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Taxation—Treasury Regulation Valuing Mutual Fund Shares for Estate Tax Purposes at the Replacement Cost Held Invalid

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remains: the indigent will go to jail, while the rich man may buy his freedom. This seems especially unfair here, where the judge has already declared that in a particular case the state's interest could have been satisfied by a fine alone. Another related and basic issue is whether the sentencing judge, with his wide range of remedies for a given offense—including fines and terms of imprisonment—should be allowed to imprison a defendant solely because he knows or suspects the defendant will not be able to pay a fine. If the defendant's record and the circumstances of the commission of the crime indicate that only a fine is required, then a sentence of imprisonment, due to the defendant's indigency, contains the same vice of discriminatory treatment that has been condemned in the instant case, *Morris* and *Williams*.

RICHARD L. WOLL

TAXATION—TREASURY REGULATION VALUING MUTUAL FUND SHARES FOR ESTATE TAX PURPOSES AT THE REPLACEMENT COST HELD INVALID

As the executor of decedent's estate, plaintiff commenced an action in the United States District Court for the Western District of New York to recover $3,092.59 in estate taxes and interest paid on shares held by the decedent at the time of her death in an open-end investment company (mutual fund).[1] The decedent had acquired the shares over a period of years through gift, inheritance, and reinvestment of capital gains and ordinary income distributions. The Commissioner had valued the shares for estate tax purposes at their *asked price*, that is, the price at which these shares could be purchased from the mutual fund at the time of decedent's death.[2] Plaintiff contended that the true value of the shares was reflected in the *bid price* for such shares,

1. An estate tax is imposed by the INT. REV. CODE of 1954, § 2001 as follows:

> A tax . . . is hereby imposed on the *transfer* of the taxable estate . . . of every decedent, citizen or resident of the United States . . . . (emphasis added).

2. Treas. Reg. § 20.2031-8 (b) (1958), T.D. 6680, 1963-2 CUM. BULL. 417, 419 which provides as follows:

> *Valuation of shares in an open-end investment company.* (1) The fair market value of a share in an open-end investment company (commonly known as a "mutual fund") is the public offering price of a share . . . .

that is, the price at which the mutual fund would redeem them.[3] *Held,* Treasury Regulation 20.2031-8 (b) is unreasonable since it imposes a tax not only on the value of the shares but also on the load charge, which does not represent any value inherent in the shares and which cannot be realized by the estate upon redemption. *Cartwright v. United States,* 323 F. Supp. 769 (W.D.N.Y. 1971).

The nature and constitutionality of the original federal estate tax[4] was first examined in *Knowlton v. Moore,*[5] where the Supreme Court rejected the taxpayer's contention that the estate tax was a direct and unapportioned tax prohibited by the United States Constitution.[6] Instead, the Court held the tax to be indirect, imposed not upon the possession or ownership of property but upon "the happening of an event or an exchange."[7] "[D]eath," said the Court, "is the generating source from which the particular taxing power takes its being and that it is the power to transmit, or the transmission from the dead to the living, on which such taxes are more immediately rested."[8] It is not the property, then, that is being taxed, but rather the power to transfer the property.

While the estate tax is levied upon the transfer of property,[9] the amount of the tax imposed is determined only after a valuation of the property held by the decedent.[10] Generally, the value

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3. The current "asked price" is determined by adding to the net asset value of each share a "load charge" which covers the costs and profits of the broker. The net asset value is determined by subtracting the mutual fund's liability from assets and dividing that figure by the number of shares outstanding. The load charge is usually about 7% of the net asset value. The "bid price" or redemption price is simply the net asset value. *See* Lobell, *The Mutual Funds: A Structural Analysis,* 47 VA. L. REV. 181, 182 (1961).

4. WAR REV. ACT §§ 29-30, 20 Stat. 448 (1898).

5. 178 U.S. 41 (1900).

6. U.S. CONST. art. I, § 2 provides as follows:

[D]irect Taxes shall be apportioned among the several states which may be included within the Union . . . .

See New York Trust Co. v. Eisner, 256 U.S. 345 (1921).

7. Knowlton v. Moore, 178 U.S. 41, 47 (1900).

8. *Id.* at 56.

9. INT. REV. CODE of 1954, § 2001.

10. Treas. Reg. § 20.2031-1 (b) (1958), T.D. 6826, 1965-2 CUM. BULL. 367, 367-68 provides as follows:

Valuation of property in general. The value of every item of property includible in a decedent's gross estate . . . is its fair market value at the time of the decedent's death . . . . The fair market value is 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 of the property held is determined in relation to the fair market value of similar property.[11] Since personal property is often traded in one of three possible markets, the price an item of property will realize upon sale changes as the market context changes.[12] Consequently, a definition of *market* is essential to an application of the fair market value standard. The Treasury Regulations have defined *market* as *retail market*.[13] Since personal property generally realizes its highest price on the retail market, it is evident that the Regulations require a valuation above the amount which can be realized by the executor. In short, certain property is to be valued according to its replacement cost, and not in terms of the amount which the executor could realize upon a sale of the property.

The apparent harshness of the "retail market test," however, is partially mitigated by Treasury rulings. First, where an item of the estate is sold to a "dealer" for less than its fair market value (as computed under the retail market test), the difference between its retail value and the price received may be deducted as an administrative expense.[14] Thus, in the case of an automobile which must be valued at its retail price,[15] but is later sold to a dealer for less than the retail price, the difference

relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles.

11. *Id.*

12. The general public usually deals in property in one of three markets: (1) purchases at retail; (2) sales to non-merchant individuals; (3) sales to merchants or dealers. The price any particular item will realize changes as the context changes. For example, a dealer in used automobiles can obtain a higher price than can an executor selling the same automobile.

13. *See* Treas. Reg. § 20.2031-1 (b) (1958), T.D. 6826, 1965-2 CUM. BULL. 367.

14. Treas. Reg. § 20.2053-3 (d) (2) (1958), T.D. 6826, 1965-2 CUM. BULL. 367, 368-69.

15. *Compare* the example in Treas. Reg. § 20.2031-1 (b) (1958), T.D. 6826, 1965-2 CUM. BULL. 367.

may be deducted. The net effect, of course, is to tax only the cash value received by the estate. Secondly, where an item has been sold via a public auction or a classified ad, the sale price will be the measure of the property's value for estate tax purposes.[16] Since the value is initially reported at the sale price rather than the retail price, there is no need for a deduction as is the case where the item is sold to a dealer. It must be noted, however, that the retail market standard is affected only when there is a sale of the property—if it is conveyed to a beneficiary, the retail market price will be treated as the value.[17]

Determining the value of property according to retail market prices for estate and gift tax purposes has found support in case law. In *Guggenheim v. Rasquin*,[18] the Supreme Court had to determine whether the value of a single premium life insurance policy for gift tax purposes was the cost of the policy ($850,000.00) or its cash surrender value ($720,000.00). Reasoning that the donor did not pay $850,000.00 in order to make a gift of only $720,000.00, the Court upheld the Commissioner's contention that the proper value was the replacement cost. Similarly, in *Estate of Gould*,[19] the court held that for gift tax purposes the value of an item of jewelry includes the excise tax since the donee would have had to pay the tax had he purchased the same ring.

In 1963 the retail market test was applied to mutual funds.[20] Until this time the Regulations did not specify any particular standards for valuing mutual funds. At first, such shares could be reported at their bid prices.[21] Thus, the load charge was not con-

16. Rev. Proc. 65-19, 1965-2 CUM. BULL. 1002.

17. This discrepancy may have a rational basis. *See* p. 263-64 *infra*.

18. 312 U.S. 254 (1941).

19. 14 T.C. 414 (1950). *See also* Duke v. Commissioner, 200 F.2d 82 (2d Cir.), *cert. denied*, 345 U.S. 906 (1952).

20. Treas. Reg. § 20.2031-8 (b) (1958), T.D. 6680, 1963-2 CUM. BULL. 417, 419-20. Although the Regulation may not often be challenged to the point of litigation, there have been conflicting decisions as to its reasonableness. In Wells v. Commissioner, 50 T.C. 871 (1968) (6 judges dissenting), *aff'd sub. nom.* Ruehlman v. Commissioner, 418 F.2d 1302 (6th Cir. 1969), the court upheld the Regulation as a reasonable application of the willing buyer-willing seller standard. *But see* Davis v. United States, 306 F. Supp. 949 (C.D. Cal. 1969), where a California district court held that the Regulation was unreasonable since the estate should be treated as a seller and since the estate cannot receive more than the bid price, a tax upon the higher asked price is a tax upon an artificial value.

21. Cartwright v. United States, 323 F. Supp. 769, 771 (W.D.N.Y. 1971) [hereinafter cited as the instant case].

sidered part of the value. By the 1960's, however, the load charge was partially included since mutual fund shares were treated as common stock,[22] and therefore, the mean between the bid and asked price was taken to be the taxable value. Thus, one-half of the load charge would be included within the gross estate.[23] In one sense, however, the comparison of mutual fund shares and common stock was artificial since common stock may actually be purchased at or near the mean between the high and the low bids—whereas shares of mutual funds trade either at the bid or the asked price, but not in between.[24] The application of a retail market standard to mutual fund shares in 1963, then, can be seen as an end to the Commissioner's indecision rather than as a rejection of his prior policy of compromising disputed evaluations.

In the instant case, the court refused to support the Commissioner's application of the retail market test in valuing mutual fund shares held by the decedent at the time of her death. The first issue faced by the court was to determine whether the general rule for determining value according to a willing buyer-willing seller standard should apply. The Commissioner argued that the only time a willing buyer-willing seller situation exists is at the sale of the mutual fund shares to the public. Bid prices, he contended, are set by law; and the mutual fund is required to redeem its shares. Thus, since the mutual fund acts under a compulsion at the time of redemption, the value of the shares should be determined at the time of sale to the public.[25] The court, however, found that the mutual fund was not compelled to make the sale in the first place, but made it with full knowledge of its duty to repurchase at the bid price.[26] Having freely entered the transaction with the shareholder, the mutual

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22. *Id.*

23. This result is consistent with Commissioner's policy of compromising contested evaluations. *See* Powell, *Estate Valuation—View from the Internal Revenue System's Standpoint,* 22 OHIO ST. L.J. 249 (1961).

24. Mutual fund shares trade at prices set by law. The prices are not subject to negotiation and compromise. Investment Company Act of 1940 §§ 1-53, 15 U.S.C.A. §§ 80(a) (1)-(52) (1941). The asked and bid prices on common stock, however, do not necessarily represent the prices at which shares are trading since purchases may be made somewhere between the asked and bid prices.

25. Instant case at 772.

26. *Id.*

fund should be treated as a willing buyer at the time of redemption even though it must redeem the shares at a price set by law.

The court next faced the problem of deciding which of the two markets should determine value—the market in which shares are sold to the public or the redemption market. The court selected the latter for two reasons. First, the Commissioner's desire to treat the decedent as a member of the buying public ignored the facts of the case, since the decedent had acquired the shares not by purchase at the asked price but through gift, inheritance and acquisition at the redemption price.[27] Secondly, the load charge or sales commission added nothing to the value of the shares. The court felt that "to include the load charge in the value of the shares to the estate creates an artifical value that cannot possibly be obtained by the estate in any readily accessible market."[28]

The Commissioner next contended that valuing the mutual fund shares in terms of their replacement cost was justified in light of *Guggenheim v. Rasquin*.[29] If a life insurance policy could be valued for gift tax purposes at an amount above that which could be received upon surrendering the policy for cash, then a mutual fund share should receive analogous treatment. Unpersuaded, the court determined that a life insurance policy involves rights quite different from those found in ownership of mutual funds. The insurance policy, it asserted, carries with it not only the right to surrender the contract for cash but also the right to retain the contract. This added right is of great importance since there is a question of insurability involved, which is absent in the mutual fund situation. An individual can, at any time, purchase a mutual fund whereas one's ability to purchase an insurance contract is not always clear.[30]

The court in the instant case suggested a second distinction between mutual fund shares and insurance contracts:

> [W]hen death occurs, the insurance company pays under the policy, the tax is paid, and that is the end of it. Mutual fund shares can pass from estate to estate with a tax paid on each transfer.[31]

27. *Id.*
28. *Id.*
29. 312 U.S. 254 (1941).
30. Instant case at 773.
31. *Id.*

The result, the court suggested, is a repetitive tax on a value which does not exist. In response, the Commissioner argued that there would, in fact, be no hardship at all.[32] In several revenue rulings promulgated soon after the retail market test was applied to mutual funds, the Commissioner provided that where property is sold by the estate at a price below the retail price, the difference can be deducted as an administrative expense.[33] Thus, if the executor in the instant case had redeemed the shares at the bid price, the estate could have deducted the difference between the asked and bid prices as an expense. If the shares were distributed, however, no loss would occur and no deduction could be made. The court's reply was to the point. "[I]f the regulation setting fair market value is unreasonable, this unreasonableness cannot be cured by a regulation which limits the hardship imposed upon the taxpayer."[34]

Upon initial consideration, the willing buyer-willing seller rule would seem to be a simple and fair method of valuing property. But as can be seen from the instant case, the problem in applying it is in defining just who is the buyer and who is the seller. If the estate is the buyer, it is clear that it would have to pay the asked price for these mutual fund shares. But if the estate can be treated as the seller and the mutual fund as the buyer, the value of the shares, defined as cost to the buyer, changes to the bid price.

To reach its decision, the court in the instant case relied heavily upon the facts. The decedent never purchased the shares at the asked price; she received them by gift, inheritance, and at the redemption price. Apparently the upshot of this is that the decedent's estate should not be treated as a buyer for purposes of the willing buyer-willing seller rule because she never paid the asked price. The court's reading of the willing buyer-willing seller doctrine is at least curious. What does the method by which a particular person acquires property have to do with that property's value? Is the value of a mutual fund received by gift any less than one acquired by purchase?

The court's treatment of the manner in which the decedent acquired the property, however, is of minimal concern since

32. *Id.*

33. Treas. Reg. § 20.2053-3 (d), T.D. 6826, 1965-2 CUM. BULL. 367.

34. Instant case at 773.

it does not seem to have been the crux of its position. The real significance in the court's treatment of the estate as a seller is the fact that the court in effect rejected the retail market test in general. The court could not understand how an item of property could be valued above the amount which could be realized upon its sale. After all, why should the estate pay a tax based upon the asked price when it can only realize the bid price through redemption? The standard of the court, therefore, seems to be that property held by an estate should not be valued at an amount greater than that at which it can be sold in the only available market. If it is presumed that the assets will be liquidated prior to distribution, this would seem to be a sound position. Under such circumstances, it may be more reasonable to tax only the amounts received upon liquidation and not the value of the property as determined by a retail market standard since all the decedent will transfer, and thus all the beneficiary will receive, is a particular dollar amount. But if we assume that there will be no liquidation, then the soundness of the court's position becomes less clear. The decedent had a choice in making testamentary dispositions. He could have transferred his estate in kind or in cash. Suppose, for example, that the bid and asked prices of the shares held by the estate in the instant case were \$17.00 and \$19.00 respectively. The decedent could have instructed the executor to redeem the shares at the bid price and thereafter distribute the proceeds. Under the proper circumstances, a deduction for the difference between the asked price and the amount received from the redemption is available.[35] In this manner, there will not actually be a tax upon the load charge even though it has been included as part of the gross estate. In short, the estate will not pay an estate tax on property which it is unable to transfer. The court in the instant case recognized that this deduction would correct the apparent over-evaluation required by Treasury Regulation 20.2031-8 (b). It remained troubled, however, by the fact that where the estate does not redeem the shares but instead distributes them, the estate will pay a tax based upon the asked price (\$19.00).

While there may be a discrepancy between the value for estate tax purposes of mutual funds sold and those distributed,

35. *See supra* note 12 and accompanying text.

this can be justified in view of the fact that what is transferred in each case is really different. Where the mutual fund is redeemed, only the cash received ($17.00) can be distributed, whereas a distribution of the mutual fund share itself allows the beneficiary to hold property for which he would have had to pay the asked price ($19.00). Thus, since the estate tax is a transfer tax, measuring the value of what is actually transferred would seem to be the objective of any standard of valuation.

The fact that the beneficiary would have had to pay the asked price in order to purchase similar mutual fund shares was overlooked by the court. In light of several earlier cases, however, this fact deserved more attention. In *Gould,* the court had to determine whether the excise tax paid by the donor of a diamond ring should be included as part of the value of the gift. In determining that the total cost should be taken as the value, the court reasoned that since the donor wished the donee to have the diamond ring, he would have given either the ring or enough cash to buy one. If cash were given, the total amount would be the value taxed even though part of the cash would be used to pay the excise tax.

In *Guggenheim,* the Court determined that the value of insurance policies for gift tax purposes was the replacement cost and not the cash surrender value. It was held that "presumptively, the value of these policies at the date of the gift was the amount which the insured had expended to acquire them."[36] Here the Court recognized that it would be an odd transaction, indeed, if the donor paid over $800,000.00 for an insurance policy in order to make a gift worth only $720,000.00. The court in the instant case, however, read *Guggenheim* as being founded upon the fact that an insurance policy gives the holder a "bundle of rights."[37] One right is to surrender the policy for cash; another is the right to retain the policy, which is of special importance when the insured is no longer insurable. It is this latter right that accounts for the difference between the cost of the policy and its surrender value.

While the "bundle of rights" notion may accurately distinguish insurance policies and mutual funds, it should be ques-

36. Guggenheim v. Rasquin, 312 U.S. 254, 257 (1941).
37. Instant cast at 773.

tioned whether such considerations provide the proper analytical approach to the problem. Justification for applying the retail market test to mutual funds probably cannot be found by a comparison of the rights inherent in insurance policies with those in mutual fund shares. But does this mean that mutual fund shares should not be valued for estate tax purposes at their replacement cost? Rather than attempting a juxtaposition of the rights found in insurance contracts and mutual fund shares, the proper approach would be to ask how much all of the rights that have been transferred are worth.

In summary, the decision of the court in the instant case to declare Treasury Regulation 20.2031-8 (b) unreasonable, carries beyond the mutual fund situation. The court has redefined the willing buyer-willing seller rule by treating the estate as the seller. The court's emphasis upon the particular facts of the case, that is, that the decedent never acquired the shares by purchase at the redemption price, to achieve this metamorphosis, is quite unsupportable. The manner of acquisition clearly is not a relevant criterion for evaluation.

By treating the estate as the seller, the court has challenged the entire retail market test. The retail market test, however, seems to comport with the nature of the tax, namely, to impose a levy upon the decedent's power to transfer property. Since the estate tax is essentially a transfer tax, it seems proper to determine the value of the decedent's power of transmission by measuring the value of that which is transferred. Thus, where a mutual fund share is transferred, a valuation of the share according to retail market prices seems to be justified, since that is the amount which the beneficiary would have had to pay to acquire this same share. On the other hand, where the shares are sold by the executor, and only the proceeds distributed to the beneficiary, the decedent is actually transferring only the cash received. Under current Treasury Regulations,[38] only that amount will be taxed.

The retail market test, therefore, and the accompanying regulations and rulings may be seen as an effort on the Commissioner's part to structure the estate tax so that only the value transferred will be taxed. The court in the instant case, however, appears to have indulged in the presumption that the shares will be sold prior

38. Treas. Reg. § 20.2053-3 (d) (1958), T.D. 6826, 1965-2 CUM. BULL. 367.

to a distribution of the estate's assets. The resulting standard does not permit a valuation above the amount of cash the executor can realize upon a sale of the mutual fund shares. If this standard is followed in other courts, it seems clear that the application of the retail market test as a whole, and not merely in the area of mutual fund shares, will be found unreasonable, although the retail market test is a fair application of intent of the estate tax.

JAMES E. BROWN

TORTS—LIABILITY OF VEHICLE OWNER TO THIRD PARTIES INJURED BY THIEF'S NEGLIGENT OPERATION OF VEHICLE, WHERE KEYS LEFT IN IGNITION LED TO THEFT

On June 28, 1969 between 10:00 and 10:30 p.m. defendant, Gorsky, attended a V.F.W. field day event with a close friend. The defendant parked his car in the vicinity of the event. At approximately 11:30 p.m. that evening the car was stolen by two youths aged 16 and 17. The elder thief drove and, as a result of his negligence, the Gorsky vehicle collided with a car driven by the plaintiff, Guaspari, and occupied by his wife and daughter. The plaintiff brought actions against the defendant for personal injuries, medical expenses, property damages and wrongful death. The actions were based on the defendant's alleged violation of New York's Vehicle and Traffic Law, section 1210 (a),[1] the plaintiff claiming that the defendant left the keys in the ignition. Both Gorsky and his friend testified that the keys were removed from the ignition, but that a spare set was left in the glove compartment of the car. However, the thief testified that the keys *were* in the ignition when he entered the vehicle, though his testimony was attenuated by the discovery that the other thief had entered the automobile first and searched the glove compartment. Jury verdicts were rendered for the plaintiff and the defendant appealed on the law and facts. The Appellate Division for the Fourth Department affirmed. *Held*, defendant's

1. N.Y. VEHICLE AND TRAFFIC LAW § 1210 (a) (McKinney 1970) provides: "No person driving or in charge of a motor vehicle shall permit it to stand unattended without first stopping the engine, locking the ignition, removing the key from the vehicle . . . ."