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Fair Market Value, Blockage, and the Valuation of Art

John G. Steinkamp

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FAIR MARKET VALUE, BLOCKAGE, AND THE VALUATION OF ART

JOHN G. STEINKAMP*

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* Associate Professor of Law, University of Arkansas School of Law, Fayetteville, AR; B.A., University of Illinois; J.D., University of Colorado School of Law; LL.M. (Taxation), University of Denver College of Law.

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INTRODUCTION

David Smith, Alexander Calder, and Georgia O'Keeffe expressed their artistic creativity in distinct and novel ways.[1] To varying degrees, each experienced the financial success that accompanies recognition of artistic merit in today's art world.[2] Their status as successful artists led to a common result after their deaths: litigation over federal transfer taxes involving the valuation of large blocks of their art.[3]

Artists and their estates confront two problems in connection with the valuation of large blocks of art for federal gift and estate tax purposes.[4]

1. *See* Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699, 2701 (1992) ("O'Keeffe's diverse range of subject matters, such as flowers, trees and leaves, landscapes (New Mexico and New York), and abstractions (early and late), and her various 'periods' appealed to different segments of the public."); Estate of Smith v. Commissioner, 57 T.C. 650, 651 (1972), *aff'd*, 510 F.2d 479 (2d Cir.), *cert. denied sub nom.* 423 U.S. 827 (1975) ("Most of his [Smith's] work is of the abstract, nonrepresentational variety and fashioned out of welded steel and other metals, a technique which Smith pioneered."). Robert Hughes, *The Iron Age of Sculpture*, TIME, May 3, 1993, at 63, opined that:

> [Alexander] Calder's genius in the '20s and '30s was for making extraordinarily delicate and literally "wiry" sculptures that danced at a breath. . . .
>
> By 1951 . . . [David] Smith's pre-eminence in American sculpture was complete: he could draw with steel in space with as much fluency as with pencil on paper, creating metaphors that mingle the organic and the mechanical in an unstoppable lyric eloquence. . . . Sculpture's iron age, in such hands, was also a golden one.

Id. at 64.

2. Gallery sales of 75 of David Smith's works between 1940 and his death in 1965 grossed $218,080.50. *Smith*, 57 T.C. at 651-52. Georgia O'Keeffe was an extremely successful artist. The average price of paintings she sold personally reached a high of $631,250.00 in 1983 and auction sales of her works at the major houses from 1979 through 1985 totaled $4,474,000.00. *O'Keeffe*, 63 T.C.M. (CCH) at 2700-01.

3. *O'Keeffe*, 63 T.C.M. (CCH) at 2699; Calder v. Commissioner, 85 T.C. 713 (1985); *Smith*, 57 T.C. at 650.

4. Consideration of income tax issues that confront artists and their estates is beyond the scope of this article. *See generally* RALPH E. LERNER & JUDITH BRESLER, ART LAW: THE GUIDE FOR COLLECTORS, INVESTORS, DEALERS, AND ARTISTS (4th ed. 1989 & Supp. 1992); Jeffrey C. McCarthy, *Federal Income Taxation of Fine Art*, 2 CARDOZO ARTS & ENT. L. J. 1 (1983); Douglas J. Bell, Note, *Changing I.R.C. § 170(e)(1)(A): For Art's Sake*, 37 CASE W. RES. L. REV. 536 (1986-87).

First, individual artworks[5] must be valued. Second, it must be determined whether the aggregate value of the works should be reduced because of the large number transferred or included in the estate.[6] While similar issues arise in the taxation of nonartists, these issues present particular problems for artists and their estates because of the difficulties in the valuation of art and the unique nature of the art market.[7]

The Internal Revenue Code ("Code") imposes federal estate and gift taxes[8] on the transfer of property which are determined by reference to the value of the property transferred.[9] Value for transfer tax purposes means fair market value—"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

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5. All references in this article to "art," "art objects," "artworks," and "works of art" are to the tangible items produced by artists. Consideration of copyright issues is beyond the scope of this article. Consequently, no attempt has been made to distinguish between *art objects* (tangible property) and *works of art* (intangible property rights).

> A distinction must be made between ownership of the material object in which the copyrighted work is embodied and ownership of the copyright itself. A copyrighted work may be "a literary work printed on the pages of a book," for example, or "pigment painted on a canvas, or a musical work pressed into the grooves of a phonorecord." Under today's law, sale of the material object, such as a book, painting, or phonorecord of the copyrighted work, does not convey ownership of copyright in and to that work or transfer any rights under copyright.

LERNER & BRESLER, *supra* note 4, at 357 (footnotes omitted); David W. Schaaf, *Estate Planning for Authors and Artists*, 423 TAX MGMT. (BNA) 1, A-4(1) (1990) ("A copyright is essentially an aggregation of intangible rights, including the exclusive rights of reproduction and distribution, the rights of public performance and display, and the right to prepare derivative works.") (footnote omitted); Peter H. Karlen, *Appraiser's Responsibility for Determining Fair Market Value: A Question of Economics, Aesthetics and Ethics*, 13 COLUM.-VLA J.L. & ARTS 185, 210 n.157 (1989).

6. It may not always be in the best interests of estate beneficiaries that the value of property for estate tax purposes be reduced by all available discounts. Under I.R.C. § 1014(a)(1) (1986), the basis of property acquired from a decedent is its fair market value at the date of the decedent's death or, if alternate or special use value is elected, its value under § 2032 or 2032A. A discount will decrease not only the value of the property for estate tax purposes, but the basis of the property to the successor. *See* Nelson E. Weiss, *Using Blockage to Obtain a Lower Value for Stock Is Not Always to the Taxpayer's Advantage*, 32 TAX'N FOR ACCT. 356, 357 (1984) (suggesting that it may be more advantageous in some circumstances to gain the step-up in basis than to reduce value through use of blockage).

All references herein are to the Internal Revenue Code of 1986, as amended and in effect on the date of this article, unless otherwise indicated.

7. *See O'Keeffe*, 63 T.C.M. (CCH) at 2702 ("Appraising, buying, or selling a large group of works by a single artist is considerably different from appraising, buying, or selling a single work. This difference is a result of the nature of the art market.").

8. The federal government imposes a generation-skipping transfer tax in addition to the estate and gift taxes. *See* I.R.C. §§ 2601-2663 (1986). Transfers at death and by gift during life may, consequently, be subject not only to estate and gift tax, but to the generation-skipping transfer tax. Valuation issues that may arise in connection with the generation-skipping transfer tax are not considered in this article. *See* I.R.C. §§ 2621-2624 (1986) (providing rules for determining the taxable amount for purposes of the tax and for the valuation of property).

9. *See* I.R.C. § 2001(a) (imposing an estate tax on the transfer of the taxable estate of every decedent) and § 2501(a) (imposing a gift tax on the transfer of property by gift); Reinecke v. Northern Trust Co., 278 U.S. 339, 347 (1929); Estate of Bright v. United States, 658 F.2d 999, 1001 (5th Cir. 1981); Walter v. United States, 341 F.2d 182, 185 (6th Cir. 1965); United States v. Land, 303 F.2d 170, 172 (5th Cir.), *cert. denied*, 371 U.S. 862 (1962); Treas. Reg. § 20.0-2(a) (as amended in 1992); Treas. Reg. § 25.0-1(b) (as amended in 1992).

relevant facts."[10] This measure of value generally applies to all property for federal estate and gift tax purposes.[11]

Some types of property, however, are more easily valued than others. Shares of stock regularly traded on established exchanges are relatively easy to value objectively by reference to actual sales of identical shares on or near the valuation date.[12] Valuation of artworks, however, offers no such ease or certainty. Artworks are not fungible; each is unique. Sales of the particular work to be valued, or of comparable pieces, may occur infrequently.[13] Sale prices of similar works by the same artist, moreover, may have much different values than the item to be valued.[14] The difficulty of valuing art is increased by the fact that art is bought and sold in private sales, galleries, and at auctions.[15] Expert opinions, consequently, usually must establish the value of art. While most of the factors upon which the experts base their opinions are objective,[16] valuation of art is an inherently subjective process[17] and experts' opinions often vary dramatically.[18]

The difficulty of valuing art for estate tax purposes is often compounded by the fact that many artists die owning significant numbers of

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10. Treas. Reg. § 20.2031-1(b) (as amended in 1965); *accord* United States v. Cartwright, 411 U.S. 546, 551 (1974) (quoting Treas. Reg. § 20.2031-1(b)); Treas. Reg. § 25.2512-1 (as amended in 1992); Rev. Rul. 93-12, 1993-7 I.R.B. 13.

11. Property is not always valued at fair market value for estate and gift tax purposes. I.R.C. § 2032A (1986) permits executors to elect to value certain real property at its special use, rather than fair market value. I.R.C. §§ 2701-2704 (1986) provide special valuation rules which can result in valuation of property at other than fair market value.

12. *See* Treas. Reg. § 20.2031-2 (as amended in 1992); Treas. Reg. § 25.2512-2 (as amended in 1976); *but see* Harrop A. Freeman & Stephen P. Vinciguerra, *Blockage Valuation in Federal Tax Law*, 94 U. PA. L. REV. 365, 376 (1945-46) ("The most objective test of all, namely, actual market rate, is nothing less than a series of individual subjective estimates by those who do trade.").

13. *See* Furstenberg v. United States, 78-1 U.S. Tax Cas. (CCH) 83,545, 83,545 (Ct. Cl. 1978) ("Unlike such things as fungible goods or corporate stocks that are traded daily in substantial quantities at markets that provide readily available price statistics as indications of value, [Jean Baptiste Camille] Corot's figure paintings are rare, they are bought and sold infrequently . . . .").

14. William M. Speiller, *The Favored Tax Treatment of Purchasers of Art*, 80 COLUM. L. REV. 214, 227 (1980) ("To determine fair market value one first looks to sales of similar works by the same artist. Yet even similar works will differ in quality, size, subject matter, condition, provenance, and rarity. Such differences can result in substantial variations in fair market value.") (footnotes omitted).

15. *See infra* text accompanying notes 557-87.

16. *See* Rev. Proc. 66-49, 1966-2 C.B. 1257, 1258 ("It is only where expert opinion is supported by facts having strong probative value, that the opinion testimony will in itself be given appropriate weight. The underlying facts must corroborate the opinion; otherwise such opinion will be discounted or disregarded."); *see also* Karlen, *supra* note 5, at 189 (suggesting that the appraisal of art "is objective because most of the factors, whether physical or 'market,' are already objective, such as size, condition, past sales prices, and other appraisals. Even 'subjective' elements of the appraisal, such as aesthetic value and artistic value, are relatively objective . . . .").

17. *See* Debra B. Homer, *Fine Art Appraisers: The Art, the Craft, and the Legal Design*, 8 COLUM.-VLA J.L. & ARTS 457, 462 (1984) (suggesting that the subjective aspects of the art valuation process increase the chances for valuation errors); *but see* Karlen, *supra* note 5, at 189 (suggesting that the appraisal of art is an objective process).

18. *See, e.g.*, Furstenberg v. United States, 78-1 U.S. Tax Cas. (CCH) 83,545, 83,548 (Ct. Cl. 1978) (noting that three experts with impressive qualifications valued "La Meditation" by Jean Baptiste Camille Corot at $40,000, $90,000, and $250,000).

unsold works.[19] Self-created artworks may represent the single greatest component of value in an artist's estate.[20] If the entire block of art were offered for sale immediately after the artist's death, supply would almost always exceed demand, and the prices of all the works would suffer.[21] The transfer of a substantial block of art by gift may present the same problem.[22] Similarly, if a large block of listed securities (large in relation to the number of shares typically traded during a reasonable period of time) were offered for sale, the forces of supply and demand would depress the market and all shares would command a reduced price.[23]

The concept of blockage in tax law recognizes the impact of supply and demand on value. Blockage acknowledges the realities of the marketplace. Supply and demand determine the price at which any item will exchange hands in a market economy. Supply and price tend to be inversely correlated: decreasing supply increases price, while increasing supply decreases price.[24] This factor has been accepted as relevant in the valuation of large blocks of securities for more than fifty years,[25] and recently has been used in the valuation of large blocks of art.[26]

The Tax Court's recent decision in *Estate of O'Keeffe v. Commissioner*[27] provides the occasion to consider the proper application of blockage in the valuation of large blocks of art. Examination of the issue requires an understanding of the valuation of property for transfer tax purposes, blockage, and the valuation of art. Parts I, II, and III provide the necessary foundation. I conclude that the value of large blocks of art should be determined by reference to the price at which the block, as such, could be sold outside the usual retail art market.

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19. *See, e.g.*, Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699, 2700 (1992) (artist who produced between 1,100 and 1,200 substantial works died owning approximately 400); Estate of Smith v. Commissioner, 57 T.C. 650, 650-53 (1972), *aff'd*, 510 F.2d 479 (2d Cir.), *cert. denied sub nom.* 423 U.S. 827 (1975) (artist who sold only 75 pieces of art through galleries during his life died owning 425 pieces).

20. *See, e.g.*, Estate of Smith v. Commissioner, 510 F.2d 479, 484-85 (2d Cir. 1975) (Mulligan, J., dissenting) (noting that the art in David Smith's estate represented approximately 93% of the value of the total estate).

21. *O'Keeffe*, 63 T.C.M. (CCH) at 2700; Estate of Smith v. Commissioner, 57 T.C. 650, 653 (1972), *aff'd*, 510 F.2d 479 (2d Cir.), *cert. denied sub nom.* 423 U.S. 827 (1975).

22. *See* Calder v. Commissioner, 85 T.C. 713 (1985).

23. *See infra* note 280.

24. *See* Commissioner v. Shattuck, 97 F.2d 790, 792 (7th Cir. 1938) ("It is a matter of common knowledge that the value of any product or commodity, whether it be wheat, hogs or otherwise, is affected by the law of supply and demand, and that where the former far exceeds the latter, it has a depressing effect upon value."); Jenkins v. Smith, 21 F. Supp. 251, 253 (D. Conn. 1937) ("Since market value varies with the quantity offered, (in this respect differing from intrinsic value), the effect of placing the 17,679 shares in the market at one time is a factor of great importance.").

25. *See infra* notes 282-325 and accompanying text.

26. Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699 (1992); Calder v. Commissioner, 85 T.C. 713 (1985); Estate of Smith v. Commissioner, 57 T.C. 650 (1972), *aff'd*, 510 F.2d 479 (2d Cir.), *cert. denied sub nom.* 423 U.S. 827 (1975).

27. 63 T.C.M. (CCH) 2699 (1992).

I. Valuation of Property for Estate and Gift Tax Purposes

Federal estate and gift taxes function as taxes on the transfer of property,[28] not taxes on property.[29] Consequently, the value of the property transferred must be determined in order to calculate the tax.[30]

A. *Time of Valuation*

The value of property is not static; it changes with time as economic conditions shift and perceptions about the future change.[31] The value of property for estate tax purposes is generally determined at the time of death.[32] Although the Code purports to require valuation as of the *time* of death, value is determined as of the date of death, without regard to the hour of demise.[33] The executor of the estate, however, can elect in certain cases to value property other than as of the date of death under alternate valuation.[34] The value of property for gift tax purposes is determined at the date of gift.[35]

The value of property, however, is not always the same immediately before and immediately after death. A term life insurance policy in the hands of an insured-owner may have little value before death, but have value equal to the face amount of the policy to the beneficiary immediately after the insured's death.[36] The death of a business partner may adversely affect the value of a business.[37]

Similarly, the value of property is not always the same the moment before and the moment after transfer by gift. Shares of stock in a closely held corporation which are part of a control block in the hands of a donor may have a value greater than their pro rata share of the corporation's value.[38] If only a few shares are transferred by gift, however, the shares in

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28. *See supra* note 9.

29. United States v. Land, 303 F.2d 170, 172 (5th Cir.), *cert. denied*, 371 U.S. 862 (1962); Treas. Reg. § 20.0-2(a) (as amended in 1992); Treas. Reg. § 25.0-1(b) (as amended in 1992). The distinction is important because of the constitutional prohibition against unapportioned direct taxes. *Land*, 303 F.2d at 172.

30. *See* I.R.C. §§ 2031, 2512 (1986).

31. Rev. Rul. 59-60, 1959-1 C.B. 237, 238.

32. I.R.C. § 2031(a) (1986); United States v. Cartwright, 411 U.S. 546 (1973); Treas. Reg. § 20.2031-1(a) (as amended in 1965).

33. *See* David E. Watts, *The Fair Market Value of Actively Traded Securities*, 30 Tax Law. 51, 57 (1976).

34. I.R.C. § 2032 (1986).

35. I.R.C. § 2512(a) (1986).

36. *See* United States v. Land, 303 F.2d 170, 173 (5th Cir.), *cert. denied*, 371 U.S. 862 (1962).

37. *Id.* at 172 ("It is only in the few cases where death alters value, as well as ownership, that it is necessary to determine whether the value at the time of death reflects the change caused by death, for example, loss of services of a valuable partner to a small business."); Newell v. Commissioner, 66 F.2d 102, 103-04 (7th Cir. 1933) (holding that a reduction should have been made in the valuation of a company to reflect the loss of a key person); Rev. Rul. 59-60, 1959-1 C.B. 237, 239.

38. Amerada Hess Corp. v. Commissioner, 517 F.2d 75, 84 (3d Cir. 1975) (the market price of stock which carries control should be adjusted to reflect a control premium); Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1581 (1987); Treas. Reg. § 20.2031-2(e) (as amended in 1992); Treas. Reg. § 25.2512-2(e) (as amended in 1976); Rev. Rul. 59-60, 1959-1 C.B. 237, 242.

the hands of the donee would constitute a minority interest and have less than a pro rata share of the corporation's value.[39] At what time and in whose hands is value determined for estate and gift tax purposes?

The Fifth Circuit rejected "before-and-after" and "in-whose-hands" approaches to valuation in *United States v. Land*:

> Brief as is the instant of death, the court must pinpoint its valuation at this instant—the moment of truth, when the ownership of the decedent ends and the ownership of the successors begins. It is a fallacy, therefore, to argue value before-or-after death on the notion that valuation must be determined by the value either of the interest that ceases or of the interest that begins. Instead, the valuation is determined by *the interest that passes*, and the value of the interest before or after death is pertinent only as it serves to indicate the value *at* death.[40]

Accordingly, where the value of property after death is different from its value before death, courts have given full effect to changes in value that occurred at death.[41]

Similarly, the gift tax regulations recognize that the value of property transferred by gift is to be determined by valuing the property at the moment of transfer, without reference to its value in the hands of the donor or donee:

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.[42]

Valuing property as of the moment of the taxable event, the moment of transfer, without reference to its value in the hands of the transferor or the transferee, afforded taxpayers substantial tax avoidance opportunities[43] and led to some dramatic results. In *Estate of Harrison v. Commissioner*,[44] the Tax Court valued a limited partnership interest, which had a value in decedent's hands before death of $59,555,020, at $33,000,000 for

39. *See* Estate of Bright v. United States, 658 F.2d 999, 1002-04 (5th Cir. 1981) (reviewing cases in which minority discounts had been allowed for estate and gift taxes).

40. 303 F.2d at 172; *accord* Goodman v. Granger, 243 F.2d 264, 269 (3d Cir.), *cert. denied*, 355 U.S. 835 (1957) ("The [estate] tax is measured by the value of assets transferred by reason of death, the critical value being that which is determined as of the time of death."). Not all courts, however, have found focus on the moment of transfer enlightening. *See* Citizens Bank & Trust v. Commissioner, 839 F.2d 1249, 1252 (7th Cir. 1988) ("Nor do we get much help from being told that 'brief as is the instant of death, the court must pinpoint its valuation at this instant'—the much-cited but enigmatic formulation in *United States v. Land* . . .").

41. Ahmanson Found. v. United States, 674 F.2d 761, 768 (9th Cir. 1981); *Land*, 303 F.2d at 172.

42. Treas. Reg. § 25.2511-2(a) (as amended in 1983).

43. *See* John A. Wallace, *Now You See It, Now You Don't—Valuation Conundrums in Estate Planning*, 24 INST. ON EST. PLAN. 8-1 (1990).

44. 52 T.C.M. (CCH) 1307 (1987).

estate tax purposes because the decedent's right as a general partner to dissolve the partnership ceased to exist at death.[45] Congress enacted § 2704(a) in response to the result of *Estate of Harrison*.[46] Section 2704(a) provides that the lapse of certain voting or liquidation rights will be treated as additional transfers for tax purposes. Consequently, some of the tax avoidance opportunities that existed under prior law have been curtailed.

Congress, however, did not change the moment at which property is valued for estate and gift tax purposes. The value of the transferred property is still determined as of the moment of the taxable event, without regard to the value it had in the hands of the transferor or will have in the hands of the transferee.[47] This principle is consistent with the meaning of fair market value that has developed over the years.[48] Valuation as of the taxable event and the current concept of fair market value provide the foundation for the allowance of minority and blockage discounts.[49]

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45. *Id.* at 1308. The Tax Court relied upon the decision in *Land*. It valued the property interest that was transferred at the moment of death; not the interest that the decedent had owned. *Id.* at 1308-09. The value of the partnership interest, consequently, was the amount a potential buyer would pay for the limited partnership interest which did not possess a liquidation right. *Id.* at 1309.

46. *See* S. Stacy Eastland, *Family Limited Partnerships: Transfer Tax Benefits*, 7 PROB. & PROP. 59 (1993); Benton C. Strauss & James K. Shaw, *Final Chapter 14 Regs. Clarify GRATs, Business Planning*, 19 EST. PLAN. 259, 265-66 (1992).

47. Joseph M. Dodge has suggested a change from the current valuation approach:

> [T]he best approach is the pragmatic one of including in the tax base the greater of what the transferor had or what the transferee received. Such a rule is justified, not so much by revenue maximizing considerations, but rather by the fact that any other rule would create a situation wherein tax considerations would distort economic and family decisions. Thus, any rule allowing a reduction in the tax base with reference to what the transferee receives relative to what the transferor had would encourage economic destruction and waste—or at least assertions to that effect—and any rule actually producing such a result embodies silly policy.

Redoing the Estate and Gift Taxes Along Easy-to-Value Lines, 43 TAX L. REV. 241, 254 (1988).

48. *See infra* part I.B.

49. Not all tax reduction opportunities have been eliminated. *See* Wallace, *supra* note 43. Courts, however, have sometimes refused to allow minority discounts, notwithstanding the fact that a minority interest was transferred. In Estate of Murphy v. Commissioner, the Tax Court refused to allow a minority discount for a 49.65% stock interest where the decedent "implemented a plan [involving the gift of 1.76% of a company's stock] 18 days before her death with the sole and explicit purpose to obtain a minority discount." 1990 T.C.M. (P-H) ¶ 90,472, at 2243, 2257 (1990). The Court found the facts "extreme" and held that "[a] minority discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce Federal tax." *Id.* (citations omitted). The court found that a clear understanding existed between the parties "to maintain family control of the corporation." *Id.* at 2263. It also found that decedent had enjoyed the power of control until death notwithstanding her transfer. *Id.* at 2265. The substance over form doctrine was also relied upon by the court. *Id.* at 2260-61. *But see* Wallace, *supra* note 43, at 8-16:

> Absent proof of an express prior agreement concerning the future of the transferred stock between the donor and the donee, however, the failure to accord separate and distinct transfers of minority interests a discount runs contrary to the gift and estate tax regulations, which focus upon the property actually passing between a given donor and donee.

Id.

Several commentators have suggested changes that would prevent control from escaping taxation. Dodge, *supra* note 47, at 255 (suggesting that minority discounts be disallowed for transfers which were originally part of a control block and that value be determined by reference to the largest interest in the property ever owned by the transferor); Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A*

B. *Fair Market Value*

The Internal Revenue Code provides that the "value" of certain property be included in decedents' gross estates for estate tax purposes[50] and that the "value" of gifted property is the amount of the gift for gift tax purposes.[51] The Code, however, does not define "value" or specify how it is to be determined.[52] The Treasury by its regulations has interpreted "value" to mean "fair market value"[53] and the courts have approved that interpretation.[54] Treasury Regulations and case law, consequently, must be reviewed to determine the meaning of fair market value.[55]

Initial Treasury Regulations relating to the 1916 estate tax gave no indication as to how value was to be determined for estate tax purposes.[56] Regulations issued in 1919, however, specified that "[t]he value to be ascertained is the market, or sale, value of the property."[57] Value as the price which a willing buyer would pay a willing seller for the property[58] and the term "fair market value"[59] were introduced by the 1922 regulations. In 1924, the term "fair market value" was first defined in the gift and estate tax regulations and absence of compulsion to buy or sell was added to the formula.[60] The requirement that both the willing buyer and willing seller have reasonable knowledge of relevant facts was added in 1958.[61] Finally, a 1965 amendment directed that property be valued in the market in which it is most commonly sold to the public.[62]

Current Treasury Regulations use fair market value as the measure of value for tax purposes[63] and define the term as follows:

> [F]air 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 relevant facts. The fair market

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Statutory Solution to the Disappearing Wealth Syndrome, 30 STAN. L. REV. 895, 923 (1978) (proposing "statutory modifications to provide that any gratuitous transfer of shares from a donor who originally owned a controlling interest in a corporation shall be valued as if they were part of the controlling block").

50. I.R.C. § 2031 (1986).

51. I.R.C. § 2512 (1986).

52. Korn v. Commissioner, 35 B.T.A. 1071, 1076 (1937).

53. *Id.* at 1077.

54. *See, e.g.*, United States v. Cartwright, 411 U.S. 546, 551 (1973).

55. Estate of Gilford v. Commissioner, 88 T.C. 38, 48 n.14 (1987).

56. *See* Treas. Reg. 37, T.D. 2378, 18 Treas. Dec. Int. Rev. 182 (1916).

57. Treas. Reg. 37, Art 14, T.D. 2910, 21 Treas. Dec. Int. Rev. 752, 761 (1919).

58. Treas. Reg. 63, Art. 13, T.D. 3384, 24 Treas. Dec. Int. Rev. 1036, 1047 (1922).

59. Treas. Reg. 63, Art. 14(2), 14(8), 14(9)(c), T.D. 3384, 24 Treas. Dec. 1036, 1048, 1050, 1052 (1922).

60. Treas. Reg. 67, Art. 7(1), T.D. 3648, 26 Treas. Dec. Int. Rev. 1162, 1166 (1924) ("The fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell."); Treas. Reg. 68, Art. 13(a)(1), T.D. 3683, 27 Treas. Dec. Int. Rev. 81, 95 (1924).

61. Treas. Reg. § 20.2031-1(b) (as amended by T.D. 6296, 1958-2 C.B. 432, 479); Treas. Reg. § 25.2512-1 (as amended by T.D. 6334, 1958-2 C.B. 627, 650).

62. Treas. Reg. § 20.2031-1(b) (as amended by T.D. 6826, 1965-2 C.B. 367, 368); Treas. Reg. § 25.2512-1 (as amended by T.D. 6826, 1965-2 C.B. 367, 369).

63. Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992).

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.[64]

Fair market value is best understood by examining its components.

1. Price at Which Property Would Change Hands

Treasury Regulations define fair market value by reference to a hypothetical sale in the marketplace.[65] It is "what-you-could-have-got-for-it-in-money-if-you-had-sold-it,"[66] in other words, the cash price at which a trade would occur.[67]

Value in the marketplace is forward-looking and reflects opinions, expectations, and prophecies about the future. In 1929 Justice Holmes observed:

> [T]he value of property at a given time depends upon the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market. Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future; and the value is no less real at that time if later the prophecy turns out false than when it comes out true.[68]

Judge Hand similarly noted that "[i]n the end value is no more than the opinions of those who have, and those who have not, when they coincide."[69]

While fair market value is the price that would result if the property changed hands, the regulations sometimes require value be determined by reference to actual sale prices of comparable property. Current regula-

64. Treas. Reg. § 20.2031-1(b) (as amended in 1965); *see also* Treas. Reg. § 25.2512-1 (as amended in 1992).

65. [No. 115] FED. EST. & GIFT TAX REP. (CCH) 8 (Oct. 14, 1985) (containing text of IRS training material titled *IRS Valuation Guide for Income, Estate and Gift Taxes*) [hereinafter *IRS Valuation Guide*]. The IRS Valuation Guide was:

> [D]esigned primarily to benefit IRS officials who negotiate settlements of income, estate and gift tax cases in which valuation of real or personal property is necessary, but it also gives taxpayers and tax advisors a valuable insight into the major valuation problem areas and the accepted methods and approaches applied by IRS Appeals Officers in considering valuation questions.

Id. at 1.

66. Andrews v. Commissioner, 135 F.2d 314, 317 (2d Cir.), *cert. denied*, 320 U.S. 748 (1943).

67. *IRS Valuation Guide*, *supra* note 65, at 8.

68. Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929) (citations omitted).

69. Rice v. Eisner, 16 F.2d 358, 361 (2d Cir. 1926), *cert. denied*, 273 U.S. 764 (1927); *accord* United States v. Land, 303 F.2d 171, 173 (5th Cir.), *cert. denied*, 371 U.S. 862 (1962); *see also* Rev. Rul. 59-60, 1959-1 C.B. 237, 238 (noting that "valuation is not an exact science").

tions generally require the value of stocks and bonds traded in active markets be determined on the basis of actual sales of identical securities.[70] The value of property for which special rules have not been provided, however, is to be determined on the basis of a hypothetical sale considering "[a]ll relevant facts and elements of value."[71]

Resort to the market and use of the price at which the property would have sold in an arm's length sale provides a reasonable approach to determining value for transfer tax purposes.[72] Sale prices in active markets reflect the consensus of the public as to value and the prospects for the property.[73] The property, moreover, presumably could have been sold at fair market value and the cash proceeds, rather than the property, could have been transferred.[74]

2. Willing Buyer and Willing Seller

Fair market value is the price at which both a willing buyer and a willing seller would have traded. The "willing" nature of the parties appears to have been the Treasury's initial attempt to postulate a voluntary sale; one made without coercion.[75] "Willingness" on the part of the parties, therefore, is related to the requirement that value not be determined in a forced sale or a sale under compulsion.[76]

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70. Treas. Reg. § 20.2031-2(b) (as amended in 1992); *see also* Treas. Reg. § 25.2512-2(b) (as amended in 1976) (providing that the fair market value of stocks or bonds traded on exchanges is generally the mean between the highest and lowest quoted selling prices on the valuation date).

71. Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992).

72. *See* Emanuel L. Gordon, *What Is Fair Market Value?*, 8 TAX L. REV. 35, 37 (1952) ("In the light of the difficulties involved in determining intrinsic value, [fair market value] . . . is, in fact, a more acceptable and practical administrative device, whatever its relative theoretical deficiencies may be.").

73. *See* Rev. Rul. 59-60, 1959-1 C.B. 237, 238.

74. *See* Estate of Wright v. Commissioner, 43 B.T.A. 551, 556 (1941) (noting that the securities to be valued could have been sold at a comparable price with the stock which had actually traded had they been offered); Gordon, *supra* note 72, at 38.

75. *See infra* part I.B.3.

76. The IRS views willingness as a state of mind, different from the absence of a compulsion, if only in degree:

> What exactly is a willing buyer or seller? Basically, it is a state of mind—so this hypothetical sale starts out with someone who wants to buy the property and someone who wants to sell the property. Why is this important? Because if the buyer doesn't want to buy, and the seller doesn't want to sell, either no sale would take place, or the sale that did take place would not be representative of fair market value.
>
> Please note that the presence of a willing buyer and a willing seller is different from the absence of a compulsion to buy or sell—the difference is one of degree.

IRS Valuation Guide, *supra* note 65, at 8-9. *See also* Gordon, *supra* note 72, at 46 ("[T]he term 'willing' has generally come into issue only in cases of a sharp departure from sales in the ordinary course. A sale which is part of a complete sellout of some activity or is a forced sale is disqualified by the 'willing' requirement.") (footnotes omitted).

a. *Hypothetical Nature of Buyer and Seller*

i. Relationship Between the Transferor and Transferee

The Internal Revenue Service ("IRS" or "Service") long maintained that the relationship between the transferor and transferee was a factor to be considered in valuing property for estate and gift tax purposes.[77] If a donor made gifts of stock within his family, the Service presumed the family would act in concert to maximize value. Further, if the family's ownership provided control, the Service valued the gifts as a pro rata share of the value of the family's controlling interest under a "unity of ownership" theory.[78]

The Fifth Circuit soundly rejected the Service's position in *Estate of Bright v. United States.*[79] In *Bright*, a husband and wife owned 55% of a company's stock as community property.[80] Upon the wife's death, the stock was divided under local law[81] and the wife's 27.5% interest was devised in trust naming the husband as trustee.[82] The IRS argued that the 55% control block should be valued and that one-half of this control block value should be included in the wife's gross estate.[83]

The Fifth Circuit rejected the IRS's argument and determined that only decedent's 27.5% interest was to be valued.[84] Family attribution was rejected for three reasons. First, it was not supported by the case law.[85] Second, attribution was "logically inconsistent" with the willing buyer, willing seller rule contemplated by the regulations.[86] Third, rejection of attribution advanced the policy that the law should be stable and predictable.[87]

The court held that the willing buyer and willing seller in the fair market value formulation were hypothetical persons, unrelated to each other:

> The notion of the "willing seller" as being hypothetical is also supported by the theory that the estate tax is an excise tax on the transfer of property at death and accordingly that the valuation is to be made as of the moment of death and is to be measured by the interest that passes, as contrasted with the interest held by the decedent before death or the interest held by the legatee after death. . . . It would be strange indeed if the estate

77. Estate of Bright v. United States, 658 F.2d 999, 1001 n.2 (5th Cir. 1981); *see also IRS Valuation Guide, supra* note 65, at 88.

78. Rev. Rul. 81-253, 1981-2 C.B. 187, 188; *IRS Valuation Guide, supra* note 65, at 88. The IRS revoked Rev. Rul. 81-253 in 1993. Rev. Rul. 93-12, 1993-7 I.R.B. 13, 14.

79. 658 F.2d 999 (5th Cir. 1981).

80. *Id.* at 1000.

81. *Id.* at 1001.

82. *Id.* at 1000.

83. *Id.* at 1001.

84. *Id.*

85. *Id.* at 1005.

86. *Id.*

87. *Id.* at 1006.

> tax value of a block of stock would vary depending upon the legatee to whom it was devised.[88]

The decision not only precluded valuation of decedent's 27.5% interest as part of a control block, but opened the door to the possibility that a minority discount might be allowed.[89]

The Service issued Revenue Ruling 81-253[90] in response to *Bright* and maintained that minority discounts were not ordinarily allowable in the valuation of stock transferred among family members where the family possessed control.[91] The Service justified its position on the basis that the judicial authority was inconsistent[92] and it was unlikely that shares that were part of a controlling interest would be sold outside the family other than as a unit.[93] According to the Service, "where a controlling interest in stock is owned by a family, the value per share of stock owned by one family member is the same as stock owned by any other family member and is the same value that would exist if all the stock were held by one person."[94]

The weak judicial authority relied upon by the Service, however, soon disappeared entirely as courts followed *Bright*.[95] The Ninth Circuit joined the Fifth in rejecting the Service's "unity of ownership" theory and held that determining value by reference to hypothetical buyers and sellers provided a desirable objective standard of valuation.[96] Similarly, the Tax Court held that it was improper to place any weight upon the identity of the parties in determining fair market value.[97]

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88. *Id.*

89. *Id.* at 1000 n.1 ("The [district court's] order did not mandate a minority discount; it held only that the interest to be valued was in fact a 27 1/2% interest, which of course left open for proof at trial whether or not the taxpayer would in fact adduce proof to support a minority discount.").

90. Rev. Rul. 81-253, 1981-2 C.B. 187.

91. *Id.* at 188.

92. *Id.* Several commentators have suggested that the cases relied upon by the Service provided weak support for the ruling. Wallace, *supra* note 43, at 8-16 ("The Service cited several cases in Revenue Ruling 81-253 in support of its position, all of which involved transactions where the members of the family in question were rather obviously undertaking concerted action with respect to the transfers in question."); Sandra S. Kramer, *Questions Remain in the Valuation of Blocks of Stock*, 16 TAX ADVISOR 630, 637 (Oct. 1985). The Tax Court, in a decision rendered after issuance of Revenue Ruling 81-253, found two of the cases relied upon by the Service provided "at best weak support" for denial of minority discounts. Estate of Andrews v. Commissioner, 79 T.C. 938, 955-56 (1982).

93. Rev. Rul. 81-253, 1981-2 C.B. 187, 188.

94. *Id.*

95. *See, e.g.*, Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982); *Andrews*, 79 T.C. 938.

96.
> The use of an objective standard avoids the uncertainties that would otherwise be inherent if valuation methods attempted to account for the likelihood that estates, legatees, or heirs would sell their interests together with others who hold undivided interests in the property. Executors will not have to make delicate inquiries into the feelings, attitudes, and anticipated behavior of those holding undivided interests in the property in question.

Propstra, 680 F.2d at 1252.

97. *Andrews*, 79 T.C. at 954-56; Estate of Gallo v. Commissioner, 50 T.C.M. (CCH) 470, 486 (1985).

Confronted with judicial rejection of its position, the IRS acknowledged defeat in Revenue Ruling 93-12.[98] The Service revoked Revenue Ruling 81-253 and ruled that in valuing shares of stock transferred to family members for gift tax purposes, shares of other family members would not be aggregated with the transferred shares to determine whether they should be valued as part of a controlling interest.[99] The IRS also ruled that "a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest."[100] The ruling recognized that fair market value should be determined by valuing the interest transferred at the moment of the taxable event, without reference to the relationship between the transferor and transferee, and without regard to the property's value in the hands of the transferor or transferee.

ii. Identity of Willing Buyers

Although case law establishes that the willing buyer and willing seller are hypothetical, unrelated parties, is the fact that the group of potential buyers contains a particular person to whom the property has greater value relevant in determining value? If fifty-one shares of stock provide control of a closely held corporation, the owner of fifty shares would place a greater value on one share offered for sale than would someone who owned no shares. The additional share would provide control to the owner of fifty shares and increase the value of his other shares, but to the nonshareholder, it would merely represent a minority interest in a closely held business.[101]

The IRS argued in *Bright* that a factor to consider in determining value was whether the property might have greater value to some buyers than to others.[102] The Fifth Circuit did not decide whether such evidence was relevant, however, because the issue had not been raised prior to appeal.[103] The court noted, nonetheless, that a "few cases had acknowledged the relevance of such facts."[104] The IRS read the court's discussion of this issue as suggesting its position might have merit.[105]

Determination of fair market value, however, should not be made by reference to the property's value to particular individuals, but by reference

98. Rev. Rul. 93-12, 1993-7 I.R.B. 13.

99. *Id.* at 14.

100. *Id.*

101. The Tax Court has recognized that two separate discounts, a minority shareholder discount and a lack of marketability discount, may apply in the valuation of a minority interest. *Andrews*, 79 T.C. at 953; *accord* Estate of Murphy v. Commissioner, 1990 T.C.M. (P-H) ¶ 90,472, at 2243, 2255-56 (1990); *see also* Fellows & Painter, *supra* note 49, at 920-21 (discussing the minority and lack of marketability discounts as separate discounts).

102. Estate of Bright v. United States, 658 F.2d 999, 1007 (5th Cir. 1981).

103. *Id.* at 1008.

104. *Id.* at 1007 (citations omitted).

105. One argument raised but not considered by the Court [in *Bright*] (because it was not timely raised) appears to have merit based upon the discussion in the opinion. The argument is that within the group of "willing buyers" is that shareholder who has a minority interest, but, with the interest being valued, would have control.

IRS Valuation Guide, *supra* note 65, at 88 (footnote omitted).

to its value to members of the general public. A contrary conclusion would emasculate *Bright* and its progeny.

Consider a corporation capitalized with 100 shares of stock owned by parent (30), child (50), and unrelated investor (20). Assume that control of the corporation would be provided by ownership of fifty-one shares. If parent makes a gift of one share to child, case law and Revenue Ruling 93-12 preclude aggregation of parent's and child's shares to value the transferred share as part of a controlling interest. But if the IRS could consider child (to whom the share would provide control and have greater value than to the general public) as a member of the group of willing buyers, a valuation similar to that which would be derived under the "unity of ownership" theory would result; the transferred share would be valued as part of a control block.

Such an approach, carried to its logical extreme, would have additional unjustified results. What if parent (owner of thirty shares) gave one share to a valuable employee? What would the fair market value of that share be for gift tax purposes? The single share represents a minority interest in the closely held business. It was not part of a control block in the hands of the transferor and will not be part of a control block in the hands of the transferee. Fair market value is the price at which the share would trade hands in a hypothetical sale. If child (owner of fifty shares) is included in the group of willing buyers for purposes of determining value, the share would be valued as part of a control block. The valuable employee, after all, could resell the share to child to whom the share would provide the margin of control.[106]

Fair market value should be established by reference to the price that a member of the general public would pay for the property. The price that a particularly motivated buyer would pay could be disregarded on the grounds that he "is acting unreasonably if he cannot make a purchase with confidence that the . . . [property] could be immediately resold for the same or similar price."[107] If child (owner of fifty shares) purchased the additional share and thereafter offered the single share for resale, what price would a willing buyer, who could not obtain control, be willing to pay?

The Tax Court has correctly rejected consideration of the price particularly motivated buyers would pay in the valuation of property:

> Respondent's approach would have us tailor "hypothetical" so that the willing seller and willing buyer were seen as the particular persons who would most likely undertake the transaction. However, the case law and regulations require a truly hypothetical willing seller and willing buyer. We must assume these hypothetical parties exist even though the reality of the situation may

106. This is essentially the argument made by the IRS in *Bright*. 658 F.2d at 1007.

107. Karlen, *supra* note 5, at 202; *cf.* Fellows & Painter, *supra* note 49, at 919-20.

> be that the stock will most probably be sold to a particular party or type of person.[108]

The price that a particularly motivated buyer would pay does not establish fair market value because it is an artificially high value not obtainable in a sale to a member of the general public.

3. Neither Being Under any Compulsion to Buy or to Sell

The notion that fair market value is the price that would be obtainable in a voluntary sale emerged as successive Treasury Regulations were promulgated. Regulations adopted in 1922 provided that value was the price a willing buyer would pay a willing seller for property.[109] Two years later, the requirement that neither buyer nor seller be under any compulsion to buy or to sell was added.[110] In 1933, the regulations provided that fair market value was not to be determined by a "forced sale."[111]

A price in a forced sale is obviously not one for fair market value[112] and should not be used to determine transfer taxes. The IRS Valuation Guide provides that "[a] sale under which one party or the other would be compelled would not be representative of fair market value, because if the buyer is compelled to buy, the price would be artificially high, and if the seller is compelled to sell, the price would be artificially low."[113]

But is this requirement not inconsistent with the statutory requirement that value be determined as of a particular date?[114] If value must be determined as of a certain date, is the price that would be obtained in a sale on that date, even if in a forced sale, not the value required by the Code?

Not surprisingly, taxpayers have argued that value must be determined by what the property would have sold for on the valuation date.[115]

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108. Estate of Andrews v. Commissioner, 79 T.C. 938, 956 (1982); *accord* Estate of Gallo v. Commissioner, 50 T.C.M. (CCH) 470, 486 (1985) (rejecting an IRS argument that presumed shares being valued would be purchased by members of decedent's family as being "inconsistent with the holding of Estate of Bright v. United States, expressly adopted by both the Ninth Circuit Court of Appeals and this Court. For our purposes, the assumed purchaser of the shares in issue must be hypothetical, not a Gallo family member.") (citations omitted).

109. Treas. Reg. 63, Art. 13, T.D. 3384, 24 Treas. Dec. Int. Rev. 1036, 1047 (1922).

110. Treas. Reg. 67, Art. 7(1), T.D. 3648, 26 Treas. Dec. Int. Rev. 1162, 1166 (1924); *see also* Treas. Reg. 68, Art. 13(1), T.D. 3683, 27 Treas. Dec. Int. Rev. 81, 95 (1925).

111. Treas. Reg. 79, Art. 19(1) (1933 ed.), *reprinted in* 139 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 (Bernard D. Reams, Jr., ed. 1979); *see also* Treas. Reg. 80, Art. 13(1) (1934 ed.), *reprinted in* 139 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 (Bernard D. Reams, Jr., ed. 1979).

112. *See* Korn v. Commissioner, 35 B.T.A. 1071, 1079 (1937) (holding that the limited market price of a remainder interest did not establish fair market value, where taxpayer's witness did not believe the sale prices were fair and had a forced sale character).

113. *IRS Valuation Guide*, *supra* note 65, at 9.

114. *See supra* part I.A.

115. Laird v. Commissioner, 85 F.2d 598, 599 (3d Cir. 1935).

> The petitioners argue that, had they dumped on the market large blocks of the listed stock, they could not have obtained prices even approximating those determined by the Commissioner. They contend that the listed stock should be valued at the prices which their expert witnesses testified could probably be obtained upon a forced sale.

Indeed, a district court adopted such an approach in an early case,[116] but other courts have correctly rejected forced sale single-date valuations.[117] Fair market value is to be determined by what the property would have sold for if offered for sale in a prudent manner for a reasonable period of time.[118]

4. Both Parties Having Reasonable Knowledge of Relevant Facts

The willing buyer and willing seller in the hypothetical sale used to determine fair market value are required to have reasonable knowledge of relevant facts. A purchase or sale made without such knowledge cannot be said to be "fair" except by coincidence.[119] However, only "reasonable knowledge" is required; neither equal nor complete knowledge is mandated. The seller will almost always have more complete and accurate information regarding the property than will the buyer.

Courts have recognized that not all participants in markets will be equally well-informed.[120] But where markets exist, as is the case for publicly traded stocks, it has been held that the market should be considered as having assimilated the available information.[121] Attempts to disregard quoted prices on the basis that relevant information had been concealed, and thus the market price did not reflect a "fair" value, have been rejected.[122] Organized markets normally produce prices which an owner

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Id. Estate of Sawade v. Commissioner, 49 T.C.M. (CCH) 214, 224 (1984), *aff'd*, 795 F.2d 45 (8th Cir. 1986).

116. Jenkins v. Smith, 21 F. Supp. 251, 253 (D. Conn. 1937).

117. Richardson v. Commissioner, 151 F.2d 102 (2d Cir.), *cert denied*, 326 U.S. 796 (1946):

> [N]othing in the law or common sense requires the trier to attempt to ascertain what the property in question would have fetched at a sale through a sales effort begun and ended on the critical date. Surely the fair market value of, say, a residence is not measured by the price which the owner could have obtained for it on the very day upon which he first decided to sell. Rather, the measure there, as in the case here, is what "a skillful broker could within a reasonable period have realized."

Id. at 103; Helvering v. Safe Deposit & Trust Co., 95 F.2d 806, 812 (4th Cir. 1938) ("It would have been improper of course to have adopted as the true value of the stock the price obtainable by forcing or dumping the whole block on the market at one time . . . ."); *Laird*, 85 F.2d at 599 ("[P]rices obtained upon a sacrifice sale do not necessarily represent the true value of the listed stock."); *Sawade*, 49 T.C.M. (CCH) at 225 ("[W]e are not required to assume that the entire block was dumped on the market at one time on the valuation date."); *see also* Weston Vernon, Jr. & Robert T. Molloy, *Blockage and the Invested Capital Credit*, 8 TAX L. REV. 131, 144 (1953).

118. *Richardson*, 151 F.2d at 103; Bull v. Smith, 119 F.2d 490, 492 (2d Cir. 1941).

119. Gordon, *supra* note 72, at 36.

120. *See, e.g.*, Rogers v. Helvering, 107 F.2d 394, 396 (2d Cir. 1939) (per curiam).

121. Estate of Gilford v. Commissioner, 88 T.C. 38, 55 (1987). *But see* Watts, *supra* note 33, at 65 (suggesting that information that has a substantial market impact and which becomes available on the valuation date, but which is not fully reflected in selling prices, should result in valuation adjustments).

122. In *Estate of Wright v. Commissioner*, the taxpayer contended that prices at which stock traded on an exchange should not be used for estate tax purposes because the prices resulted from misrepresentations and concealments of facts of which sellers and purchasers were unaware. 43 B.T.A. 551, 555 (1941). The Board rejected that argument on the basis that the estate's shares could have been sold at the market prices. *Id.* at 555. The consequences that would follow acceptance of the taxpayer's argument also warranted rejection:

> [T]he administrative and judicial difficulties which would be involved in the adoption of any different rule convince us that petitioner's position is untenable. If it

could have received had he sold on the date on which price is determined.[123] The ability to have sold the property in the market justifies use of market prices even if the market was "rigged."[124]

a. *Post-Valuation Date Events and Information*

The value of property for federal transfer tax purposes is generally determined as of the date of death or gift. Treasury Regulations provide that all relevant facts and elements of value *as of the applicable valuation date* shall be considered in determining value.[125] But must all events occurring thereafter and information learned thereafter be ignored in the valuation process? What if the property is sold after the valuation date? Shouldn't the actual price obtained in a bona fide sale within a reasonable period after the valuation date be relevant in determining value? What better evidences "fair market value" than an actual sale in the marketplace?[126] Why hypothesize a sale price when the actual sale price is known?

Early Treasury Regulations recognized that the price at which property sold after death might be the best evidence of value.[127] The 1919 regulations provided that the sale price of property sold within a reasonable time after the decedent's death would be accepted as the estate tax value, if the sale was made in a manner that would "insure the best price obtainable under existing circumstances."[128] Regulations promulgated in 1924, however, limited the use of selling prices by requiring a showing that the sale price reflected fair market value as of the valuation date.[129] The regulations did not, however, specify how far removed a sale could be from the valuation date and still have been made within a reasonable time.

Early on the Supreme Court confronted the question of whether post-death events should be considered in determining estate taxes. In *Ithaca*

> were always necessary to discover whether every material fact was known to the public before stock exchange prices could be relied upon in fixing fair market value, and indeed to determine what factors are and what are not material in the operations of the whole body of the trading public, it would, we think, be impossible for administrative officers or taxpayers to make an intelligent approximation of their own situation.

Id. at 556. *See also* Watts, *supra* note 33, at 62-63 (suggesting that the convenience and simplicity of using stock market quotations to establish value justifies refusals to permit challenges to the use of market prices, except in unusual circumstances, and that adjustments to market prices might not produce a more reliable valuation than the market quotations).

123. *Wright*, 43 B.T.A. at 555; Gordon, *supra* note 72, at 37.

124. Andrews v. Commissioner, 135 F.2d 314, 318 (2d Cir.), *cert. denied*, 320 U.S. 748 (1943).

125. Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992).

126. *See* Estate of Kaplin v. Commissioner, 748 F.2d 1109, 1111 (6th Cir. 1984) ("In determining the fair market value of property, little evidence could be more probative than the direct sale of the property in question."); Chiu v. Commissioner, 84 T.C. 722, 734 (1985) ("[W]e have what has been described as the most reliable evidence of value, to wit, sales of the same property within a short period of time prior to the valuation date."); *IRS Valuation Guide*, *supra* note 65, at 8 ("Obviously, an actual sale of the property would be the best indicator of value . . . .").

127. Treas. Reg. 37, Art. 14, T.D. 2910, 21 Treas. Dec. Int. Rev. 752, 761 (1919).

128. *Id.*

129. Treas. Reg. 67, Art. 7(1), T.D. 3648, 26 Treas. Dec. Int. Rev. 1162, 1166 (1924); Treas. Reg. 68, Art. 13(1), T.D. 3683, 27 Treas. Dec. Int. Rev. 81, 95 (1925).

Trust Co. v. United States,[130] the decedent devised the residue of his estate to his spouse for life with remainder in trust for charities.[131] Decedent's spouse died within six months of his death[132] and the Court had to decide the effect, if any, that her death had on the amount of the charitable deduction. Should the value of the wife's life estate be calculated using mortality tables, or on the basis that she had died within six months of decedent?[133] The Court relied upon the nature of the estate tax in answering the question:

> The [estate] tax is on the act of the testator not on the receipt of property by the legatees. Therefore the value of the thing to be taxed must be estimated as of the time when the act is done. . . . Tempting as it is to correct uncertain probabilities by the now certain fact, we are of opinion that it cannot be done, but that the value of wife's life interest must be estimated by the mortality tables.[134]

The subsequent event was not to be considered.[135]

Consideration of post-valuation date events or information not available on date of valuation may impact the value of property included in the gross estate, the amount of a charitable or marital deduction, and the amount of deductible claims against an estate. *Ithaca Trust* is frequently cited in cases involving these diverse issues.[136] While *Ithaca Trust* might suggest that subsequent events are irrelevant for all estate tax purposes, the correct reading of *Ithaca Trust* is the subject of differing views.[137] Courts have not always read the decision broadly.[138]

The Tax Court has suggested that the conflicting case law can be understood if decisions are separated into "valuation" and "enforceability" cases.[139]

In *First National Bank of Kenosha v. United States*,[140] a valuation case, the Seventh Circuit characterized the principle of *Ithaca Trust* as a rule of rele-

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130. 279 U.S. 151 (1929).

131. *Id.* at 154.

132. *Id.* at 155.

133. *Id.*

134. *Id.* (citations omitted).

135. *Id.*

136. *See, e.g.*, Estate of Sachs v. Commissioner, 856 F.2d 1158, 1160 (8th Cir. 1988) (amount of claim); First Nat'l Bank of Kenosha v. United States, 763 F.2d 891, 894 (7th Cir. 1985) (value of property); Estate of Van Horne v. Commissioner, 720 F.2d 1114, 1116 (9th Cir. 1983) (amount of claim); Propstra v. United States, 680 F.2d 1248, 1255 (9th Cir. 1982) (amount of claim); Estate of Cafaro v. Commissioner, 1989 T.C.M. (P-H) ¶ 89,348 at 1759, 1762 (1989) (amount of claim).

137. *See Sachs*, 856 F.2d at 1160 (noting that in the Eighth Circuit the date-of-death rule of *Ithaca Trust* had been limited to the valuation of charitable bequests); *Cafaro*, 1989 T.C.M. (P-H) at 1762 (observing that the cases are apparently divided on how *Ithaca Trust* applies to deductions other than charitable ones).

138. *See Sachs*, 856 F.2d at 1160 (*Ithaca Trust* rule limited to valuation of charitable bequests); Estate of Kyle v. Commissioner, 94 T.C. 829, 849 (1990) (noting that lower courts frequently considered post-death events notwithstanding *Ithaca Trust*).

139. *Cafaro*, 1989 T.C.M. (P-H) at 1763.

140. 763 F.2d 891 (7th Cir. 1985).

vance.[141] The court found subsequent sale information generally admissible:

> [C]ourts have not been reluctant to admit evidence of actual sales prices received for property after the date of death, so long as the sale occurred within a reasonable time after death and no intervening events drastically changed the value of the property. . . . Moreover, evidence of actual price received for property in the estate after the date of death is generally admitted without any discussion of the rule against admission of post-valuation date events.
>
> This seeming inconsistency is explained by looking to the purposes of the rule. The rule against admission of subsequent events is, simply stated, a rule of relevance.[142]

Evidence of a post-death sale could be relevant to the question of date of death value, whereas evidence of most post-valuation date events would not.[143]

Evidence of subsequent sales, consequently, is generally admissible.[144] But such evidence is not determinative of value,[145] nor by itself does it establish value.[146] Subsequent sales may be used to confirm that a valuation as of the valuation date was correct.[147] But not all such sales are relevant. In order for a subsequent sale to be relevant the sale must be at arm's length, for reasonable consideration, not have been forced or made under distress conditions, and have been made reasonably close in time to the valuation date.[148] Factors affecting value that arise after the valuation date must be carefully considered;[149] the proximity of a sale to the valuation date affects the weight to be given the sale.[150] Although no rule exists as to when a reasonable time will be exceeded,[151] the "question should be resolved by a consideration of the amount of activity in the particular market for the asset involved, the trend of the market, and the overall change in economic conditions between the dates of reference."[152]

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141. *Id.* at 894.

142. *Id.*

143. *Id.*

144. *Id.*

145. Buffalo Tool & Die Mfg. v. Commissioner, 74 T.C. 441, 450 (1980).

146. *See* Messing v. Commissioner, 48 T.C. 502, 510 (1967); *Buffalo Tool & Die*, 74 T.C. at 450.

147. Mott v. Commissioner, 139 F.2d 317, 318 (6th Cir. 1943); Estate of Larson v. Commissioner, 3 T.C.M. (CCH) 481, 486 (1944); Jenkins v. Smith, 21 F. Supp. 251, 254 (D. Conn. 1937); Freeman & Vinciguerra, *supra* note 12, at 374.

148. LAWRENCE H. AVERILL, JR., ESTATE VALUATION HANDBOOK § 2.11, at 46-47 (1983).

149. Wheeler v. Commissioner, 37 T.C.M. (CCH) 883, 893 (1978).

150. Sirloin Stockade, Inc. v. Commissioner, 40 T.C.M. (CCH) 928, 932 (1980); *Wheeler*, 37 T.C.M. (CCH) at 893.

151. *See, e.g.*, Estate of Kaplin v. Commissioner, 748 F.2d 1109, 1111-12 (6th Cir. 1984) (Tax Court erred in not considering the sale of property made approximately two years after the valuation date, but Tax Court's refusal to consider sale of the property five and one-half years after the valuation date was not error); Wheeler v. Commissioner, 37 T.C.M. (CCH) 883, 893 (1978) (sale of property in the year following the valuation date was highly probative evidence of value on the valuation date).

152. Michael F. Beausang, Jr., *Valuation: General and Real Estate*, 132-3rd Tax Mgmt. (BNA) at A-5 (1989) (footnote omitted).

The IRS provided guidance on the use of post-death sale prices of certain tangible personal property in Revenue Procedure 65-19.[153] The Service recognized that certain items of tangible personal property, while available at retail stores, are often obtained through public auctions or sales advertised in classified advertisements.[154] This ruling provides that the price at which such property sells in a bona fide sale as a result of a newspaper classified ad or at a public auction will be presumed to be the retail sales price of the item at the time of sale.[155] More importantly, the sales price will be presumed to be the value as of the applicable valuation date provided the sale is made within a reasonable time after decedent's death and market conditions and other circumstances affecting value have not changed substantially since death.[156] The ruling comports with the approach courts have taken in considering subsequent sale evidence.

Evidence other than of subsequent sales prices learned after the valuation date may also be relevant in determining value. But the only relevant facts are those that the hypothetical buyer and seller could reasonably have been expected to know at the valuation date.[157] Subsequent events are not to be considered, except to the extent they were reasonably foreseeable on that date.[158] Use of information unknown or unavailable on the valuation date would result in valuation on a later date, rather than on the date of the taxable event.[159]

5. In a Market in Which Such Item is Most Commonly Sold to the Public

Two issues arise in connection with identification of the market in which the hypothetical sale used to determine value takes place. First, in what market is value determined? Is it the retail or wholesale market? The answer is important because the market in which property is sold affects price;[160] retail prices tend to exceed wholesale prices. Second, from whose perspective is value determined? Is value determined by the price the willing buyer would pay or by the amount the willing seller would receive in the hypothetical sale? While there may be no difference in these amounts in a private sale, transactional costs payable by the buyer or the seller may cause these amounts to vary significantly.

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153. Rev. Proc. 65-19, 1965-2 C.B. 1002.

154. *Id.*

155. *Id.*

156. *Id.* at 1003.

157. First Nat'l Bank of Kenosha v. United States, 763 F.2d 891, 893-94 (7th Cir. 1985); Estate of Mosher v. Commissioner, 1988 T.C.M. (P-H) 145, 147 (1988); *see* Rev. Rul. 59-60, 1959-1 C.B. 237, 238 (value of securities to be determined on the basis of facts available at the required valuation date).

158. *First Nat'l*, 763 F.2d at 894; Estate of Gilford v. Commissioner, 88 T.C. 38, 52 (1987).

159. *See First Nat'l*, 763 F.2d at 894 ("Information that the hypothetical willing buyer could not have known is obviously irrelevant to this calculation [of value]."); Watts, *supra* note 33, at 63 ("Subsequently discovered facts relating to conditions existing at the date of valuation but not then known to any person, such as an unsuspected mineral deposit, should not constitute a basis for adjustments to the relevant trading data.").

160. Biagiotti v. Commissioner, 1986 T.C.M. (P-H) ¶ 86,460, at 2115, 2120 (1986).

Early estate tax regulations provided that "[t]he highest price obtainable for the property within a reasonable period of the decedent's death" was its value for estate tax purposes.[161] The market in which the hypothetical sale was to be made was not specified and the regulations failed to distinguish between retail and wholesale markets.[162] The regulations recognized that sales could be made by several methods and required that value be determined under the method that produced the best price.[163]

In 1941, the Supreme Court recognized that in some circumstances neither the amount that a willing buyer would pay, nor the amount that a willing seller would receive adequately establishes value for gift tax purposes. In *Guggenheim v. Rasquin*,[164] the taxpayer paid $852,438.50 for several single-premium life insurance policies on her life.[165] She assigned the policies simultaneously upon issuance.[166] The taxpayer argued that the market for the policies was limited and that their value was the amount which could be obtained in a sale in that limited market under the willing buyer and willing seller test.[167] According to the taxpayer, the market consisted of the issuing company or a lender and neither would pay more than the amount realizable by the owner: the policies' cash surrender value ($717,344.81).[168]

The Supreme Court held that the taxpayer's approach overlooked the nature of the property to be valued.[169] The Court found that the owner of a life insurance policy did not merely have the right to receive its cash surrender value, but could hold it until the insured's death and receive the face amount of the insurance.[170] The difference between the cost of the policy and its cash surrender value was evidence that purchasers of insurance deemed these other rights to have substantial value.[171] The Court held that the value of the policies was their cost even though "[c]ost in this situation is not market price in the normal sense of the term."[172] The Court appeared to recognize the tax avoidance possibilities that would exist if cash surrender value established value for gift tax purposes.[173]

161. Treas. Reg. 37, Art. 14, T.D. 2910, 21 Treas. Dec. Int. Rev. 752, 761 (1919).

162. Treas. Reg. 37, Art. 19, T.D. 2910, 21 Treas. Dec. Int. Rev. 752, 766 (1919) (permitting certain tangible personal property to be appraised at what it would sell for in a "bona fide sale to individual purchasers, to dealers, or upon a well-advertised auction sale.").

163. Treas. Reg. 39, Art. 14, T.D. 2910, 21 Treas. Dec. Int. Rev. 752, 761 (1919).

164. 312 U.S. 254 (1941).

165. *Id.* at 256.

166. *Id.* at 255.

167. *Id.* at 256-57.

168. *Id.* at 256.

169. *Id.* at 257.

170. *Id.*

171. *Id.*

172. *Id.* at 258.

173. *Id.* at 257-58 ("Certainly the petitioner here did not expend $852,438.50 to make an immediate gift limited to $717,344.81. Presumptively the value of these policies at the date of the gift was the amount which the insured had expended to acquire them. Cost is cogent evidence of value."). If the Court had not adopted replacement cost as the measure of value in this situation, taxpayers could remove value from the estate and gift tax system without taxation. The taxpayer in *Guggenheim v. Rasquin* had two options. First, she could acquire

In *Publicker v. Commissioner*,[174] the idea of cost as value for gift tax purposes was expanded to include excise taxes paid upon purchase. Publicker purchased a diamond ring for $45,000 and paid a ten percent federal excise tax of $4,500.[175] Five years later she gave the ring to her daughter.[176] The ring was reported as having a value of $50,000 on the gift tax return.[177] The IRS, however, valued the ring at $100,000.[178] The Tax Court determined value by adding together the cost paid ($45,000), twenty percent for appreciation ($9,000), and the excise tax that had been paid ($4,500).[179] On appeal, the Third Circuit relied on *Guggenheim v. Rasquin* for the principle that cost could be used to establish value.[180] The court held that the excise tax should be added in determining value because the gift tax regulations provided value was the price at which the property would exchange hands in a hypothetical sale.[181] The court concluded that "valuing the property as a sale, the amount of the excise tax must be included for both the buyer and the seller would have in mind and necessarily would calculate the amount of the excise tax as part of the cost of the property."[182]

These cases did not, however, consider whether amount receivable or replacement cost was the measure of value for estate tax purposes. Tax avoidance opportunities, for example, eluding tax on acquisition costs, are less likely to be exploited in connection with the estate tax. Use of an amount receivable approach could be justified in determining values for estate tax purposes.[183]

In Revenue Ruling 55-71,[184] the Service determined that excise taxes paid on jewelry, furs, and related articles of personal property are relevant in the determination of value for both gift and estate tax purposes.[185] Three years later, in 1958, the Treasury amended the gift, but not estate,

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the policies and assign ownership or, second, she could transfer cash to the donees who could purchase the policies. Unless the gift tax consequences to the taxpayer are identical in both situations, taxpayers will be encouraged to purchase property, incur sales commissions, taxes, and other costs, then transfer the property to the donee at a lower value determined under the willing buyer willing seller construct. *See* LERNER & BRESLER, *supra* note 4, at 534; Recent Case, *Gift Tax—Valuation—Sale or Replacement Value*, 7 VAND. L. REV. 292, 294 (1954) ("Certainly when the article is purchased with the intent to make a gift, cost should be the primary criterion.") (footnote omitted).

174. 206 F.2d 250 (3d Cir. 1953), *cert. denied*, 346 U.S. 924 (1954).

175. *Id.* at 251.

176. *Id.*

177. *Id.*

178. *Id.* at 252.

179. *Id.* at 252-53.

180. *Id.* at 254 ("If [*Guggenheim*] . . . is the applicable law, the Tax Court's approach in the instant case is correct, for here cost and market value realizable on sale of the diamonds to an individual for his personal use might well have been substantially the same.").

181. *Id.* at 256.

182. *Id.*

183. *See* LERNER & BRESLER, *supra* note 4, at 534-36 (suggesting the estate tax value of property should normally be determined by the amount receivable rather than by reference to decedent's cost); Recent Case, *Gift Tax—Valuation—Sale or Replacement Value*, *supra* note 173, at 294 (suggesting that it would be unfair to determine estate tax value on the basis of cost where cost exceeded current sale value).

184. Rev. Rul. 55-71, 1955-1 C.B. 110.

185. *Id.* at 111.

tax regulations to address the effect of excise taxes on valuation.[186] The Treasury provided that the value of property purchased at retail and transferred by gift within a reasonable time is generally the purchase price plus the excise tax paid.[187] If the transfer is made beyond a reasonable time after purchase, the excise tax is considered only to the extent it affects the price at which the property would be sold in a hypothetical sale.[188]

In 1965, the Treasury amended the estate and gift tax regulations to provide that fair market value is determined in the market in which the property is most commonly sold to the public.[189] Value is determined in a retail rather than wholesale market for items generally obtained by the public at retail.[190] An example in the regulations provided that the value of a used automobile is the price at which a similar automobile could be purchased by a member of the general public.[191] The regulations generally adopted a replacement cost, or buyer's perspective, rather than an amount receivable, or seller's perspective approach to valuation.[192] The Treasury thus addressed both issues that arise in connection with identification of the market. First, it provided that value is generally determined in the retail, rather than the wholesale market. Second, it adopted a replacement cost approach to value.

A retail sale normally is one made to the ultimate consumer[193] who does not hold the item for resale.[194] Sales to dealers or wholesalers, consequently, will not ordinarily establish fair market value for items generally obtained by the public at retail.[195] Retail market sales may sometimes be made by several methods. In Revenue Procedure 65-19,[196] the Service recognized that certain tangible personal property generally obtained by the public in the retail market, while available at retail stores, was frequently obtained through public auctions or by sales resulting from classified

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186. Treas. Reg. § 25.2512-7 (T.D. 6334, 1958-2 C.B. 627, 659).

187. *Id.* Failure of the Treasury to provide a similar rule in the estate tax regulations may have been in recognition of the fact that the potential for tax abuse is less likely in connection with the estate tax.

188. *Id.*

189. Treas. Reg. § 20.2031-1(b) (as amended by T.D. 6826, 1965-2 C.B. 367, 368); Treas. Reg. § 25.2512-1 (as amended by T.D. 6826, 1965-2 C.B. 367, 369); Note, *Federal Estate and Gift Taxation: Amended Regulations Change Valuation for Estate and Gift Taxes*, 1966 DUKE L.J. 248, 248-49 (1966).

190. Treas. Reg. § 20.2031-1(b) (as amended by T.D. 6826, 1965-2 C.B. 367, 368); Treas. Reg. § 25.2512-1 (as amended by T.D. 6826, 1965-2 C.B. 367, 369).

191. *Id.*

192. Joslyn v. Commissioner, 57 T.C. 722, 724 (1972), *rev'd on other grounds*, 500 F.2d 382 (9th Cir. 1974); Dodge, *supra* note 47, at 253 ("The basic willing buyer, willing seller test for valuing gift and estate transfers is oriented towards what the transferee would have to pay to acquire the item, not what the decedent would have obtained by selling it."); Note, *supra* note 189, at 254.

193. Biagiotti v. Commissioner, 1986 T.C.M. (P-H) ¶ 86,460, at 2115, 2120 (1986); Skripak v. Commissioner, 84 T.C. 285, 322 (1985); Anselmo v. Commissioner, 80 T.C. 872, 882 (1983).

194. *Biagiotti*, 1986 T.C.M. (P-H) at 2120.

195. *See* Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992).

196. Rev. Proc. 65-19, 1965-2 C.B. 1002.

newspaper advertisements.[197] Similarly, art may be purchased in the retail market through private sales, galleries, or at auctions.[198] But if property can be acquired by several methods, alternative markets, not merely alternative sale methods, may be involved.[199]

A seller will not always receive what a buyer pays in a sale because transactional costs reduce the amount received. It is the price that the willing buyer would pay, however, not the net amount receivable by the seller, that must generally be included in a decedent's gross estate for estate tax purposes. If the estate sells property and incurs selling expenses, taxation based upon value under the replacement cost approach results in taxation of amounts that are not being transferred by the decedent.

Some relief is provided by § 2053(a) of the Internal Revenue Code, which provides a deduction in the computation of the estate tax for administration expenses allowable under local law.[200] Treasury Regulations, however, limit the deduction for selling expenses to those incurred in sales that are necessary "to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution."[201] These regulations also provide that if a sale is "necessary" under the regulation, a sale to a dealer at less than fair market value can result in an administration expense deduction equal to the difference.[202] While similar relief is not provided in connection with the gift tax (there being no administration), the donor can achieve an equivalent result by selling the item and making a gift of the net sale proceeds, effectively converting the gift tax from a tax measured by replacement cost to one determined by the amount receivable.[203]

C. *Burden of Proof and Procedural Issues*

The value of property is a question of fact.[204] The Commissioner's valuation carries a presumption of correctness that the taxpayer has the

197. *Id.*; *see supra* text accompanying notes 153-56.

198. *See infra* text accompanying notes 557-87.

199. *See Biagiotti*, 1986 T.C.M. (P-H) at 2121. The court held auction sales of pre-Columbian art did not reflect sales in the retail market because such sales were composed of wholesale and retail transactions.

200. I.R.C. § 2053(a) (1986).

201. Treas. Reg. § 20.2053-3(d)(2) (as amended in 1979); *see infra* notes 531-33 and accompanying text.

202. Treas. Reg. § 20.2053-3(d)(2) (as amended in 1979); *see* Note, *supra* note 189, at 250-51.

203. Several reasons may explain why donors might not sell the property and transfer the cash proceeds. First, the donor may not desire to complete an income taxable event because the item's fair market value exceeds the donor's basis. Second, the donee may desire the particular property rather than its net realizable value. Third, the donor may be concerned that the donee might more readily spend a cash gift.

204. *E.g.*, Morris v. Commissioner, 761 F.2d 1195, 1200 (6th Cir. 1985); Propstra v. United States, 680 F.2d 1248, 1251 (9th Cir. 1982); Helvering v. Maytag, 125 F.2d 55, 62 (8th Cir.), *cert. denied*, 316 U.S. 689 (1942).

burden of proving incorrect.[205] The Tax Court has discussed the effect of the presumption and burden of proof as follows:

> This presumption is a procedural device which requires petitioner [taxpayer] to come forward with enough evidence to support a finding contrary to the [Commissioner's] determination. Petitioner also bears the burden of proof. . . . This burden is a burden of persuasion; it requires petitioner to demonstrate the merits of its claim by at least a preponderance of the evidence. Respondent's presumption and petitioner's burden of proof thus impose two separate and distinct obligations: (1) The burden of going forward, and (2) the burden of persuasion.
>
> To rebut respondent's presumption, petitioner must introduce some substantial evidence tending to show that respondent was wrong.[206]

If the taxpayer introduces sufficient evidence, the burden of going forward, but not the burden of persuasion, shifts to the Commissioner.[207] The burden of proof is also upon the taxpayer in tax refund litigation in the district courts and U.S. Claims Court.[208]

The Tax Court, as the trier of fact, must weigh all the evidence and draw appropriate inferences in determining value.[209] No formula exists which can be used to determine value in every case.[210] All relevant facts and elements of value are to be considered.[211] Relevant factors are those that a buyer and seller would wish to know[212] and could reasonably have been expected to know as of the valuation date.[213]

Tax Court determinations of value are infrequently overturned on appeal. This is because the standard of review for findings of fact, originally whether the determination was supported by "substantial evidence,"[214] is now whether the court's conclusion of value is "clearly erroneous."[215] A finding of fact is clearly erroneous when: 1) based upon substantial error

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205. *E.g.*, Welch v. Helvering, 290 U.S. 111, 115 (1933); Hamm v. Commissioner, 325 F.2d 934, 937 (8th Cir. 1963), *cert. denied*, 377 U.S. 993 (1964); Gamble v. Commissioner, 101 F.2d 565, 567 (6th Cir.), *cert. denied*, 306 U.S. 664 (1939).

206. Estate of Gilford v. Commissioner, 88 T.C. 38, 51 (1987) (citations omitted).

207. *Id.* at 61.

208. Ahmanson Found. v. United States, 674 F.2d 761, 776 (9th Cir. 1981); Meyers v. United States, 134 F. Supp. 520, 522 (Ct. Cl. 1955); *see* Rockwell v. Commissioner, 512 F.2d 882, 887 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975).

209. Helvering v. Nat'l Grocery Co., 304 U.S. 282, 294 (1938); *Hamm*, 325 F.2d at 938.

210. *Hamm*, 325 F.2d at 938; Rev. Rul. 59-60, 1959-1 C.B. 237, 238 ("No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases.").

211. Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992).

212. *Hamm*, 325 F.2d at 938.

213. First Nat'l Bank of Kenosha v. United States, 763 F.2d 891, 893-94 (7th Cir. 1985); Estate of Mosher v. Commissioner, 1988 T.C.M. (P-H) ¶ 88,024, at 145, 147 (1988).

214. *E.g.*, Helvering v. Nat'l Grocery Co., 304 U.S. 282, 294 (1938); Elmhurst Cemetery Co. v. Commissioner, 300 U.S. 37, 40 (1937); Helvering v. Rankin, 295 U.S. 123, 131 (1934); Mott v. Commissioner, 139 F.2d 317, 317 (6th Cir. 1943); Phipps v. Commissioner, 127 F.2d 214, 217 (10th Cir.), *cert. denied*, 317 U.S. 645 (1942).

215. *E.g.*, Morris v. Commissioner, 761 F.2d 1195, 1200 (6th Cir. 1985); Estate of Kaplin v. Commissioner, 748 F.2d 1109, 1110 (6th Cir. 1984); Rushton v. Commissioner, 498 F.2d 88, 95 (5th Cir. 1974); Maytag v. Commissioner, 187 F.2d 962, 964 (10th Cir. 1951).

in the proceeding, 2) unsupported by any substantial evidence, 3) contrary to the clear weight of all the evidence, or 4) supported by evidence but the appellate court has a definite and firm conviction that a mistake has been committed upon reviewing the evidence.[216]

Challenging a Tax Court's determination of value is indeed difficult. Absent a showing to the contrary, it is presumed that the Tax Court took all evidence into consideration and gave it the weight to which it was entitled.[217] Furthermore, the value determined need only be within the range of values that may be deduced from the evidence and need not be a figure as to which there was specific testimony.[218] These precepts reflect recognition that valuations are "inherently imprecise"[219] and that appellate courts should not retry factual issues.

While value is a question of fact, the criterion used to determine value is a question of law.[220] Determinations of value may be overturned if an incorrect rule of valuation was applied.[221] Determinations of value will not be reversed, however, even if based upon an erroneous rule of law, "if the findings of fact, governed by the correct rule of law, were sufficient to sustain the decision and had adequate support in the evidence."[222]

Tax Court decisions often contain lengthy recitations of evidence and statements that the court considered all the evidence in determining value.[223] Such recitations and conclusory statements may preclude successful appellate challenge because of the limited scope of appellate review.[224] But the Tax Court's mere recital of evidence and its determination of value will not always withstand challenge. The Sixth Circuit has held that the Tax Court must reveal its valuation method so that the appellate court may perform its function.[225]

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216. *Maytag*, 187 F.2d at 964.

217. *Id.* at 966.

218. Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957), *cert. denied*, 356 U.S. 950 (1958); Hamm v. Commissioner, 325 F.2d 934, 939-41 (8th Cir. 1963), *cert. denied*, 377 U.S. 993 (1964).

219. *See, e.g.*, Estate of Gilford v. Commissioner, 88 T.C. 38, 50 (1985); Messing v. Commissioner, 48 T.C. 502, 512 (1967); Estate of Smith v. Commissioner, 57 T.C. 650, 655 (1972), *aff'd* 510 F.2d 479 (2d Cir.), *cert. denied sub. nom.*, 423 U.S. 827 (1975).

220. *E.g.*, Powers v. Commissioner, 312 U.S. 259, 260 (1941); Morris v. Commissioner, 761 F.2d 1195, 1200 (6th Cir. 1985); Amerada Hess Corp. v. Commissioner, 517 F.2d 75, 82 (3d Cir.), *cert. denied*, 423 U.S. 1037 (1975); Maytag v. Commissioner, 187 F.2d 962, 964 (10th Cir. 1951).

221. Champion v. Commissioner, 303 F.2d 887, 893 (5th Cir. 1962).

222. *Maytag*, 187 F.2d at 964; *see also* Clinton Cotton Mills v. Commissioner, 78 F.2d 292, 295 (4th Cir. 1935).

223. *E.g.*, Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699, 2707 (1992); *Estate of Smith*, 57 T.C. at 660.

224. Sandra S. Kramer, *Blockage: Valuation of Large Blocks of Publicly Traded Stocks for Tax Purposes*, 57 ACCT. REV. 70, 76 (1982) ("Because failure to consider relevant data is a reversible error in the court system under examination, judges are strongly encouraged to record their consideration of all relevant data in their written opinion to lessen the likelihood of reversal by a higher court.").

225. Akers v. Commissioner, 798 F.2d 894, 897 (6th Cir. 1986); *see also* Estate of Mueller v. Commissioner, 1992 T.C.M. (P-H) ¶ 92,284, at 1398, 1407 (1992); Estate of Gilford v. Commissioner, 88 T.C. 38, 50 (1987).

D. *Role of Expert Appraisers*[226]

Determining fair market value often requires an expert's appraisal. Early Treasury Regulations required that expert appraisals support the value of certain property,[227] and cautioned taxpayers to select carefully appraisers of recognized competence.[228] Current regulations mandate appraisals, under oath, for articles of artistic value having a value in excess of $3,000.[229] These regulations direct that if "expert appraisers are employed, care shall be taken to see that they are reputable and of recognized competency to appraise the particular class of property involved."[230] Executors are required to submit statements, under penalties of perjury, as to the qualifications and disinterested character of the expert appraisers employed.[231]

If a valuation dispute with the IRS is not settled, expert appraisers will usually testify in the ensuing litigation. Over the years courts have articulated numerous maxims regarding expert opinion evidence. Such testimony is admissible if it will assist the trier of fact in understanding the evidence that will determine a fact in issue.[232] Courts, however, are not bound by expert testimony and can accept or reject it as they determine appropriate.[233] Expert testimony is to be weighed in light of the expert's qualifications as well as all the other credible evidence in the record.[234] Courts can accept the opinion of one expert in its entirety to the exclusion of others.[235] Testimony which is so exaggerated as to not be credible may be rejected.[236] These maxims are consistent with the trier of fact's role in determining value.

Because expert opinion is central to the determination of the value of much property, what is the proper role of appraisers in the process? Is

226. *See* Nina J. Crimm, *A Role for "Expert Arbitrators" in Resolving Valuation Issues Before the United States Tax Court: A Remedy to Plaguing Problems*, 26 IND. L. REV. 41 (1992).

227. Treas. Reg. 37, Arts. 17, 18, T.D. 2910, 21 Treas. Dec. Int. Rev. 752, 765 (1919) (value of jewelry or silverware of more than ordinary value and of articles having marked artistic value, such as paintings, engravings, statuary, vases, oriental rugs, or antiques, was to be supported by expert appraisals).

228. Treas. Reg. 37, Art. 19, T.D. 2910, 21 Treas. Dec. Int. Rev. 752, 765-66 (1919).

229. Treas. Reg. § 20.2031-6(b) (1958).

230. Treas. Reg. § 20.2031-6(d) (1958); *see* AVERILL, *supra* note 148, § 2.3, at 40 (suggesting that the expert's experience, the amount and quality of his appraisal study or training, the relationship between the expert's experience and training and the property to be appraised, and the appraiser's commitment to the art of appraising should be considered in selecting an appraiser).

231. Treas. Reg. § 20.2031-6(b) (1958).

232. *E.g.*, Adair v. Commissioner, 54 T.C.M. (CCH) 705, 707 (1987); Estate of Gallo v. Commissioner, 50 T.C.M. (CCH) 470, 480 (1985).

233. *E.g.*, Helvering v. Nat'l Grocery Co., 304 U.S. 282, 295 (1938); Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976); Sundstrand Corp. v. Commissioner, 96 T.C. 226, 359 (1991).

234. Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957), *cert. denied*, 356 U.S. 950 (1958); *Sundstrand*, 96 T.C. at 359; Chiu v. Commissioner, 84 T.C. 722, 734 (1985).

235. *E.g.*, *Sundstrand*, 96 T.C. at 359; Buffalo Tool & Die Mfg. v. Commissioner, 74 T.C. 441, 452 (1980).

236. *Chiu*, 84 T.C. at 730; Dean v. Commissioner, 83 T.C. 56, 75 (1984).

their role consistent with the expectations of the parties that retain them?[237] Are appraisers advocates?

The Tax Court considered the role of appraisers at length in *Estate of Halas v. Commissioner.*[238] The court rejected the assertion that professional appraisers serve a role analogous to that of attorneys.[239] Attorneys owe their clients undivided loyalty and are to persuade a judge and jury to uphold their client's position.[240] Appraisers, in contrast, are not advocates and play a much different role.[241] The court noted that advocacy is strictly forbidden by the Code of Ethics of the American Society of Appraisers.[242] The Code bars appraisers from presenting facts in a manner calculated to favor their clients' positions.[243] The appraised value is to be "objective and unrelated to the desires, wishes, or needs of the client who engages the appraiser to perform the work."[244]

The court held that appraisers have a duty to the Court that exceeds their duty to their client. They are not to:

> suppress any facts, data, or opinions which are adverse to the case his client is trying to establish; or to over-emphasize any facts, data, or opinions which are favorable to his client's case. . . . It is the appraiser's obligation to present the data, analysis, and value without bias, regardless of the effect of such unbiased presentation on his client's case.[245]

The Tax Court concluded that the testimony of an expert, under the Code of Ethics, should be essentially the same regardless of which party retained him.[246]

Courts have recognized that not all appraisers act as impartially as suggested in *Estate of Halas.* If appraisers serve as advocates, they lose credibility and their testimony may be rejected.[247] Such experts may be viewed only as hired guns[248] and their advocacy may preclude them from assisting the court in determining value.[249]

E. *Valuation Restraints*

Transfer tax valuation disputes often resemble "horse-trading" or "car-haggling" in which the value reported on the tax return may be seen as the opening bid.[250] Valuations that are challenged by the IRS may,

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237. *See* Crimm, *supra* note 226, at 44 ("Partisan expert witnesses are hired to contribute the best observations, reasoning, and opinions to support the hiring party's position. Stated in the extreme, an expert witness can become a party's 'hired champion' or 'hired gun'.").
238. 94 T.C. 570 (1990).
239. *Id.* at 576-77.
240. *Id.* at 577.
241. *Id.*
242. *Id.*
243. *Id.* at 578.
244. *Id.*
245. *Id.* (citation omitted).
246. *Id.*
247. *E.g., id.* at 577-78; Chiu v. Commissioner, 84 T.C. 722, 734 (1985).
248. Jacobson v. Commissioner, 1989 T.C.M. (P-H) ¶ 89,606, at 3061, 3065 (1989).
249. *Id.*; *Estate of Halas,* 94 T.C. at 577 n.3 (1990).
250. Chelcie C. Bosland, *Tax Valuation By Compromise,* 19 TAX L. REV. 77, 78 (1963).

through negotiations, result in a compromise settlement.[251] But if the parties are unable to agree on value, the matter is settled in the courts where a compromise valuation may result.[252] What restrains taxpayers[253] from taking extreme valuation positions?

1. Tax Court Risk

In *Buffalo Tool & Die Manufacturing v. Commissioner*,[254] the Tax Court, as it has done frequently,[255] expressed frustration at having to determine valuation issues better resolved by the parties.[256] The court, "recognizing the possibility that a judicial tendency to find a middle ground in concluding valuation controversies tended to encourage the Service and taxpayers to advocate overzealous positions,"[257] suggested it might find one party's evidence more convincing and not reach a compromise valuation anticipated by the parties:

> [E]ach of the parties should keep in mind that, in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach.[258]

The court announced it would continue to determine value when required to do so, but was seeking to administer its responsibilities more efficiently.[259]

The Tax Court has frequently cited *Buffalo Tool* in deciding valuation cases.[260] In one case, finding one party's evidence more convincing than

251. *See id.* at 78.

252. *See* Bosland, *supra* note 250 (reviewing the question of whether courts determine value by compromise at amounts between the claims of the parties).

253. Appraisers may be restrained from overvaluing or undervaluing property by penalties that may be imposed for aiding or abetting the understatement of a tax liability. I.R.C. § 6701; *see also* LERNER & BRESLER, *supra* note 4, at 557:

> An appraiser may be subject to a $1,000 penalty under section 6701 if he or she aids or assists in the preparation or presentation of an appraisal in connection with the tax laws if the appraiser (1) knew that the appraisal would be used in connection with the tax laws and (2) knew that it would result in an understatement of the tax liability of another person.

Id. (footnote omitted).

254. 74 T.C. 441 (1980).

255. *E.g.*, Estate of Gilford v. Commissioner, 88 T.C. 38, 62 (1987); Adair v. Commissioner, 54 T.C.M. (CCH) 705, 707 (1987); Messing v. Commissioner, 48 T.C. 502, 512 (1967).

256. *Buffalo Tool*, 74 T.C. at 452 ("We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement which will reflect a compromise Solomon-like adjustment, thereby saving the expenditure of time, effort, and money by the parties and the Court—a process not likely to produce a better result.").

257. Wallace, *supra* note 43, at 8-39.

258. *Buffalo Tool*, 74 T.C. at 452.

259. *Id.*

260. *E.g.*, Chiu v. Commissioner, 84 T.C. 722, 734 (1985); Estate of Watts v. Commissioner, 51 T.C.M. (CCH) 60, 63 (1985); Sirloin Stockade, Inc. v. Commissioner, 40 T.C.M. (CCH) 928, 934 (1980).

the other's, the court asserted that the wisdom of *Buffalo Tool* had been demonstrated.[261]

In *Estate of Kaplin v. Commissioner*,[262] a taxpayer argued that the Tax Court (which had adopted the government's valuation) had applied *Buffalo Tool* and sanctioned it for not settling the case.[263] The Sixth Circuit held that the Tax Court cannot sanction taxpayers for seeking a judicial determination of their cases, but found no evidence that a sanction had been imposed.[264] The Tax Court itself has cautioned against too broad a reading of *Buffalo Tool*, suggesting that *Buffalo Tool* simply indicated that one reason for rejecting an expert's testimony is that another's is more persuasive.[265]

How have taxpayers fared in valuation cases decided by the Tax Court after *Buffalo Tool*? *Buffalo Tool* inspired an empirical study of the use of partisan expert witnesses in Tax Court valuation cases decided from 1985 through 1990.[266] The study revealed the Tax Court's determination of value coincided with the opinion of a single expert witness in 34.8% of the cases studied.[267] The court's valuation was consistent with the opinion of the IRS expert in 67.2% of those cases.[268] The study also revealed that in the remaining cases "most of the valuation amounts finally determined by the judge were closer to the figure suggested by the IRS's expert witness than by the taxpayer's expert."[269] The statistics led to the conclusion that the financial defeat suggested in *Buffalo Tool* more often than not was suffered by the taxpayer.[270] Another commentator, however, suggested that the Tax Court has referred to *Buffalo Tool* far more often to the delight of the taxpayer than to the advantage of the Service.[271]

If the Tax Court rejects evidence presented by both the taxpayer and the Service, it may "leave the Court with no factual basis for determining the fair market value, resulting in a determination based solely upon burden of proof."[272] Because the burden of proof is upon the taxpayer, this will result in a determination of value in favor of the Service.

2. Undervaluation Penalties

I.R.C. § 6662 provides for the imposition of accuracy-related penalties. A penalty may be imposed where a substantial understatement of value results in the underpayment of estate or gift tax.[273] No penalty is

261. Strutz v. Commissioner, 40 T.C.M. (CCH) 757, 762 (1980).
262. 748 F.2d 1109 (6th Cir. 1984).
263. *Id.* at 1111-12.
264. *Id.* at 1112.
265. Estate of Gallo v. Commissioner, 50 T.C.M. (CCH) 470, 480-81 (1985).
266. Crimm, *supra* note 226, at 46.
267. *Id.* at 50.
268. *Id.* at 51.
269. *Id.* at 52 (footnote omitted).
270. *Id.* at 54.
271. Wallace, *supra* note 43, at 8-40.
272. Skripak v. Commissioner, 84 T.C. 285, 326 (1985); *see* Anselmo v. Commissioner, 80 T.C. 872, 885-86 (1983).
273. I.R.C. § 6662(a), (b)(5), (g) (1986).

imposed, however, unless the undervaluation resulted in the underpayment of more than $5,000 of tax.[274]

If the tax underpayment attributable to the undervaluation exceeds $5,000, the amount of the possible penalty depends on the amount of the undervaluation.[275] If the value reported on the tax return is fifty percent or less of the amount finally determined, a penalty equal to twenty percent of the tax understatement attributable to the undervaluation is imposed.[276] If the value reported on the tax return is twenty-five percent or less of the amount finally determined, a penalty equal to forty percent of the tax underpayment attributable to the undervaluation is imposed.[277] No penalty is to be imposed, however, if it is shown that a reasonable cause existed for the undervaluation and the taxpayer acted in good faith.[278] These possible penalties "are stiff and should act as a sobering restraint on both overenthusiastic taxpayers and return preparers."[279]

II. Blockage

The idea that value established by reference to market prices on a unit basis should be adjusted because of the size of a block of items reflects the realities of the marketplace and the dynamics of supply and demand.[280] In order to attract buyers when supply increases, price declines so that trades occur at a lower per item price.[281]

A. *Recognition of Blockage*

Estate tax regulations issued in 1919 provided that the value of listed stocks generally was to be determined by the mean between the highest and lowest sale prices on the date of death.[282] The regulations precluded consideration of the number of shares owned by a decedent by providing

274. I.R.C. § 6662(g)(2) (1986).

275. *See* I.R.C. § 6662(h) (1986).

276. I.R.C. § 6662(a), (g) (1986).

277. I.R.C. § 6662(g)(2)(C) (1986).

278. I.R.C. § 6664(c)(1) (1986). This represents a departure from prior law which authorized the Service to waive the undervaluation penalties if there was a reasonable basis for the valuation claimed on the return and the claim was made in good faith. *See* I.R.C. § 6660(e) (1986) (repealed for returns the original due date for which is after Dec. 31, 1989 by Pub. L. No. 101-239, § 7721(c)(2) (1989)); Wallace, *supra* note 43, at 8-44 to 8-45 ("Now, accuracy-related penalties simply do not apply in the case of returns due after 1989 if there was a 'reasonable cause' for the underpayment and the taxpayer 'acted in good faith.' Thus, the question of avoiding the undervaluation and overvaluation penalties in the Code is no longer completely a matter of administrative grace.").

279. Wallace, *supra* note 43, at 8-45. These penalties do not serve to restrain the IRS from overzealous positions because they do not apply to the Service. *Id.* at 8-46.

280. *See* Ralph E. Badger, *Blockage as a Valuation Problem*, 20 Inst. on Fed. Tax'n 587 (1962); Freeman & Vinciguerra, *supra* note 12; C.W. Hughes, *"Blockage" in Valuation of Assets for Federal Tax Purposes*, 25 Fordham L. Review 702 (1956-57); Kramer, *supra* note 224; Judith F. Todd & Roy F. King, *Valuation of Publicly Traded Securities: Blockage and Related Matters*, 248-2nd Tax Mgmt. (BNA) (1990); Vernon & Molloy, *supra* note 117; Thomas W. Wiley, *Valuing Large Holdings of Publicly Traded Stock: The "Blockage" Problem*, 8 Inst. on Est. Plan. 8-1 (1974); Donald S. Chisum, Note, *A Reconstruction of Taxation's Blockage Doctrine*, 20 Stan. L. Rev. 336 (1967-68); James M. Barrett, Jr., *Valuation of Stocks by the Blockage Rule*, 29 Taxes 465 (1951).

281. Kramer, *supra* note 92, at 631.

282. Treas. Reg. 37, Art. 15(2), T.D. 2910, 21 Treas. Dec. Int. Rev. 752, 762 (1919).

that "such sale price obtains irrespective of the number of shares held by the estate."[283]

The Treasury reversed itself three years later.[284] Regulations promulgated in 1922 provided that a decedent's shares should be valued using the willing buyer — willing seller construct in cases where the shares were large in relation to the number of shares traded within a reasonable period.[285] This exception to the usual valuation rule recognized that market prices for small lots of stock might not accurately reflect the value of shares in a large block. The regulations also permitted estates, under certain circumstances, to use actual sale prices where market sales were "seriously disproportionate in number of shares sold to the holdings of the decedent."[286]

Two years later, however, the Treasury commenced a retreat from its early recognition of blockage. Provisions authorizing consideration of the size of a donor's gift were not included in the first gift tax regulations.[287] The regulations did not, however, preclude consideration of blockage in determining value. Donors who believed the value determined under the usual method did not reflect fair market value could introduce evidence to the contrary.[288] If market prices did not provide a proper valuation, all relevant factors were to be considered.[289]

In 1934, the Treasury attempted to close the door on blockage. Regulations issued in that year expressly precluded consideration of the size of the block by providing that fair market value was not to be determined by:

> [A]n estimate of what a whole block or aggregate would fetch if placed upon the market at one and the same time. Such value is to be determined by ascertaining as a basis the fair market value at the time of the decedent's death of each unit of the property. For example, in the case of shares of stock or bonds, such unit of property is a share or a bond.[290]

While the regulation purported to permit consideration of all relevant facts in every case,[291] it provided that the size of a holding was not a relevant factor and was not to be considered in the determination of value.[292]

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283. *Id.*

284. *See* Treas. Reg. 63, Art. 14(2) paras. 4, 6, T.D. 3384, 24 Treas. Dec. Int. Rev. 1036, 1048 (1922). Blockage discounts of from five to twenty percent apparently were allowed by the Service in the 1920s. C. LOWELL HARRISS, GIFT TAXATION IN THE UNITED STATES 80 (1940).

285. Treas. Reg. 63, Art. 14(2), T.D. 3384, 24 Treas. Dec. Int. Rev. 1036, 1048 (1922).

286. *Id.*

287. *See* Treas. Reg. 67, Art. 7(3), T.D. 3648, 26 Treas. Dec. Int. Rev. 1162, 1166-67 (1924).

288. *See* Treas. Reg. 67, Art. 7(3) para. 4, T.D. 3648, 26 Treas. Dec. Int. Rev. 1162, 1167 (1924).

289. *Id.*

290. Treas. Reg. 80, Art. 13(1) (1934 ed.), *reprinted in* 139 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 (Bernard D. Reams, Jr. ed., 1979).

291. *Id.*

292. Treas. Reg. 80, Art. 13(3) para. 7 (1934 ed.), *reprinted in* 139 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 (Bernard D. Reams, Jr. ed., 1979). Gift tax regulations adopted in 1936 contained similar provisions precluding consideration of the size of the block. *See* Treas. Reg. 79, Art. 19(1), (3) para. 6 (1936 ed.), *reprinted in* 139 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 (Bernard D. Reams, Jr. ed., 1979).

Several trial court decisions in the 1930's valued blocks of stock on the basis of market prices in a manner consistent with the regulations.[293] These valuations were upheld on appeal on the basis that the trial courts' determinations were supported by substantial evidence.[294] In 1937, however, the trend turned as several trial courts considered the size of the holding a relevant factor in determining value.[295]

In *Safe Deposit & Trust Co. v. Commissioner*,[296] the Board of Tax Appeals refused to be bound by the estate tax regulation and considered the size of a block of shares in determining value.[297] The Board concluded that the evidence demonstrated that the valuation method set forth in the regulations (mean price) was not consistent with reality regarding a taxpayer's large block of stock.[298] The Board pointed out that its decision was not the result of application of a "blockage" rule under which large blocks of shares are always to be valued without regard to the value of shares in a smaller block.[299] Blockage, it held, is not a "law of economics, a principle of law, or a rule of evidence."[300] Whether the size of the block would influence value was a matter to be decided on the facts of each case.[301]

The Fourth Circuit affirmed.[302] The court refused to enforce the estate tax regulation because it did not permit consideration of a relevant factor (size of the block) in the determination of value:

> The essential basis for the determination to be made in the instant case is the fair market value of the property at the time of the decedent's death. But the regulation makes such a determination impossible because it declares that the size of the holding is not a relevant factor and should not be considered in the determination of value . . . .[303]

The Board's consideration of the size of the block did not result in valuation at forced sale prices because the size of the block was only one of several relevant factors considered.[304] The court agreed that the Board "could not ignore the pregnant fact, having found it to exist, that a large block of stock cannot be marketed and turned into money as readily as a few shares."[305]

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293. *See* Roth v. Wardell, 15 A.F.T.R. (P-H) 995, 996 (N.D. Cal. 1934), *aff'd*, 77 F.2d 124 (9th Cir. 1935); Richardson v. Commissioner, 31 B.T.A. 245, 248 (1934), *aff'd in part and rev'd in part*, 80 F.2d 548 (D.C. Cir. 1935).

294. *See* Richardson v. Helvering, 80 F.2d 548, 552 (D.C. Cir. 1935); Roth v. Wardell, 77 F.2d 124, 125 (9th Cir. 1935).

295. *See* Safe Deposit & Trust Co. v. Helvering, 35 B.T.A. 259 (1937), *aff'd*, 95 F.2d 806 (4th Cir. 1938); Shattuck v. Commissioner, 1937 B.T.A.M. (P-H) 133, 135 (1937); Jenkins v. Smith, 21 F. Supp. 251 (D. Conn. 1937).

296. 35 B.T.A. 259 (1937), *aff'd*, 95 F.2d 806 (4th Cir. 1938).

297. *Id.* at 263-64.

298. *Id.* at 262-63.

299. *Id.* at 263.

300. *Id.*

301. *Id.*

302. Helvering v. Safe Deposit & Trust Co., 95 F.2d 806 (4th Cir. 1938).

303. *Id.* at 811.

304. *Id.* at 812.

305. *Id.*

Three months after having decided *Safe Deposit & Trust Co.*, the Board, in a consolidated case, similarly rejected the gift tax regulation.[306] The Fourth and Seventh Circuits affirmed on appeal.[307] The Fourth Circuit affirmed on the basis of its decision in *Safe Deposit & Trust Co.*[308] The Seventh Circuit affirmed on the basis that the gift tax imposed a tax measured by the value of property and no regulation can preclude consideration of a factor which is relevant to the determination of value.[309]

In 1939, the Treasury eliminated the language prohibiting consideration of the size of the block from the regulations,[310] "[e]vidently concluding that regulations which courts refuse to honor are the equivalent of no regulations at all."[311] The amended regulations, however, continued to provide that value was to be determined on the basis of the fair market value of each unit of property.[312]

Additional circuits soon recognized blockage as a relevant factor in the determination of value.[313] By 1942, "[a]s well as any controverted question of administrative law may be settled without declaration by the Supreme Court, it is established that the size of a block of listed stock may be a factor to be considered in its valuation for gift and estate tax purposes."[314]

The IRS, nonetheless, did not concede that the size of the holding should be considered in determining value. At times it tried to avoid consideration of blockage by arguing that the concept of fair market value assumed an increase in demand equal to the available supply.[315] In a few cases in which blockage adjustments were denied, one of the reasons given for denial was that the definition of fair market value assumed the existence of a willing buyer.[316] But if a buyer willing to purchase any and all shares offered at the price established in the market for smaller lots is assumed to exist, a blockage discount could never be justified.[317] The assumed buyer would provide the demand needed to absorb the additional supply.[318]

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306. Shattuck v. Commissioner, 1937 B.T.A.M. (P-H) 133, 135 (1937).

307. Helvering v. Kimberly, 97 F.2d 433 (4th Cir. 1938) (per curiam); Commissioner v. Shattuck, 97 F.2d 790 (7th Cir. 1938).

308. *Kimberly*, 97 F.2d at 434.

309. *Shattuck*, 97 F.2d at 792.

310. T.D. 4901, 35 Treas. Dec. Int. Rev. 74 (1939); T.D. 4902, 35 Treas. Dec. Int. Rev. 76 (1939).

311. Rushton v. Commissioner, 498 F.2d 88, 91 (5th Cir. 1974).

312. Treas. Reg. 79, Art. 19(1), T.D. 4901, 35 Treas. Dec. Int. Rev. 74 (1939); Treas. Reg. 80, Art. 10(a), T.D. 4902, 35 Treas. Dec. Int. Rev. 76 (1939).

313. *See, e.g.*, Bull v. Smith, 119 F.2d 490, 492 (2d Cir. 1941); Page v. Howell, 116 F.2d 158, 159 (5th Cir. 1940).

314. Helvering v. Maytag, 125 F.2d 55, 63 (8th Cir.), *cert. denied*, 316 U.S. 689 (1942).

315. *See* Maytag v. Commissioner, 1940 B.T.A.M. (P-H) 249, 258 (1940).

316. Estate of McKitterick v. Commissioner, 42 B.T.A. 130, 137 (1940); Newberry v. Commissioner, 39 B.T.A. 1123, 1132 (1939); Gordon, *supra* note 72, at 55 & n.80 (1952).

317. Gordon, *supra* note 72, at 55; *see* Maytag v. Commissioner, 1940 B.T.A.M. (P-H) 249, 258 (1940).

318. *See* Vernon & Molloy, *supra* note 117, at 145 ("If the presence of a buyer for such block, as willing to purchase as the seller is to dispose of it, were assumed, then the number of shares being valued could logically possess no relevance whatever.").

In 1946, the Second Circuit in *Richardson v. Commissioner*[319] rejected opinions of value based upon an assumed increase in demand as not relevant to the determination of value.[320] The court held that the issue to be decided was the existence of demand for the stock and that it contributed nothing "to assume the fact which is the main point at issue."[321] The established role of the assumed willing buyer is to preclude a finding of no value, rather than to determine the amount of that value.[322]

In 1958, the Treasury conceded defeat and promulgated new regulations explicitly recognizing the possibility of a blockage discount:[323]

> In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations.[324]

This regulation remains unchanged to this date.[325]

B. *Identification of the Block*

The property that constitutes a block must be identified before it can be determined whether the block is sufficiently large to be relevant in determining value. In many cases identification presents no difficulty because the block encompasses either the property owned by a decedent at death devised to one individual or the property gifted *en bloc* to a single donee. Identifying the block in other cases presents more difficulties.

1. Estate Tax

Should identification of the block depend on the reason property is included in a decedent's gross estate or the number of beneficiaries of the property?

An example will illustrate the issues that exist in identification of the relevant block. Assume that a blockage discount would not be justified unless the block to be valued consisted of 52,000 shares of X Company

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319. 151 F.2d 102 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946).
320. *Id.* at 104.
321. *Id.*
322. Gordon, *supra* note 72, at 56.
323. Rushton v. Commissioner, 498 F.2d 88, 91 (5th Cir. 1974).
324. Treas. Reg. § 20.2031-2(e) (as amended by T.D. 6296, 1958-2 C.B. 432, 480); *see also* Treas. Reg. § 25.2512-2(e) (as amended by T.D. 6334, 1958-2 C.B. 627, 652) (making comparable changes in the gift tax regulation and providing that the relevant block was to be determined on the basis of "each separate gift"). Both regulations also provided that, if a block of stock represented a controlling interest, the price at which other lots traded might not accurately reflect the fair market value of the controlling interest.
325. *See* Treas. Reg. § 20.2031-2(e) (as amended in 1992); Treas. Reg. § 25.2512-2(e) (as amended in 1976).

stock. Decedent died owning 10,000 shares individually, possessed a general power of appointment over 20,000 shares held in Irrevocable Trust, and was the beneficiary of a qualified terminable interest property trust (QTIP Trust) that owned 30,000 shares. The value of all 60,000 shares is included in decedent's gross estate for estate tax purposes under various Code sections.[326] Assume, further, that decedent's 10,000 shares are devised to A, the 20,000 shares in Irrevocable Trust are appointed to B, and the 30,000 shares in the QTIP Trust will be distributed to C. Is decedent's estate entitled to consider blockage as a factor in the valuation of the 60,000 shares? Or will the three blocks of stock be considered separate blocks and valued independently?

The rule for estate tax purposes is that the block includes all shares required to be included in the decedent's gross estate.[327] All property included in the gross estate is to be aggregated for purposes of valuation regardless of the reason for inclusion and regardless of the number of beneficiaries. This rule results from the nature of the estate tax as a tax upon a single taxable event (transfer at death) and from determination of value under the hypothetical sale posited by fair market value. This rule also is necessary to preclude tax avoidance that would be possible if property in the gross estate was not aggregated for valuation.

The estate tax aggregation rule applies regardless of the reason property is included in the gross estate. Section 2001 imposes an estate tax "on the transfer of the taxable estate" of decedents. The estate tax is a single-taxable-event tax imposed upon the transfer of property at death. The taxable estate is defined in § 2051 as the gross estate reduced by deductions allowed under the Code. Section 2031 provides that the value of the gross estate is determined by including the value of all the property at the time of decedent's death, on occurrence of the taxable event.

The determination of fair market value under § 2031 requires the aggregation of property included in a decedent's estate for valuation purposes.[328] Fair market value hypothesizes a sale of the property included in the gross estate on the valuation date to a willing buyer possessing reasonable knowledge of relevant facts. One of the relevant facts is that all property included in a decedent's gross estate, regardless of the reason for inclusion, is in the market for sale. In the example, a willing buyer would know that 60,000 shares were being offered for sale.

326. *See* I.R.C. §§ 2033, 2041, and 2044 (1986).

327. Kramer, *supra* note 92, at 631 (noting that the relevant block consisted of the total number of shares transferred in every estate tax case the author found).

328. *Cf.* Estate of Curry v. United States, 706 F.2d 1424 (7th Cir. 1983). In *Curry*, the decedent owned a sufficient number of shares of voting common stock to possess control. *Id.* at 1427. Decedent also owned shares of non-voting common stock. *Id.* at 1425. The estate contended that the two blocks of stock should be valued separately. *Id.* The Seventh Circuit held that "both the law and common sense compel the conclusion that the fair market value of the non-voting stock in the hands of an estate with sufficient shares of voting stock to ensure the estate's control cannot be less than the value of the estate's voting stock." *Id.* at 1427. Aggregation of the interests formed "the only basis for valuation which rationally comports with the purpose of the tax at issue." *Id.* at 1428.

Revenue Ruling 79-7[329] supports the estate tax aggregation rule. The IRS held in that ruling that stock included in a decedent's gross estate under § 2035 (property transferred in contemplation of death) should be combined with shares included under § 2033 (property owned at death) to determine whether the stock should be valued as two minority blocks or as one controlling block.[330] The Service ruled that stock included under § 2035 should be taxed as if the decedent had retained it until death.[331] The two blocks, consequently, were treated as one for valuation purposes.[332]

Four years after issuing Revenue Ruling 79-7, the Service ruled that stock includible in a decedent's gross estate under § 2041 (general power of appointment property) should be aggregated with stock included under § 2033 for purposes of determining the extent (minority or control) of a decedent's interest.[333] Similarly, in 1991, the Service ruled that an undivided interest in real property included in a decedent's estate under § 2044 (Qualified Terminable Interest Property) should be aggregated with an undivided interest included under § 2033 for valuation purposes.[334]

The estate tax aggregation rule also applies regardless of the number of beneficiaries of property included in the decedent's gross estate.[335] The estate tax "is a tax imposed upon the transfer of the entire taxable estate and not upon any particular legacy, devise, or distributive share."[336] The Ninth Circuit has held that nothing in the Code or case law suggests that valuation of the gross estate should take into account the fact "that

329. Rev. Rul. 79-7, 1979-1 C.B. 294.

330. *Id.* at 295.

331. *Id.*

332. *Id.*

333. Tech. Adv. Mem. 83-30-004 (Mar. 16, 1983).

334. Tech. Adv. Mem. 91-40-002 (June 18, 1991) ("Because the Decedent is treated as owning outright the real property in the QTIP trust and because he actually owned the other undivided interests in the real property outright, the undivided interests in the real property are aggregated for valuation purposes."); *but see* Kenneth T. Eichel and Ellen J. Abrams, *Family Ownership May Jeopardize Minority Discounts on Closely Held Stock*, 60 TAXES 378 (1982). The authors suggest that whether stock included in a decedent's gross estate under different code sections should be valued as a block might depend on the degree of control the decedent possessed over the stock and the code section that required inclusion. *Id.* at 387-88. They suggest that "under Section 2044, the decedent would not 'own' the stock at the moment of his death for purposes of disposing of it as part of a control block." Determination of whether property included under different code sections is to be aggregated on the basis of a decedent's control, however, would be inconsistent with the nature of the estate tax and the notion of fair market value. It would also permit taxpayers to arrange ownership in several forms to reduce estate taxes; control premiums could be eliminated and minority discounts could be obtained.

335. *See* Watts, *supra* note 33, at 71.

336. Treas. Reg. § 20.0-2 (as amended in 1992).

the assets will come to rest in several hands rather than one."[337] It noted that a contrary rule would open the door to tax avoidance.[338]

A no-aggregation rule would be inconsistent with the nature of the estate tax as a tax on the transfer of property at death and determination of value by reference to a hypothetical sale. It would also open the door to tax avoidance through planning. An owner of a control block of stock could eliminate the control premium and position his estate to secure minority discounts in two ways. First, he could arrange ownership in a manner permitting him to retain its benefit during life, while including it in his gross estate under different Code sections at death. Second, he could dispose of the stock to multiple beneficiaries. The estate tax aggregation rule closes both these avenues.

a. *Effect of Alternate Valuation Election*

Section 2032 permits executors to elect to value all property in a decedent's gross estate in accordance with the rules set forth in that section rather than at their date of death value under § 2031.[339] Congress enacted alternate valuation in 1935.[340] The legislation was intended to provide relief for estates whose assets had declined in value shortly after death.[341] The election may only be made if it decreases both the value of the gross estate and taxes otherwise payable.[342]

Under the alternate valuation rules, property that is "distributed, sold, exchanged or otherwise disposed of," within six months of decedent's death is valued as of the date of such disposition under § 2032(a)(1).[343] All other property is valued as of the date six months after decedent's death under § 2032(a)(2).[344]

Extension of the earlier example will demonstrate the issues that may arise when alternate valuation is elected. Assume that the decedent died owning 60,000 shares of X Company stock on January 1st and that a blockage discount would not be warranted unless the block consisted of 52,000 shares. If an alternate valuation election is not made, blockage will be considered in the valuation of decedent's stock. Will an alternate valuation election change that result?

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337. Ahmanson Found. v. United States, 674 F.2d 761, 768 (9th Cir. 1981); *see also* Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1582 (1987) ("Since the [estate] tax is laid upon the decedent's estate as a whole, and not upon the property which is received by the various legatees, the valuation of decedent's assets, *at least for purposes of computing his gross taxable estate under section 2031*, can usually be made without reference to the destination of those assets.").

338. *Ahmanson Found.*, 674 F.2d at 768; *accord* Estate of Curry v. United States, 706 F.2d 1424, 1428 (7th Cir. 1983).

339. I.R.C. § 2032 (1986).

340. Revenue Act of 1935, Pub. L. No. 407, § 202, 49 Stat. 1014, 1022-23.

341. S. Rep. Nos. 1240, 1240 Part 2, 74th Cong., 1st Sess. (1935), *reprinted in* 101 INTERNAL REVENUE LAWS OF THE UNITED STATES 1909-1950 (Bernard D. Reams, Jr. ed., 1979).

342. I.R.C. § 2032(c) (1986).

343. I.R.C. § 2032(a)(1) (1986).

344. I.R.C. § 2032(a)(2) (1986).

The correct result (consideration of blockage) under alternate valuation is achieved in two situations. First, if the estate sells the entire block in a single transaction during the six-month period and elects alternate valuation, the value as of the date of sale will be the block's value for estate tax purposes.[345] Although § 2032(a)(1) does not provide that the sale price establishes value, an arms' length, bona fide sale for value should be accepted as the date of sale value.[346] Disputes over blockage, consequently, can be avoided if the entire block is sold during the alternate valuation period and the election is made.[347] The adverse effect of selling the block within the six-month period, if any, will be reflected in the sale price. Second, if the block is not disposed of for value, but entirely distributed on one day to a single beneficiary during the alternate valuation period, the entire block would be valued *en bloc* on the date of distribution.[348]

But disposition of only part of the block raises substantial problems in valuing the shares under blockage. What if the executor sells 30,000 shares at the end of the third month and has 30,000 shares on hand at the six month date? Is decedent's estate entitled to value either block as part of the original block? Or will the two blocks be valued independently? If valued separately, neither meets the 52,000 share blockage threshold.

Under *Estate of Van Horne v. Commissioner*,[349] the shares would be valued as two separate blocks and no blockage adjustment would be allowed. Ada Van Horne died owning 56,454 shares of Wm. Wrigley Jr. Co. stock.[350] The executors of her estate determined that it was necessary to sell a portion of the stock to generate cash to pay expenses and taxes.[351] They sold 42,416 shares during the alternate valuation period at a discount from market prices.[352] The estate owned 14,038 shares on the six month alternate valuation date.[353] It claimed a blockage discount in the valuation of the unsold shares,[354] asserting that the shares should be valued as part of the original, larger block.[355]

The Tax Court held that the value of the shares that had been sold was "fixed as of the date of sale" under § 2032(a)(1).[356] The opinion, however, does not reveal whether the value of those shares was the discounted price at which the shares had been sold or the mean market price. As to the unsold shares, the court declared that a "simple examina-

345. *See* I.R.C. § 2032(a)(1) (1986); Estate of Van Horne v. Commissioner, 720 F.2d 1114 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984); Estate of Sawade v. Commissioner, 49 T.C.M. (CCH) 214, 225 (1984).

346. *See supra* part I.B.

347. Todd & King, *supra* note 280, at A-17.

348. I.R.C. § 2032(a)(1) (1986).

349. 78 T.C. 728 (1982), *aff'd*, 720 F.2d 1114 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984).

350. *Id.* at 730.

351. *Id.*

352. *Id.* at 730-31.

353. *Id.* at 731.

354. *Id.*

355. *Id.* at 739.

356. *Id.*

tion" of § 2032(a) revealed the weakness of the estate's argument as to the identity of the relevant block.[357] The court held that § 2032(a)(2), by addressing property not disposed of during the alternate valuation period, "by definition applies only to property remaining in the estate at the alternate valuation date."[358] The relevant block for consideration of blockage, therefore, consisted of only the unsold shares.[359] When the court valued the unsold block independently, it held that the block was of insufficient size to warrant a blockage discount.[360] The Ninth Circuit affirmed on appeal.[361]

Consideration of whether *Van Horne* was correctly decided must begin with the language of the Code. Section 2032(a)(1) provides that property disposed of within six months after death shall be valued as of the date of disposition. Section 2032(a)(2) provides that property, not disposed of during the six months following death, is to be valued as of the alternate valuation date. These provisions merely establish the *time* at which to value the property. They do not provide how to value the property, nor indicate whether property that was part of a larger block at date of death should be valued as if it were still part of the larger block.

Section 2032 was enacted in 1935[362] at a time when Treasury Regulations precluded consideration of blockage.[363] The legislative history, not surprisingly, is silent on the question of whether sale of part of a block would cause the unsold property to be valued as a separate, smaller block.[364]

The rationale for enacting § 2032 provides insight into resolving this issue. Section 2032 was intended to provide tax relief to estates whose assets had declined in value.[365] This section should not result in the denial of an otherwise available blockage discount. Likewise, § 2032 should not result in changing the identity of the relevant block where the entire block is not sold during the alternate valuation period. Estates may, as did the estate in *Van Horne*,[366] need to sell part of a block during the alternate valuation period in order to raise cash to pay estate taxes, administration expenses, or debts. If *Van Horne* was correctly decided, executors who elect alternate valuation may lose a blockage discount when they sell only part of the block during the alternate valuation period.

Assuming that shares disposed of for value during the six-month period should be valued under § 2032(a)(1) at their sale price (date of sale value of a small lot), rather than at their hypothetical value as part of the

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357. *Id.* at 739-40.
358. *Id.* at 740.
359. *Id.*
360. *Id.* at 741-42.
361. Estate of Van Horne v. Commissioner, 720 F.2d 1114 (9th Cir. 1983).
362. Revenue Act of 1935, Pub. L. No. 407, § 202, 49 Stat. 1014, 1022-23.
363. *See supra* notes 290-92 and accompanying text.
364. *See* H.R. Rep. Nos. 1681, 1885, S. Rep. Nos. 1240, 1240 Part 2, 74th Cong., 1st Sess. (1935), *reprinted in*, 101 INTERNAL REVENUE LAWS OF THE UNITED STATES 1909-1950 (Bernard D. Reams, Jr. ed., 1979).
365. *Id.*
366. Estate of Van Horne v. Commissioner, 78 T.C. 728, 730 (1982).

larger block, how should unsold shares be valued? Valuing unsold shares as if they were still part of the larger block would be consistent with the economic reasons that justify consideration of blockage. In the example, it is assumed that a block of 60,000 shares is sufficiently large on date of death to warrant consideration of blockage. That determination will ordinarily mean that the block could not be disposed of during a period as short as six months (the alternate valuation period) without adversely affecting price.[367] If that is correct, how can the sale of part of the block eliminate the blockage effect as to the unsold shares?

If the estate in the example were to sell 51,999 of its 60,000 shares, the facts assume the sale would not adversely affect the per share price and that a market price would be received. The facts assume, however, that the market could not absorb the remaining 8,001 shares at market prices. *Van Horne*, nonetheless, would value the 8,001 shares as a separate block, isolated from the impact the earlier sales had on the market.[368] Such an approach ignores a fact (the earlier sale of a portion of the original block) relevant to the valuation of the unsold shares.

The unsold shares should be valued in a two-step process. First, the value of 60,000 shares (the original block) on the alternate valuation date should be determined. A blockage adjustment should be allowed if the estate establishes that the block was so large that it could not be liquidated within a reasonable time without depressing prices. Second, a pro rata portion of that value should be allocated to the 8,001 unsold shares.

Valuation under the suggested method would be consistent with the fact that the estate tax is a one-taxable-event tax. The estate tax is imposed on "the transfer" of the taxable estate.[369] Alternate valuation merely allows valuation of the assets at other than date of death values. It does not cause the estate tax to become a multiple-taxable-event tax; it should not change the character of property in the taxable estate. *Van Horne* taxes estates as if the decedent made two separate taxable transfers to be valued independently of each other. The decedent, however, should be taxed on the single taxable transfer that occurs at death—on the transfer of the original block. If the estate elects alternate valuation, the shares should be valued as part of the date of death block.

The language of § 2032, however, makes it difficult to reach the correct result. In order to value unsold shares under § 2032(a)(2) in the manner suggested, it would have to be read as if it provided "such property shall be valued as *a pro rata share of the value of the date of death block* as of the date 6 months after the decedent's death." If § 2032(a)(2) were read in that manner, it would seem to follow that § 2032(a)(1) should be read as if it provided "such property shall be valued as *a pro rata share of the value of the date of death block* as of the date of" disposition. Such a reading, however, seems contrary to the direction in § 2032(a)(1) to value property at date of sale values, presumably using bona fide sale prices.

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367. *See infra* part II.D.2.
368. *Van Horne*, 78 T.C. at 740.
369. I.R.C. § 2001 (1986).

Van Horne, consequently, was correctly decided under existing law. The effect that an alternate valuation election might have on valuation when blockage is relevant simply was not considered when § 2032 was enacted.

Current law, however, is inconsistent with the nature of the estate tax as a single-taxable-event tax. The character of a decedent's property should not change as a result of any action taken during the alternate valuation period. An estate that owns all of the stock of a closely held corporation should not be able to distribute the shares on different dates to different beneficiaries during the alternate valuation period and value the shares as minority interests. That, however, seems to be permitted under current law. An estate, similarly, should not lose the benefit of blockage as a result of actions taken during the alternate valuation period.

2. Gift Tax

In *Helvering v. Kimberly*,[370] the taxpayer made gifts of 10,000 shares of stock to each of his three children.[371] The Fourth Circuit affirmed the Board of Tax Appeals' consideration of blockage in valuing the shares by reference to the total gift of 30,000 shares.[372] The Board followed the Commissioner's approach in valuating the gifts as a unit.[373] On appeal, however, the Commissioner argued (apparently for the first time) that the gifts should be valued as three separate gifts of 10,000 shares, rather than as one gift of 30,000 shares.[374] The Fourth Circuit rejected the Commissioner's argument, stating:

> It is difficult to believe that the sale of three blocks of 10,000 shares each would have had a different effect from a sale of one block of 30,000 shares, and there is no reason to believe that the estimates of the experts would have been different if their attention had been specifically called to the point.[375]

The court recognized the impact a sale of all the shares would have had in the marketplace.

However, the Board of Tax Appeals and Tax Court in later cases refused to aggregate gifts and valued gifts to different donees as separate blocks.[376] Some appellate courts agreed that separate gifts were not to be aggregated,[377] while one court sidestepped the issue because it found identical outcomes under either approach.[378]

370. 97 F.2d 433 (4th Cir. 1938).
371. *Id.* at 434.
372. *Id.* at 434-35.
373. *Id.* at 435.
374. *Id.* at 434-35.
375. *Id.* at 435.
376. *E.g.*, Standish v. Commissioner, 8 T.C. 1204, 1209 (1947); Clause v. Commissioner, 5 T.C. 647, 650 (1945), *aff'd*, 154 F.2d 655 (3d Cir. 1946); Avery v. Commissioner, 3 T.C. 963, 971 (1944); Phipps v. Commissioner, 43 B.T.A. 1010, 1022 (1941).
377. *See, e.g*, Maytag v. Commissioner, 187 F.2d 962, 965 (10th Cir. 1951); Clause v. Commissioner, 154 F.2d 655 (3d Cir. 1946) (affirming decision without discussion).
378. Phipps v. Commissioner, 127 F.2d 214, 217 (10th Cir.), *cert. denied*, 317 U.S. 645 (1942).

In 1951, the Tenth Circuit rejected aggregation of gifts in identifying the block for gift tax purposes in *Maytag v. Commissioner.*[379] Separate valuation was necessary to determine a taxpayer's net gifts, allowance of the annual exclusion, and transferee liability under the Code.[380] But, while requiring separate valuation, the court found that the making of multiple gifts was a factor deserving consideration.[381] Separate valuation of gifts was required, but roundabout aggregation was permitted. The same value, obviously, can be determined by roundabout or by actual aggregation.[382]

In 1958, the Treasury, when it acknowledged that blockage could be a factor in determining value, provided that each gift was to be valued as a separate block:

> If the donor can show that the block of stock to be valued, *with reference to each separate gift*, is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations.[383]

The regulation was consistent with the case law. It did not, however, address the roundabout aggregation permitted by the Tenth Circuit in *Maytag*.

The Fifth Circuit considered the validity of the gift tax regulation in 1974. In *Rushton v. Commissioner*,[384] the court upheld the regulation as a "legitimate exercise of discretion under the statute."[385] It rejected the roundabout aggregation permitted by *Maytag* as "very strongly against the thrust of the regulation."[386] The court found blockage was triggered by the size of each particular gift without consideration of other gifts.[387] The regulation required each gift be valued separately in the actual market existing at the time of the gift, not a fictitious market flooded by other gifts.[388]

The reason *Rushton* was correctly decided and that the no aggregation of gifts regulation is a reasonable interpretation[389] of the Code is found in the nature of the gift tax as a multiple-taxable-event transfer tax, and from

379. 187 F.2d at 965.

380. *Id.*

381. *Id.*

382. *See* Vernon & Molloy, *supra* note 117, at 151.

383. Treas. Reg. § 25.2512-2(e) (as amended by T.D. 6334, 1958-2 C.B. 627, 652) (emphasis added).

384. 498 F.2d 88 (5th Cir. 1974).

385. *Id.* at 92. The court also held that the regulation must stand, even if a court concluded aggregation was a better rule, because it was reasonable and court review of regulations is limited. *Id.* at 94.

386. *Id.* at 92.

387. *Id.* at 92-93.

388. *Id.* at 93.

389. *Contra* Michael H. Simpson, Note, *Federal Gift Tax Regulation 25.2512-2(e)—The Use of the Blockage Principle*, 1974 WIS. L. REV. 612, 626 (1974) (suggesting that courts should not give effect to the Regulation because it excludes consideration of other gifts which are relevant to the determination of value).

determination of value under the hypothetical sale posited by fair market value upon the occurrence of each separate taxable event.

Section 2501 imposes a gift tax on "the transfer of property by gift." Each transfer constitutes a separate taxable event. If the gift is made in property, § 2512(a) provides the amount of the gift is the value of the property. The property transferred in each taxable event is to be valued independently.[390] Gifts are aggregated for purposes of determining allowance of the annual exclusion[391] and for purposes of determining taxable gifts,[392] but not for valuation.

Fair market value hypothesizes a sale of the property transferred in the taxable event to a willing buyer possessing reasonable knowledge of relevant facts. Are the other gifts made by the donor on the same day relevant? If all transfers during a day constituted a single taxable event, such gifts would be relevant. But under the multiple-taxable-event gift tax, such other gifts are irrelevant in determining the value of the property transferred in a single taxable event. Value is the price the property transferred *in the separate taxable event* would sell for in the hypothetical sale. Evidence of other gifts made by the donor is no more relevant than is evidence of gifts made by other donors[393] or of property included in estates of decedents who died on that date.[394] In determining value for purposes of the gift tax, only the property transferred in the taxable event is relevant.

3. Reconciliation of Estate and Gift Tax Rules

The estate tax is imposed on one taxable event (transfer of the taxable estate at death).[395] The gift tax is imposed on multiple taxable events (transfers of property by gift).[396] Valuation of the property transferred is to be made upon occurrence of the taxable event—the moment of transfer.[397] Value is the price at which the property transferred would have

390. Whittemore v. Fitzpatrick, 127 F. Supp. 710, 714 (D. Conn. 1954) (In discussing the predecessor of § 2512(a), the court held that the statute's "language plainly imports each gift made in property is to be valued separately. Not here or elsewhere does the [gift tax] statute provide or even suggest that, *for purposes of valuation*, gifts made to separate persons must be aggregated for purposes of valuation."). *See* Watts, *supra* note 33, at 71 (suggesting that reference to "the gift" in § 2512 does not support the conclusion that the value of property transferred on a single day is affected by the number of donees); *but see* Simpson, *supra* note 389, at 619 (contending that none of the pertinent sections of the gift tax statute requires that the value of each gift be derived in isolation from all other gifts).

391. *See* I.R.C. § 2503(b) (1986) (excluding the first $10,000 of gifts of present interests per donee per year).

392. I.R.C. § 2503(a) (1986).

393. *But see* Simpson, *supra* note 389, at 625 (noting that, if aggregation of gifts were permitted, an argument could be made that all gifts made by other donors should also be considered).

394. *See* Gordon, *supra* note 72, at 57 (recognizing that if aggregation of gifts were allowed "parties should be able to adduce evidence of all other gifts, deaths, and exchanges").

395. I.R.C. § 2001 (1986).

396. I.R.C. § 2501 (1986).

397. *See* Publicker v. Commissioner, 206 F.2d 250, 256 (3d Cir. 1953) ("Both the gift tax statute and the excise tax statute deal with taxable events . . . . One must look to the value of the property at the time of the happening of the taxable event and determine the amount of the tax, whether gift or estate."), *cert. denied*, 346 U.S. 924 (1954).

sold in fair market value's hypothetical sale at the moment of the taxable event.

Identification of the taxable event necessarily results in identification of the relevant block to be valued and plays a major role in deciding whether a minority or blockage discount will be allowed. It is the single (estate) versus multiple (gift) taxable-event nature of the taxes which justifies different valuation results in seemingly similar situations.[398]

A taxpayer who owns all 300 shares of a closely held corporation will pay less transfer tax if he transfers the stock in equal shares to his three children by gift, than if he transfers the shares to the children at death. If he gives 100 shares to each of his children, the three gifts will be valued separately as minority interests and discounts will be allowed. The no aggregation of gifts rule results in separate valuation. But if he transfers 100 shares to each of his children at death, the estate tax aggregation rule will result in valuation of the 300 shares as a block. No minority discount will be allowed even though the shares pass to three devisees.

A taxpayer who owns 60,000 shares of publicly traded stock, a quantity assumed to be sufficient to trigger blockage, will pay less transfer tax if he transfers the shares in equal shares to his three children at death, than if he transfers the shares to the children by gift. The estate tax aggregation rule results in valuation of the shares as a block and a blockage discount will be allowed even though the shares are devised to multiple beneficiaries. But if he transfers 20,000 to each of his children by gift, the gift tax no aggregation rule will result in separate valuation of each block. Assuming 20,000 share blocks are insufficient to warrant consideration of blockage, no blockage discounts will be allowed.

A remarkable consistency, therefore, exists in the estate and gift tax laws which can be understood by focusing on valuation of the property transferred in the taxable events under the two taxes. Fair market value is determined for the property transferred *in the taxable event* under the respective taxes.

C. *Transferee's Intended Use of the Property*

What if a block of property, sufficiently large to warrant consideration of blockage, is transferred to a person who intends to retain the property indefinitely? If the property is not brought to market, it will not depress prices. Should a blockage discount, which assumes the property will be sold, be allowed in such circumstances? Should consideration of blockage depend on the transferee's intended use of the property?

This question is similar to the question of whether the identity of the transferor and transferee is relevant in determining value.[399] The answer to both questions is no. Neither the transferee's intended use of the prop-

398. *But see* Simpson, *supra* note 389, at 624-25 (suggesting that, unless specifically prohibited by the gift tax statute, the value of property transferred on one date should be the same whether subject to the gift or the estate tax).

399. *See supra* part I.B.2.a.i.

erty, nor the transferor or transferee's identity is relevant in the determination of fair market value.

Fair market value posits a willing buyer and a willing seller who participate in a hypothetical sale. In *Estate of Bright*,[400] the court held that "[i]t would be strange indeed if the estate tax value of stock would vary depending upon the legatee to whom it was devised."[401] In *Seas Shipping Co. v. Commissioner*,[402] the Second Circuit rejected the Tax Court's refusal to consider blockage where the taxpayer did not intend to sell the block, noting that "[t]he court's underlying assumption—that fair market value is a subjective quality varying with the particular owner of the property—is incorrect."[403] Fair market value is the value of the property at the moment of transfer (the taxable event). It is not determined by the property's value in the hands of the transferror or transferee. It necessarily follows that the transferee's intended use of the property is not relevant in determining value. This conclusion eliminates consideration of difficult to prove subjective factors in the determination of value.[404] How could a transferee's intent to sell (and suffer the consequences of blockage) or retain the property be confirmed? Tax results should not depend on such subjective factors.

Courts have correctly rejected the transferee's intended use of the property as a factor in blockage. In 1942, the Eighth Circuit affirmed the Tax Court's allowance of a blockage discount where the IRS had argued there was "no evidence that the blocks of stock to be valued were added or expected to be added to the supply in the market."[405] In 1967, the Second Circuit recognized that a taxpayer's intention to sell was irrelevant in the application of blockage.[406] In 1974, the Ninth Circuit noted that blockage discounts are allowed regardless of whether the property is subsequently sold.[407]

The Tax Court recently addressed this issue in *Estate of O'Keeffe v. Commissioner*.[408] The IRS took the position that blockage did not apply in the valuation of art works bequeathed to museums, because such works would not be available for sale and would not affect the marketprice.[409] The court, citing *Bright*, rejected that argument and stated:

> Respondent's expert's opinion is erroneous as a matter of law. There is no justification for his exclusion of the bequeathed art from the total subject to discount. Determination of fair mar-

400. 658 F.2d 999 (5th Cir. 1981).
401. *Id.* at 1006.
402. 371 F.2d 528 (2d Cir.), *cert. denied*, 387 U.S. 943 (1967).
403. *Id.* at 530 n.3.
404. *See* Propstra v. United States, 680 F.2d 1248, 1252 (9th Cir. 1982); Minahan v. Commissioner, 88 T.C. 492, 499 (1987) (noting that if valuation were not based on an objective standard "the subjective inquiry into feelings, attitudes, and anticipated behavior might well be boundless") (citation omitted).
405. Helvering v. Maytag, 125 F.2d 55, 62-63 (8th Cir.), *cert. denied*, 316 U.S. 689 (1942).
406. 371 F.2d at 530 n.3.
407. Estate of Joslyn v. Commissioner, 500 F.2d 382, 384 (9th Cir. 1974).
408. 63 T.C.M. (CCH) 2699 (1992).
409. *Id.* at 2703.

> ket value assumes that works are in the market and precludes consideration that works are "unavailable for sale." He was not entitled to consider the actual disposition of the works of art of the estate any more than fair market value may be determined by assuming that particular purchasers will purchase works of art from the estate.[410]

The transferee's intended use of the property is simply not relevant in determining value.

D. *Blockage Factors*

Valuation, as a question of fact, must be supported by evidence. "'Blockage' is not a law of economics, a principle of law, or a rule of evidence."[411] Whether the value of a block of property is affected by the size of the block is a matter of evidence.[412] It will not be assumed that shares in a large block will sell for less per share than shares in a small block.[413] The taxpayer, having the burden of proof, must demonstrate that a blockage adjustment is warranted[414] as well as the extent of any discount.[415]

The basic condition for consideration of blockage in the valuation of stocks is "a small turnover of shares on the valuation date and for a reasonable period of time thereafter, compared to the size of block to be valued."[416] While the blockage concept is relatively simple to state, its application in different situations may be difficult.[417] Courts have relied on many factors in determining whether the facts warranted a blockage adjustment. Fourteen factors, cited frequently in cases decided from 1924 to 1979, have been identified.[418]

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410. *Id.*

411. Safe Deposit & Trust Co. v. Commissioner, 35 B.T.A. 259, 263 (1937), *aff'd* 95 F.2d 806 (4th Cir. 1938).

412. *E.g.*, Estate of Sawade v. Commissioner, 49 T.C.M. (CCH) 214, 225 (1984), *aff'd*, 795 F.2d 45 (8th Cir. 1986); Estate of Christie v. Commissioner, 33 T.C.M. (CCH) 476, 478 (1974); *Safe Deposit & Trust Co.*, 35 B.T.A. at 263.

413. *See, e.g.*, Richardson v. Commissioner, 151 F.2d 102, 103 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946); DuPont v. Commissioner, 2 T.C. 246, 256 (1943).

414. *Sawade*, 49 T.C.M. (CCH) at 225; Estate of Van Horne v. Commissioner, 78 T.C. 728, 741 (1982), *aff'd*, 720 F.2d 1114 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984); Treas. Reg. § 20.2031-2(e) (as amended in 1992); Treas. Reg. § 25.2512-2(e) (as amended in 1976).

415. Rushton v. Commissioner, 498 F.2d 88, 94 (5th Cir. 1974).

416. Vernon & Molloy, *supra* note 117, at 139.

417. Barrett, *supra* note 280, at 466.

418. Kramer, *supra* note 224, at 73-75. The fourteen factors were:

1. The size of the block of stock compared to the number of shares of stock outstanding.
2. The size of the block of stock compared to its daily trading volume.
3. Whether the block represents control.
4. The trend of general market prices.
5. The trend of market prices for this stock.
6. The existence of large block trades or secondary offerings of the stock.
7. The existence of restrictions on resale of the stock.
8. The mention of expert witness testimony for the taxpayer only.
9. Whether the stock trades on a national stock exchange.
10. The earnings trend of the company.
11. The dividend-paying history of the company.
12. The book value per share of stock on the valuation date.
13. The type of tax involved in the case (estate, gift, or income).

Since the question of whether a blockage adjustment is warranted is one of fact, each case must be decided upon its own merits. An analysis of the facts relied upon by courts in blockage cases involving the valuation of stock is beyond the scope of this article. Taxpayers confronted with a blockage issue involving stock may profit from such a study, however, as it has been suggested that courts have relied primarily upon precedent in deciding blockage valuation questions.[419]

Two critical factors appear in every blockage case: the size of the block and the length of time that would be required to liquidate the block without adversely affecting price.

1. Size of the Block

Consideration of blockage is warranted where the size of the block is so large that it cannot be liquidated within a reasonable time without depressing the per unit price of all items. At what point does a block reach the critical mass sufficient to trigger blockage? This question is answerable only in relative, not absolute terms. A block of property, although large in dollar value, may simply lack the requisite size in relation to the market. Since blockage is always a matter of proof, no rule regarding size which will be deemed sufficient exists.

The question of whether a block is sufficiently large to invoke blockage cannot be answered in isolation. It can only be answered in the context of the market in which the property is sold. In deciding whether blockage applies, courts determine whether the block could have been sold on the valuation date or within a reasonable period of time thereafter without adversely impacting price.[420] Courts have reached varying results depending on the size of the block and the volume of trading in the market.[421]

2. Time Required to Liquidate Without Adverse Impact on Price

The Internal Revenue Code generally provides that property is to be valued for estate and gift tax purposes as of the date of the taxable event

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14. The size of the block of stock compared to the number of shares actively traded. *Id.* at 75 tbl. 1.

419. *Id.* at 84.

420. Richardson v. Commissioner, 151 F.2d 102, 103 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946); Bull v. Smith, 119 F.2d 490, 492 (2d Cir. 1941).

421. *See, e.g.*, Bankers Trust Co. v. United States, 518 F.2d 1210, 1222 (Ct. Cl. 1975) (blockage discount denied where the court found the number of shares to be valued was smaller than the number of shares traded during the month preceding the valuation date), *cert. denied*, 424 U.S. 966 (1976); Mott v. Commissioner, 139 F.2d 317, 317-18 (6th Cir. 1943) (blockage discount denied for 100,000 shares of General Motors stock where 375,000 shares were sold during the two month period following the valuation date); *Bull*, 119 F.2d at 491 (blockage discount denied where the number of shares was approximately equal to the number sold during the week prior to the valuation date); Estate of Kopperman v. Commissioner, 37 T.C.M. (CCH) 24, 27 (1978) (blockage discount allowed for 27,050 shares where 691,000 shares were traded during the entire year). *See also* Todd & King, *supra* note 280, at B-1102 to B-1113 (analyzing 63 blockage cases and listing the number of shares valued, the percentage of all outstanding stock represented by the shares, and the time needed for sale).

— the date of death[422] or the date of gift.[423] Taxpayers, consequently, have often claimed that the value of a block of property was the price at which it would have sold if the entire block were offered for sale at the moment of transfer.[424] The price for which a block would have sold on the valuation date, however, is not the measure of value for tax purposes.[425]

In *Helvering v. Safe Deposit & Trust Co.*,[426] the first appellate court decision to recognize blockage, the court held that value was not determined by the price obtainable by dumping the entire block on the market at one time.[427] This type of procedure would have resulted in valuing the property in a hypothetical forced sale.

Three years later, the Second Circuit endorsed a skilled broker-reasonable time test in *Bull v. Smith*:[428]

> The trial court held as follows: "The fair market value as of a given date of a large block of stock, within the meaning of the Internal Revenue laws, is the highest value at which it could be sold if the owner on the critical date were to instruct a broker, reasonably skilled in dealing with such stock, to liquidate the block on the best terms available within the period of time reasonably required for liquidation in view of the situation as it then existed and should develop during the progress of liquidation."[429]

Other circuits quickly adopted this approach.[430] If a block of stock could be sold by a skilled broker within a reasonable time without depressing market prices, no blockage discount is warranted.[431]

What constitutes "a reasonable period of time depends on all the facts and circumstances."[432] In determining that period "[f]actors such as the number of shares in the block, the amount of trading activity in the exchange before and after the valuation date, the total number of outstanding shares, and the general market conditions will be important."[433]

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422. I.R.C. § 2031(a) (1986).

423. I.R.C. § 2512(a) (1986).

424. *See, e.g.*, Helvering v. Safe Deposit & Trust Co., 95 F.2d 806, 811 (4th Cir. 1938); Laird v. Commissioner, 85 F.2d 598, 599 (3d Cir. 1935); Estate of Sawade v. Commissioner, 49 T.C.M. (CCH) 214, 224 (1984); Estate of Smith v. Commissioner, 57 T.C. 650, 657 (1972), *aff'd*, 510 F.2d 479 (2d Cir.), *cert. denied*, 423 U.S. 827 (1975).

425. *E.g.*, Richardson v. Commissioner, 151 F.2d 102, 103 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946); *Safe Deposit*, 95 F.2d at 812; *Sawade*, 49 T.C.M. (CCH) at 225-26; Estate of Van Horne v. Commissioner, 78 T.C. 728, 742 (1982), *aff'd*, 720 F.2d 1114 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984).

426. 95 F.2d at 806.

427. *Id.* at 812.

428. 119 F.2d 490, 492 (2d Cir. 1941).

429. *Id.*

430. *E.g.*, Mott v. Commissioner, 139 F.2d 317, 317 (6th Cir. 1943); Helvering v. Maytag, 125 F.2d 55, 63 (8th Cir.), *cert. denied*, 316 U.S. 689 (1942).

431. *E.g*, *Mott*, 139 F.2d at 317; *Bull*, 119 F.2d at 492.

432. Estate of Sawade v. Commissioner, 49 T.C.M. (CCH) 214, 226 (1984), *aff'd*, 795 F.2d 45 (8th Cir. 1986).

433. Todd & King, *supra* note 280, at A-9.

While some courts have used a one-year trading volume test,[434] no rule exists and the length of the period depends on the facts in the particular case.[435] Because market volatility and time limitations on sales may adversely affect price, the length of the reasonable period could be relatively short.[436] Commentators have generally suggested using a short period in determining blockage.[437]

E. *Effect of Blockage on Value*

Blockage is triggered by a determination that an item's value in the marketplace does not accurately reflect its fair market value because it is part of a block which cannot be sold within a reasonable time without adversely affecting price. If value is determined by reference to market prices on the basis that the taxpayer in fact could have sold the property at the market price, support for such an approach disappears when the quantity available for sale greatly exceeds the market's usual volume.[438] Judicial consideration of blockage resulted from recognition that per unit market prices did not always accurately reflect the fair market value of units held as part of a large block.[439]

Taxpayers, bearing the burden of proof, must demonstrate the extent of any blockage discount.[440] They cannot satisfy their burden by merely relying upon an arithmetical average of blockage discounts allowed in prior cases.[441] The trier of fact, in turn, must determine value considering all the relevant evidence.

Treasury Regulations provide both general as well as specific guidance in determining value when blockage is a factor. The general provision, which does not mention blockage, applies when market prices do not reflect fair market value, and it states:

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434. *Sawade*, 49 T.C.M. (CCH) at 226; Bankers Trust Co. v. United States, 518 F.2d 1210, 1221-22 (Ct. Cl. 1975). *But see* Robinson v. Commissioner, 50 T.C.M. (CCH) 89, 94 n.15 (1985) (discussing but declining to use the one-year trading volume test), *rev'd on other grounds*, 805 F.2d 38 (1st Cir. 1986).

435. *See, e.g.*, Estate of Kopperman v. Commissioner, 37 T.C.M. (CCH) 24, 27 (1978) (blockage discount allowed where it would take three months to sell all the shares); Estate of Larson v. Commissioner, 3 T.C.M. (CCH) 481, 483-84 (1944) (blockage discount denied where stock could have been disposed of without adverse impact on price within six months); DuPont v. Commissioner, 2 T.C. 246, 257 (1943) (blockage discount allowed where stock could not have been disposed of at market prices within 90 days); *see also* Todd & King, *supra* note 280, at B-1102 to B-1113 (analyzing 63 blockage cases and listing the number of shares valued and the time needed for sale).

436. Watts, *supra* note 33, at 73.

437. *See, e.g.*, John H. Butala, Jr., *Fair Market Value Concept—Valuation of Securities Generally*, 14 W. RES. L. REV. 179, 185 (1963) (suggesting the reasonable period for stocks should not extend beyond several weeks due to market risk); Watts, *supra* note 33, at 74 (suggesting the reasonable period for stocks should be around three months); Wiley, *supra* note 280, at 8-5 (suggesting the reasonable period for stocks would ordinarily be considerably less than 90 days and possibly as short as two or three weeks).

438. *See* Gordon, *supra* note 72, at 56.

439. Phipps v. Commissioner, 127 F.2d 214, 216 (10th Cir.), *cert. denied*, 317 U.S. 645 (1942); Mitchell v. United States, 46 A.F.T.R. 2d 6141, 6142 (C.D. Cal. 1979).

440. Rushton v. Commissioner, 498 F.2d 88, 94 (5th Cir. 1974).

441. Estate of Christie v. Commissioner, 33 T.C.M. (CCH) 476, 479 (1974).

> If it is established that the value of a bond or share of stock determined on the basis of selling or bid and asked prices as provided [in] . . . this section does not reflect the fair market value thereof, *then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining fair market value.* Where sales at or near the date of death are few or of a sporadic nature, such sales alone may not indicate fair market value.[442]

A second provision specifically applies when blockage is a factor:

> If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, *the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations.*[443]

The regulations do not address the impact of blockage in the valuation of property other than securities.

Generally, the regulations reflect the two ways in which courts have determined value when blockage has been found relevant. Some courts have allowed a discount (a "reasonable modification") from market prices and considered blockage as an additional factor (another relevant fact or element of value) along with all other factors in determining value.[444] Other courts have valued the block by reference to its value in an alternative market ("outside the usual market"); i.e. in a secondary offering ("as through an underwriter").[445] Courts need not, however, follow one approach to the exclusion of the other.[446]

1. All Relevant Factors Valuation

In the first appellate decision upholding consideration of blockage, the Fourth Circuit observed that the Board of Tax Appeals had considered blockage as well as other relevant evidence in determining value.[447] The

442. Treas. Reg. § 20.2031-2(e) (as amended in 1992) (emphasis added); *accord* Treas. Reg. § 25.2512-2(e) (as amended in 1976) (containing similar provisions in connection with the gift tax).

443. Treas. Reg. § 20.2031-2(e) (as amended in 1992) (emphasis added); *see* Treas. Reg. § 25.2512-2(e) (as amended in 1976) (containing similar provisions in connection with the gift tax).

444. *See infra* part II.E.1.

445. *See infra* part II.E.2.

446. Estate of Joslyn v. Commissioner, 500 F.2d 382, 384 (9th Cir. 1974). The court noted that:

> The specific amount of the adjustment of value is normally computed by referring to a variety of evidentiary indices, including, for example, the book value of the stock, its corporate earnings, the value of any outstanding preferred stock and the amount of dividends payable thereon, and the volume of trading in the stock in question.
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> . . . Nor is there any requirement that the amount of "blockage" be calculated by reference to such [secondary offering] figures rather than by a consideration of earnings (past and projected), book value, or any other criteria that accurately reflect the true value of the stock.

Id.; *see generally* Freeman & Vinciguerra, *supra* note 12, at 368-69 (suggesting eight methods for valuing blocks of securities).

447. Helvering v. Safe Deposit & Trust Co., 95 F.2d 806, 812 (4th Cir. 1938).

court recognized blockage as an additional factor requiring consideration with all other relevant evidence in the determination of value.[448]

In *Bull v. Smith*,[449] the Second Circuit adopted the skilled broker-reasonable time approach not only as a way to determine whether blockage should be considered, but also as a method of determining value when blockage was relevant.[450] Under the skilled broker method "the blockage discount would take into account the depression in price, if any, upon the announcement of the contemplated sale, the broker's charge for handling the market arrangement, and registration and other costs when applicable."[451] This approach permits consideration of all marketing techniques that would be available under the circumstances.[452]

Determination of fair market value when blockage is a factor depends on all the evidence:

> Each case must be decided on its own merits, by reference to the amount of stock to be disposed of, the number of shares outstanding, the activity of the market for the stock and such other factors as may be relevant in the particular case. A method of valuation which neglects these highly individual factors is obviously unsuited to the task.[453]

Since valuation depends on the evidence in each case, no formula exists which is applicable in every blockage case. Courts usually recite the evidence which formed the basis for the determination of value,[454] but do not often reveal the manner in which value was determined or the weight given to the various factors.[455]

2. Alternative Market Valuation

A large block of stock may be reducible to cash only through special marketing devices.[456] Alternative techniques for selling large blocks of stock include private placements and secondary, special, and exchange distributions.[457] Secondary, special, and exchange distributions require approval of an exchange which is granted only if it is shown that the regular market could not absorb the securities within a reasonable time.[458]

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448. *Id.*

449. Bull v. Smith, 119 F.2d 490 (2d Cir. 1941).

450. *Id.* at 492; STANLEY S. SURREY ET AL., FEDERAL WEALTH TRANSFER TAXATION at 954 (1987); Kramer, *supra* note 224, at 72.

451. SURREY ET AL., *supra* note 450, at 954-55.

452. Wiley, *supra* note 280, at 8-13.

453. Estate of Christie v. Commissioner, 33 T.C.M. 476, 479 (1974); *see also* Estate of Joslyn v. Commissioner, 500 F.2d 382, 384 (9th Cir. 1974) (noting that value is normally computed by referring to a variety of evidentiary indices).

454. *See supra* note 418 (listing fourteen factors cited by courts in deciding blockage valuation cases).

455. *See, e.g.*, Estate of Kopperman v. Commissioner, 37 T.C.M. (CCH) 24, 33 (1978); *Estate of Christie*, 33 T.C.M. (CCH) at 479; Estate of Smith v. Commissioner, 57 T.C. 650, 658-59 (1972), *aff'd*, 510 F.2d 479 (2d. Cir.), *cert. denied*, 423 U.S. 827 (1975).

456. Vernon & Molloy, *supra* note 117, at 137-38.

457. Todd & King, *supra* note 280, at A-13.

458. *Id.* at A-13 to A-14.

Approval, consequently, depends on proof similar to that required to invoke blockage for valuation purposes.

The Board of Tax Appeals, in the first case which recognized blockage in the valuation of property for gift tax purposes, recognized that the value of a large block of property might have to be determined outside the usual market in which the property was sold. In *Shattuck v. Commissioner*,[459] the Board, discussing the evidence presented by the taxpayer, observed:

> [I]t is quite evident that . . . disposal could not have been effected except at so-called wholesale prices, by an arrangement for the underwriting of the disposal of the sale of stock which would have entailed an expense netting a price below that possible to have been secured for small blocks of stock through market sales at retail.[460]

The Board's determination of value, nonetheless, was based upon all the evidence.[461] On appeal, the Seventh Circuit recognized that the market for a large block of stock was different from the market for small lots.[462] It agreed with the Board's statement, quoted above.[463]

In 1943, however, the Tax Court refused to accept the argument that the value of a large block of stock should always be determined by the wholesale price in a secondary offering.[464] While recognizing that such a price could be a factor in valuation, the Tax Court held that the facts relating to the property control valuation and that it was "not at liberty to say that wholesale prices and not retail prices are controlling factors."[465] In 1944, the Tax Court allowed a blockage discount where it concluded the stock would have been sold either through a secondary offering or in small lots over time.[466] The court recognized that a sale through a secondary distribution was "practically equivalent to a sale by wholesale" since adequate compensation must be paid to the seller.[467]

The net amount receivable for stocks in secondary or special distributions was also considered in other cases in which blockage was a factor.[468] In 1951, one commentator suggested that determination of value by reference to secondary distributions provided valuations generally acceptable to the IRS and eliminated much of the guesswork previously involved in the valuation of large blocks.[469]

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459. 1937 B.T.A.M. (P-H) 133 (1937).

460. *Id.* at 135.

461. *Id.*

462. Commissioner v. Shattuck, 97 F.2d 790, 792 (7th Cir. 1938).

463. *Id.*

464. Mott v. Commissioner, 1 T.C.M. (CCH) 356, 357 (1943).

465. *Id.*

466. Avery v. Commissioner, 3 T.C. 963, 971 (1944).

467. *Id.* at 969.

468. *See* St. Joseph Bank & Trust Co. v. United States, 48 A.F.T.R. 1561, 1564 (N.D. Ind. 1953); Standish v. Commissioner, 8 T.C. 1204, 1212 (1947).

469. Roger K. Powell, *Estate Tax Valuation*, *in* THE ESTATE TAX HANDBOOK 369, 383 (J.K. Lasser ed., 1951).

Indeed, in 1974, the Ninth Circuit noted in *Estate of Joslyn v. Commissioner*[470] that a block of stock, as a result of an IRS proposal, had been valued at the actual net amount received by the estate in a secondary offering.[471] The Tax Court, in its decision in *Joslyn*, observed that large blocks of stock could be valued by reference to the amount they could be sold to an underwriter, even though property generally must be valued at its retail or replacement cost value.[472] The estate in *Joslyn* was allowed to deduct all costs, including underwriting fees, incurred in connection with the sale in determining value.[473]

Valuation of large blocks of stock by reference to the net amount that would be received in a secondary distribution, consequently, was long-recognized by the courts and, indeed, by the IRS. Recognition continued after amendment of the regulations in 1965 and adoption of a retail (replacement cost) measure of value for most property. Determining the value of blocks of property in an alternative market (i.e., secondary distributions) resulted in a valuation at wholesale prices; the stock's market price was generally reduced by the estimated expenses of the distribution, including brokerage commissions.[474]

Valuation was not an issue in *Joslyn*.[475] Resolution of the issues in *Joslyn*, however, resulted in the IRS changing its position regarding blockage valuation and created the uncertainty which remains unresolved. It is necessary, therefore, to examine *Joslyn* in more detail.

In *Joslyn*, the IRS valued a large block of listed stock by allowing a blockage discount in the exact amount of actual expenses, including underwriter fees, incurred in connection with a secondary offering.[476] The estate not only accepted that valuation, but claimed the expenses paid in the secondary offering as administration expense deductions under § 2053.[477] The Tax Court denied the selling expense deduction and viewed the claim as an attempt to secure an unjustified double deduction (once in determining value under § 2031 and then as a deduction under § 2053).[478]

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470. 500 F.2d 382 (9th Cir. 1974).

471. *Id.* at 383.

472. Estate of Joslyn v. Commissioner, 57 T.C. 722, 724 (1972), *rev'd on other grounds*, 500 F.2d 382 (9th Cir. 1974).

473. *Joslyn*, 500 F.2d at 383 n.2.

474. *Id.* at 383; St. Joseph Bank & Trust Co. v. United States, 48 A.F.T.R. 1561, 1564 (N.D. Ind. 1953); Standish v. Commissioner, 8 T.C. 1204, 1212 (1947); *see* Kramer, *supra* note 224, at 72.

475. 500 F.2d at 383.

476. *Id.* at 383 n.2.

477. Estate of Joslyn v. Commissioner, 57 T.C. 722, 724 (1972), *rev'd*, 500 F.2d 382 (9th Cir. 1977).

478. *Id.* at 726. ("We perceive no rational basis for allowing both the reduction in value and the deduction for the same expenses. There is no judicial authority supporting the allowance of both tax benefits, nor is there any indication that Congress intended to allow both tax benefits.").

The Ninth Circuit reversed[479] and rejected the Tax Court's double deduction analysis.[480] The court held that the case involved separate, unrelated issues of valuation and deduction.[481] Blockage was a matter of valuation, not of deduction.[482] The court supported its conclusion by the fact that blockage adjustments are allowed in determining value regardless of whether the stock is sold.[483] The court noted that the blockage adjustment normally was determined by reference to a variety of factors.[484] Indeed, in many cases the actual costs of a secondary offering would not be available and other factors would be considered in determining value.[485] The Ninth Circuit remanded the case for a determination of whether the expenses should be allowed as deductions under § 2053.[486]

On remand, the Tax Court found that the underwriter had sold the stock at $19.25 per share and paid the estate $18.095 per share.[487] The estate claimed deductions for incidental expenses of the underwriting which it had paid and the underwriting discount (the difference between $19.25 and $18.095).[488] The court held that the incidental expenses were clearly deductible selling expenses.[489] Deduction of the underwriting discount, however, depended on the nature of the transaction.[490] The court held that the transaction, both in substance and in form, was a sale by the estate to the underwriters.[491] The controlling factor was the fact that the underwriters' obligations were not conditional upon their ability to sell the stock.[492] Having determined that the transaction was a sale by the estate at $18.095 per share, the court held that the underwriter's subsequent profit (the difference between $19.25 and $18.095) was not a deductible administration expense.[493]

The Ninth Circuit, once again, reversed on appeal.[494] The court held it irrelevant that the amount withheld by the underwriters was considered a profit; it represented the amount paid by the estate for the underwriters' services.[495] The court responded to the underlying double benefit issue by noting that had the stock "been valued in the estate at a different figure, because the blockage had been estimated differently, there would not have been the appearance of duplication."[496] Yet, in either case, the sell-

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479. *Joslyn*, 500 F.2d at 382.
480. *Id.* at 384, 386-87.
481. *Id.* at 386.
482. *Id.* at 384, 386.
483. *Id.* at 384.
484. *Id.*
485. *Id.* at 386.
486. *Id.* at 387.
487. Estate of Joslyn v. Commissioner, 63 T.C. 478, 481 (1975), *rev'd*, 566 F.2d 677 (9th Cir. 1977).
488. *Id.*
489. *Id.* at 483.
490. *Id.* at 485.
491. *Id.*
492. *Id.* at 483 n.5.
493. *Id.* at 485.
494. Estate of Joslyn v. Commissioner, 566 F.2d 677 (9th Cir. 1977).
495. *Id.* at 678.
496. *Id.*

ing expense issue would have been the same.[497] The amount withheld by the underwriters was a deductible selling expense and was found to be "no different than the charge which a real estate broker might make for selling a house."[498]

In the year following the Ninth Circuit's second decision in *Joslyn*, the Seventh Circuit addressed the same issue in *Estate of Jenner v. Commissioner*.[499] The estate in *Jenner* also sold stock in a secondary distribution after death.[500] The Tax Court, relying on its second decision in *Joslyn*,[501] denied a selling expense deduction for the underwriting discount.[502] On appeal, the Seventh Circuit adopted the Ninth Circuit's approach and allowed the selling expense deduction.[503] Since the estate bore the entire cost (including the underwriting discount) of the secondary offering, it should receive a deduction for all the expenses.[504] The court rejected characterization of the secondary offering as a sale to the underwriters, noting that SEC regulations prohibited underwriters from purchasing stock for their own accounts.[505] In a footnote, the court noted the absence of even an appearance of a double deduction (as existed in *Joslyn*) because blockage was only one factor considered in the determination of value (actual expenses had not been used).[506]

The IRS responded to *Joslyn* and *Jenner* by issuing Revenue Ruling 83-30.[507] The Service viewed *Joslyn* and *Jenner* as permitting an unwarranted double benefit by allowing administration expense deductions for underwriting fees already reflected in the valuation of the estate.[508] Having lost the double benefit argument on the administration expense side, the Service came at the problem from the valuation side. It ruled that underwriting fees, necessarily incurred in the sale of a large block of stock through an underwriter, are deductible as administration expenses, but are not to be considered in the valuation of the stock.[509]

In justification, the Service relied upon the regulations. It assumed that the requirements had been met in order to value a large block of stock "through an alternative *method* of disposal."[510] The IRS then inter-

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497. *Id.*

498. *Id.* at 679.

499. 577 F.2d 1100 (7th Cir. 1978). The estate in *Jenner* sold stock in a secondary offering to underwriters at $38.85 per share. *Id.* at 1102. The underwriters, in turn, sold the stock to the public at $42.00 per share. *Id.* The registration statement reported an "underwriting discount" of $3.15 per share ($42.00 - $38.85). *Id.* The underwriter paid the estate $42.00 per share and the estate paid the underwriters $3.15 per share for the underwriting discount. Estate of Jenner v. Commissioner, 36 T.C.M. (CCH) 241, 250 (1977). The estate also paid certain incidental costs of the secondary offering. *Id.*

500. 577 F.2d at 1102.

501. *Jenner*, 36 T.C.M. (CCH) at 249.

502. *Id.* at 250.

503. *Jenner*, 577 F.2d at 1107.

504. *Id.* at 1104.

505. *Id.* at 1105.

506. *Id.* at 1104 n.7.

507. Rev. Rul. 83-30, 1983-1 C.B. 224.

508. *Id.* at 225.

509. *Id.*

510. *Id.* (emphasis added).

preted the regulation to preclude consideration of underwriting fees in valuation:

> Note that, in such a situation where a blockage discount is allowable, section 20.2031-2(e) of the regulations provides that the price at which the stock could be sold *through, rather than to,* an underwriter may be a more accurate indication of value than market quotations. This indicates that the relevant figure is the price that the public would pay to the underwriter for the stock, and not the price the underwriter would pay to the estate. Accordingly, underwriting fees should not be considered in determining the blockage discount.[511]

The Service sought to overturn law that had existed for forty-six years.[512] Two trial decisions have discussed the double benefit issue since issuance of Revenue Ruling 83-30.[513] Neither court, however, has decided the question.[514]

The potential double benefit in this situation must be recognized. The facts of *Jenner* illustrate this potential. In *Jenner*, stock was sold in a secondary offering by underwriters at $42.00 per share.[515] The estate paid the underwriters $3.15 per share for their services (the underwriting discount) and netted $38.85 per share.[516] If the stock had been valued in decedent's gross estate at $38.85 per share because actual expenses were considered[517] and the estate was allowed an administration expense deduction of $3.15 per share for the underwriting discount, the net effect would be that the estate would pay estate tax on $35.70 per share. The

511. Rev. Rul. 83-30, 1983-1 C.B. 224, 225 (emphasis added). The ruling adopted a position similar to one advocated fifteen years earlier. Chisum, *supra* note 280, at 343. Chisum suggested the regulations do not require use of net sales figures:

> The Regulations refer to the price for which the block could be "*sold as such* outside the usual market, as *through an underwriter.*" "Through" does not speak with the clarity that "to" might have. "To" would ordinarily mean the net value to the seller; "through" can just as well mean the price the underwriter receives from the public.

Id. (footnote omitted).

512. *See supra* notes 459-63 and accompanying text.

513. Robinson v. Commissioner, 1985 T.C.M. (P-H) 1227 (1985), *rev'd on other grounds*, 805 F.2d 38 (1st Cir. 1986); Rifkind v. United States, 54 A.F.T.R 2d (P-H) 6453 (Cl. Ct. 1984). In *Robinson*, the Tax Court recognized the double deduction issue had not yet been resolved. 1985 T.C.M. (P-H) at 1233 n.16 ("The ordinary costs of selling securities are not subtracted from trading prices in fixing fair market value, but it is not entirely clear whether the extra costs of a hypothetical secondary distribution should be deducted."). In *Rifkind*, the IRS made the double benefit argument. 54 A.F.T.R. 2d (P-H) at 6463. Consistent with the position announced in Revenue Ruling 83-30, it did not challenge the § 2053 administration expense deduction, but contended that it was improper to consider anticipated costs of a secondary offering in determining value under § 2031. *Id.* The court stated that "[t]he right to take such a 'double deduction' has never been squarely presented before any court, although its potential existence has been recognized and criticized." *Id.* (citation omitted).

514. *Robinson*, 1985 T.C.M. (P-H) at 1233 n.16 (the court determined stock was to be valued as if sold in a private sale where underwriting costs would not be incurred); *Rifkind*, 54 A.F.T.R. 2d (P-H) at 6464 (the IRS offered no evidence that the discount allowed in valuation was "intended to cover the anticipated costs of sale . . .").

515. Estate of Jenner v. Commissioner, 577 F.2d 1100, 1102 (7th Cir. 1978).

516. *Id.*

517. The stock in *Jenner* was not valued by reducing market price by the exact amount of expenses incurred in the secondary offering. Value was determined on the basis of many factors including blockage. *Id.* at 1104 n.7.

cash in the estate available for distribution, however, would be $38.85 per share.

The value of large blocks of property, nonetheless, should be determined by considering the price that the seller could receive in an *en bloc* sale of the property in an alternative market. In the stock context, this would include consideration of the underwriting discount. Several considerations justify this conclusion.

First, the courts in *Joslyn* and *Jenner* were correct in viewing valuation under § 2031 and deductions under § 2053(a) as "separate and distinct."[518] Nothing in the code suggests that administration expense deductions play any part in determining value, or that administration expense deductions are limited by the manner in which value is determined.[519] Section 642(g), which precludes an income tax deduction for administration expenses allowed under § 2053 in the computation of the estate tax, does not apply.[520]

Second, Revenue Ruling 83-30 is inconsistent with case law and disregards the regulation which it purports to enforce. The ruling requires valuation of property that would be disposed of in an alternative market as if it were sold in the usual retail market to ultimate consumers.

Treasury Regulations generally require that the value of property be determined in the market "in which such item is most commonly sold to the public."[521] Items generally obtained by the public in the retail market are to be valued at retail prices (replacement cost).[522] These provisions are, however, subject to two important qualifications. First, "public" does not always refer to the ultimate, individual consumer; it may refer to a middleman who sells to the ultimate consumer.[523] Second, the regulations expressly permit valuation outside the usual (retail) market where blockage is relevant. The value of a large block of stock may be "the price at which *the block* could be sold *as such* outside the *usual market*, as through an underwriter."[524]

In Revenue Ruling 83-30, the IRS mischaracterized the regulation as permitting valuation by an alternative "method," rather than in an alterna-

518. *Id.* at 1103.

519. *See* Mark D. Maloney, Recent Development, *Estate Tax Deductibility of Underwriters' Expenses After an Executor's Sale of Stock: A Loophole in Section 2053*, 32 VAND. L. REV. 1003, 1013 (1979) (concluding that no provision of the code "limits the use of one item both to reduce gross estate value and as a deduction for estate tax purposes").

520. *Id.*

521. Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992).

522. Treas. Reg. § 20.2031-1(b); Treas. Reg. § 25.2512-1.

523. Anselmo v. Commissioner, 757 F.2d 1208, 1214-15 (11th Cir. 1985). The court held:

> The major flaw in [taxpayer's] argument . . . is that the "public" refers to the customary purchasers of an item. The most appropriate purchaser of an item is not invariably the individual consumer. For example, the general buying public for live cattle would be comprised primarily of slaughterhouses rather than individual consumers. The fair market value of live cattle accordingly would be measured by the price paid at the livestock auction rather than at the supermarket.

Id.

524. Treas. Reg. § 20.2031-2(e) (as amended in 1992) (emphasis added); Treas. Reg. § 25.2512-2(e) (as amended in 1976) (emphasis added).

tive "market." It focused on the phrase "as through an underwriter" as if that were the controlling provision, without acknowledging that those words merely illustrate how a sale outside the usual market could be made. The phrase relied upon by the Service is of secondary importance. The regulation's primary provision is that value may be established by the price at which "the block could be sold as such outside the usual market." Correctly understood, the regulation confirmed case law which recognized that the value of a block of stock could be determined by reference to its sale price in a secondary offering at wholesale, rather than retail prices.[525]

The regulation focuses on what "the block," "as such," could be sold for in the alternative market. It contemplates a bulk sale at wholesale prices to one who would resell at retail.[526] Who are the potential buyers of "the block" "as such" in the alternative market? The answer will depend on the property that constitutes the block.

In the stock context, the decisions in *Joslyn* and *Jenner*, unfortunately, confuse rather than enlighten. Both in essence treated the underwriters as agents for the seller, rather than as buyers purchasing stock for their own account.[527] Indeed, the Seventh Circuit in *Jenner* observed that Securities and Exchange Commission regulations prohibited underwriters from purchasing for their own account.[528] This might suggest that the buyer was the group consisting of the individual purchasers in the secondary offering. That group, however, paid a price higher than received by the estates. The ultimate purchasers of the stock in the secondary offering should not be viewed as the purchaser of "the block." They did not purchase the stock *en bloc* and the estates did not have access to them in a secondary offering without the services of the underwriters. Notwithstanding the difficulties that exist in identifying the buyer, the value of a large

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525. *See supra* notes 459-74 and accompanying text. *But see* SURREY ET AL., *supra* note 450, at 955:

> The general valuation principle that retail sales price is the determinant of value is violated to the extent that the broker's cost is recognized as an element of the blockage discount. Recognition of this element also appears to ignore the statement in Regulations, section 20.2031-2(e), giving evidentiary weight to 'the price at which the block could be sold as such.' That statement should be interpreted to mean that the price paid *to* the broker should determine the value of the stock rather than the net amount the holder of the block receives. Otherwise, an estate may receive the substantive equivalent of a double deduction for broker's fees and other selling expenses if the stock is actually sold and the same broker's fees are allowed as deductions under section 2053.

Id. (citation omitted) (emphasis added).

526. Several commentators, before *Joslyn*, *Jenner*, and Revenue Ruling 83-30, recognized that blockage may result in valuing property at liquidation prices rather than at retail prices. *See* Wiley, *supra* note 280, at § 74.801, 8-4 ("[A]s approved by many courts (and possibly by the Treasury's Regulations), blockage valuation appears to permit discounts for hypothetical costs of the liquidation, and to this extent there may be a departure from what is permitted in other contexts."); Chisum, *supra* note 280, at 340 ("[C]ourts have extended this economic contention about the 'realities' of the marketplace to assume that value . . . means value in liquidation—the price that would be received if the property were actually sold at once."); Note, *supra* note 189, at 254 (suggesting that blockage represented the only departure from the trend in the law toward replacement cost valuation).

527. Estate of Jenner v. Commissioner, 577 F.2d 1100, 1105 (7th Cir. 1978); Estate of Joslyn v. Commissioner, 566 F.2d 677, 678 (9th Cir. 1977).

528. *Jenner*, 577 F.2d at 1105 (citing 17 C.F.R. § 240.10b-6 (1978)).

block of stock, "as such," valued outside the usual market by reference to a secondary offering, should reflect the net amount receivable by the seller.[529]

Third, property would be taxed at values in excess of the amounts that could be realized upon a sale *en bloc*, unless costs incurred in the disposition of the block are considered in valuation. While selling expenses are not deductible in the valuation of most property for transfer tax purposes, large blocks of property justify different treatment. The owner of a small holding of stock has several alternatives if he desires to sell. He can sell the stock through a broker, in which case he will incur a sales commission. Alternatively, he can negotiate a private sale and avoid payment of a commission. The owner of a large block of stock does not have that option. The *market* for "the block", "as such," is limited to disposition through special marketing devices which utilize the services of underwriters. The owners of large blocks have access to the usual market only through a sale outside the usual market.

Fourth, adoption of a replacement cost approach in the valuation of large blocks of property could result in their valuation at a premium rather than at a discount, as was recognized in 1951:

> Buying a large block of stock would raise the price to a premium; "blockage," however, recognizes that a large block of stock cannot be converted into cash as readily as a few shares and allows the donor to value his stock at a lower price than the sum of the stocks multiplied by the current exchange rate on the market. Thus, value is measured by the money for which the donor could sell the stock.[530]

Supply and demand work both ways. If a buy order for a substantial block of stock were entered, the price of the stock would rise to reflect the increased demand. Such a valuation would result in taxation at a value which the estate could never receive. These considerations justify valuation of a block of property by reference to the amount receivable in an *en bloc* sale.

Resolution of this valuation issue will not merely decide whether certain amounts (i.e. the underwriting discount) will effectively be allowed once or twice in the computation of federal estate taxes. In certain cases, it will decide whether the amounts will be allowed at all in that calculation.

If the IRS' position in Revenue Ruling 83-30 is sustained, these amounts might never be deductible for estate tax purposes for two reasons. First, administration expenses are deductible only if paid. If the property is not sold, there will be no selling expenses to deduct. Second, even if the property is sold and selling expenses are paid, they might not be deductible as administration expenses under § 2053. Section 2053(a)(2), by its terms, allows a deduction for administration expenses

529. *See* Watts, *supra* note 33, at 77.

530. Recent Case, *supra* note 173, at 294-95 (footnote omitted); *see also* HARRISS, *supra* note 284, at 83 (suggesting that the unit value of a large block of stock would exceed market prices for smaller blocks if value were interpreted as cost of acquisition).

"allowable by the laws of the jurisdiction" under which the estate is being administered. It is the Treasury's position, however, that not all administration expenses are deductible. The regulations provide that only selling expenses incurred in sales necessary to pay decedent's debts, expenses of administration, taxes, or to preserve the estate or effect distribution are deductible.[531] The circuit courts have reached different conclusions as to whether deductibility is solely a matter of state law.[532] Consideration of that issue is beyond the scope of this article.[533] Deductibility of administration expenses, however, is never an issue in connection with the gift tax because no estate is being administered.[534]

Concluding that the value of large blocks of property may be determined by reference to sales in alternative markets at wholesale, rather than retail prices, does not mean that estates must also be allowed a selling expense deduction for items considered in valuation. While *Joslyn* and *Jenner* correctly allowed deductions for underwriting expenses under current law,[535] Congress could conclude that the double benefit should be pre-

531. Treas. Regs. § 20.2053-3(a), 3(d)(2) (as amended in 1979). These regulations are substantially unchanged since their promulgation in 1919. Estate of Park v. Commissioner, 475 F.2d 673, 676 n.3 (6th Cir. 1973); Estate of Smith v. Commissioner, 57 T.C. 650, 660 (1972), *aff'd*, 510 F.2d 479 (2d Cir.), *cert. denied*, 423 U.S. 827 (1975).

532. The Sixth and Seventh Circuits have held that state law alone determines deductibility. *Park*, 475 F.2d at 676 ("Congress has committed to the considered judgment of the states whether a particular expense is allowable as a proper or necessary charge against estate assets."); *Jenner*, 577 F.2d at 1106 ("As a general rule the decree of a probate court approving expenditures as proper administrative expenses under state law will control."). The Second, Fourth, Fifth, Ninth, and Eleventh Circuits, however, have held that state law alone does not control. *Smith*, 510 F.2d at 482-83 ("[T]he federal courts cannot be precluded from reexamining a lower state court's allowance of administration expenses to determine whether they were in fact necessary to carry out the administration of the estate or merely prudent or advisable in preserving the interests of the beneficiaries.") (footnote omitted); Estate of Love v. Commissioner, 923 F.2d 335, 338 (4th Cir. 1991) ("Given this regulation, it is clear that this is a question of federal law and federal taxation policy which would not be properly addressed under a state statute."); Pitner v. United States, 388 F.2d 651, 659 (5th Cir. 1967) ("In the determination of deductibility under section 2053(a)(2), it is not enough that the deduction be allowable under state law."); Hibernia Bank v. United States, 581 F.2d 741, 744 (9th Cir. 1978) ("We agree with the district judge that allowability under state law is not the sole criterion for determining the deductibility of a particular expenditure under section 2053(a)(2)."); Marcus v. DeWitt, 704 F.2d 1227, 1229 (11th Cir. 1983) ("[T]he law is established for this circuit that the state probate court determination is not conclusive.") (citation omitted).

533. Several recent articles have considered this issue. For additional discussion, see Sharon C. Nantell & Marjorie A. Rogers, *Deductibility of Administration Expenses Is Not Always Black and* White, 16 HAMLINE L. REV. 105 (1992); Michael H. Tow, Note, *Estate of Love and § 2053(a)(2): Why State Law Should Control the Determination of Deductible Administration Expenses*, 12 VA. TAX REV. 283 (1992); Paul L. Caron, *Must an Administration Expense Allowed by State Law also Meet a Federal Necessity Test?*, 70 J. TAX'N 352 (1989).

534. No deduction is allowed for selling expenses in the determination of gift taxes. Taxpayers, however, can decide whether to make gifts of property or of cash. A donor may decide to sell property and make a gift of the net sale proceeds, effectively obtaining a full deduction for selling expenses incurred.

The valuation issue, however, can arise in connection with the gift as well as the estate tax. If the owner of a large block of stock transfers the entire block to one donee in a single transfer, the same question arises regarding valuation. *See* Treas. Reg. § 25.2512-2(e) (as amended in 1976). With no possible administration expense deduction, the only way the donor can benefit from consideration of items such as underwriting discounts is if they are considered in valuation of the block gifted.

535. Maloney, *supra* note 519, at 1019.

cluded and amend the Code.[536] Alternatively, it has been suggested that the double benefit problem could be solved by amendment of the regulations under § 2053.[537]

The difficulty with either approach, however, would lie in identifying how much of the blockage discount was attributable to selling expenses that would be incurred in the hypothetical sale in the alternative market (i.e., in a secondary distribution). While those amounts could be determined in *Joslyn* because actual expenses were used in determining value, the amounts could not be determined in *Jenner* where the Tax Court considered blockage as only one of many valuation factors. Valuation of a block of property in an alternative market will usually reflect consideration of many factors, making it difficult to isolate the expenses which would not be deductible under an amended § 2053.

III. VALUATION OF ART

Art, unlike most property, has no intrinsic value.[538] The value of art largely depends on the reputation of the artist at the time of sale.[539] Changing tastes and artists falling in and out of favor both affect the value of art.[540] It has been suggested that art "prices float more or less aimlessly"[541] and that only critics who succeed in redirecting general tastes are able to profit from their judgment.[542]

Recent history demonstrates the dramatic price fluctuations that can occur in the art market. Art prices boomed in the 1980s, peaked in 1989, but, by late 1992, had declined to 1987 levels.[543] It is unclear whether the

536. *See id.* at 1020 (proposing amendment of § 2053(a)(2) to allow deductions for administration expenses only "when the value of the gross estate is undiminished by such administration expenses or estimates thereof").

537. Watts, *supra* note 33, at 79 (suggesting amendment of the regulations under § 2053 "to exclude any deduction for selling expenses thereunder to the extent that the particular expenses have already been reflected in the relevant estate tax valuation").

538. *See* Estate of O'Keeffe v. Commissioner, 63 T.C.M (CCH) 2699, 2702 (1992) ("A work of art usually does not have intrinsic financial value beyond its desirability as art and lacks external indicia of return prior to resale, such as earnings or dividends.").

539. LERNER & BRESLER, *supra* note 4, at 49.

540. *Id.*; *see also* William J. Baumol, *Unnatural Value: Or Art Investment as Floating Crap Game*, 15 J. ARTS MGMT. & L. 47, 53, 58 (1985) (concluding, after studying 640 art transactions from 1652 to 1961, that history "tells us that the main lesson imparted by the test of time is the fickleness of taste whose meanderings defy prediction"); McCarthy, *supra* note 4, at 8 (noting that factors relating to art valuation change, rendering the art market artificial and subject to manipulation).

541. Baumol, *supra* note 540, at 47.

542. *Id.* at 58.

543. *See* Ralph E. Lerner, *Big Picture: Dealing with the Business Side of Art*, 79 A.B.A. J. 84 (March 1993). Lerner noted that:

> The art world has been on a roller coaster in recent years.
>
> The art market peaked in May 1990, when Van Gogh's "Portrait of Dr. Gachet" sold for a staggering $82.5 million at a Christie's auction. Forty-eight hours later, "Au Moulin de la Galette" by Renoir sold for $78.1 million at Sotheby's.
>
> But the plunge has been as sharp as the climb. Battered by the recession, artists, dealers, collectors and auction houses have sought to encourage sales by reducing prices.

Id.; Alexandra Peers, *Art Prices Begin Emerging From 2-Year Slump, But Remain Far Below the Height of '80s Boom*, WALL ST. J., Nov. 20, 1992, at C1 ("Sales of paintings back on the [Nov.

art market has recovered.[544] In valuing art, the Tax Court has noted and apparently considered the boom and subsequent bust of art prices.[545]

The value of art, as with other property, is a question of fact to be determined on the basis of all relevant facts.[546] Art, however, is particularly difficult to value because of the multitude of factors that may affect its value.[547] In *Estate of Smith v. Commissioner*,[548] for example, the Tax Court listed the following factors in determining the value of a large block of art: the artist's reputation at time of death; the market's acceptance of the works; the distribution of works according to size, period during which they were created, and their expression of the quality of the artist's work; the tendency of the artist in working in series and whether an item was part of a complete series to be valued; sales before and after death; and the location of the items.[549]

Although the taxpayer has the burden of proof, commentators have suggested that the Commissioner rarely challenges art valuations.[550] One

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1992] auction block after only a brief time in private hands illustrate the erosion in art prices since 1989. Frank Stella's 'Sketch Red Lead' sold for $198,000, a pale 45% of the price it fetched at auction in May 1990. Andy Warhol's 'Race Riot' fetched $627,000, down 65% from its November 1989 price. Kenneth Noland's 'Blue Horizon' brought $93,500, off 30% from its auction-block price two years ago this month.").

544. Ann E. Berman, *Spring Art Auctions: The Apples of Cezanne's*, WALL ST. J., May 18, 1993, at A14 (suggesting the art market was still confusing and that "to anyone taking a global perspective, art still must seem like an unsafe vehicle for investment or pleasure"); Alexandra Peers, *At 227 Years Old, Christie's Is Undergoing a Face Lift*, WALL ST. J., July 7, 1993, at B6 (noting, despite encouraging results at recent Impressionist auctions, that the CEO of Christie's could not answer the question of whether the art market was back); Peers, *supra* note 543, at C1 (noting art prices were still far below 1989 levels).

545. Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699, 2701-2702 (1992).

546. *See, e.g.*, Morris v. Commissioner, 761 F.2d 1195, 1200 (6th Cir. 1985).

547. *See* Karlen, *supra* note 5, at 187-88. Karlen listed the following factors:

> The primary physical and temporal considerations for evaluating a painting, sculpture, or other art object include the identity of the artist; date or period of creation; physical condition; quantum of restoration; subject matter; medium; physical dimensions; authenticity; rarity; artistic value; aesthetic value; and other factors peculiar to the physical creation and physical existence of the art object. Also, because value is based upon a "market," the physical aspects of the work are then related to past and present market considerations such as past sales prices for the same or similar works; provenance; offers to purchase; other earlier appraisals; state of the economy and market in general; size and extent of local, national and/or international markets for the type of work in question; and changes in fashion and taste which affect the demand for the work or works like it. Other considerations affecting value are impediments and restrictions such as those imposed by joint ownership; import and export laws; claims made on the art object; and artists' rights in the work of art.

Id. (footnotes omitted); Speiller, *supra* note 14, at 227-29 (discussing the difficulties that exist in the valuation of art and identifying relevant factors).

548. 57 T.C. 650 (1972), *aff'd*, 510 F.2d 479 (2d. Cir.), *cert. denied*, 423 U.S. 827 (1975).

549. *Id.* at 658-59. The court noted that in listing these factors it did "not mean to imply that we have set forth every consideration which has influenced our decision herein." *Id.* at 658 n.7.

550. McCarthy, *supra* note 4, at 13; *see also* Lawrence Malkin, *How the IRS Looks at Art*, CONNOISSEUR, May 1989 at 170, 172 ("The IRS does not quibble with differences in valuation of less than about 15 percent and is also loath to fine-tune larger but still moderate disagreements in valuation that might represent honest differences of opinion."); *see also* Calder v. Commissioner, 85 T.C. 713, 714 (1985) (the IRS determined the amount reported by the taxpayer for estate tax purposes ($949,750) "was within an acceptable range and no change was recommended" where the IRS's appraiser valued the art as having a value of $1,164,600

reason suggested for the Service's avoidance of litigation in art valuation disputes is the difficulty it has in obtaining witnesses.[551] Indeed, in the three cases in which blockage was considered in the valuation of art, the IRS agreed with the taxpayer prior to trial as to the per-item value of art valued at $4,284,000,[552] $2,911,750,[553] and approximately $73,000,000.[554]

A. *Relevant Market*

Treasury Regulations require the value of property be determined in the market in which it is most commonly sold to the public: the retail market for items generally obtained by the public at retail.[555] The value of an individual work of art, as a result, will generally be determined by the price at which it could be purchased in the retail market by the ultimate consumer of the property.[556]

Art is sold and purchased through private sales, gallery sales, and auction sales. Which of these is the retail market in which art is most commonly sold to the public?[557] Do these represent different markets or merely different sale methods within the same (retail) market? The IRS has ruled[558] that, absent evidence to the contrary, the retail market for art includes dispositions by private sales, gallery sales, or through auctions because a buyer would pay a comparable price regardless of how the art was acquired.[559] The answer to the question, however, will depend on the facts in each case[560] and may hinge on the nature and price of the item being valued.[561]

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to $1,293,800). *Cf.* Speiller, *supra* note 14, at 238 (suggesting that, while the IRS is in "constant disagreement" with taxpayers in art valuation cases, litigation rarely results).

551. Speiller, *supra* note 14, at 238.

552. *Smith*, 57 T.C. at 655.

553. *Calder*, 85 T.C. at 717.

554. Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699, 2703 (1992) (the parties agreed that the value exceeded $72,759,000).

555. Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992).

556. Biagiotti v. Commissioner, 1986 T.C.M. (P-H) 2115, 2120 (1986).

557. *See* Jessica L. Furey, Note, *Painting a Dark Picture: The Need for Reform of IRS Practices and Procedures Relating to Fine Art Appraisals*, 9 CARDOZO ARTS & ENT. 177, 178 (1990) (suggesting that the regulations are ambiguous because they fail to specify whether auction value, retail (dealer) value, or private sales figures are to be used in determining value).

558. Tech. Adv. Mem. 92-35-005 (May 27, 1992).

559. *Id.* ("[T]he estate could have sold the artwork directly to a purchaser or through a private art dealer. The buyer would pay an amount that would be comparable to the total amount paid by the buyer at a public auction.").

560. *See Biagiotti*, 1986 T.C.M. (P-H) at 2121 (holding that auction sales of pre-Columbian art did not reflect prices in the retail market because they were composed of wholesale, as well as retail transactions).

561. *See* Williford v. Commissioner, 1992 T.C.M. (P-H) 2419, 2426 (1992) (the court found a limited market existed for a five-panel, 110.5 foot-long frieze because of its large size and uniqueness); Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699, 2706 (1992) (the court found different works of art in the estate would appeal to different segments of the art market); LERNER & BRESLER, *supra* note 4, at 668 ("The market for a seven-foot sculpture weighing five tons is smaller than the market for a three-foot-by-two-foot oil painting. Relative price also enters into the determination, that is, the market for oil paintings selling for more than $100,000 is probably smaller than the market for those selling for between $1,000 and $10,000.").

But what if the price varied depending on whether art were purchased in a private sale, in a gallery, or at auction?[562] Courts have dealt with that situation in two ways. First, such evidence may mean that different markets are involved. Auction prices for pre-Columbian art have been rejected for this reason—purchases by collectors, dealers, and museums made it a mixed retail and wholesale market.[563] Second, courts have recognized that within a retail market consumers may pay a wide range of prices for the same item depending on where they choose to shop.[564] In cases involving income tax charitable contribution deductions, courts have held that the most appropriate market in which to determine value is "the most active marketplace for the item."[565] Estate and gift tax regulations, similarly, provide that value is determined in the market in which the item is "most commonly sold to the public."[566]

1. Private Sales

It is difficult to use private sales prices to determine fair market value because sales figures are often confidential, and no publication exists which details sales information.[567] The Tax Court, however, has considered evidence of private sales in determining value where it found the sales were "adequately verified and documented."[568]

2. Gallery Sales

Art sold by dealers in galleries to ultimate consumers may appear to be most representative of the traditional "retail" sale used to establish fair market value. As with private art sales, however, gallery sales information may be difficult to obtain,[569] a fact recognized by the Tax Court.[570] Despite this difficulty, the Tax Court has considered gallery sales in determining fair market value.[571]

Prices in gallery sales, moreover, may not represent fair market value because sale prices might be too high or too low. Gallery sales prices may be too high because:

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562. *See* Furey, *supra* note 557, at 178 (suggesting that "large discrepancies" usually exist between private, gallery, and auction prices).

563. *Biagiotti*, 1986 T.C.M. at 2118, 2121.

564. Lio v. Commissioner, 85 T.C. 56, 69-70 (1985), *aff'd sub nom.* Orth v. Commissioner, 813 F.2d 837 (7th Cir. 1987).

565. *Id.* at 70.

566. Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992).

567. Furey, *supra* note 557, at 179 n.12.

568. Williford v. Commissioner, 1992 T.C.M. (P-H) 2419, 2426 (1992) (court found the IRS expert, who relied on auction sales and rejected using private sales, less persuasive than taxpayer's experts who used both).

569. Furey, *supra* note 557, at 179 n.12.

570. Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699, 2701 (1992) ("O'Keeffe's works were also sold through galleries, although exact data concerning such sales is difficult to obtain or to verify.").

571. *E.g.*, Calder v. Commissioner, 85 T.C. 713, 719 (1985); Estate of Smith v. Commissioner, 57 T.C. 650, 651-52 (1972), *aff'd*, 510 F.2d 479 (2d Cir.), *cert. denied*, 423 U.S. 827 (1975).

> Dealers who have well-established reputations can often demand artificially high prices for the paintings they sell. Private collectors will often pay considerably more for a painting purchased from a well-known dealer than its current market value as determined at auction, in order to gain the benefit of the dealer's experience, guidance, personalized service, and professional guarantee regarding authenticity.[572]

Conversely, gallery sales prices may be too low as evidenced by subsequent auction sales.[573]

Artists sometimes sell works of art to dealers for resale.[574] Sales made *to* dealers must be distinguished from sales made *by* dealers. While gallery sales prices may evidence value in the retail market, sales *to* galleries will probably be considered in the wholesale market and not reflective of fair market value.[575]

3. Auction Sales[576]

Auction prices are readily available through several publications.[577] Because auction prices are easily verified and often reflect current market developments,[578] commentators have suggested adoption of auction prices as the standard to determine the fair market value of art.[579] The Tax Court has recognized that auction prices may be relevant in the determination of fair market value.[580]

Auction prices, however, may not always reflect fair market value. They may be too high due to some items receiving more publicity than others, the attendance of an avid collector,[581] or "auction fever."[582] Additionally, prices might be inflated because a dealer bought back paintings in order to drive up prices[583] or to protect the value of works in his inventory.[584] On the other hand, auction prices may be "too low if the auction

572. Furey, *supra* note 557, at 197-98; *accord* Speiller, *supra* note 14, at 229 ("[D]ealers have been known to obtain extraordinary prices from clients whom they have wined and dined over the years.").

573. Speiller, *supra* note 14, at 229.

574. LERNER & BRESLER, *supra* note 4, at 4.

575. *See* Treas. Reg. § 20.2031-1(b) (as amended in 1965) (providing that the fair market value of a used automobile is the price at which a comparable vehicle could be purchased by the public rather than the price that a dealer would pay); *see also* Alan Halperin, *The IRS Rules that a Picture is Worth 1,100 Words*, 132 TR. & EST., Mar. 1993, at 36, 42.

576. Sotheby's Holdings Inc. and Christie's International PLC handle approximately 98% of the world auction market for art and antiques. Peers, *supra* note 544, at B6; *see generally* LERNER & BRESLER, *supra* note 4, at 143-45.

577. *IRS Valuation Guide*, *supra* note 65, at 27-28; *Furey*, *supra* note 557, at 179 n.13.

578. Furey, *supra* note 557, at 179.

579. Furey, *supra* note 557, at 179; *see also* Halperin, *supra* note 575, at 38 (suggesting that the IRS should recognize "the dominant market place is the public auction" for estates containing valuable art).

580. Mathias v. Commissioner, 50 T.C. 994, 999 (1968).

581. McCarthy, *supra* note 4, at 11.

582. Speiller, *supra* note 14, at 229.

583. McCarthy, *supra* note 4, at 11; *accord IRS Valuation Guide*, *supra* note 65, at 27-28 ("While such [auction price] information may prove helpful, experience discloses that such publications have reported (without any intent to mislead) prices resulting from rigged sales.").

584. Speiller, *supra* note 14, at 229.

is not well attended because the items offered are unexciting or even because the weather is bad."[585]

The large number of dealer purchases at auctions, moreover, suggests the auction market may be a mixed retail-wholesale market. One commentator has suggested that:

> With respect to the auction market, Sotheby Parke Bernet, Inc. (New York) estimated that sixty percent of its sales are to dealers. Is then the price obtained at auction a retail price that represents fair market value or a wholesale price that does not? The question is unanswerable because the dealers may be bidding as agents for clients, thereby paying a retail price, or they may be bidding for their own account, thus paying what may be regarded as a wholesale price, which they will presumably mark up for resale.[586]

Nonetheless, one commentator has observed that executors overwhelmingly select the auction market as the method of disposing of art.[587]

a. *Buyer's Premium*

The purchaser of art at major auction houses must pay not only the "hammer price," but also a "buyer's premium."[588] The premium had been a uniform 10% of the bid price until January 1, 1993, when it was increased to 15% on the first $50,000 of the price.[589]

The Service recently ruled[590] that the fair market value of art in a decedent's gross estate which was sold at auction was the auction price plus the buyer's premium.[591] The IRS relied upon *Guggenheim v. Rasquin*[592] and *Publicker v. Commissioner*[593] for the proposition that fair market value is the total amount (purchase price plus excise tax and other charges) that a purchaser has to pay to acquire property.[594] Although *Rasquin* and *Publicker* involved valuation for gift tax purposes, the Service noted that fair market value should be the same for gift and estate tax purposes.[595]

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585. *Id.* (footnote omitted).

586. Speiller, *supra* note 7, at 229 (footnote omitted); *see also* Furey, *supra* note 557, at 179 n.15 (suggesting that most dealers buy works of art at auctions and resell them at a considerable markup in order to make a profit).

587. Halperin, *supra* note 575, at 38.

588. Tech. Adv. Mem. 92-35-005, (May 27, 1992); *see generally*, LERNER & BRESLER, *supra* note 4, at 153.

589. Ann E. Berman, *Good New, Bad News in the Art Market*, WALL ST. J., Nov. 25, 1992, at A12; Alexandra Peers, *Sotheby's Raises Commissions for Buyers by 50% in a Bid To Increase Its Revenue*, WALL ST. J., Nov. 3, 1992, at C1.

590. Tech. Adv. Mem. 92-35-005 (May 27, 1992). An attorney in the firm that represented the taxpayer has written an article analyzing the ruling. Halperin, *supra* note 575.

591. *Id.*

592. 312 U.S. 254 (1941); *see supra* text accompanying notes 164-73.

593. 206 F.2d 250 (3d Cir. 1953), *cert. denied*, 346 U.S. 924 (1954); *see supra* text accompanying notes 174-82.

594. Tech. Adv. Mem. 92-35-005 (May 27, 1992).

595. *Id.*

The IRS concluded that the estate could have received the hammer price plus the premium, if it had sold the art other than by auction.[596] The IRS stated that:

> The estate was not obligated by statute or otherwise to sell the art work in any particular manner, and there is no indication that, if the estate sold the art work directly or through a private dealer, that the sales price would not have been higher, reflecting the fact that the buyer would not have had to pay the purchase premium.[597]

It held that although known as a "buyer's premium," it was really a seller's cost of sale, regardless of who paid it.[598] Finally, the Service noted that the gross estate includes the value of property unreduced by selling expenses, which may be deductible as administration expenses under § 2053.[599]

The Service's ruling that actual sale prices established value recognized that post-valuation date sales are relevant in determining value consistent with long-established precedent.[600] But, whether the buyer's premium should be added to the hammer price depends on identification of the relevant market and on whether the estate had access to buyers in that market by alternative sale methods.

Since the ruling did not involve the blockage issue, the value of the artworks was to be determined in the market in which art was most commonly sold to the public.[601] Because art is generally obtained by the public in the retail market, value is the price at which it would be sold at retail.[602] The regulations provide that value is determined from the buyer's perspective.[603] If the estate could have obtained an amount equal to the auction price plus the buyer's premium by negotiating a private sale, determining value by reference to the willing buyer's total cost would be appropriate.

In *United States v. Cartwright*,[604] the Supreme Court held that regulations valuing mutual fund shares at the price a buyer would have to pay (the asked price), rather than at the amount a seller could receive (the bid price), were invalid.[605] The Court noted that private trading of mutual fund shares was "virtually nonexistent"[606] and that the bid price was "the only price that the estate could hope to obtain if the shares had been sold."[607] The regulation was held to be "unrealistic and unreasonable."[608]

596. *Id.*
597. *Id.*
598. *Id.*
599. *Id.*
600. *See supra* part I.B.4.a.
601. Treas. Reg. § 20.2031-1(b) (as amended in 1965).
602. *See id.*
603. *Id.*
604. 411 U.S. 546 (1973).
605. *Id.* at 550.
606. *Id.* at 549.
607. *Id.* at 551.
608. *Id.* at 550.

The IRS distinguished *Cartwright* in its recent ruling and held that the sale of art does not involve a restricted market as did the sale of mutual fund shares in *Cartwright*.[609] The estate, therefore, could have sold the art directly, or through a dealer, and obtained "an amount that would be comparable to the total amount paid by the buyer at a public auction."[610] If the IRS is correct, valuing the art by the buyer's total cost at auction is correct.

It has been suggested, however, that estates cannot sell art directly in the retail market:

> [A]n executor of an estate containing paintings cannot function as a dealer of fine art and dispose of the paintings in that market. An executor can place an advertisement in a newspaper and sell a used car, but it would not be prudent for an executor to sell a valuable painting in that manner. The art market is composed of highly specialized experts whose dealer-customer relationships are more analogous to a lawyer-client relationship than to a used-car dealer-customer relationship. Years of trust, experience, prestige, and warranties bind a dealer to his or her customers.[611]

The public auction, therefore, is "the most commonly used marketplace for an executor" to dispose of art.[612] Value determined in that market should be the amount obtainable by the estate—the hammer price.[613]

This issue should be resolved on the basis of whether estates can realistically and reasonably dispose of art other than through public auctions. The art market, unlike the market for mutual fund shares in *Cartwright*, is not a market restricted by law.[614] But does its unique nature effectively restrict the market? Can an estate dispose of art directly in the retail market? The courts should resolve the buyer's premium issue on the basis of evidence regarding the realities of the market.

B. *Art Appraisers*[615] *and Appraisals*

Early Treasury Regulations required that the value of artworks be supported by expert appraisals.[616] Value was to be determined by the amount the art "would bring at a bona fide sale to individual purchasers, to dealers, or upon a well-advertised auction sale."[617] Current regulations require appraisals of personal property whose value exceeds $3,000.[618]

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609. Tech. Adv. Mem. 92-35-005 (May 27, 1992).

610. *Id.*

611. LERNER & BRESLER, *supra* note 4, at 367 (Supp. 1992); *see also* Halperin, *supra* note 575, at 38 (noting that a retail market exists in the art field, but that it is generally not available to or appropriate for most executors).

612. LERNER & BRESLER, *supra* note 4, at 367 (Supp. 1992); Halperin, *supra* note 575, at 38.

613. LERNER & BRESLER, *supra* note 4, at 369 (Supp. 1992); *see* Halperin, *supra* note 575, at 40.

614. Tech. Adv. Mem. 92-35-005 (May 27, 1992); Halperin, *supra* note 575, at 37.

615. For detailed treatment of issues involving art appraisers, see Furey, *supra* note 557; Homer, *supra* note 17.

616. Treas. Reg. 37, Art. 17, 18, T.D. 2910, 21 Treas. Dec. Int. Rev. 752, 765 (1919).

617. *Id.* at 766.

618. Treas. Reg. § 20.2031-6(b) (1958).

Art appraisals can be obtained from many sources, including members of appraisal associations, art dealers, auction houses, and art museum personnel. Two factors are important in assessing the relative merits of these appraisers: competence and objectivity.[619] Competence refers to the training and experience that qualifies one to appraise art.[620] Objectivity refers to the absence of a conflict of interest.[621] Lack of an inherent conflict of interest, however, does not mean that the appraiser will not assume the role of an advocate for the party that retains him. It means only that the appraiser does not have any other personal stake in the appraisal result. Competence and objectivity obviously depend on the individual appraiser. But membership within a particular group may affect an appraiser's competence and objectivity.[622]

There are a number of associations of art appraisers.[623] Requirements for membership in the associations vary greatly.[624] Failure to ensure competence of their members is "[t]he fundamental problem with appraiser societies."[625] The current system does not require uniform accreditation and, consequently, allows persons with little or no training or experience to make appraisals.[626] Although questions exist regarding their competence, professional appraisers may be objective because they have "no financial incentive to become an advocate."[627]

Art dealers also appraise art. Their competence to appraise art, however, may be questioned.[628] They may lack knowledge and training in the appraisal process and have limited exposure to art other than that for sale in their galleries.[629] Art dealers also have a serious conflict of interest in valuing art.[630] They "have every reason to want to establish high prices, since high art values are financially beneficial to collectors who, upon donation of artworks, can take maximum charitable deductions."[631] Dealers might also overvalue art in order to increase the prices of comparable works in their galleries.[632]

Art appraisals may also be obtained from representatives of major auction houses which have full-time appraisal staffs.[633] Such appraisers are usually well-trained, experienced, and familiar with the latest market de-

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619. Homer, *supra* note 17, at 463.

620. *Id.*

621. *Id.*

622. *Id.* at 462-80 (discussing these issues in detail).

623. Furey, *supra* note 557, at 185 n.63.

624. *Id.*; Homer, *supra* note 17, at 464-66.

625. Homer, *supra* note 17, at 465.

626. Furey, *supra* note 557, at 199; Homer, *supra* note 17, at 461 (suggesting "formal state regulation of appraisers via appraiser licensing and accreditation legislation could solve some of the problems of incompetence in the profession").

627. Homer, *supra* note 17, at 466.

628. *Id.* at 472.

629. *Id.*

630. *Id.* at 470.

631. *Id.*

632. *Id.* at 466.

633. *Id.* at 473.

velopments.[634] Most staff members possess knowledge of a particular art market and have a background in the arts and art history.[635] If the possibility of overvaluation to obtain art for auction and the resultant commissions is dismissed,[636] auction houses lack a conflict of interest in appraising art.[637]

Finally, museum curators and staff sometimes appraise art, although some may be prohibited from preparing appraisals for outsiders.[638] Museum personnel with credentials and training as art historians would appear to be competent appraisers.[639] But valuation of art requires knowledge of current market conditions that they may not possess.[640] Moreover, museum personnel may have a conflict of interest when valuing art.[641] A high appraisal may result in the museum's receipt of the piece or increase the chances that a collection might be donated in the future.[642]

Treasury Regulations address the competence and objectivity of appraisers.[643] Taxpayers are advised to select carefully appraisers that are "reputable and of recognized competency to appraise the particular class of property"[644] and are required to provide a statement under penalties of perjury "as to the disinterested character and the qualifications of the appraiser."[645] Courts have focused on experts' competence and objectivity in determining whether to accept their testimony and how much weight it should be given.[646] Courts have disregarded expert testimony determined to be exaggerated, biased, or given by one inexperienced in the appraisal of the item valued.[647]

Objective facts must support appraisals. An "appraiser's opinion is never more valid than the facts on which it is based; without these facts it is simply a guess."[648] An appraiser's failure to support his opinion with facts may lead the IRS to challenge the appraisal.[649] The IRS has set forth the

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634. Furey, *supra* note 557, at 186.

635. Homer, *supra* note 17, at 474.

636. *Id.* (stating that her interviewees "claimed this is unlikely to occur; and stated that it never had occurred to their knowledge").

637. *Id.*; *see* Furey, *supra* note 557, at 186 n.71.

638. Homer, *supra* note 17, at 467.

639. *Id.*

640. *Id.* at 468.

641. *Id.* at 467-68.

642. *Id.* at 467.

643. Treas. Reg. § 20.2031-6(b), (d) (1958).

644. Treas. Reg. § 20.2031-6(d) (1958); *see also* INTERNAL REVENUE SERVICE, PUB. NO. 561, DETERMINING THE VALUE OF DONATED PROPERTY 9 (1992) ("The weight given the appraisal depends on the completeness of the report, the qualifications of the appraiser, and the appraiser's demonstrated knowledge of the donated property."); *cf.* McCarthy, *supra* note 4, at 20 (suggesting one reason the IRS challenges appraisals is "use of an appraiser unfamiliar with the type of property being valued").

645. Treas. Reg. § 20.2031-6(b) (1958).

646. *See, e.g.*, Williford v. Commissioner, 1992 T.C.M. (P-H) ¶ 92,450, at 2419 (1992); Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699 (1992); Biagiotti v. Commissioner, 1986 T.C.M. (P-H) ¶ 86,460, at 2115 (1986).

647. *See supra* text accompanying notes 233-36.

648. INTERNAL REVENUE SERVICE, PUB. NO. 561, DETERMINING THE VALUE OF DONATED PROPERTY 9 (1992); *see* Rev. Proc. 66-49, 1966-2 C.B. 1257, 1258.

649. McCarthy, *supra* note 4, at 20.

sort of data to be included in art appraisals for federal income tax purposes.[650] The IRS factors also serve as a useful guide for transfer tax purposes. Seventeen items that would be contained in an "ideal appraisal" have been identified.[651]

C. *IRS Art Advisory Panel*

In 1968, the IRS created the Art Advisory Panel ("Panel") to determine whether art donated to charity was being realistically appraised.[652] The Service maintains the Panel to assist it in reviewing selected cases involving taxpayer valuations of major art objects.[653] An Art Valuation Group within the Service's Engineering and Valuation Branch provides staff support for the Panel.[654]

The Internal Revenue Manual provides that objects valued by taxpayers at $20,000 or more are to be referred to the National Office for review by the Panel.[655] The large number of cases meeting that threshold, however, has required the Art Valuation Group to select cases for Panel consideration and handle the rest itself.[656]

The Panel's meetings are closed to the public to prevent disclosure of taxpayer information.[657] Several procedures are followed to ensure an objective review. Panel members are not informed in advance of the meeting of the taxpayer's identity or whether the valuation issue arose in an estate or income tax context.[658] The Panel discusses works in alphabetical order by artist (or by culture in the case of non-western art) to minimize recognition of a taxpayer's collection.[659]

After discussion, the Panel reaches a consensus value.[660] If the Panel disagrees with the taxpayer's valuation, it usually recommends a specific valuation.[661] Although the Panel's recommendations are merely advisory, they become the Service's position after review by the National Office Art Valuation Group staff.[662] The IRS prepares a report of the Panel's determination and a copy is given to the taxpayer.[663] If the taxpayer provides additional information or new evidence deemed substantive by the staff, it

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650. Rev. Proc. 66-49, 1966-2 C.B. 1257, 1259.
651. McCarthy, *supra* note 4, at 18-20.
652. Furey, *supra* note 557, at 182.
653. *IRS Valuation Guide*, *supra* note 65, at 13.
654. *Id.*
655. INTERNAL REVENUE MANUAL 42(16)4.2 (11-19-82), *reprinted in IRS Valuation Guide*, *supra* note 65, at 18; *cf.* Speiller, *supra* note 14, at 234 (noting that items valued at less than $20,000 are primarily handled in the district offices by appraisers who have no training or background in art).
656. Speiller, *supra* note 14, at 235 & n.82.
657. *IRS Valuation Guide*, *supra* note 65, at 25.
658. *Id.* at 24-25.
659. Internal Revenue Service, *Annual Summary Report for 1992 of Closed Meeting Activity of the Art Advisory Panel of the Commissioner of Internal Revenue* [hereinafter *1992 Regular Meeting Summary*].
660. *Id.*
661. *IRS Valuation Guide*, *supra* note 65, at 13.
662. INTERNAL REVENUE MANUAL 42(16)4.1 (11-6-84), *reprinted in IRS Valuation Guide*, *supra* note 65, at 17; *1992 Regular Meeting Summary*, *supra* note 659.
663. *1992 Regular Meeting Summary*, *supra* note 659.

will be submitted to the Panel for reconsideration at a subsequent meeting.[664]

The Panel is composed of nationally prominent art museum directors, curators, and art dealers[665] appointed by the Commissioner as "special government employees."[666] Members of the Panel receive no compensation, but are reimbursed for travel expenses at the allowable government rate.[667] The Panel currently has twenty-five members.[668] Conflicts of interest may arise because the Panel is composed of art dealers (who may profit from high valuations of works by artists they represent) and museum directors (who may not risk offending donors by lowering valuations).[669] If a conflict of interest exists, the panelist with the conflict does not participate in the deliberations and leaves the room.[670]

In 1992, the Panel met three times[671] and reviewed a total of 2,642 items.[672] It recommended acceptance of 56% of the appraisals, adjustments as to 42%, and determined that 1% required additional staff development[673] (the missing 1% appears to have resulted from rounding). The Panel's recommendations resulted in a 55% reduction of "overvalued items" in charitable contribution appraisals and a 56% increase of "undervalued items" in estate and gift appraisals.[674]

The Panel reviewed 126 estate and gift tax cases in 1992 and appraisals of 1,910 items.[675] It recommended acceptance of the appraised value for 71% of the items.[676] The Panel recommended adjustments for 27% of the items (increases - 20%; decreases - 7%).[677] The remaining 2% required further staff development.[678] These statistics, however, are misleading because they include two categories: (1) Painting and Sculpture; and, (2) African, Oceania and the Americas.[679] The Panel recommended acceptance of the appraisals for all 803 items in the second category,[680] but recommended acceptance of only 50% of the appraised values within

664. *Id.*

665. *IRS Valuation Guide*, *supra* note 65, at 13.

666. Karen E. Carolan, *Documenting Art Appraisals for Federal Tax Purposes*, *in* THE LAW AND BUSINESS OF ART, at 797, 824 (PLI Patents, Copyrights, Trademarks, & Literary Property Course Handbook Series No. 297, 1990).

667. *Id.*

668. *1992 Regular Meeting Summary*, *supra* note 659 (a list of the members is provided with the report).

669. Furey, *supra* note 557, at 184-85.

670. *1992 Regular Meeting Summary*, *supra* note 659.

671. *Id.*

672. *Id.*

673. *Id.*

674. *Id.*

675. *Id.*

676. *Id.*

677. *Id.*

678. *Id.*

679. *Id.*

680. *Id.*

the Painting and Sculpture category.[681] Increases were recommended for 34% of the items, decreases for 12%.[682]

IV. Blockage and the Valuation of Art

Blockage was initially recognized in cases involving the valuation of securities for transfer tax purposes, and the Regulations discuss it only in that context. Blockage, however, has not been limited to transfer tax valuation cases,[683] nor to cases involving securities.[684] Blockage "is relevant in the valuation of any commodity."[685]

A. Estate of Smith v. Commissioner[686]

David Smith died from injuries suffered in an automobile accident in 1965.[687] He died owning 425 pieces of sculpture created during various periods of his life.[688] A large majority (291) of the works were located at Bolton Landing, N.Y.[689] Most of Smith's art consisted of abstract metal sculptures.[690]

In determining the value of Smith's art, the estate first valued the pieces individually.[691] The estate determined the art, if sold separately, had an aggregate value of $4,284,000.[692] The estate, however, discounted the aggregate value by 75% for blockage.[693] It asserted that value had to be determined by the amount that could be obtained if all the sculptures had been offered for sale at the moment of death.[694] The only purchaser under those circumstances would have been a bulk purchaser acquiring the art for resale.[695] Such a purchaser, the estate believed, would have made a large cash investment which could only be recovered with an acceptable profit over a long period of time.[696] As a result, such a buyer would have only paid 25% of the art's aggregate value.[697] Finally, the estate reduced the already discounted figure by one-third to take into account gallery commissions that would be paid under a contract existing at

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681. *Id.*

682. *Id.*

683. *See, e.g.*, Amerada Hess Corp. v. Commissioner, 517 F.2d 75 (3d Cir.) (income tax), *cert. denied*, 423 U.S. 1037 (1975); Seas Shipping Co. v. Commissioner, 371 F.2d 528 (2d Cir.) (income tax), *cert. denied*, 387 U.S. 943 (1967); Champion v. Commissioner, 303 F.2d 887 (5th Cir. 1962) (income tax).

684. *See* Estate of Folks v. Commissioner, 43 T.C.M. (CCH) 427 (1982) (valuation of lumberyards).

685. Rushton v. Commissioner, 498 F.2d 88, 90 n.2 (5th Cir. 1974).

686. 57 T.C. 650 (1972), *aff'd*, 510 F.2d 479 (2d Cir.), *cert. denied*, 423 U.S. 827 (1975).

687. *Id.* at 651.

688. *Id.*

689. *Id.* Bolton Landing is in upstate New York.

690. *Id.*

691. *Id.* at 654.

692. *Id.*

693. *Id.*

694. *Id.* at 657.

695. *Id.*

696. *Id.*

697. *Id.*

Smith's death.[698] The artworks, according to the estate, had a value of $714,000;[699] less than 17% of the aggregate value determined on a per-item basis.

The estate, relying on the blockage discount, valued the sculptures at the price at which "the block" could be sold "as such" "outside the usual market."[700] Who would purchase such a large block of art in the alternative market? Not individual consumers in the retail market, but a person who would buy *en bloc* at wholesale prices with the intent to resell. Such a buyer would consider recovery of his investment as well as profit in determining price. The estate's approach was consistent with the manner in which large blocks of stock had been valued at wholesale prices outside the usual market.[701]

The IRS, in its deficiency notice, valued Smith's works at $5,256,918.[702] At trial, however, the IRS conceded that the art's value did not exceed the $4,284,000 amount determined by the estate.[703] The IRS did not allow a blockage discount; it claimed that simultaneous availability of all works would not adversely affect prices.[704] Value, therefore, was determined on an item-by-item basis in accordance with the regulations.[705]

The Tax Court rejected the estate's argument that sale commissions should be considered in determining value.[706] The court relied upon *Publicker v. Commissioner*[707] and held the measure of value is what could be received on a sale, not by what would be retained on a sale.[708]

If the court was determining value in the retail market, it was correct in holding that the value of property is the price that the purchaser would have paid to acquire the property, not what the seller, after transactional costs, would have received. But if value is determined outside the usual market, the proper measure is the amount that the estate would have received: a wholesale price. The claimed reduction for commissions, however, appears to duplicate the 75% blockage discount. If the estate could only have sold the block to a bulk purchaser for 25% of the art's aggregate value, that would be its value for estate tax purposes. No additional discount would be warranted.

The Tax Court refused "to make any hard-and-fast choice between the two approaches urged by the parties."[709] It did not reject the estate's

698. *Id.* at 654.

699. *Id.* In the Tax Court, the estate took the position that the artworks could not be valued and had no value. *Id.* at 655. The court summarily rejected that argument; difficulties in determining value are not a bar to valuation. *Id.*

700. *See id.* at 654.

701. *See supra* part II.E.2.

702. 57 T.C. at 655.

703. *Id.*

704. *Id.* at 656-57.

705. *Id.* at 657.

706. *Id.* at 659.

707. 206 F.2d 250 (3d Cir. 1953), *cert. denied*, 346 U.S. 924 (1954).

708. 57 T.C. at 659.

709. *Id.* at 657.

valuation method although it believed a 75% discount was too large.[710] On the other hand, it held that the Commissioner should have given "considerable weight" to the fact that each item would not be offered in isolation.[711]

The court found that the large number of artworks in the estate would adversely affect prices in the market.[712] If the public had known of the great number of unsold artworks and had all 425 pieces been made immediately available, the estate could "reasonably have expected to get substantially less money for them than if the works were slowly disseminated in the market over a period of years."[713] The Tax Court thus made the threshold factual determination required to invoke blockage. It specifically found that blockage provided a useful analogy in determining the value of the large block of art.[714]

In the most puzzling statement in the opinion, the court concluded "in this case, the amount which an *en bloc* purchaser for resale would pay and the aggregate of the separate 'one-at-a-time' values to be obtained by a variety of dispositions in the 'retail market' would be the same."[715] Wholesale prices, however, must differ from retail prices. A wholesale purchaser of Smith's art would have incurred substantial opportunity costs (use of money) and carrying costs (transportation, maintenance, insurance, etc.). If such a purchaser could only resell the works at his purchase price, the purchase would not be made.

The court listed a multitude of factors it professed to have considered in determining value,[716] including pre-death and post-death sales.[717] The court then declared that it had "carefully considered the entire record" and valued the artworks at $2,700,000.[718] It did not discuss its valuation process or the weight it had given to any of the evidence. The determination of value was not appealed.[719]

The Tax Court took an important first step in recognizing and applying blockage in the valuation of art in *Smith*. The court, unfortunately, provided little guidance as to how value is determined when blockage is involved. The opinion suggests the court used the "all relevant factors valuation" approach. The court's lengthy recitation of factors and its hold-

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710. *Id.* at 657-58.
711. *Id.* at 658.
712. *Id.* at 653.
713. *Id.*
714. *Id.* at 658.
715. *Id.*
716. *Id.* at 658-59.
717. *Id.* at 659 n.8 (giving little weight to sales made more than two years after Smith's death). The court's consideration of post-death sales has been criticized. Martin S. Echter, *Equitable Treatment for the Artist's Estate*, 114 TR. & EST. 394, 397 (1975) ("To establish a date-of-death fair market valuation based on the fortuitous post-death appreciation in the value of sculptures several years after the artist's death is utterly incompatible with the concept of taxing an estate based on its value at the date of decedent's death.").
718. 57 T.C. at 660.
719. Estate of Smith v. Commissioner, 510 F.2d 479, 480 (2d Cir.), *cert. denied*, 423 U.S. 827 (1975). The issue on appeal was whether commissions paid by the estate were deductible as administration expenses under § 2053.

ing that value is determined by the amount that could be received (rather than retained) is consistent with that method. The court apparently considered the amount that a bulk purchaser would have paid as one of many relevant factors.

The $2,700,000 value and the lack of any discussion of the valuation process suggest, however, that the court simply "split the baby" by reaching a compromise value close to the average of the parties' positions.[720] The court's valuation was 37% less than the agreed upon per-item aggregate value. The 37% figure and the final value strongly suggest that the court allowed a 37.5% blockage discount (exactly in the middle of the parties' positions) and rounded the resulting number to the nearest hundred thousand dollar amount.[721]

B. *IRS Valuation Guide*

The IRS specifically recognized that blockage applies in the valuation of art in the IRS Valuation Guide published commercially in October, 1985:

> In handling an artwork valuation case, the appeals officer may also encounter a blockage issue. The concept of blockage is essentially one of timing. A discount may be allowed where a large quantity of any one type of art is offered on the market at one time, and would substantially depress its value. The amount of the discount would be determined, in part, on a reasonable estimate of the time it would take to sell the entire quantity in smaller lots. Some of the factors to be considered in determining whether a blockage discount is available are the opportunity cost of holding the inventory, the carrying costs of the inventory, and the expected period of time it will take to dispose of the inventory.[722]

The Service correctly identified size of the block and time required to liquidate as the primary factors in deciding whether consideration of blockage is justified. The other factors listed (opportunity cost and carrying costs) are more relevant in determining the amount of the discount than in deciding whether blockage is to be considered at all.

The IRS Valuation Guide gives a curious example based upon *Smith:*

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720. The estate valued the art at $714,000 (ignoring its argument that the art had no value). 57 T.C. at 654. The IRS valued the art at $4,284,000. The average of those values is $2,499,000. Others have reached a similar conclusion. Norman E. Donoghue, II, *Art Appraisals and Valuation for Federal Tax Purposes: Mechanics of New IRS Appraisal Rules, in* THE LAW AND BUSINESS OF ART at 183, 220 (PLI Patents, Copyrights, Trademarks, & Literary Property Course Handbook Series No. 297, 1990) ("In *Smith,* the Tax Court literally split the difference between the IRS valuation and one of the executors' valuations."); Echter, *supra* note 717, at 396 ("The Court valued the sculptures at $2,700,000, approximately mid-way between the executors' $0 valuation and that of the government.").

721. 75% (estate) + 0% (IRS) = 75% ÷ 2 = 37.5%; $4,284,000 × 37.5% = $1,606,500 blockage discount; $4,284,000 − $1,606,500 = $2,677,500; $2,677,500 rounded to $2,700,000. *See* LERNER & BRESLER, *supra* note 4, at 429 (Supp. 1992) (concluding the court allowed a 37.5% blockage discount).

722. *IRS Valuation Guide, supra* note 65, at 30.

> *Example 3* A famous sculptor died, leaving a large inventory of unsold sculptures. Because the sculptures could not be sold in one group, a discount may be allowable based upon the time required to dispose of the inventory in smaller lots.[723]

By assuming that the sculptures could not be sold in one group, the IRS seemed to reject determination of value by reference to a bulk sale in an alternative market as advocated by the taxpayer in *Smith.* The IRS issued Revenue Ruling 83-30[724] after *Smith* and before commercial publication of the valuation guide in 1985. Was this example, as well as the Revenue Ruling, intended as a rejection of the Regulation which recognizes that the value of a large block might be "the price at which *the block* could be sold *as such* outside the usual market?"

C. Calder v. Commissioner[725]

Alexander Calder died November 11, 1976.[726] His estate contained 1,292 gouaches (opaque water color paintings).[727] The estate claimed a 60% blockage discount in the valuation of the gouaches[728] and reported them on the estate tax return at $949,750.[729] The Service's appraiser also determined that a blockage discount of about 60% should be allowed and valued the gouaches in a range from $1,164,600 to $1,293,800.[730] In determining value, the Service assumed that approximately fifty could be sold per year.[731] Although its appraiser valued the art at least 22% higher than did the estate, the IRS concluded that the estate's valuation was within an acceptable range and did not recommend a change for estate tax purposes.[732]

Louisa Calder, widow of the decedent, received 1,226 of the 1,292 gouaches.[733] In the month following her husband's death, Louisa Calder transferred her 1,226 gouaches to four irrevocable trusts for her children and grandchildren.[734] Calder believed that the value of the gouaches had not changed in the forty days following her husband's death.[735] She claimed a 60% blockage discount and reported the gifts at the same value used for estate tax purposes.[736] The IRS disagreed with Calder's valuation and issued a notice of deficiency.[737]

In the Tax Court, Calder and the IRS agreed on the fair market value of the individual gouaches, but disagreed as to the application of block-

723. *Id.*
724. Rev. Rul. 83-30, 1983-1 C.B. 224.
725. 85 T.C. 713 (1985).
726. *Id.* at 714.
727. *Id.*
728. *Id.* at 717.
729. *Id.* at 714.
730. *Id.*
731. *Id.* at 719.
732. *Id.* at 714.
733. *Id.*
734. *Id.* at 717.
735. *Id.*
736. *Id.*
737. *Id.* at 713.

age.[738] The disagreement involved three issues: (1) whether blockage applied for gift tax purposes, (2) identification of the relevant block, and (3) the manner in which the blockage discount was to be determined.[739]

The IRS argued that blockage discounts should not be allowed in the valuation of gifts "because gifts, unlike deaths, are contemplated events and one can manipulate the circumstances surrounding the transfers."[740] The court summarily rejected that argument as inconsistent with the gift tax regulations and case law.[741]

Calder treated her transfers into the four trusts as four separate gifts (even though there were six beneficiaries under the trusts)[742] and calculated a blockage discount on the basis that all four gifts should be valued as part of one large block.[743] Calder argued that value should be determined on the basis of all gifts in order to take into account the time required to sell the gifts in an orderly manner.[744] She contended the Regulation's "no aggregation of gifts" rule applied only to the valuation of securities.[745] The Commissioner, on the other hand, calculated a blockage discount on the basis of six separate gifts.[746]

The Tax Court determined that Calder had made six, not four, separate gifts.[747] Case law established that gifts in trust are regarded as gifts to the trust beneficiaries, not gifts to the trust.[748] That determination was also consistent with the duty imposed on the trustees to administer the funds as separate trusts for the beneficiaries.[749]

The court held that the blockage discount must be applied separately to each gift under the "no aggregation of gifts" rule.[750] Although Calder attempted to restrict that rule to the valuation of securities,[751] the court held that the limitation also applied in the valuation of other property,[752] citing the Fifth Circuit's decision in *Rushton*.[753]

The opinion does not reveal how Calder computed the 60% discount that she claimed. The Commissioner calculated a blockage discount by taking the agreed-upon prices of each gouache, estimating the number of years that would be required to sell each block, and determining the discounted present values of the rights to receive those amounts, using tables

738. *Id.* at 721.
739. Another issue, unrelated to blockage, involved the gift tax annual exclusion. *Id.* at 726-30. Consideration of that issue, however, is beyond the scope of this article.
740. *Id.* at 721. Similar arguments against allowance of blockage discounts for gift tax purposes had previously been made. *See* HARRISS, *supra* note 284, at 82.
741. 85 T.C. at 721-22.
742. *Id.* at 720.
743. *Id.* at 722.
744. *Id.*
745. *Id.*
746. *Id.* at 718.
747. *Id.* at 720-21.
748. *Id.*
749. *Id.* at 721.
750. *Id.* at 723.
751. *Id.* at 722.
752. *Id.* at 723.
753. *Id.*

provided in the regulations for the valuation of annuities for a term certain.[754] He discounted the date of gift per-item values for the time that receipt of those amounts would be delayed.[755] The six gifts were valued independently with no consideration of the possible impact one trust's sales would have on the others.[756] The net effect of the Commissioner's approach was allowance of a 25% discount for gifts which would require five years to liquidate and an 18% discount for gifts which would require three years to liquidate.[757]

The Tax Court recognized the annuity approach taken by the Commissioner:

> [R]espondent treated the gouaches here as a large number of illiquid assets, whose worth could be realized only through liquidation over a period of time at a uniform rate, yielding an assumed amount of dollars each year over such period. Under this approach, realization of the value of the artworks can be compared to the right to receive an annuity of the stated amount over the given period, and the present worth of such annuity can be determined from the appropriate valuation tables. Sec. 25.2512-5, Gift Tax Regs. The appropriate valuation factor reflects a discount for the amount of time the various installments of the annuity are deferred. As applied in the instant case, the effect is to grant a blockage discount in a somewhat more sophisticated manner than the usual method of applying a single percentage discount to the retail value of the items at the date of the gift.[758]

It did not find the annuity approach unreasonable, but noted that its accuracy depended upon the validity of the assumptions regarding the number of pieces that could be sold each year and the length of the liquidation process.[759]

The problem with the Service's valuation, according to the court, was that it assumed 330 gouaches could be sold each year.[760] The evidence established, however, that combined average annual sales of all six blocks from 1977 though 1982 had been sixty.[761]

The court then engaged in the roundabout aggregation rejected by the Fifth Circuit in *Rushton*:

> We agree that the discount should be calculated for each gift separately, but it is not realistic to apply the total sales figure for *all* gouaches sold during the year to *each* gift, separately, in determining the liquidation period. Rather, it seems more logical to us to use the actual average annual sales for *each* of the six gifts to determine the relative liquidation periods.[762]

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754. *Id.* at 724.
755. *Id.*
756. *Id.* at 718.
757. *Id.*
758. *Id.* at 724.
759. *Id.*
760. *Id.*
761. *Id.*
762. *Id.* at 724-25.

It attempted to justify its departure from the "no aggregation of gifts" rule on the grounds that "blockage is a question of fact rather than a rule of law."[763] Actual sales, according to the court, provided the best evidence of the true absorption rate of the market and were to be used to determine the blockage adjustment through the annuity approach employed by the Service.[764]

The court utilized the Service's annuity approach to determine value and the blockage discount.[765] It concluded that sixty gouaches could be sold each year and that it would take twenty-two years to liquidate all 1,226.[766] The court took the per-item fair market value of the gouaches as stipulated by the parties and discounted those amounts to present value using a 10% discount rate over the twenty-two year liquidation period.[767] It concluded that the value of the gouaches was $1,210,000, after an appropriate discount for blockage.[768] The court thus allowed Calder a discount of approximately 58%, close to the 60% she had claimed.[769]

The court, although professing to uphold the "no aggregation of gifts" regulation, refused to enforce its requirement that blockage be determined by reference to each separate gift.[770] The court did indirectly what it refused to do directly. The Tax Court, moreover, had earlier recognized the inconsistency of allowing roundabout aggregation. In *Rushton* it had held that it was "illogical to determine the value of each gift separately and yet take into account the effect of all gifts of shares upon the market. The two concepts are irreconcilable."[771] The Fifth Circuit, similarly, had found roundabout aggregation "strongly against the thrust of the regulation."[772]

763. *Id.* at 725.
764. *Id.*
765. *Id.* at 725-26.
766. *Id.*
767. *Id.* at 726.
768. *Id.*
769. Calder stipulated that each gouache had a value of $2,375, resulting in an aggregate value of $2,911,750 for the 1,226 gouaches. Calder claimed a 60% discount resulting in a net value of $1,164,700. The Tax Court valued the gouaches at $1,210,000.

	Calder	Tax Court
Aggregate Value	$2,911,750	$2,911,750
Effective Discount	-1,747,050 (60%)	-1,701,750 (58.444%)
Value	$1,164,700	$1,210,000.

770. *See* Todd & King, *supra* note 280, at A-12 (recognizing the inconsistency in *Calder* and noting that "[i]n considering the reality of actual sales by each block, the court's application of the blockage theory to each separate gift is somewhat inconsistent. However, that may be the result of not wishing to invalidate the regulations, but, at the same time, being unable to ignore reality."). The Tax Court earlier recognized that allowing roundabout aggregation would be equivalent to holding the regulation invalid. Rushton v. Commissioner, 60 T.C. 272, 276 (1973) ("Although petitioners do not ask us to hold the above-quoted section of the regulations invalid, we would, in effect, be doing so if we adopt petitioners' position."), *aff'd*, 498 F.2d 88 (5th Cir. 1974). Two years after deciding *Calder*, the Tax Court cited the "no aggregation of gifts" regulation, *Calder*, and *Rushton* and suggested, somewhat surprisingly given *Calder*, that it had consistently valued gifts separately. Adair v. Commissioner, 54 T.C.M. (CCH) 705, 708 (1987).
771. Rushton v. Commissioner, 60 T.C. 272, 278 (1973).
772. Rushton v. Commissioner, 498 F.2d 88, 92 (5th Cir. 1974).

The court in *Calder* confronted a difficult problem. How could it value a block of art as of Dec. 21, 1976 (date of gift), at a value substantially different from its value on Nov. 11, 1976 (date of death), when the parties had agreed that the value of the individual gouaches did not vary between the date of the death and the date of the gift?[773] The court could not, and disregarded the Regulation.[774]

On this issue the court erred. Notwithstanding the apparent inequities that may arise as a result of the "no aggregation of gifts" rule, the rule is required by the multiple-taxable-event nature of the gift tax and the hypothetical sale posited by fair market value. Enforcement of the rule is also necessary to maintain consistency in allowing minority and blockage discounts for estate and gift tax purposes.[775] The court should have valued each gift separately without considering the other gifts.

The Tax Court is to be commended, however, for utilizing the annuity approach. The court's use of that approach may have laid the foundation for future recognition that the value of a block of art may be determined at what "the block" could be sold for "as such" "outside the usual market." The court did not discuss its valuation in those terms; however, several considerations support that conclusion.

First, the court recognized that the property to be valued consisted of blocks of art and that, for such property, no established retail market existed.[776] Second, its use of the annuity approach considered factors (opportunity cost of money and length of resale period) which the taxpayer in *Estate of Smith* suggested would be important to a bulk purchaser for resale. The annuity approach discounted a stream of payments to current value. Stated another way, the value determined was the amount an investor (a bulk purchaser) would have paid to receive the right to future sale proceeds and a 10% profit on his investment. Third, the court considered the gift tax regulation that addresses blockage in the securities context as equally applicable to the valuation of art. That regulation recognizes that the value of a block of property may be "the price at which the block could be sold as such outside the usual market."[777]

The court's annuity approach, however, probably resulted in overvaluation of the art for two reasons. First, it did not consider carrying costs[778] (i.e., storage, maintenance, insurance, etc.) that a purchaser of 1,226 gouaches would incur. A bulk purchaser of art is not purchasing a financial instrument; he is acquiring tangible personal property. The IRS Valuation Guide recognizes that "the carrying costs of the inventory" are

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773. Calder v. Commissioner, 85 T.C. 713, 717 (1985).

774. *See id.* at 724-25.

775. *See supra* part II.B.3.

776. *Calder*, 85 T.C. at 723 ("[T]here is no established market in which to make a disposition, and both [large blocks of stock or art] involve sales which are privately negotiated between the buyer and the seller.").

777. Treas. Reg. § 25.2512-2(e) (as amended in 1976).

778. *Cf.* LERNER & BRESLER, *supra* note 4, at 503 ("Maintaining a collection [of art] in good condition is expensive: expenses may include framing, reframing, lighting, air conditioning and humidity controls, cleaning and other maintenance, security devices, publications, and insurance.").

relevant in determining whether blockage applies.[779] Such costs are also relevant in determining the effect of blockage on value.

Second, the market risk associated with art cannot be equated with the market risk associated with annuities. The purchaser of an annuity contract from an established insurance company is not assuming much risk of loss of capital. He can reasonably anticipate full payment under the contract. A bulk purchaser of art, on the other hand, is purchasing property which may be subject to dramatic price fluctuations. The court's valuation in *Calder*, in effect, assumed that the value of each gouache would remain unchanged during the twenty-two year liquidation period, an assumption that will undoubtedly prove false. It cannot be known whether the gouaches will rise or fall in value during that period. The higher market risk that exists with art should have been reflected in a higher discount rate. An investor will not buy a block of art with an anticipated 10% profit if a 10% annuity is available as an alternative investment. The discount rate must reflect market risk.

D. Estate of O'Keeffe v. Commissioner[780]

Georgia O'Keeffe died in 1986 at the age of ninety-eight.[781] Her gross estate contained approximately 400 works of art or groups of art that she had created.[782] The total fair market value of the artworks, valued individually, exceeded $72,759,000,[783] as determined by agreement of the estate and the IRS.[784] Although the estate and the IRS agreed on the art's aggregate per-item fair market value, they disagreed on blockage.

The estate employed Eugene Victor Thaw to appraise O'Keeffe's art.[785] Thaw had been a witness for the government in *Estate of Smith*.[786] The manner in which Thaw determined value in *O'Keeffe* (*en bloc* sale to a purchaser for resale)[787] and the percentage blockage discount which he used (75%)[788] were identical to those advocated by the taxpayer in *Smith*.

Thaw was under the impression that determination of the blockage discount required him to assume a hypothetical buyer who would purchase all of the works *en bloc* on date of death.[789] He assumed that the block would be sold to a single purchaser who would hold the art for many years and who would consider interest, selling costs, promotion, maintenance costs, and carrying charges in determining the price he would pay.[790] Such a purchaser, according to Thaw, would also consider possible price fluctuations from the high level for O'Keeffe's works in 1986,

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779. *IRS Valuation Guide*, *supra* note 65, at 30.
780. 63 T.C.M. (CCH) 2699 (1992).
781. *Id.* at 2700.
782. *Id.*
783. *Id.*
784. *Id.* at 2702.
785. *Id.*
786. Echter, *supra* note 717, at 396.
787. *O'Keeffe*, 63 T.C.M. (CCH) at 2702.
788. *Id.*
789. *Id.*
790. *Id.*

although he believed prices of her works were unlikely to decline on the average.[791] Thaw believed that a 75% blockage discount should be allowed[792] and determined the fair market value of the estate's art was approximately $18,000,000.[793] Thaw would not, however, have advised a hypothetical seller of O'Keeffe's art to sell at a 75% discount.[794]

Anthony M. Lamport, a financial analyst and advisor to venture capital funds, testified in support of Thaw's opinion.[795] He made various assumptions regarding the financial return to a bulk purchaser of the estate's art and prepared a pro forma income statement.[796] Lamport assumed that a bulk purchaser would have sold the art through a new gallery opened in New York City.[797] He made no allowance for increases in prices and used rates of 10% to 32% to discount projected cash flows after expenses.[798] Under Lamport's model, if anticipated cash flows were discounted to yield a 20% rate of return, the estate's art would have been valued at $14.4 million (an 80% blockage discount).[799] Lamport's analysis, according to the estate, "was intended only to explain expenses that a hypothetical buyer would consider in determining a fair purchase price."[800] The estate apparently argued, however, that even if expenses were ignored, a 60% discount would result if annual sales were projected at $5 million and discounted to present value.[801]

Warren Adelson prepared the valuation report for the IRS.[802] He divided the estate's works into two categories: "Bequested Art" and "Remaining Art."[803] Adelson assumed that blockage applied only to artworks that were for sale and would impact the marketplace, not to the bequested works which were unavailable for sale.[804] He valued the bequested art without a blockage discount at $32,228,000,[805] the aggregate of their individual fair market values. He then divided the "Remaining Art" into two categories.[806] The first consisted of the most valuable pieces which Adelson believed could be sold within a few years.[807] Adelson discounted these works by a nominal discount of 10%.[808] A blockage discount of 37%

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791. *Id.*
792. *Id.*
793. *Id.* at 2703. An art historian also testified on behalf of the estate. *Id.* She concluded that a bulk sale of O'Keeffe's art "would have resulted in a two-thirds to three-fourths loss in value." *Id.* She would not have recommended a bulk sale of the estate's art at the discounted value at date of death. *Id.*
794. *Id.* at 2702.
795. *Id.* at 2704.
796. *Id.*
797. *Id.*
798. *Id.*
799. David Schaengold, *Artist's Artworks Valuation: Is "Blockage" the Issue? The Estate of Georgia O'Keeffe and an Alternative Approach*, 17 EST. GIFTS & TR. J. 167, 169 (1992).
800. *O'Keeffe*, 63 T.C.M. (CCH) at 2704.
801. *Id.* at 2706.
802. *Id.* at 2703.
803. *Id.*
804. *Id.*
805. *Id.*
806. *Id.*
807. *Id.*
808. *Id.*

was suggested for the other pieces that Adelson felt would take years, perhaps a decade, to sell.[809] The IRS believed a tiered approach should be used to determine the blockage discount because of the unique nature of works of art.[810]

The court found that if all of O'Keeffe's art had been offered for sale simultaneously, the size of the block would have depressed the prices for each of the works.[811] Therefore, the court concluded that the fair market value of the block of art was substantially less than the simple total of the fair market values of the individual works.[812] The court decided not to apply a single, across-the-board discount to all the works. It held that the amount of the blockage discount with respect to each work depended on the market for that work.[813] It was necessary, therefore, to examine the history of the market for O'Keeffe's art, the prospects for her works at her death, the types of works to be valued, and the United States art market to determine the discount.[814]

The court recognized the limited market for large blocks of art created by one artist, which it attributed to the unique nature of the art market.[815] The court found that a purchaser for investment would consider the potential involvement of key dealers and collectors identified with specific markets within the larger art market.[816] Without their involvement and a broad appeal to patrons capable of investing at the required level, the court concluded it would be very difficult to sell a large block of art.[817] The court found that O'Keeffe's works were classified as early American Modernism and that the market for such art had few key dealers and collectors to support it.[818]

The court found each of the experts qualified to express opinions as to value.[819] But it was "frustrated and imposed upon by the lack of reliable expert opinion supporting the discounts claimed by the opposing parties."[820] Its frustration resulted from what it believed to be erroneous instructions to the experts regarding blockage[821] and from their tendency to ignore relevant facts inconsistent with the position of the party employing them and to exaggerate facts consistent with their own views.[822] The

809. *Id.*

810. *Id.* at 2704. The IRS claimed its tiered approach reflected the fact that works of art are unique and incorporated factors enunciated by the Tax Court in *Estate of Smith* and *Calder*. *Id.*

811. *Id.* at 2700.

812. *Id.*

813. *Id.*

814. *Id.*

815. *Id.* at 2702.

816. *Id.*

817. *Id.*

818. *Id.*

819. *Id.* at 2704.

820. *Id.* at 2707.

821. *Id.* at 2703.

822. *Id.* at 2704.

court found each conclusion as to the appropriate discount suffered from substantial defects and was patently unreliable.[823]

The Tax Court rejected the estate's valuation. It found that Thaw, in effect, had determined value on the basis of an assumed forced sale to a single buyer at date of death.[824] The estate argued that fair market value required property change hands at date of death.[825] The court rejected the argument as unsupported by authority or reason and because it ignored the concepts of willing buyers and sellers acting without compulsion.[826] It rejected the estate's $18,000,000 valuation as defying common sense, noting that the individual values of 44 pieces totaled almost one-half of the agreed value of all works.[827]

The Service's opinion of value was held to be erroneous as a matter of law.[828] The court found no justification for exclusion of bequested art from the total subject to blockage discount.[829] Fair market value assumes that the property is in the market.[830] Actual disposition of the property is not relevant to the determination of value.[831]

The court also held that the Service's discounts for the remaining art were inadequate and inconsistent with statements in the IRS Valuation Guide.[832] The small discount Adelson allowed was found to be at odds with the amount of time he anticipated would be required to sell the works and apparently did not reflect any opportunity or carrying costs.[833]

The Service's tiered approach appealed to the court; the approach made sense and was supported by the evidence.[834] The court, however, rejected the percentages used by the Service.[835] Its tiered approach was based entirely on the dollar values of individual artworks.[836] It allowed no discount for works valued at $500,000 or more; a 20% discount for works valued at $200,000 to $499,999; and a 50% discount for works valued at less than $200,000.[837] The court found, however, that the most valuable works, for which no discount was allowed, would not necessarily be sold first.[838] Some works of all types and values would be introduced into the market at a controlled pace.[839] The court noted that the consensus of the

823. *Id.*
824. *Id.*
825. *Id.*
826. *Id.*
827. *Id.*
828. *Id.* at 2703.
829. *Id.*
830. *Id.*
831. *Id.*
832. *Id.* at 2704.
833. *Id.*.
834. *Id.* at 2705.
835. *Id.*
836. *Id.* at 2704.
837. *Id.*
838. *Id.* at 2705.
839. *Id.*

experts was that the better works could be sold within seven years, but that the bulk of the pieces would require more than ten years to sell.[840]

The Tax Court sidestepped a critical issue in *O'Keeffe*. The IRS argued that the estate's valuation improperly took into account expenses that would be incurred in the sale of the art, in violation of § 2053.[841] The estate's position was that expenses that would be considered by a hypothetical purchaser were relevant in determining value and were not affected by § 2053.[842] The court refused to decide the issue, stating that it did not include assumptions about specific expenses or rates of return in its analysis.[843] It did consider, however, that the "works could not be sold simultaneously on the date of death and that carrying costs would be incurred."[844]

This essentially is the issue addressed by Revenue Ruling 83-30[845] which is central to the correct application of blockage. It is the question of whether the value of a block of property, consistent with case law and the regulations, may be determined by reference to "the price at which the block could be sold as such outside the usual market." Factors potential purchasers of "the block" "as such" would consider in determining price are relevant since the price they would pay is the price "at which the block could be sold."[846] Fair market value, moreover, assumes the willing buyer has reasonable knowledge of relevant facts, including expenses he would incur in disposing of the block over the anticipated liquidation period.[847]

In 1993, the Tax Court recognized and correctly decided this issue in *Estate of Smith v. Commissioner*:[848]

> Petitioner's expert did not reduce the value of decedent's mineral interest properties by a fictional seller's cost, but rather took the relevant costs and various factors that a potential buyer would have to pay and thus take into account in determining the price he would be willing to pay. This, of course, is consistent with the definition of fair market value.[849]

Similarly, the court in *O'Keeffe* should have held that a potential buyer's expenses were relevant in determining the price he would pay for the block of art.[850] The bulk purchaser, after all, would not be the ultimate consumer; he would purchase for resale.

In *O'Keeffe*, the Tax Court reviewed its earlier decisions in *Smith* and *Calder*. It rejected the parties' reading of *Smith* as allowing a 37% blockage discount, noting that "[n]othing in the opinion, however, explains the con-

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840. *Id.*
841. *Id.* at 2705-06.
842. *Id.* at 2706.
843. *Id.*
844. *Id.*
845. Rev. Rul. 83-30, 1983-1 C.B. 224; *see supra* text accompanying notes 507-37.
846. *See* LERNER & BRESLER, *supra* note 4, at 434 (Supp. 1992).
847. *Id.*
848. 1993 T.C.M. (P-H) ¶ 93,236, at 1173, 1176 (1993).
849. *Id.* at 1176 (citation omitted).
850. LERNER & BRESLER, *supra* note 4, at 434 (Supp. 1992).

clusion of value by application of a particular percentage to the total."[851] The court highlighted the major shortcoming of *Smith*: its failure to disclose the amount of the blockage discount or the manner in which it had been determined.

The court discussed *Calder* as a case in which it had calculated the blockage discount by reference to actual annual sales and had reduced the projected income stream to its present value.[852] The court apparently dismissed the *Calder* approach in *O'Keeffe* for two reasons. First, only a small percentage of O'Keeffe's works had been sold after death.[853] Second, neither party advocated application of that approach.[854]

The Tax Court concluded that the amount that would be paid by a hypothetical *en bloc* purchaser of O'Keeffe's art would be different from the amount that would be paid by individual purchasers.[855] The court was correct because retail prices must exceed wholesale prices. This conclusion apparently contributed to the court's refusal to determine value by reference to the amount that could have been received in a bulk sale.

The court held that each of the experts had failed to consider the relevant market for O'Keeffe's works.[856] The market, according to the court, included not only a bulk purchaser as suggested by the estate, but collectors and museums.[857] It found that many factors affected "the probable market for *each work*."[858] The court's focus on the market for *each work* evidences its failure to consider the market for "the block" "as such." When a block of art is to be valued, however, the Regulations recognize that its value may be the value of "the block" "as such" outside the usual market. The market and potential buyers of "the block" "as such" should have been identified and considered by the court.

The Tax Court decided that O'Keeffe's art should be segmented, not on the basis of value, but by quality, uniqueness, and salability.[859] It determined the art should be divided into at least two categories.[860] One would consist of works that could be sold within a relatively short period at approximately their individual values.[861] The other would include works that could be sold only over a long period of years with substantial ef-

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851. Estate of O'Keeffe v. Commissioner, 63 T.C.M. (CCH) 2699, 2705 (1992).

852. *Id.*

853. *Id.*

854. *Id.*

855. *Id.*

856. *Id.* at 2706.

857. *Id.*. It has been suggested that the court's view of the appropriate marketplace was unrealistic:

> The executor could conceivably sell some works at auction in an attempt to reach the collectors market, as indicated in *O'Keeffe*. However, the reality of the art world is that the executor would substantially hurt any chance of making a bulk sale of the works of art if some of the works were separately offered on the auction market.

LERNER & BRESLER, *supra* note 4, at 435 (Supp. 1992).

858. *O'Keeffe*, 63 T.C.M. (CCH) at 2706 (emphasis added).

859. *Id.* at 2707.

860. *Id.*

861. *Id.*

fort.[862] Lacking a more reliable breakdown, the court allocated one-half of the agreed upon, per-item aggregate value to each category.[863]

Having divided O'Keeffe's art into two categories, the court determined the effect of blockage separately with respect to each. It believed the Service's valuation approach was valid as to the first category and allowed a 25% discount.[864] It found the estate's experts' opinion valid as to the second category and allowed a 75% blockage discount.[865] The court made its customary "we considered the entire record" statement and concluded the fair market value of O'Keeffe's art was $36,400,000.[866] By using the approach advocated by each of the parties as to exactly one-half the value of O'Keeffe's art, the Tax Court, once again, appears to have "split the baby" and reached a compromise valuation.

The Tax Court confused two important aspects of fair market value by concluding that valuation of O'Keeffe's art by reference to an *en bloc* date of death sale would be at forced sale prices.[867] The court incorrectly equated determination of value as of the moment of death with a forced sale. This led the court to reject the estate's valuation approach.

Fair market value is the price that property (properly identified) would command if offered for sale in a prudent manner for a reasonable period of time beginning on the valuation date. Valuation as of the date of death is not applied literally. Value, nonetheless, is to be determined by reference to a hypothetical sale; the property must change hands.[868]

When blockage is involved, "the price at which the block could be sold as such outside the usual market" may indicate the property's value. The property to be valued is "the block" "as such." Identifying the property as "the block" determines the potential purchasers and the relevant market. Valuing property by reference to what a bulk purchaser would have paid for the block at the moment of death is not the same as establishing value in a forced sale. Obviously, the bulk seller as well as the bulk buyer must be "willing" and neither must act under compulsion.[869] Identifying fair market value's hypothetical sale as a bulk sale, however, no more indicates compulsion than does identification of the property and its potential buyers in other circumstances.

V. Conclusion

Artists and their estates confront difficult valuation problems when large blocks of art are valued for estate and gift tax purposes. Fair market value must reflect the impact of supply and demand upon prices.

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862. *Id.*
863. *Id.*
864. *Id.*
865. *Id.*
866. *Id.*
867. *Id.*. at 2704.
868. *See* Lerner & Bresler, *supra* note 4, at 433 (Supp. 1992).
869. *See id.* (suggesting that the court in *O'Keeffe* seemed to be saying that the willing buyer - willing seller hypothetical sale must not be a forced sale and, if it would be a forced sale, does not necessarily occur as of the date of death).

Large blocks of art should be valued, consistent with case law and the regulations, by considering the price at which "the block" "as such" could be sold "outside the usual market." An annuity approach, if modified to reflect a potential buyer's carrying costs and market risk, would provide a reasonable result. The present value of anticipated sale proceeds (net of expenses) discounted at a rate that compensates for market risk, should be the price at which the block could be sold to the only purchasers in the market for large blocks of art—purchasers for resale.[870] Such a buyer necessarily pays wholesale prices.

Courts should not hesitate to determine value for large blocks of art by reference to what are, admittedly, wholesale prices. While Treasury Regulations generally provide that value is to be determined in the retail market, they recognize an exception where blockage is relevant. The reasons courts long ago permitted valuation of large blocks of stock by reference to wholesale prices in secondary offerings also justify valuation of large blocks of art in alternative markets.

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870. *See* Schaengold, *supra* note 799, at 172. The author reached a similar conclusion but suggested that an artist's works be valued as a business rather than under blockage:

> In the context of valuing a business, the position that the valuation should be established on the basis of what a purchaser for resale would pay for the property in its entirety is logical, realistic, and consistent with the regulations. It would follow, therefore, that the procedure for ascertaining the value should follow along the line of what the O'Keeffe experts actually did: provide evidence on what a willing buyer for profit purposes would pay for the property on the basis of a fair return on investment after deducting selling and all other expenses necessarily incurred in realizing a profit.

Id. Valuation of an artist's art works as a business, however, should not result in a different valuation than under blockage properly applied. The valuation would be determined largely on the basis of the art inventory.