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Estate Tax Deductibility of Underwriters' Expenses After an Executor's Sale of Stock: A Loophole in Section 2053

Mark D. Maloney

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Estate Tax Deductibility of Underwriters' Expenses After an Executor's Sale of Stock: A Loophole in Section 2053

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I. INTRODUCTION

The Internal Revenue Code of 1954 (Code) imposes a federal estate tax to be paid by the executor of a decedent's estate¹ on both conveyances of property at death² and on gifts made during the three years prior to death.³ This estate tax is imposed on the net value of the estate. To arrive at the net value or "taxable" estate, the executor first determines the gross estate value by adding the fair market value of all assets owned by decedent at death⁴ and all assets gratuitously transferred by him during the three years prior to death.⁵ This gross estate value is then reduced by any applicable deductions⁶ to arrive at the taxable estate. This Recent Develop-

1. I.R.C. § 2002.
 2. I.R.C. § 2001.
 3. I.R.C. § 2035.
 4. I.R.C. §§ 2031, 2033.
 5. I.R.C. § 2035. Two exceptions do exist. The executor may elect to value the estate by reporting the value of the assets as of the date six months after the date of the decedent's death, or in the case of property disposed of before such time, the value as of the date of disposition. I.R.C. § 2032. Additionally, the executor may elect to value certain farm and closely held business real property in accordance with their value for farming or closely held business purposes rather than at fair market value. I.R.C. § 2032A.
 6. I.R.C. §§ 2053-2057. Allowable deductions include amounts for certain expenses, indebtedness, taxes, and losses, and bequests to charity, to the surviving spouse, and to any surviving orphaned minor children. *Id.*

ment will examine the relationship between two Code provisions that are essential to the calculation of the taxable estate. Section 2031 establishes the value of the "gross estate," and section 2053 provides that certain administrative expenses are deductible from the gross estate.

Recently, in *Estate of Joslyn v. Commissioner*⁷ and *Estate of Jenner v. Commissioner*,⁸ two United States Courts of Appeals applied sections 2031 and 2053 in a manner that substantially benefits estates that possess large holdings of a particular stock. Because large blocks of stock are difficult to liquidate, the per-share price of the stock will actually be lower than the stock exchange price.⁹ Under section 2031, the executor may account for this factor in calculating the fair market value of the stock.¹⁰ Accordingly, in both recent cases, the executors reduced the value of the section 2031 gross estate by the amount of underwriters' commissions necessary to liquidate the stock. The executors then deducted the same commissions from the gross estate as administrative expenses under section 2053. In both cases, the courts allowed the deductions. The estates thus benefited from a double deduction. This Recent Development will examine the interrelationship between sections 2031 and 2053 and proposes that Congress eliminate this "double deduction" by amending section 2053.

II. SECTION 2031: THE VALUATION OF THE STOCK

The enactment of the Internal Revenue Code of 1954 included the general valuation provisions of the Internal Revenue Code of 1939¹¹ without substantial revision.¹² The broad, general language of section 2031 appears to require the taxation of every existing asset in a decedent's estate, regardless of ownership. This is limited elsewhere in the Code to the value of the decedent's interest in property.¹³ Furthermore, except for the valuation of unlisted stocks and

7. 566 F.2d 677 (9th Cir. 1977).

8. 577 F.2d 1100 (7th Cir. 1978).

9. See notes 18-21 *infra* and accompanying text.

10. See notes 23-27 *infra* and accompanying text.

11. Int. Rev. Code of 1939, ch. 3, § 811, 53 Stat. 120 (now I.R.C. §§ 2031-2045).

12. Pub. L. No. 83-591, §§ 2031, 2033, 68A Stat. 380, 381 (1954). In 1962, Congress deleted the exemption for foreign real property resulting in the present formulation of the language of the Code. Pub. L. No. 87-834, § 18(a)(1), 76 Stat. 1052 (1962). I.R.C. § 2031(a) provides:

(a) General.—The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

13. I.R.C. § 2033 provides that "[t]he value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

securities,¹⁴ the section provides no guidance as to the definition or calculation of value. Instead, the Code leaves the valuation of different types of property to the regulations. As a general rule, an asset's value is its fair market value at the time of the decedent's death.¹⁵ The regulations define fair market value as the price at which a willing buyer would buy and a willing seller would sell if both were under no compulsion and had reasonable knowledge of relevant facts.¹⁶ In addition, the regulations provide specific valuation rules for certain types of property,¹⁷ including stocks and bonds. If no precise fair market value can be given to stock as of the date of death,¹⁸ the regulations provide a formula by which the executor may determine the value. The formula sets the stock's value at the mean between the high and the low selling prices on the date of death or an interpolated mean based on trading on the days closest to the date of death of the decedent.¹⁹

This method of valuing stock is adequate for stock holdings of the average estate. When the estate possesses large holdings of a particular stock, however, this formulaic approach may not present the stock's true value. The sale of large blocks of stock on the valuation date would tend to force prices down because of the volume. Supporters of this "blockage" theory²⁰ contend that since such a

14. I.R.C. § 2031(b).

15. Treas. Reg. § 20.2031-1(b), T.D. 6826, 1965-2 C.B. 368 provides in part:

(b) *Valuation of property in general.* The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death, except that if the executor elects the alternate valuation method under section 2032, it is the fair market value thereof at the date, and with the adjustments, prescribed in that section. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail.

16. *Id.*

17. See Treas. Reg. §§ 20.2031-1 to .2031-10 (1958) (portions subsequently amended).

18. Treas. Reg. § 20.2031-2(a) (1958).

19. Treas. Reg. § 20.2031-2(b), T.D. 7327, 1974-2 C.B. 294.

20. The courts looked askance at the blockage theory when it was argued initially. In the early case of *Bingham's Adm'r v. Commonwealth*, 196 Ky. 318, 244 S.W. 781 (1922), the administrator of an estate attempted to assert the blockage theory in a state inheritance tax proceeding. At the time of her death, the decedent owned very large blocks of stock in the Standard Oil group of corporations and in several others. *Id.* at 333, 244 S.W. at 788. The administrator argued that the "bid" prices from the stock exchanges did not accurately reflect the "fair cash value" of the decedent's holdings. He suggested that such prices were

accurate for small holdings of from ten to 100 shares but that the difficulty in disposing of a large block of stock necessarily lowered its value per share by as much as twenty percent. *Id.* at 333, 244 S.W. at 788, 789-90. The Kentucky Court of Appeals rejected this argument, reasoning that to appraise the same property on the same date at different values per unit merely because of the size of the holding was unjust. In the court's view, such a theory utterly disregarded the constitutional guarantees that all men are "free and equal" and that taxes "shall be uniform upon all property of the same class." *Id.* at 336, 244 S.W. at 789. The court viewed the blockage theory as an attempt to devise "one method applicable to the rich and another to the poor for valuing the same kind of property on the same day." *Id.* at 338, 244 S.W. at 790.

Similarly, many federal courts refused to consider the size of a holding in valuing stock. In *Gamble v. Commissioner*, 101 F.2d 565 (6th Cir.), *cert. denied*, 306 U.S. 664 (1939), the Sixth Circuit upheld a Board of Tax Appeals finding that the value of a large holding of Procter & Gamble stock equaled that calculated by the general rule of the statute. *Id.* at 568. The court noted that the board rightfully had chosen to ignore the opinions of the executor's experts. *Id.* at 567. The decision hinged upon the speculative nature of the estimated reduced value of the stock in the absence of specific examples. The court relied upon the concrete method of valuation promulgated by the Commissioner. *Id.* In a holding similar to that of the *Gamble* court, the Board of Tax Appeals in *Estate of Chisholm v. Commissioner*, 37 B.T.A. 167 (1938), rejected as "conjectural" a stockbroker's opinion that decedent's large holding of mining stock would be worth almost thirty percent less because of blockage factors. *Id.* at 170. The board particularly noted the lack of evidence as to the financial condition and prospectus for the corporation. *Id.* at 171.

Despite the blistering attack of the *Bingham* court upon the blockage theory and its rejection in later decisions, the courts grudgingly began to grant approval to its use as a factor in determining fair market value. *See, e.g., Commissioner v. Stewart's Estate*, 153 F.2d 17 (3d Cir. 1946); *Phipps v. Commissioner*, 127 F.2d 214 (10th Cir.), *cert. denied*, 317 U.S. 645 (1942). In its decision in *Safe Deposit & Trust Co. v. Commissioner*, 35 B.T.A. 259 (1937), the Board of Tax Appeals reduced the Commissioner's formulaic appraisal of a large block of railroad stock from \$44 per share to \$35 per share. *Id.* at 261-63. The board, however, relied heavily on the declining value of the stock just prior to the decedent's death during the Depression. It specifically noted that its finding of value was not "any dogmatic recognition or nonrecognition of any so-called 'blockage' rule," calling it merely "a matter of evidence." *Id.* at 263.

During the late 1930's the courts overtly began to recognize the correctness of the principles of the blockage theory. The opinion in *Jenkins v. Smith*, 21 F. Supp. 251 (D. Conn. 1937), represents the early rationale of the courts in accepting the theory. The *Jenkins* court refused to acknowledge *per se* that each share in a large block of stock is worth less than each in a small lot. *Id.* at 253. It did admit, however, that the value of the whole is not necessarily the sum of the values of its parts. Quoting from a treatise, the court stated that the "determination of market value requires a consideration of the salability of the entire block held." *Id.* at 254 (quoting 5 R. PAUL & J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 52.17A (1934 & Supp.)). The court then proceeded to reduce the Commissioner's formulaic valuation by approximately five percent. *Id.* at 254. Following the reasoning of the *Jenkins* court, the Board of Tax Appeals allowed a reduction from the Commissioner's determination of value in *Girard Trust Co. v. Commissioner*, 6 B.T.A.M. (P-H) 15 (1937). The board ruled that the "'fair market value' to be arrived at then is the fair market value of the decedent's total holdings in Curtis Publishing Co. stock—not the fair market value of a part thereof." *Id.* at 18.

Ultimately the United States Court of Appeals for the Eighth Circuit ensured the legitimacy of the blockage theory by endorsing it in *Helvering v. Maytag*, 125 F.2d 55 (8th Cir.), *cert. denied*, 316 U.S. 689 (1942). The court stated: "As 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 or estate tax purposes." *Id.* at 63.

voluminous sale would lower the price of the stock, the executor should consider the effect of such a sale in valuing the stock in the decedent's estate.²¹ The fair market value rule of a willing buyer and a willing seller with knowledge of relevant facts supports this claim. A willing buyer who knows that the seller has a large block of stock to sell also realizes that in order to dispose of the block the seller may accept a price somewhat lower than the market price. This will affect the price that the buyer offers.

The blockage principle is not necessarily based on a hypothetical sale on the date of the decedent's death. Such an assumed sale could lead to a valuation based on a forced sales price, which would violate the requirement of noncompulsion on the part of the buyer or seller. Instead, blockage refers to the difference between the sum of the unit values of the stock if it is sold in quantities easily absorbed by the market and the value of the block in question. Relevant factors include distribution methods, market capacity, market development costs, selling-period length, and prolonged-sales risks.²²

Executors have attempted to extend the blockage theory to include a reduction in value for the expense of secondary distributions, arguing that in certain situations the most favorable method of disposing of stock is through an underwriter rather than on an open exchange.²³ Thus they argue that the fair market value of a block of stock should equal the net proceeds received by the estate after payment of the costs of underwriting.

Initially, the courts did not look favorably upon this extension of the blockage theory.²⁴ In *Clause v. Commissioner*²⁵ the Tax Court refused to allow any reduction from the stock exchange price for the cost of a secondary distribution. Although emphasizing the value of the stock to taxpayer if the stock were retained, the court pointed out that the ultimate purchasers would pay the quoted price.²⁶ This emphasis on retention value, however, runs counter to the definition of fair market value based on a sale between a willing buyer and a willing seller.²⁷ In contrast to *Clause*, the Tax Court permitted a reduction from market quotations on the valuation of a large block

21. [1977] 2 FED. EST. & GIFT TAX REP. (CCH) ¶ 6380.75.

22. 10 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 59.15 (rev. ed. 1976).

23. *Id.*

24. *E.g.*, *Groff v. Munford*, 150 F.2d 825 (2d Cir. 1945), *aff'g* *Groff v. Smith*, 43-2 U.S. Tax Cas. ¶ 10,067 (D. Conn. 1943). *Contra* *Richardson v. Commissioner*, 151 F.2d 102 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946).

25. 5 T.C. 647 (1945), *aff'd*, 154 F.2d 655 (3d Cir. 1946).

26. *Id.* at 650.

27. Treas. Reg. § 20.2031-1(b), T.D. 6826, 1965-2 C.B. 368.

of stock in *Avery v. Commissioner*.²⁸ Despite the lack of an actual disposition through a secondary distribution, the court allowed the reduction based upon a hypothetical transaction.²⁹ Similarly, in *Havemeyer v. United States*,³⁰ the Court of Claims established the value of large holdings of stock to be that amount that could be realized from an underwriter.³¹ In addition, other courts have characterized secondary distribution expenses as blockage elements, and thus have clearly established these expenses as a stock valuation factor.³²

Initially, the Internal Revenue Service (Service) strenuously resisted application of the blockage theory.³³ Regulations to the Internal Revenue Codes of 1926 and 1932 expressly prohibited any consideration of the size of a stock holding during valuation.³⁴ As the courts began to favor the blockage theory, however, the Service began to retreat from its position. First, the regulations to the Internal Revenue Code of 1939 did not refer to whether size of holdings is a relevant factor in stock valuation.³⁵ Later regulations to the Internal Revenue Code of 1954 acknowledged blockage as a factor of valuation.³⁶ Finally, in a subsequent revenue ruling, the Service emphasized the importance of size in determining the value of hold-

28. 3 T.C. 963 (1944).

29. *Id.* at 970-71.

30. 59 F. Supp. 537 (Ct. Cl.), *cert. denied*, 326 U.S. 759 (1945).

31. *Id.* at 549.

32. *See, e.g., St. Joseph Bank & Trust Co. v. United States*, 48 A.F.T.R. (P-H) 1561 (N.D. Ind. 1953); *Estate of Garrett v. Commissioner*, 22 T.C.M. (P-H) 1026, 1034 (1953); *Fleming v. Commissioner*, 20 T.C.M. (P-H) 660, 663-65 (1951).

33. The *Maytag* court acknowledged the persistence of the Commissioner in opposing the blockage theory in sixteen other cases. 125 F.2d at 63.

34. 26 C.F.R. § 80.10(c) (1938) (superseded) provided in part:

In exceptional cases in which it is established by clear and convincing evidence that the value per bond or share of any security determined upon the basis of selling or bid and asked prices as herein provided does not reflect the fair market value thereof, other relevant facts and elements of value will be considered in determining the fair market value. *The size of holdings of any security to be included in the gross estate is not a relevant factor and will not be considered in such determination.* [Emphasis added.]

35. 26 C.F.R. § 81.10(c) (1942) (superseded).

36. Treas. Reg. § 20.2031-2(e) (1958) provides in part:

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 On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.

ings of stock.³⁷ Thus blockage theory is now clearly considered a relevant factor in stock valuation under section 2031.

III. SECTION 2053: THE DEDUCTION OF THE UNDERWRITER'S DISCOUNT

In arriving at the taxable estate upon which the estate tax is imposed, the executor may deduct several items from the gross estate under section 2053 of the Code,³⁸ including administrative expenses allowable under local law.³⁹ The Service has attempted to police abuse of these deductions by imposing additional requirements on these deductions.⁴⁰ Specifically, the Service allows a de-

37. Rev. Rul. 59-60, 1959-1 C.B. 237, § 4.01(g).

38. See note 6 *supra*.

39. I.R.C. § 2053(a) provides:

(a) General Rule.—For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—

- (1) for funeral expenses,
- (2) for administration expenses,
- (3) for claims against the estate, and
- (4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,

as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

40. Treas. Reg. § 20.2053-3(a)(1953) provides:

(a) *In general.* The amounts deductible from a decedent's gross estate as "administration expenses" of the first category (see paragraphs (a) and (c) of § 20.2053-1) are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. Administration expenses include (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses. Each of these classes is considered separately in paragraphs (b) through (d) of this section.

Treas. Reg. § 20.2053-3(d)(2) (1965) provides:

Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution. The phrase "expenses for selling property" includes brokerage fees and other expenses attending the sale, such as the fees of an auctioneer if it is reasonably necessary to employ one. Where an item included in the gross estate is disposed of in a bona fide sale (including a redemption) to a dealer in such items at a price below its fair market value, for purposes of this paragraph there shall be treated as an expense for selling the item whichever of the following amounts is the lesser: (i) the amount by which the fair market value of the property on the applicable valuation date exceeds the proceeds of the sale, or (ii) the amount by which the fair market value of the property on the date of the sale exceeds the proceeds of the sale. The principles used in determining the value at which an item of property is included in the gross estate shall be followed in arriving at the fair market value of the property for purposes of this paragraph.

duction for selling expenses only if the sale of assets is necessary to meet the obligations of the estate, including debts, taxes, expenses, and distribution requirements.

A split of authority has developed in the courts over the validity of this necessity requirement.⁴¹ In *Estate of Park v. Commissioner*⁴² the Sixth Circuit rejected the Service's argument that a selling expense must be necessary in order to be deductible.⁴³ The decedent died owning a residence and a cottage, both of which passed to the decedent's four sons under the residuary clause of her will. Because they were not interested in retaining the properties, the sons requested the administrator⁴⁴ to sell the property.⁴⁵ The Michigan probate court allowed the selling costs as miscellaneous administrative expenses,⁴⁶ and the administrator deducted them as such. The Commissioner disallowed the deduction,⁴⁷ and the Tax Court affirmed.⁴⁸

The Commissioner based his argument on the failure of the taxpayer to meet the necessity requirement stated in the regulations. Taxpayer argued that the regulations "impose[d] an invalid and impermissible restriction on the availability of a deduction provided in the Internal Revenue Code."⁴⁹ Resting its decision upon the literal language of the Code and ignoring the regulations, the court reasoned that Congress had committed to the states the decision whether a particular item was an allowable expense. Thus the court concluded that, because the Michigan probate court allowed the expenses as a deduction, the expenses were deductible from the gross estate for federal estate tax purposes.⁵⁰

In contrast to the decision of the Sixth Circuit, the Second Circuit in *Estate of Smith v. Commissioner*⁵¹ upheld a Tax Court ruling imposing the necessity requirement. In *Estate of Smith*, the decedent artist died while still possessing several of his own sculp-

41. For detailed discussions of the necessity requirement and its ramifications, see Note, *Current Problems Facing the Executor Taking the Section 2053 Estate Tax Deduction*, 30 VAND. L. REV. 795, 796-811 (1977); Note, *Deductibility of Estate Selling Expenses*, 51 S. CAL. L. REV. 101 (1977).

42. 475 F.2d 673 (6th Cir. 1973).

43. *Id.* at 676.

44. The decedent's personal representative was an administrator with will annexed.

45. 475 F.2d at 674.

46. There was no question that the items were allowable under Michigan law. *Id.* at 674 n.2.

47. *Id.* at 674.

48. 57 T.C. 705 (1972).

49. 475 F.2d at 675.

50. *Id.* at 676.

51. 510 F.2d 479 (2d Cir. 1975).

tures. In order to obtain the most beneficial return from the sale of the sculptures, the executors proceeded with an orderly eight-year plan of disposal.⁵² Due to the size of the collection and the care necessary for disposal, the estate incurred brokerage fees in excess of \$1,500,000. Upon presentation of the executors' report, the New York Surrogate's Court allowed the entire amount as a deduction.⁵³ The Tax Court, however, allowed only the amount necessarily incurred to obtain the funds to meet estate obligations.⁵⁴

The executors argued that the full amount of selling costs was necessary to preserve the estate and meet obligations and that the decision of the Surrogate's Court was determinative of the issue of necessity.⁵⁵ The Second Circuit found that the judgment of the Tax Court as to the amount necessary was not clearly erroneous.⁵⁶ Regarding the finality of the state court's determination of necessity, the court of appeals noted that the interest of the federal government in taxing estates would not always coincide with the interest of state governments in supervising executors and administrators. The court reasoned that the interest of the federal government might not be sufficiently protected by the state. Thus, in the Second Circuit's view, the federal judiciary must be able to reexamine the facts to determine necessity.⁵⁷

IV. INTERACTION OF SECTIONS 2031 AND 2053

A. Introduction

The statutory provisions and judicial interpretation outlined above indicate that an estate that holds large blocks of securities that are difficult to dispose of will enjoy a significant tax benefit. First, in valuing the stock the executor will be able to reduce the value to account for selling costs and other blockage elements.⁵⁸ In the usual situation, the executor will file the estate tax return nine months after the date of the decedent's death,⁵⁹ at which time he

52. *Id.* at 480.

53. *Id.* at 480-81.

54. 57 T.C. 650, 661-62 (1972).

55. 510 F.2d at 481-82.

56. *Id.* at 482.

57. *Id.* at 482-83. In a strong dissent, the minority chastised the court for its failure to follow the plain meaning of the statute. It followed the argument in *Estate of Park* that because Congress placed the question in the hands of the state, state law controlled without limitation. The dissenting judge found the "clearly erroneous" test inappropriate, and thought that the Tax Court should have no role in determining necessity. *Id.* at 483-85 (Mulligan, J., dissenting).

58. See note 20 *supra*.

59. I.R.C. § 6075(a).

probably will not have disposed of the stock. After calculating the fair market value according to the section 2031 formula,⁶⁰ the executor will consult an expert appraiser who will give his opinion as to the percentage discount that would properly reflect the expenses necessary to sell the securities through an underwriter. The executor then determines the value of the stock to the estate by reducing the fair market value calculated earlier by this percentage discount. The sum of this figure and the values of all other property held by the estate will equal the value of the gross estate.

To arrive at the taxable estate, the executor will then reduce the gross estate by any applicable deductions,⁶¹ including the selling costs incurred in disposing of the stock.⁶² This figure may equal the full amount allowable under state law or only that amount necessarily spent to obtain funds to meet estate obligations.⁶³ Whatever the figure, the executor will derive the taxable estate by reducing the calculated fair market value of the securities twice for the same expense.

B. Statutory Provisions

Despite the obvious boon to the taxpayer, the Internal Revenue Code places no limitations upon this double benefit for selling expenses. In contrast, section 642 forbids the double deduction of amounts allowable under both sections 2053 and 2054⁶⁴ from the taxable income of the estate.⁶⁵ The Tax Reform Act of 1976 extends the disallowance of double deductions by prohibiting executors from both deducting selling expenses from the gross estate of the decedent for estate tax purposes and offsetting those expenses against

60. See notes 15-19 *supra* and accompanying text.

61. See notes 38-39 *supra* and accompanying text.

62. The exact figure is unknown at the time the return is filed; it may be entered in the return upon an audit by the Internal Revenue Service after the disposition has been completed. If not, any adjustments to the deduction can be reported in the income tax return of the estate. I.R.C. § 642(g).

63. See notes 38-57 *supra* and accompanying text.

64. Section 2053 allows deductions from the gross estate for expenses, indebtedness, and taxes while § 2054 permits deductions for losses.

65. I.R.C. § 642(g) provides:

(g) Disallowance of Double Deductions.—Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate or of any other person, unless there is filed, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect of decedents).

the selling price of property in determining gain or loss for income tax purposes.⁶⁶ The restrictions of section 642 apply only in those cases in which a single item could reduce both estate and income tax liabilities. No provision, however, limits the use of one item both to reduce gross estate value and as a deduction for estate tax purposes.

C. Judicial Interpretation

Prior to the two recent court of appeals cases discussed in this Recent Development,⁶⁷ no case specifically considered the double deduction issue. The Third Circuit, however, hinted at how courts might receive the double deduction question in *Haggart's Estate v. Commissioner*.⁶⁸ In *Haggart's Estate*, the court reversed a Tax Court decision⁶⁹ disallowing deduction of certain trust expenses when the decedent's estate included the corpus of the trust.⁷⁰ The court allowed the deduction but refused to characterize it as an administrative expense or a reduction in gross estate value, reasoning that the result would be the same.⁷¹ The decision implies, however, that an item is either a deductible expense or a reduction in value, but not both.

V. RECENT DECISIONS

A. Estate of Joslyn v. Commissioner

(1) *Joslyn I*

The first case expressly to consider the deductibility of underwriters' commissions after they have reduced the value of a block of stock was *Estate of Joslyn v. Commissioner*.⁷² At the time of his death the decedent in *Joslyn* owned a large block of stock in a manufacturing corporation.⁷³ The estate incurred substantial extraordinary expenses in the probate of the will. To meet the obligations of the estate, the executor elected to liquidate a portion of the

66. Pub. L. No. 94-455, § 2009(d), 90 Stat. 1896 (1976). In addition to the executor, any other person is prohibited from offsetting these selling expenses against the selling price in determining gain or loss for income tax purposes. I.R.C. § 642(g).

67. See text accompanying notes 72-118 *infra*.

68. 182 F.2d 514 (3d Cir. 1950).

69. 13 T.C. 14 (1949).

70. 182 F.2d at 515-16.

71. *Id.* at 516. The court stated, "Whether they are to be allowed as expenses of administration or whether they are to be allowed in diminution of the gross estate does not matter in this case. It comes out the same either way . . ." *Id.*

72. 57 T.C. 722 (1972), *rev'd*, 500 F.2d 382 (9th Cir. 1974), *on remand*, 63 T.C. 478 (1975), *rev'd*, 566 F.2d 677 (9th Cir. 1977).

73. 57 T.C. at 723. The decedent owned 66,099 shares of Joslyn Mfg. & Supply Co. *Id.*

stock through a secondary offering.⁷⁴ Following an audit, the Service and the executor agreed upon the value of the stock. This value reflected a reduction for blockage elements of the full amount of selling expenses, including underwriters' fees.⁷⁵ After agreeing to this valuation, the executor claimed as administrative expenses a deduction for the full amount of the selling costs relating to the secondary offering. The Commissioner disallowed over ninety-eight percent of the deduction.⁷⁶

The Tax Court agreed with the Commissioner that selling expenses could not be both offset against the value of the property and deducted as an administrative expense.⁷⁷ The court based its decision mainly upon the equitable principle that no item could be used twice to reduce the taxable estate of a decedent. Without any definitive authority, the court stated that such a benefit "surely was not contemplated under section 2053(a)."⁷⁸ The decision did refer to *Haggart's Estate* and the Tax Court's later opinion in *Abbett v. Commissioner*,⁷⁹ in which the courts permitted certain items either to reduce the gross estate or to be deducted as an expense.⁸⁰ In addition, the court distinguished *Estate of Bray v. Commissioner*,⁸¹ in which the court allowed the deduction of selling expenses for estate tax purposes and their use as an offset against the selling price for determination of gain or loss.⁸² In the court's opinion, the

74. *Id.*

75. The IRS and the executor agreed to establish the value as follows:

Fair market value at date of death determined by taking the mean between the high and the low		\$3,470,197.50
Less: Travel expense	\$489.52	
Bond premium for underwriter	13,679.09	
Attorneys for underwriter	6,860.35	
Reimbursement to Joslyn Mfg.	46,366.66	
Additional cost for Joslyn Mfg.	1,081.30	
Costs of Kindel & Anderson	1,327.70	
Additional costs Kindel & Anderson	399.07	
Fees for registration	7,546.38	
Underwriters fees	<u>288,750.00</u>	
Total blockage elements		<u>366,500.07</u>
Value included in gross estate		<u>3,103,697.43</u>

Id. at 724.

76. *Id.*

77. *Id.* at 727.

78. *Id.* at 725.

79. 17 T.C. 1293 (1952) (cited in 57 T.C. at 725).

80. See text accompanying notes 68-71 *supra*.

81. 46 T.C. 577 (1966) (distinguished in 57 T.C. at 726).

82. Prior to October 4, 1976, selling expenses could be deducted for estate tax purposes and used as an offset to gross value in determining gain or loss for income tax purposes. The

reduction in value coupled with a deduction was permissible in the interaction of two separate schemes of taxation, but not within the parameters of the single estate tax.⁸³

On appeal the Ninth Circuit reversed the decision of the Tax Court.⁸⁴ The court noted that expenses of administration allowed by the state probate court were generally deductible in calculating the estate, but that the Tax Court had failed to consider the deductibility under section 2053 of the Code.⁸⁵ The court did not recognize *Haggart's Estate* as precedent because that case did not raise the blockage issue.⁸⁶ Finally, the court found that no double deduction existed. According to the court, prior decisions disallowing double deductions in the calculation of income tax had considered the actual deduction of the same item twice. This case, however, presented a reduction in gross estate value and a deduction for expenses. The court concluded that this was not the " 'practical equivalent of double deduction.' "⁸⁷ The court of appeals thus remanded the case to the Tax Court for a determination of deductibility under section 2053.⁸⁸

(2) *Joslyn II*

On remand the Tax Court characterized the selling costs, not as administrative expenses, but as profit to the underwriters.⁸⁹ The court reasoned that because the form of agreement between the estate and the underwriters was a "firm commitment" underwriting,⁹⁰ it was essentially a sale to the underwriters who then resold the stock to the public.⁹¹ The executor argued that the estate still bore significant risk because certain conditions could prevent the sale. If the sale was not consummated, the executor argued, the stock would remain in the estate rather than in the hands of the underwriters.⁹² Rejecting the executor's arguments, the Tax Court reasoned that the underwriters were more than agents of the estate

Tax Reform Act of 1976 eliminated this double deduction. See note 66 *supra* and accompanying text.

83. 57 T.C. at 725-26.

84. 500 F.2d 382, 387 (9th Cir. 1974).

85. *Id.* at 385.

86. *Id.* at 385-86.

87. *Id.* at 386 (quoting *Charles Ilfield Co. v. Hernandez*, 292 U.S. 62, 68 (1934)).

88. *Id.* at 387.

89. 63 T.C. 478, 485 (1975).

90. A "firm commitment" underwriting is one in which the seller is assured of a sum certain at a specified time. Many of the risks are transferred to the underwriter, although some risk remains with the seller. 1 *LOSS, SECURITIES REGULATION* 164 (2d ed. 1961).

91. 63 T.C. at 483-84.

92. *Id.* at 484.

because they lacked the power to terminate the contract at will. Thus the firm commitment offering constituted a sale rather than a "mere formalism."⁹³

Persisting in his belief that the expenses were deductible, the executor again appealed to the Ninth Circuit.⁹⁴ The court of appeals analyzed the case as if the amount of blockage had been estimated instead of known precisely. The court reasoned that if the executor had valued the asset at a different figure because he had estimated the blockage element without the benefit of hindsight, the reduction in value would not have equaled the administrative expense deduction. Thus the appearance of duplication would have vanished and the deduction would have been allowed. Accordingly, the court concluded that whether or not the figures were duplicative, the validity of the deduction remained the same.⁹⁵ The court viewed the transaction simply as a service for which the estate paid, and which the probate court allowed as an expense.⁹⁶ Citing cases allowing brokerage and underwriting fees as deductions,⁹⁷ the court equated the underwriting fee in this case to the charge made by a real estate broker for selling a home.⁹⁸

B. Estate of Jenner v. Commissioner

*Estate of Jenner v. Commissioner*⁹⁹ presented the same issue as *Joslyn*, but in a slightly different factual setting.¹⁰⁰ The decedent owned a large block of stock in a nonleveraged, nondiversified, closed-end investment company.¹⁰¹ The decedent's corporate executor¹⁰² decided to sell some of this stock in order to meet estate obliga-

93. *Id.* at 484-85.

94. 566 F.2d 677 (9th Cir. 1977).

95. *Id.* at 678.

96. *Id.*

97. *Id.* (citing *Estate of Park v. Commissioner*, 475 F.2d 673 (6th Cir. 1973); *Estate of Huntington v. Commissioner*, 36 B.T.A. 698, 726 (1937)).

98. 566 F.2d at 679.

99. 36 T.C.M. (CCH) 241 (1977), *rev'd*, 577 F.2d 1100 (7th Cir. 1978).

100. In addition, the court set the value of large blocks of stock in two corporations held by the decedent at the time of her death. Subsequent to the decedent's death, the two corporations merged leaving only the stock of one corporation to be liquidated to obtain the funds to meet estate obligations. 36 T.C.M. (CCH) at 241, 243-44.

101. An investment company is non-leveraged if it has no debt in its capitalization; non-diversified if it has more than five percent of the value of its total assets invested in one issue; and closed-end if it has no redeemable security outstanding and does not constantly offer new shares for sale. Investment Company Act of 1940, ch. 686, tit. I, sec. 5, 54 Stat. 800, 15 U.S.C. sec. 80a-5.

Id. at 241 n.2. On the date of death the decedent held 226,800 shares of Baker Fentress & Co. or approximately 13.9% of that company's outstanding stock. *Id.* at 241. Following the merger the estate held 319,347 shares of the corporation. *Id.* at 243.

102. The executor was Continental Illinois National Bank and Trust Company of Chi-

tions.¹⁰³ He proposed a secondary offering and filed a preliminary registration with the Securities and Exchange Commission.¹⁰⁴ The executor entered into a firm commitment underwriting agreement that provided for a selling price of \$38.85 per share. The estate was to bear all expenses, but, following the usual practice, the contract did not require the payment of an underwriting discount or commission. It was apparent, however, that the underwriters would sell the securities to the public for \$42 per share, retaining the difference of \$3.15 as their commission.¹⁰⁵ The agreement also provided that the underwriters could unilaterally terminate the contract if the SEC withheld approval, legal counsel objected to the offering, accountants disagreed on valuation, or a majority of the underwriters believed a material adverse change in the value of the corporation occurred between the prospectus date and the sale date.¹⁰⁶ Upon completion of the transaction, the underwriters presented a check to the executor in an amount equivalent to \$42 per share. In return the estate paid the underwriters \$3.15 per share, netting \$38.85 per share as the proceeds of the sale.¹⁰⁷

In setting the value of the stock held by the estate, the Tax Court heard the testimony of several expert witnesses and considered blockage elements.¹⁰⁸ The executor argued that the underwriting discount should be deducted along with the other expenses of the sale despite the consideration of blockage elements in establishing value.¹⁰⁹ Relying solely on its prior decision in *Joslyn II*,¹¹⁰ the

cago. *Id.* at 243.

103. The estate needed to raise between \$5.8 and \$8.8 million to satisfy debts, taxes, and administrative expenses. *Id.*

104. Hereinafter referred to as SEC.

105. 36 T.C.M. (CCH) at 244.

106. *Id.* Such provisions are styled "market-out" clauses and are common in firm commitment underwritings. See *Estate of Joslyn v. Commissioner*, 63 T.C. 478, 484 (1975).

107. 36 T.C.M. (CCH) at 244-45.

108. *Id.* at 246-49.

109. The executor claimed the following items as administrative expenses:

Registration fee	\$	2,722.00
Knouff & Ley legal fee and expenses		25,002.25
Consolidated-Tomoka Land Co. reimbursement for expenses		610.00
Consolidated-Tomoka Land Co. reimbursement for expenses		256.93
Rex Meighen & Co. accounting services		7,500.00
Touche Ross & Co. accounting services		24,000.00
Blyth & Co., Inc., reimbursement Blue Sky Laws expense ..		5,025.00
Sorg Printing Company printing expense		6,205.16
Fred James & Co. premium for Securities Act Liability Insurance		66,780.00

Tax Court affirmed the Commissioner's disallowance of the deduction.¹¹¹ The court placed great emphasis upon the fact that no contractual obligation to pay an underwriting discount existed. Echoing its decision in *Joslyn II*, the court classified the underwriting agreement as a contract to sell the securities. The risks borne by the estate did not outweigh the inability of the underwriters to terminate the contract at will. The court viewed the exchange of checks as "mere paper transactions,"¹¹² the result of which was a sale of stock for \$38.85 per share. Moreover, that court concluded that any amounts beyond that were underwriters' profits and not administrative expenses.¹¹³

On appeal the Seventh Circuit reversed and allowed the deduction of underwriters' expenses.¹¹⁴ Analyzing the nature of the firm commitment underwriting, the court concluded that the underwriters carried very little risk. It found incongruous the Tax Court's decision to allow the deduction for a best efforts underwriting but not for a firm commitment. In the Seventh Circuit's view, this dichotomy arbitrarily penalized those stockholders whose stock was valuable enough to obtain a firm commitment underwriting.¹¹⁵ Furthermore, the court found the characterization of the agreement as a contract for the sale of stock to be inconsistent with an underwriter's duties under SEC regulations prohibiting the purchase of stock by underwriters for their own account.¹¹⁶ Thus the court concluded that the underwriting discount was an administrative expense.

After making this determination, the court proceeded to consider the deductibility of the underwriting discount. The court cited *Estate of Park*¹¹⁷ for the proposition that state law alone should

Bell, Boyd, Lloyd, Haddad & Burns legal fee and expenses	39,769.10
Sorg Printing Company printing expense	48,240.03
James Fentress reimbursement of expenses	740.56
Glenn Ingram & Co. accounting services	995.00
Sullivan & Cromwell legal fee and expenses	7,054.89
O'Melveny & Meyer legal fee and expenses	1,269.40
Underwriting discount	945,000.00
Total	<u>\$1,181,170.32</u>

Id. at 245.

110. The Ninth Circuit had not yet decided *Joslyn II*.

111. 36 T.C.M. (CCH) at 249.

112. *Id.* at 250.

113. *Id.*

114. 577 F.2d 1100, 1107 (7th Cir. 1978).

115. *Id.* at 1105.

116. *Id.*; see 17 C.F.R. § 240.10b-6 (1978).

117. 577 F.2d at 1106 (citing 475 F.2d 673 (6th Cir. 1973)).

determine the deductibility of administrative expenses. The Commissioner argued that the court should remand the case to the Tax Court for a finding of necessity. The executor contended, on the other hand, that the Tax Court had already made that determination. Although not agreeing with the executor completely, the court determined that the record presented facts sufficient to uphold the state court's finding of necessity,¹¹⁸ and therefore allowed the deduction of the underwriters' commissions.

VI. COMMENT

The decisions of the courts of appeals in *Joslyn* and *Jenner* correctly apply the law of estate taxation to estates possessing large blocks of securities. The decisions cannot be criticized for their results. The Internal Revenue Code as drafted permits the simultaneous reduction of gross estate value for blockage elements and deduction of the selling costs that make up those elements as administrative expenses. The Ninth Circuit in *Joslyn I*, however, does stretch the bounds of reason in declaring that the executor's position does not result in the "practical equivalent of a double deduction."¹¹⁹ Undeniably, a double deduction does exist. The executor uses the same item twice to reduce the estate's liability for a single tax. In any event, whether a double deduction exists or not is irrelevant. Taxation is not a cohesive body of law. Courts often give little or no consideration to what is logical if it differs from the language of the Code. The court in *Joslyn I* implicitly recognized this. After denying the existence of a double deduction, that court found that allowing the Commissioner to select a method of determining value would deprive the estate of a statutory deduction.¹²⁰ Thus the real issue for these courts was not whether a double deduction is proper, but rather whether the Code permits the deduction even though the same item is used to reduce the gross estate. Because the Code does not prohibit this double deduction, the courts of appeals correctly allowed it to be taken.

In denying the deductions in the first place, the Tax Court in these cases attempted to fashion the law without authority. Without specific precedent, the court assumed the role of a chancellor striving to do equity. Recognizing the presence of the double deduction in the Code, the court set out to correct Congress' oversight. As the Ninth Circuit noted, however, that is not the proper role of the

118. 577 F.2d at 1106-07.

119. 500 F.2d at 386; see text accompanying note 87 *supra*.

120. 500 F.2d at 386.

court; it borders on judicial legislation.¹²¹ The courts must adhere to congressional statutory directives and cannot go beyond them to achieve a higher equitable goal. If the effect of the statutory scheme is inequitable, then Congress must change the scheme.

The Tax Court in *Joslyn I* noted that allowing the same expenses twice in computing the amount of the estate subject to tax surely could not have been contemplated by Congress.¹²² Section 2053, the section allowing the underwriting discount as a deduction, also provides evidence that Congress would not have allowed such a double deduction if it had been aware of its existence. This section eliminates any double deduction for indebtedness in property. Section 2053 permits the deduction of unpaid mortgages or any indebtedness on property only if the executor has not reduced the property's value in the gross estate by the amount of such mortgage or indebtedness.¹²³ If Congress had allowed a mortgage deduction without including the limiting language concerning gross estate value, the estate would benefit from a double deduction similar to that in the case of underwriting discounts.¹²⁴

The deduction of underwriters' commissions under section 2053 results in disregard for the true value of the securities to the estate. These commissions must *either* reduce the gross estate value under section 2031 or be deducted as expenses under section 2053, but not both. In order to remedy this situation, this Recent Development proposes that Congress amend section 2053(a)(2) of the Code to read:

- (2) for administration expenses, when the value of the gross estate is undiminished by such administration expenses or estimates thereof,¹²⁵

VII. CONCLUSION

Existing estate tax law provides an effective double deduction to estates possessing large blocks of securities that are difficult to

121. *Id.*

122. 57 T.C. at 725.

123. See note 39 *supra*.

124. Consider the calculation of the gross estate with the limiting language of § 2053 omitted: The decedent dies owning a home worth \$100,000 with an unpaid mortgage of \$20,000. The executor values the home at \$80,000 in the estate tax return since that is the amount to be realized by the estate. Then the executor deducts the \$20,000 mortgage under this fictional § 2053. The taxable value of the home is then \$60,000. Such a result is ridiculous; the estate receives \$40,000 of benefit from a \$20,000 mortgage. Any fair person cringes at such a result. Another estate that holds a home worth \$80,000 debt-free is taxed on the full value. Such a statutory scheme would ignore the equity that the owner has in the home.

125. This language is similar to the language prohibiting the double deduction of unpaid mortgages or indebtedness. I.R.C. § 2053(a) (4); see notes 39 & 123 *supra* and accompanying text.

liquidate. The executor can reduce the gross estate by an amount estimated to reflect properly the net proceeds that the estate will receive from the sale. The costs of disposition can be deducted again as administrative expenses if state law allows. Courts may require, however, that the sale be necessary to meet estate obligations.

When compared with the treatment of similar items, the treatment of underwriting expenses is clearly a loophole in estate tax law. As a general principle, no item should be used twice to reduce the gross estate. Although taxation is not necessarily based on equitable principles, without specific reason, no estate should receive inadvertent benefits because of its particular assets. Congress should therefore rectify this problem by amending section 2053 to prohibit the deduction of administrative expenses previously allowed as an offset to the gross estate.

MARK DANIEL MALONEY

