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Battle continues over how post-death events affect value

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The modern estate tax was enacted in 1916. Originally it was based on the date of death value of the decedent's assets. However, when the 1929 stock market crash occurred, Congress enacted an "alternate" valuation date: six months after death. This was to allow a downward adjustment in an estate's value and, therefore, a downward adjustment in estate tax, to reflect a post-death reduction in asset value due to factors beyond the estate's control.

However, one of the most common arguments between taxpayers and the IRS continues to be how post-mortem events affect an asset's value in a decedent's estate. Sometimes the IRS wants to use post-mortem events to achieve a higher estate value (and higher estate tax); sometimes the taxpayer wants to use post-mortem events to achieve a lower estate value (and lower estate tax). The Tax Court case discussed today is unusual because the IRS used post-mortem events to achieve a lower estate value which produced a higher estate tax. However, let's first review two real fact situations.

Joe, a single man, died on Sept. 14, 2008, with real estate worth $20 million. The next day, Lehman Brothers filed for bankruptcy. Over the next five years the real estate dropped in value by 50 percent. However, as of Joe's death, the then 46 percent estate tax rate was based on the $20 million value. The alternate valuation date - March 14, 2009 - did not help because the real estate had not yet dropped significantly in value. Joe's heirs kept the property, waiting for it to recover its value. But they had to pay ($20 million -- $2 million exclusion = $18 million net estate value *x* 46 percent rate) an $8,280,000 estate tax with assets worth $10 million. Though the IRS was sympathetic, it did not have a way to reduce the estate tax liability. As a result, Joe's heirs ended up losing everything.

A happy example of the impact of post-mortem events was Linda, who died on Dec. 6, 2011. Her estate's largest asset was a 14 percent interest in a medical office building. The building was valued at $15 million on her death. Her 14 percent interest, after discounts for lack of control and lack of marketability, was valued at $1.4 million. Five months after her death, the building was sold for $21 million , a 40 percent increase over the date of death appraisal. Was the appraiser wrong? No. The price that a *hypothetical* willing buyer would pay a hypothetical willing seller was, indeed, $15 million. However, the building was acquired by a *strategic* buyer: the hospital next door. To the hospital it was worth $21 million. Did we charge the value used on the federal estate tax return? No. Did the IRS like the fact that we did not consider the later sale? No. Did we settle the IRS audit for a minor increase in value? Yes. However, all in all, the date of death valuation prevailed.

In the March 30, 2016, case of *Estate of Dieringer v. Commissioner*, 146 T.C. No. 8, when Mom died on April 14, 2009, she owned 81 percent of the voting stock and 84 percent of the nonvoting stock in a closely held "C" corporation. The stock was valued at $14,182,471. Since it was left to Mom's private foundation, her estate received a charitable deduction for that value, eliminating any estate tax liability.

Seven months after Mom died, the corporation - on the advice of counsel - elected "S" status. That was good advice: Otherwise, the shareholders would incur two levels of tax on the sale of corporate assets. The case involved Oregon. But using California's higher rates the combination of those two taxes can be 62.26 percent compared to only 33.3 percent for an "S" corporation. Once the "S" election was made it became important for the charity not to have shares. Otherwise the charity would be subject to the unrelated business income tax. The stock purchase also protected the charity from a fall in the corporation's value and made the charity a preferred creditor so that, for purposes of cashflow, it had a priority position over the corporation's shareholders.

For these and other good reasons unrelated to the estate tax, the corporation agreed to buy the stock from the estate before the stock was transferred to the charity. An appraiser was hired with instructions to value Mom's shares as a *minority* interest. As a result the charity did not receive $14,182,471 but, instead, promissory notes with a combined value of $5,218,462 for about 72 percent of the Mom's stock. Simultaneously, Mom's sons bought stock at that same price, providing the corporation with some of the funds needed to complete the purchase.

The date of death value generally controls the amount of the charitable deduction. However, it is based on "the amount that passes to charity." Stephens, Maxwell, Lind & Calfee, "Federal Estate & Gift Taxation," Para. 5.05[3][a]. The court repeated the rule that "intra-family transaction...received a heightened level of scrutiny." It pointed out that one son was the sole executor of the estate; president, director and shareholder of the corporation; and sole trustee of the charity. As a result, he was able to "alter[ ] decedent's testamentary plan by reducing the value of the assets eventually transferred to the foundation without significant restraints. ... [He] and his brothers thwarted decedent's testamentary plan by altering the date-of-death value of decedent's intended donation through the redemption of a majority interest as a minority interest."

In addition to a multi-million dollar increase in estate tax liability, the estate will pay the 20 percent accuracy-related penalty. It argued that it relied in good faith on advice of counsel. The court dismissed that defense because the deduction was "based on an errant appraisal. ... None of the cases the estate cites in its briefs stand for the principle that an estate may deduct as a charitable contribution the date-of-death value of assets that are not actually transferred to the charitable organization."

The battle between taxpayers and the IRS over the impact of post-mortem events continues.

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