INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-106646-03/CC:PSI:BO4

JUNE 11, 2003

Taxpayer's Name:

Taxpayer's Identification No:
Date of Death:
Date of Conference:

LEGEND:

Decedent -
Corporation -
Date 1 -
Date 2 -
$A -
$B -
$C -
$D -
$E -
$F -
Business X -
Y -
$W -
$X -

ISSUE:

Whether amounts earned by Corporation during the six month period after Decedent's death that were not distributed to the Decedent's estate as the sole shareholder during that period are "excluded property" for purposes of determining the value of the stock of Corporation included in Decedent's gross estate under § 2032 of the Internal Revenue Code.

CONCLUSION:

Amounts earned by Corporation during the six month period after Decedent's death, that were not distributed to the Decedent's estate as the sole shareholder during that period are not "excluded property" for purposes of § 20.2032-1(d) of the Estate Tax Regulations.

FACTS:

Decedent died on Date 1. At the time of his death, Decedent was the sole owner of 100 percent of the issued and outstanding stock of Corporation. The information submitted indicates that Corporation is engaged in Business X, and during the year of Decedent's death, employed Y full-time personnel. As of December 31st of the year of Decedent's death, the book value of Corporation's assets was $W and shareholder equity totaled $X.

The Decedent's estate timely filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. On the return, the executor elected under § 2032(a) of the Internal Revenue Code to value the assets includible in Decedent's gross estate as of Date 2, the date six months after Decedent's death (the alternate valuation date). On the Form 706, the executor reported the fair market value of Decedent's stock in Corporation as $A, as of Date 1, the date of Decedent's death.

In determining the fair market value of Decedent's stock in Corporation as of the alternate valuation date, the appraiser retained by the estate used a guideline public company analysis and a discounted cash flow analysis and averaged the values derived from these methods. This average was then adjusted to reflect a premium for control and a marketability discount, resulting in a determined fair market value as of the alternate valuation date of $B.

At the request of the estate's counsel, the appraiser then adjusted the $B value to reflect the election of alternate valuation under § 2032(a) and the provisions of § 20.2032-1(d)(4) of the Estate Tax Regulations. Specifically, the appraiser was advised by the estate's counsel that Corporation's earnings subsequent to Decedent's death constituted "excluded property" under § 20.2032-1(d)(4). During the 6 month period between Decedent's date of death on Date 1 and the alternate valuation date on Date 2, Corporation had earnings totaling $C. Of that amount, approximately $D was declared as dividends and distributed to Decedent's estate during the 6 month period. The remaining earnings, in the amount of $E, were retained by Corporation, and were not distributed by Corporation during the 6 month period. Accordingly, the estate's appraiser determined that the value of Decedent's stock in Corporation, adjusted to reflect the election of alternate valuation under § 2032(a) and § 20.2032-1(d)(4) was $F ($B-$E). On the estate tax return, the value of Decedent's stock in Corporation was included at

$F.[1]

LAW AND ANALYSIS:

Under § 2031(a), for federal estate tax purposes, the value of the gross estate is determined by including the value at the time of the decedent’s death of all property, real or personal, tangible or intangible, wherever situated. Section 20.2033-1(b) of the regulations provides that interest and rents that have accrued as of the date of death constitute a part of the gross estate. Similarly, dividends, which are payable to the decedent or his estate by reason of the fact that on or before the date of death the decedent was a stockholder of record, constitute a part of the gross estate.

Section 2032(a) provides that, if the executor elects, then the value of the gross estate may be determined by valuing all the property included in the gross estate as of the date that is six months after the date of decedent's death, except that property distributed, sold, exchanged, or otherwise disposed of, within six months after the decedent's death is valued as of the date of distribution, sale, exchange, or other disposition.

Section 20.2032-1(d) provides that, if the executor elects the alternate valuation method under § 2032, then all property interests are divided into "included property" and "excluded property." "Included property" encompasses all property interests existing at the date of the decedent's death that form a part of the decedent's gross estate as determined under §§ 2033 through 2044. All “included property” is valued in accordance with the provisions of § 2032. Further, such property interests remain “included property” for purposes of valuing the gross estate under the alternate valuation method even though there is a change in the form of the property during the alternate valuation period because the property is actually received, or disposed of, in whole or in part, by the estate. "Excluded property" is composed of property earned or accrued (whether received or not) after the decedent's death and during the alternate valuation period with respect to any property interest existing at the date of the decedent's death, that does not represent a form of "included property" itself or the receipt of included property. ”Excluded property” is excluded in valuing the gross estate under the alternate valuation

[1] As discussed below, we do not believe these undistributed amounts constituted excluded property. We are not addressing, assuming arguendo that these amounts were excluded property, whether the appraisal was correct in subtracting this amount from the value of Corporation determined based on a discounted cash flow, in arriving at the value of Corporation as of the alternate valuation date. Compare, Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976), discussing the extent to which a lump sum of cash (in that case insurance proceeds from a policy on the decedent’s life that was owned by the corporation) might affect the value of a corporation determined based on a going concern value.

method.

Section 20.2032-1(d)(4) provides the following specific guidance regarding the treatment of corporate stock under the alternate method of valuation:

> 4) Stock of a corporation. Shares of stock in a corporation and dividends declared to stockholders of record on or before the date of the decedent's death and not collected at the date of death constitute "included property" of the estate. On the other hand, ordinary dividends out of earnings and profits (whether in cash, shares of the corporation, or other property) declared to shareholders of record after the date of decedent's death are "excluded property" and are not to be valued under the alternate valuation method. If, however, dividends are declared to stockholders of record after the decedent's death with the effect that the shares of stock at the subsequent valuation date do not reasonably represent the same "included property" of the gross estate as existed at the date of the decedent's death, the dividends are "included property," except to the extent that they are out of earnings of the corporation after the date of the decedent's death. For example, if a corporation makes a distribution in partial liquidation to stockholders of record during the alternate valuation period which is not accompanied by a surrender of a stock certificate for cancellation, the amount of the distribution received on stock included in the gross estate is itself "included property," except to the extent that the distribution was out of earnings and profits since the date of the decedent's death. Similarly, if a corporation, in which the decedent owned a substantial interest and which possessed at the date of the decedent's death accumulated earnings and profits equal to its paid-in capital, distributed all of its accumulated earnings and profits as a cash dividend to stockholders of record during the alternate valuation period, the amount of the dividends received on stock includible in the gross estate will be included in the gross estate under the alternate valuation method. Likewise, a stock dividend distributed under such circumstances is "included property".

These regulations reflect the Supreme Court's decision in Maass v. Higgins, 312 U.S. 443 (1941), 1941-1 C.B. 434. In Maass v. Higgins, the applicable Treasury Regulation governing the (optional) alternate valuation rules provided that, in the case of stocks, the value of the stock and the value of the right to dividends thereon constituted separable property and each constituted an element of the value of the stock. Thus, under the regulation, if a dividend was received during the alternate valuation period, the portion attributable to the period after death had to be included in full in the gross estate. The Commissioner argued that, under the regulation, the amount received was either a payment on account of principal, or a disposition of property existing on the date of death that was included in the gross estate. The Court, however, concluded that dividends, rents and interest received during the alternate valuation period, are commonly considered income rather than a payment or disposition of principal, and are not to be included in the value of the gross estate under the alternate method of valuation. The Court stated:

> [I]n common understanding, rents, interest, and dividends are income. Under the revenue acts, if such items are collected by a decedent's estate, the executors are bound to return them and pay tax upon them as income. In the case of a living holder, such receipts are never treated as on account of principal. Nor does the promise to pay interest, rents or dividends either to a living owner of the asset or to his executor after death, <u>which has not been legally separated from the asset of which it is an incident</u>, have any market value apart from the asset, or bear any invariable relation to the value of the capital asset.
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> . . . [T]he promise to pay interest or rent, or the expectancy of dividends upon stock, the amount of such payments, . . . and other elements bearing upon the expectation of the receipt of income affect the value of any income producing property. But these elements are not separately valued in appraising the worth of the asset at any given time. It is the uniform practice to value the asset as an entirety, taking into consideration all elements that go to give it value in the market.

(Emphasis added.) <u>Maass v. Higgins</u>, 312 U.S. at 447 - 448. In reaching its conclusion, the Court also noted that "[T]he method always adopted for valuation at death is the same used in fixing a sale price; that is, to take the market value of the bond and add accrued interest to the date of transfer, at the rate stipulated in the instrument. It is not believed that Congress, in providing for two dates of valuation, intended that a different method should be followed if one date were chosen rather than the other." <u>Maass v. Higgins</u>, 312 U.S. at 448.

The issue presented in the instant case is whether the amounts earned by Corporation during the alternate valuation period that were not distributed as a dividend to the shareholder and remained in corporate solution as of the alternate valuation date, constitute excluded property that is not included in the gross estate. The determinative question is whether these earnings represent a part of the property interest owned by the decedent at death or whether the earnings are, in effect, new property first owned by the estate. Richard B. Stephens et al., <u>Federal Estate and Gift Taxation</u>, ¶ 4.03[2][c] (8^{th} ed. 2002).

In this case, we believe that it is clear, based on applicable regulations, rulings and case law that a necessary prerequisite for corporate earnings accumulated during the alternate valuation period to be considered excluded property under the regulations is that the earnings must be declared as a dividend or otherwise distributed during the alternate valuation period. Initially, we note that § 20.2032-1(d) provides a general rule that property earned or "accrued" after the date of death is considered excluded property. As noted above, under § 20.2033-1(b) of the regulations, for estate tax purposes, dividends accrue on the stockholder record date, that is, only after the dividends are declared.[2] See also, Estate of Putnam v. Commissioner, 324 U.S. 393, 399-400 (1945) (a dividend does not accrue for federal income tax purposes before the record date.) Thus, prior to declaration, or the record date, the dividend has not accrued and therefore, is not excluded property.

Further, § 20.2032-(1)(d)(4), the regulation section specifically addressing the alternate value of corporate stock, characterizes as excluded property only those post-death corporate earnings that are actually distributed as a dividend (either in cash or in stock.) There is no indication that, in the absence of declaration or distribution, these earnings could be excluded property. Indeed, in virtually all the revenue rulings issued by the IRS addressing the application of the alternate valuation rules in the case of post-death earnings by business entities, the issue is presented only when the entity makes a distribution to the shareholder. See, e.g., Rev. Rul. 76-234, 1976-1 C.B. 271 (capital gain dividend paid by a regulated investment company during the alternate valuation period attributable solely to gains on stock held by the companies at the decedent's death are excluded property); Rev. Rul. 75-401, 1975-2 C.B. 473 (declared cash dividends attributable to earnings and profits accumulated after decedent's death are excluded property); Rev. Rul. 71-317, 1971-2 C.B. 328, clarifying Rev. Rul. 66-348, 1966-2 C.B. 433 (a portion of the net proceeds from mineral production received during the alternate valuation period constitute excluded property).

Similarly, court decisions that have addressed the issue of excluded and included property in a corporate context make it clear that an actual distribution to the shareholder of corporate property is a prerequisite to treatment as excluded property. For example, in Estate of Schlosser v. Commissioner, 277 F.2d 268 (3rd Cir. 1960), cert. denied, 364 U.S. 819 (1960), aff'g 32 T.C. 262 (1959), during the alternate valuation period, the corporation distributed a common stock dividend to each shareholder in proportion to the shareholders' respective ownership of common stock. To account for the stock dividend, the corporation transferred a specific amount per share from earned surplus to permanent capitalization. The facts indicated that accumulated earnings prior to the date of death were sufficient to fund the stock dividend, and earnings accumulated after the date of death and before declaration of the stock dividend were also sufficient to fund the stock dividend. Estate of Schlosser, 32 T.C. at 264. The estate's executor elected alternate valuation under the predecessor to § 2032(a) and the issue presented was whether the stock dividend was "included property" to be included

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[2] In general, the term "accrue" is defined as "to come into existence as an enforceable claim or right." An "accrued dividend" is defined as a dividend that has been declared but not yet paid. Black's Law Dictionary (7th Ed. 1999).

in the value of the gross estate. The court held that the stock dividend was included property. The court noted that the stock dividend:

> . . . cannot be said to constitute new property distinct from the stock owned when the dividend was declared. In neither case is it significant that additional certificates have been issued. For the ownership rights embodied in the larger number of certificates are identical with those represented by the original stock. The true stock dividend has 'merely changed the form of the estate's investment . . . by increasing the number of its shares.' [citations omitted] <u>There has been no step toward the severance or distribution of part of the corporate estate</u>.

(Emphasis added.) <u>Estate of Schlosser v. Commissioner</u>, 277 F.2d at 269.

In addressing the possibility that a portion of the stock dividend may have been funded with post-death earnings, the court commented:

> Admittedly, the recent undistributed earnings of the corporation which underlay the stock dividend could be considered new property to the corporation. But unless the corporate entity be ignored, such accessions to the corporate estate benefit the stockholder only as an increase in the value of his stock. <u>In the absence of any dividend it would not even be argued that the corporate veil be pierced or that a stockholder acquires new property when the corporation earns a profit or accumulates a surplus.</u>

(Emphasis added.) <u>Estate of Schlosser v. Commissioner</u>, 277 F.2d at 269. Thus, the court viewed a corporate distribution as a <u>prerequisite</u> to characterization as excluded property.

Similarly, in <u>Maass v. Higgins</u>, <u>supra</u>, the items the Court held to be excluded property in these consolidated cases consisted of interest, rents and dividends actually received by the estates that had been “legally separated from the asset of which it is an incident.” <u>Maass v. Higgins</u>, 312 U.S. at 444-445, 448. In <u>Estate of Johnston v. United States</u>, 586 F. Supp. 500 (No. D. Texas 1984), the court concluded (contrary to Rev. Rul. 71-317, cited above) that proceeds from the sale of oil and gas interests during the alternate valuation date were excluded property. In reaching its conclusion that the sales proceeds were not part of the estate principal existing on the date of death, the court noted that, “[t]he concept of separation became the touchstone for later decisions which, in each instance, analyzed whether proceeds during the interim period constituted principal or income by determining whether they had been severed from the asset or added to the asset.” <u>Estate of Johnston v. United States</u>, 586 F. Supp. at 506. In <u>Bartram v. United States</u>, 75-1 U.S.T.C. ¶ 13,041, 35 A.F.T.R. 2d 75-1577 (D. Conn. 1974), the court held that capital gains dividends declared and paid by a mutual fund during the alternate valuation period were excluded property. In reaching this conclusion, the court noted that the Third Circuit in <u>Estate of Schlosser</u> “tested the applicability of Maass by determining whether there had been a 'step towards the severance or distribution of part of the corporate estate.' " See also, Tuck v. United States, 282 F.2d 405, 409 (9th Cir. 1960) ("It is well settled that cash dividends paid out to the survivor [after the date of death] are his own original property for purposes of § 811 [the section defining gross estate under the Internal Revenue Code of 1939] (emphasis added); McGehee v. Commissioner, 260 F. 2d 818 (5th Cir. 1958) (stock dividends paid on stock transferred within three years of death were not includible in the gross estate under the predecessor to § 2035, where the declared stock dividends reflected the capitalization of after-transfer earnings.)

These regulations, rulings and cases make it clear that in order for post-death corporate earnings to be considered excluded property under § 2032(a), the property must be sufficiently severed from the corporate estate. Prior to such severance, these amounts have not been "earned or accrued" by the estate or the beneficiary of the shares. Rather, these amounts are part of the "corporate estate" and are reflected in the value of the corporate stock. The value of the stock on the alternate valuation date properly includes post-death appreciation and depreciation during the alternate valuation period, which is directly effected by profits and losses during that period. These amounts are a part of the corporate assets until the corporation severs these assets from the corporate estate and the assets pass to the shareholders.

Finally, to the extent the Taxpayer's argument results in the use of a different method to value stock subject to alternate valuation than is used in the absence of the alternate valuation election, the position conflicts with the Court's decision in Maass v. Higgins, indicating that the alternate valuation provision in providing for two dates of valuation, was not intended to sanction different methods of valuation if one valuation date were chosen rather than the other. Maass v. Higgins, 312 U.S. at 448.

The Taxpayer contends that post-death corporate earnings are per se "excluded property" citing § 20.2031-1(d), providing that "property earned or accrued (whether received or not) after the decedent's death and during the alternate valuation period" with respect to property existing on the date of death, is excluded property. However, as noted above, for federal estate tax purposes, there is no accrual of corporate earnings to the shareholder prior to the declaration of the dividend and the shareholder record date. Thus, the corporate earnings in this case do not constitute property "earned or accrued" within the meaning of § 20.2032-1(d). Further, § 20.2032-1(d)(4), the regulation specifically addressing the alternate valuation of corporations, and the cases cited above, make it clear that a necessary prerequisite for characterization as excluded property, is a "severance of earnings and profits from the corporate estate." Estate of Schlosser v. Commissioner, 277 F.2d at 269. Thus, we do not believe that the regulations contain any "per se" rule.

The Taxpayer next argues that, it is clear that under § 20.2032-1(d)(4), ordinary dividends declared after the date of death are excluded property. In this case, the

Decedent owned 100 percent of the stock in Corporation and therefore, Decedent's estate could have withdrawn and distributed earnings at any time, with or without formal action. Consequently, the Taxpayer argues that in this case, the declaration of dividends would have been a mere ministerial act or formality, that under the regulations, should not constitute a prerequisite to qualification as excluded property. We have not reviewed whether under the corporate by-laws, or other documents and rules governing the operation of Corporation, the declaration of a dividend by Corporation, that is engaged in Business X, had a book value of $W, and employed Y personnel, would be a mere formality or ministerial act. In any event, we do not believe that § 20.2032-1(d)(4) draws any distinction between a corporation controlled by the Decedent's estate and one that is not so controlled, in determining what constitutes excludible property. Indeed such a test, dependent on the extent to which a shareholder could influence corporate actions, would be difficult, if not impossible, to apply. Rather, as discussed above, the test that is applicable requires a severance of the earnings and profits.

Accordingly, earnings of Corporation, totaling $F, that were not declared by Corporation as dividends and distributed to Decedent's estate during the alternate valuation period, are not "excluded property" for purposes of § 20.2032-1(d).

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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