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Guest Article

Close But No Cigar: Claim For Estate Tax Valuation Discount On Retirement Accounts Rejected

By Jeffrey A. Baskies

In a decision issued Nov. 15, 2004, the 5th Circuit affirmed a summary judgment in favor of the IRS in a case seeking to discount the value of retirement account assets for federal estate tax purposes. (*Estate of Smith v. U.S.* No. 04-20194.) Citing to a recent trend in court rulings favoring discounts for built-in tax liability, the estate argued that its interest in two retirement accounts should be discounted for federal estate tax purposes. The U.S. District Court and the 5th Circuit denied the claim and re-established the need to fully value retirement assets on federal estate tax returns.

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History Of The Case

Louis R. Smith died on March 7, 1997. John Smith, the decedent's son and the executor of his estate, filed an estate tax return (Form 706) and paid tax in the amount of $140,358. On the return, the estate reported two retirement accounts that the decedent held at Phillips Petroleum Co. worth in total approximately $768,000. The retirement accounts were comprised of marketable securities.

On Oct. 30, 1999, the estate filed a claim for refund (Form 843) seeking approximately $79,000 plus interest. The amount of the refund was based on a 30% discount of the retirement account assets.

The IRS denied the claim, stating that no discount on the value of the retirement assets was appropriate for federal estate tax purposes.

In May of 2002, the estate filed a complaint in the U.S. District Court for the Southern District of Texas, seeking its claimed $79,000 refund.

After the District Court granted summary judgment in favor of the government, the estate appealed to the 5th Circuit.

The Appeal

While there were a number of procedural issues addressed in the case, the key elements - and the ones of most interest to us - were:

* should the retirement assets be discounted for built-in tax liability; and

* should the retirement assets be discounted for lack of marketability.

Ultimately, the 5th Circuit rejected both of those arguments and upheld the summary judgment. However, the reasoning is of interest and instructive.

1. Built-In Tax Liability

The most important aspect of the holding is the 5th Circuit's discussion of the estate's contention that the retirement assets should be afforded estate tax valuation discounts for built-in income tax liability (called "inherent tax liability").

In its ruling, the court walked through the basic tax analysis. As we know, these types of retirement accounts are funded with "pre-tax" dollars. That means the government does not impose an income tax on the funds going in. Plus, they grow tax-free. But the trade-off for these tax benefits is that the assets in the accounts are taxed when withdrawn.

The impact of this trade-off in the estate tax arena is recognized in the area of IRD (income in respect of a decedent). Under Sect. 691(1) of the Internal Revenue Code, IRD is defined as items of income which were not properly includible in computing the decedent's taxable income for the taxable year ending on the date of his death or for any previous taxable year.

The court noted that to preserve their income taxability, items of IRD are exempt from the step-up in basis rules of Sect. 1014 of the Code. Instead income is recognized in the year the beneficiary receives the IRD.

In addition to this future income tax, the assets are still included in the federal gross estate under Sect. 2039 of the Code and subject to estate tax. This creates a double-taxation for items of IRD.

Congress recognized this double-taxation and passed Sect. 691, offering at least a partial remedy by permitting the beneficiary to take a deduction on his income tax return equal to the amount of estate tax attributable to the item of IRD in the year the IRD is recognized. As a result of the way deductions work, and their floors and phase-outs, the deduction does not fully remedy the double-taxation.

The estate argued that the value of the asset for federal estate tax purposes should be discounted for the inherent tax liability. The argument is fairly intuitive. Had the assets been withdrawn from the retirement accounts pre-death, income tax would have been paid, and estate tax would only be due on the net amount.

However, the 5th Circuit rejected the argument.

"Section 2031 provides that the value of the decedent's gross estate is determined by including the value at the time of his death of all of his property. (26 U.S.C. Sect. 2031(a).) 'The value of every item of property includible in a decedent's gross estate ... is its fair market value.' ... Fair market value is defined as '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 the relevant facts.' ... 'The buyer and seller are hypothetical, not actual persons.' ...

"This court has stated that '[w]hen applying the willing buyer-willing seller test ... the '"willing seller" is not the estate itself, but is a hypothetical seller.' ... In applying this test, the tax court has specifically refused to view the sale as one between the estate and the beneficiary."

The 5th Circuit held that to reflect a discount for the IRD would require looking at the specific buyer and seller in this case and not the hypothetical one. A hypothetical third party buyer would not worry about IRD, as it would not be subject to it. Only the beneficiary of the estate (the specific "buyer") has that concern.

Thus, the court said, properly applying the hypothetical willing buyer-willing seller test means looking at the transaction as an outsider. And a hypothetical buyer would pay an amount equal to the exchange-traded values of the securities in order to buy that asset.

The estate, however, did not give up completely. They urged the court should take notice of a recent trend of considering potential tax liability in valuation cases. The estate cited to *Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002); *Estate of Jameson*, 267 F.3d 366 (5th Cir. 2001); *Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998) and *Estate of Davis v. Commissioner*, 110 T.C. 530 (1998).

Unfortunately for the estate, the court found those cases easily distinguishable. In each, the asset at issue was stock in a closely-held corporation, and the issue was whether or not to consider the built-in capital gains tax that would be payable upon the sale of the assets, when considering the fair market value of the corporation's stock.

As they used to say in show business: "close but no cigar." The estate's arguments failed, and the 5th Circuit reaffirmed that the proper valuation for a retirement asset is to ignore the built-in tax liability.

2. Lack Of Marketability

The estate also argued that the lack of marketability of the retirement accounts should have been factored into their valuation. This argument, however, was not addressed squarely by the 5th Circuit. Instead, the court took the position that the estate brought the issue to light too late. It refused to consider the issue, saying that the estate first brought it up on appeal and citing several decisions declaring that issues raised for the first time on appeal are not reviewable in a summary judgment appeal.

"The estate did not argue in the proceedings below that lack of marketability is a factor that should be considered in valuing the retirement accounts. More specifically, the estate failed to mention that marketability should be a factor in discounting the retirement accounts in its refund claim, complaint, response to the government's motion for summary judgment, or surreply. In fact, the refund that the Estate seeks - thirty percent of the retirement accounts' value - is based solely on a discount for the retirement accounts' 'inherent tax liability' and not for [their] lack of marketability. Accordingly, we abstain from considering the estate's argument since the estate raised it for the first time on appeal."

Interestingly, the court seemed to "leave the door open" for future argument on this point. The court could have addressed the issue and simply rejected the argument. Doing such wouldn't have caused an injustice and would have "closed the door". However, for whatever reason the court chose to abstain.

Optimists will read that as an invitation to raise the issue. But after reading the ruling on the inherent tax liability issue, it seems unlikely such an argument would win. By taking the estate

and beneficiary out of the equation for purposes of determining value, why wouldn't there be a market to purchase this account? After all, it is funded exclusively with marketable securities. Thus, at least to me, it seems unlikely that a future argument based on lack of marketability (at least in the context of a diverse portfolio of marketable securities) would succeed.

Conclusion

This case presents an interesting test of a trend. The trend is permitting discounts for built-in tax liability in the context of C-corporations. This estate tried to push the envelope by seeking to apply that logic to an estate's interests in retirement accounts. As noted above, that was a nice try, but "no cigar".

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