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IRS Proposes Change to Combat Post-Death Maneuvering of Value

-by Neil E. Harl

On April 24, 2008, the Department of the Treasury announced proposed regulations to make a change in the regulations for making the election for and using the alternate valuation method of valuing property for federal estate tax purposes.1 The move was triggered by the 2006 Tax Court decision in Kohler, Jr. v. Commissioner2 which narrowed the scope of a 1972 District Court case in California.3 The proposed regulations are designed to close the door on efforts to reduce values after death for purposes of the alternate valuation method of property ownership by the decedent which allows property to be valued as of six months after death (or the date of disposition if earlier than six months after death) if the specified conditions are met.4

The subtext of this move is that the Internal Revenue Service (and the Department of the Treasury) are coming to the realization that the federal estate tax is unlikely to be repealed in the near future.5

The core of the controversy

The controversy began with the Tax Court case of Kohler, Jr. v. Commissioner6 which was decided in 2006 and not appealed. That case involved a move by the decedent’s estate, approximately three months after death, to undertake a reorganization of the business in which the decedent held a significant interest in a tax-free reorganization.7 The reorganization, among other changes, imposed stock transfer restrictions on the stock issue in question and the decedent’s estate opted to receive shares after the reorganization was completed. The estate then proceeded to elect the alternate valuation method of valuing property in the estate8 and reported the stock values as determined based upon the valuation of the stock after imposition of the stock transfer restrictions.9 The Internal Revenue Service objected on the grounds that the move by the estate to reduce stock value was unrelated to market conditions for the stock and, therefore, should be disregarded. The reorganization had reduced the stock value from $144.5 million (based on the IRS valuation) to approximately $47 million by the estate (which was accepted). The Tax Court disagreed with the Internal Revenue Service position that the impact of the reorganization on stock values should be disregarded.

In early 2008, IRS indicated that it was entering a non-acquiescence in Kohler, Jr. v. Commissioner.10 The proposed regulations were published a few weeks later.11

As the proposed regulations state in the preamble, the regulations were issued in proposed

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In conclusion

It is difficult to disagree with the Service position in the proposed regulations although objections may well be raised by those who would like to see this as another battleground over discounting.

FOOTNOTES


4 I.R.C. § 2032(c).


7 See I.R.C. § 368(a).

8 I.R.C. § 2032(a).

9 Kohler, Jr. v. Comm’r, note 2 supra.


12 I.R.C. § 2032(a).

13 Note 2 supra.


15 Id.


17 Flanders v. United States, 346 F. Supp. 95 (N.D. Calif. 1972). The court opinion refers to an 88 percent reduction in value but the figures appear to support only an 86 percent reduction in value.

18 Id.


21 Id.

22 Id.

CHAPTER 12

ELIGIBILITY. The debtor filed for Chapter 12 in 2007. Just before the filing of the petition, a state court issued a ruling that the debtor was obligated to a creditor for not less than $481,892 for the misappropriation of trade secrets not related to the debtor’s farming operation. After the bankruptcy petition was filed, the creditor obtained relief from the automatic stay six months later so that a judgment could be entered in the state court action. The debtor argued that, because the judgment debt was contingent on the date of the bankruptcy petition, the debt was not included in the non-farming debt of the debtor for purposes of Section 101(18). The court held that the judgment debt was not contingent on the date of the bankruptcy petition because the only remaining action was the formal entry of the judgment. Therefore, because the judgment debt was non-farming debt and exceeded 50 percent of the total debt, the debtor was not eligible for Chapter 12. 


The IRS filed a claim for $1,541,604 in federal tax claims in the debtor’s Chapter 12 case and argued that the debtor did not qualify for Chapter 12 because the debtors did not file a Schedule F but filed only Schedule E for rent payments received from a trust which rented the debtors’ farm land. The trustee testified that no rent was paid but the debtors received compensation for services provided on the farm. The court rejected the argument of both parties that the sole evidence of farm income was the tax returns filed by the debtors. The court denied the IRS motion for summary judgment because issues of fact remained as to whether the amounts paid by the trust were farming income because the facts were not established as to the nature of the payments, either as rent or as compensation for services. In re Dawes, 2008 Bankr. LEXIS 670 (Bankr. D. Kan. 2008).

PLAN. The debtors’ Chapter 12 plan provided for payment on several loans by annual payments. The debtors made their first payment based on the first of 12 monthly payments which would eventually total the plan payments at the end of the 12 months; however, the debtors did not plan to make another payment for a year. The creditor objected to the payments as violating the terms of the plan, which called for annual payments only. The court agreed with the creditor, holding that the plan required payments to be based solely on equal annual payments. In re Zamora, 2008 Bankr. LEXIS 859 (Bankr. D. N.M. 2008).

CONTRACTS

FARM LEASE. The plaintiff owned a horse breeding and boarding facility and leased 10 acres to the defendants for use as a horse facility. The lease required the defendants to “keep and maintain the leased premises and appurtenances in good and sanitary condition and repair.” The defendant eventually vacated the premises and the plaintiff filed suit for damages to the facility resulting from negligence. The trial court found the defendants liable for damages, attorney’s fees and costs. On appeal the defendants argued that the economic loss rule barred recovery because the action involved a contract and sought economic loss recovery. The appellate court agreed and reversed the trial court decision, holding that the action was based on the contract duties of the defendant and the plaintiff could not seek economic damages. Eastwood v. Horse Harbor Foundation, Inc., 2008 Wash. App. LEXIS 916 (Wash. Ct. App. 2008).

FEDERAL ESTATE AND GIFT TAXATION

GENERATION-SKIPPING TRANSFER TAX. The IRS has issued proposed regulations providing guidance regarding requests for an extension of time to make an allocation of generation-skipping transfer exemption under I.R.C. §§ 2642(b)(1), (2) in view of the enactment of I.R.C. § 2642(g) by EGTRRA 2001, Pub. L. No. 107-16. The proposed regulations also provide guidance regarding requests for an extension of time to make elections under I.R.C. §§ 2632(b)(3), 2632(c)(5) as added by § 561(a) of the Act. The rules were initially provided in Notice 2001-50, 2001-2 C.B. 189, 73 Fed. Reg. 20870 (April 17, 2008).

The IRS ruled that the division of a pre-1985 trust into eight trusts with otherwise identical terms and with pro rata distribution

Note 29 supra.