements of new section 2704A) would have an exception for assets that are integral to an active trade or business. Investing and collecting would never be considered an active trade or business. In the case of real estate, an interest in timber, a working interest in natural resources, a copyright, or a similar type of interest that can have both investment (passive) and business aspects, the family entity would have to be engaged in an active trade or business to avoid look-through treatment, and family members would have to actively manage the business them-

selves.⁵⁰ The activities of managing agents, timber contractors, well operators, pipeline companies, and so on, would not be attributed to the family entity.

A family entity would be an entity treated as a C corporation, S corporation, or partnership for income tax purposes of which more than 50 percent of the voting or equity value is held by family members. The term “family member” would include (1) any descendant of a common ancestor (unless the common ancestor is more than three degrees higher than all living descendants thereof); (2) all persons who have received, or are receiving under the instrument of transfer, gratuitous transfers (transfers for less than full and adequate consideration in money or money’s worth); and (3) spouses of the foregoing. The look-through rule applies only to a transferor who is a family member so defined. In the case of a taxable termination or taxable distribution under the generation-skipping tax, the look-through rule will apply if the initial gift or estate transfer was subject to the look-through rule.

3. Supplemental tax on the lapse or removal of discount-yielding restrictions. New section 2851 (Tax on Removal of Restrictions) of new IRC chapter 16 (Supplemental Wealth Transfer Taxes),⁵¹ would impose a tax on the expiration of a restriction, added by a transferor, or on his behalf, that resulted in a discount in the value of property subject to transfer taxes on the valuation date by more than 5 percent if the expiration, lapse, termination, or removal of the restriction increases the value of assets in the hands of an individual, trust, or estate. When a restriction or partnership arrangement produces a discount in value of the property at the moment of death or other valuation date, the lapse or removal of the restriction or the distribution of the property from out of the value-reducing partnership is itself a gratuitous transfer of value, delayed to the time the restriction is removed.

The tax would not apply to the removal of any restriction that had been disregarded under new sections 2704A or 2705 or any provision or rule of prior law. Thus, it would mostly apply to the removal of restrictions that resulted in valuation discounts under prior law. Although new section 2851 would apply to the undoing of transfers, restrictions, and arrangements made before the effective date of the proposal, it would not be retroactive, because it imposes a tax on a transfer

⁴⁹See sections 951(a)(1)(A)(i), 952(a)(2), and 954(a)(1).

⁵⁰*Cf.* section 2032A(c)(1)(B) (requirement that qualified heir materially participate in family farm after decedent’s death).

⁵¹Other possible provisions that could go into chapter 16 would be recapture taxes that correct for erroneous-in-hindsight actuarial factors or other contingencies that are resolved after a transferor’s death.

that is currently completed. *Burnet v. Guggenheim*⁵² is directly on point. There, a revocable trust was created before the enactment of the gift tax, and the taxpayer released the power of revocation after the enactment of the tax. The Supreme Court held that the gift tax was validly imposed on the release of the power of revocation, even though the revocable (but incomplete) transfer was made before enactment of the gift tax.

Treating the lapse of a discount as taxable would be appropriate only when the restriction or other arrangement effected a material discount. Valuation is a highly litigated issue, and hundreds of factors go into the valuation of a complicated portfolio. This proposal is not meant to provide that a change in a valuation factor that would imply a greater value is itself a new transfer of value. The proposal to tax lapses thus would apply only to identifiable restrictions, such as a family entity or interest therein put on by (or for) the decedent that cumulatively reduced transfer tax value by more than 5 percent. The amount subject to tax would be the increase of the value of one or more equity interests therein resulting from the removal, etc., of the restriction.⁵³ That amount may well be greater (or lesser) than the original discount amount, but that is also the case with the removal of a power that renders a gift incomplete. The tax rate would be the maximum estate tax rate in effect at the time of the

⁵²288 U.S. 280 (1933).

⁵³An alternative approach would be a rule holding that the taxable amount is the discount amount, but that would flirt with being a retroactive tax.

removal of the restrictions, just as is the case with generation skipping tax on taxable terminations and distributions.⁵⁴ The tax would be offset by any unused unified transfer tax credit of the transferor determined at the time of his death.⁵⁵ Thus, if the transferor actually paid any estate tax, the credit has already been used up.⁵⁶

The tax would generally be imposed on the entity, meaning that it would be borne by the equity holders in proportion to the respective values of their interests. No income tax basis step-up would be provided when the restriction was imposed (or agreed to) before the transferor's death.

⁵⁴Section 2641.

⁵⁵See section 2642(a)(2)(A). The delayed transfer subject to the section 2501 tax will typically occur after the transferor's death, thereby avoiding estate or gift tax. The kind of restrictions and arrangements discussed herein are typically put on or agreed to before the transferor's death, but it is convenient to treat the transfer as having been made for unused credit (exemption) purposes at the date of the transferor's death. At that date, his unused exemption amount can be finally determined. Thus, no amendments of gift or estate tax returns would be required, unless a restriction was removed before the transferor's death, an unlikely event. The rationale for not allowing a separate chapter 15 credit (and not allowing the unused credit to expand or contract following the transfer), as under the generation-skipping tax, is that the unused credit amount would have been available if the initial discounts had not been taken by the transferor and his estate for transactions principally motivated by tax avoidance.

⁵⁶An alternative rule would look to the unused credit amount that would be available if the transferor died on the date of the delayed transfer. However, a transferor who engaged in tax avoidance should not obtain advantage from any post-death increase in the credit amount.