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Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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Federal Estate Tax Discounts for Potential Income Tax Liability for Retirement Accounts?

-by Neil E. Harl*

It's been well-established for decades that discounts in valuation for federal estate tax and federal gift tax purposes could be claimed on corporate stock (and partnership interests) for minority interest and non-marketability.¹ And it has been clear for nearly two decades that discounts could be claimed for co-ownership interests as well.² Moreover, for nearly a decade, in valuing corporate stock, courts have allowed a discount for potential income tax liability.³

More recently, arguments have been made that discounts for potential income tax liability should be allowed in valuing U.S. Government savings bonds⁴ and, even more significantly, that discounts should be allowed for potential income tax liability for retirement accounts.⁵ Neither argument has been successful to date.

The following discussion focuses first on the authority for discounts for potential income tax liability on corporate liquidations (which provides the underpinning for the taxpayers' arguments in the other areas) with attention then shifted to the probabilities for success with potential income tax liability on government bonds and on retirement accounts.

Discounts for potential income tax liability on corporate liquidation

The Tax Court, until 1998, had consistently held that projected income taxes (capital gains tax, recapture tax and tax on ordinary income) on liquidation did not reduce the value of closely-held stock when the fact of liquidation was speculative and uncertain.⁶ Resistance to a discount for the potential income tax liability was based on two factors – (1) when the facts did not suggest that the shareholders intended to liquidate the corporation, the court refused to assume that a hypothetical buyer would do so;⁷ and (2) before 1986, the Internal Revenue Code permitted the tax-free liquidation of corporations under some circumstances⁸ which made it possible to avoid all or most of the income taxes upon corporate liquidation.⁹ These factors were viewed as rendering the tax liability on corporate liquidations so speculative as to be irrelevant.¹⁰

In a 1998 Court of appeals case, *Eisenberg v. Commissioner*,¹¹ the court acknowledged the reasons why the Tax Court had resisted a discount for potential income tax liability but brushed off the government's assertion that liquidation was not imminent in that case and also the argument that tax liability was too speculative to be allowed.¹² The court concluded that an adjustment for potential income tax liability “ . . . should be taken into account in valuing the stock at issue in the closely-held C corporation even though no liquidation or

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

sale of the corporation or its assets was planned at the time of the gift of the stock.”¹³ The Second Circuit Court of Appeals remanded the matter to the Tax Court to ascertain how much discount should be allowed and the gift taxes to be paid by the taxpayer.¹⁴ Other courts have followed the *Eisenberg* decision.¹⁵

The argument in retirement accounts

In *Smith v. United States*,¹⁶ the estate filed a claim for refund for overpayment of federal estate tax on the grounds that retirement accounts in the estate should have been valued at a discount (suggested at 30 percent) to reflect the federal income tax liability that would be triggered when distributions were ultimately made from the retirement accounts to the beneficiaries.¹⁷ The appellate court, noting that the retirement accounts were classified as “income in respect of decedent,” pointed out that the accounts would not receive an adjustment in income tax basis at the death of the decedent and the gain would be taxed to the beneficiaries on receipt of each distribution.¹⁸ The court added that Congress had specifically provided a deduction for the federal estate tax, if any, levied on the retirement accounts in an effort to avoid a double tax.¹⁹

The appellate court then added that the Tax Court has refused to depart from the “willing buyer-willing seller” test for valuing assets and has been unwilling to accept the idea that the transfer is between the individual decedent and that individual’s estate or beneficiaries.²⁰ The appellate court then pointed out that a hypothetical buyer would pay the value of the underlying securities as reflected by the applicable securities exchange prices; a hypothetical seller would likewise sell the securities for that amount.²¹ The court concluded that a hypothetical buyer would not consider the income tax liability of a beneficiary on the income in respect of decedent *inasmuch as the buyer would not be paying the income tax on the gain involved*.²²

The Fifth Circuit Court of Appeals dismissed the argument that the recent cases allowing a discount for income tax liability on corporate liquidation²³ should be followed and explained that those cases were distinguishable.

In conclusion

The decision in *Estate of Smith v. United States*²⁴ is a compelling precedent against allowing a discount for retirement accounts (and other items of income in respect of decedent).²⁵

Footnotes

¹ See, e.g., *Estate of Berg v. Comm’r*, T.C. Memo. 1991-279, *aff’d on these issues*, 976 F.2d 1163 (8th Cir. 1992) (estate entitled to 20 percent minority discount and 10 percent for lack of marketability for 26.9 percent interest in closely-held real estate holding company). See generally 8 Harl,

Agricultural Law § 58.05[2][c] (2006); Harl, *Agricultural Law Manual* § 7.02[5][d] (2006). See also Harl, “Family Limited Partnerships,” 11 *Agric. L. Dig.* 17 (2000).

² See, e.g., *Estate of Cervin v. Comm’r*, T.C. Memo. 1994-550, *rev’d on another issue*, 111 F.3d 1252 (5th Cir. 1997) (20 percent discount allowed for 50 percent interest in farm and homestead); *Estate of Youle v. Comm’r*, T.C. Memo. 1989-138 (discount of 12 ½ percent allowed for tenancy in common ownership). See also Harl, “Co-ownership Discounts: A New Direction?” 11 *Agric. L. Dig.* 25 (2000).

³ E.g., *Eisenberg v. Comm’r*, 155 F.3d 50 (2d Cir. 1998), *rev’g*, T.C. Memo. 1997-483. See also Harl, “Discount for Potential Capital Gains Tax Liability,” 9 *Agric. L. Dig.* 189 (1998).

⁴ TAM 200303010, Sept. 19, 2002.

⁵ *Estate of Smith v. United States*, 300 F. Supp. 2d 474 (S.D. Tex. 2004), *aff’d*, 391 F.3d 621 (5th Cir. 2004); *Estate of Kahn v. Comm’r*, 125 T.C. No. 11 (2005).

⁶ E.g., *Estate of Andrews v. Comm’r*, 79 T.C. 988 (1982). Compare *Estate of Welch v. Comm’r*, T.C. Memo. 1997-167.

⁷ *Estate of Ford v. Comm’r*, T.C. Memo. 1993-580, *aff’d*, 53 F.3d 924 (8th Cir. 1995).

⁸ See I.R.C. §§ 336, 337.

⁹ *Estate of Piper v. Comm’r*, 72 T.C. 1062 (1979).

¹⁰ *Estate of Davis v. Comm’r*, 110 T.C. 530 (1998).

¹¹ 155 F.3d 50 (2d Cir. 1998), *acq.*, 1999-1 C.B. xix.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Estate of Davis v. Comm’r*, 110 T.C. 530 (1998); *Estate of Jelke III*, T.C. Memo. 2005-131. See *Estate of Jameson v. Comm’r*, T.C. Memo. 1999-43, *vac’d and remanded*, 267 F.3d 366 (5th Cir. 2001); *Estate of Dunn v. Comm’r*, 301 F.3d 339 (5th Cir. 2002) (value of assets reduced by 34 percent for built-in taxable gains for 67.96 percent interest in corporation).

¹⁶ 300 F. Supp. 2d 474 (S.D. Tex. 2004), *aff’d*, 391 F.3d 621 (5th Cir. 2004).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* See *Estate of Robinson v. Comm’r*, 69 T.C. 222, 225 (1977).

²¹ *Smith v. United States*, 391 F.3d 621 (5th Cir. 2004).

²² *Id.*

²³ See notes 6 – 15 *supra*.

²⁴ 391 F.3d 621 (5th Cir. 2004).

²⁵ See 6 Harl, *Agricultural Law* § 48.03 (2006).