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VALUATION OF MUTUAL FUND SHARES FOR FEDERAL ESTATE TAX PURPOSES

INTRODUCTION

In computing estate taxes, property in a decedent's estate is valued at its fair market value on the applicable valuation date.[1] Fair market value is defined by treasury regulation as "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 sell and both having a reasonable knowledge of relevant facts."[2] Where corporate securities are involved, the regulations provide that the fair market value is to be determined with reference to the prevailing prices in the market where the securities are traded. If the securities are regularly traded on a national or regional exchange, their market value is the mean between the highest and lowest prices at which transactions in the securities occurred on the valuation date.[3] If the securities are traded only in the over-the-counter market, their market value is the mean between the bona fide bid and asked prices on the valuation date.[4] Because the market for mutual fund shares is unlike the market

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[1] Treas. Reg. § 20.2031-2 (1958).

[2] Treas. Reg. § 20.2031-1(b) (1958) provides:

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. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles. Examples of items of property which are generally sold to the public at retail may be found in §§ 20.2031-6 and 20.2031-8. The value is generally to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of property.

[3] Treas. Reg. § 20.2031-2(b) (1958).

[4] Treas. Reg. § 20.2031-2(c) (1958). See also the discussion in text at note 13 infra.

for other over-the-counter securities; the Commissioner of Internal Revenue issued, in 1963, a specific regulation respecting the valuation of fund shares.[5] The regulation provides that the fair market value of mutual fund shares is the public offering, or asked, price of the shares.[6] The validity of this regulation has been upheld by the Court of Appeals for the Sixth Circuit in *Ruehlmann v. Commissioner*,[7] and, during the same year, by the Seventh Circuit in *Howell v. United States*.[8] Recently, however, the Second Circuit, in *Cartwright v. United States*,[9] and the Ninth Circuit, in *Davis v. United States*[10] affirmed federal district court determinations that the regulation was invalid. With the grant of certiorari in *Cartwright*, the issue is now headed for ultimate resolution by the Supreme Court.

This comment will consider the underlying factors which give rise to the mutual fund valuation problem. Analysis will focus on the method of valuation used by the Commissioner of Internal Revenue and the alternative method urged by taxpayers in the course of past litigation. The comment concludes that while the current regulation's use of the asked price requires the taxpayer to pay an estate tax based upon a value which, as a practical matter, would have been impossible for him to have realized through sale of his shares on the valuation date, this fact is legally insufficient to warrant invalidation of the applicable treasury regulation.

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[5] Prior to this time the Regulations did not specify standards for valuing mutual funds. For many years such shares were reported at their bid prices, the load charge not being considered a part of their value. During the 1960's mutual fund shares came to be treated as common stock, and therefore the mean between the bid and asked price was taken to be the taxable value. The promulgation of a specific regulation in 1963 was, some commentators believe, more an end to the Commissioner's indecision than a rejection of his previous policy of compromise. See, e.g., Note, 21 Buffalo L. Rev. 256, 259-60 (1971).

[6] Treas. Reg. § 20.2031-8(b) (1963), T.D. 6680, 1963-2 Cum. Bull. 417, provides, in pertinent part, as follows:

> (b) Valuation of shares in an open-end investment company. (1) The fair market value of a share in an open-end investment company (commonly known as a "mutual fund") is the public offering price of a share, adjusted for any reduction in price available to the public in acquiring the number of shares being valued. In the absence of an affirmative showing of the public offering price in effect at the time of death, the last public offering price quoted by the company for the date of death shall be presumed to be the applicable public offering price.

The regulation was issued as an interpretation of § 2031 of the Internal Revenue Code of 1954 which provides:

> 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.

[7] 418 F.2d 1302 (6th Cir. 1969), cert. denied, 398 U.S. 950, rehearing denied, 400 U.S. 856 (1970).

[8] 414 F.2d 45 (7th Cir. 1969).

[9] 457 F.2d 567 (2d Cir. 1972). As this comment went to press, the Supreme Court granted certiorari in the *Cartwright* case. 41 U.S.L.W. 3166 (U.S. Oct. 10, 1972).

[10] 460 F.2d 769 (9th Cir. 1972).

I. Distinguishing Characteristics of Mutual Funds

Much of the problem of valuing mutual funds arises from essential differences between the nature of and market for fund shares on the one hand and, on the other, those of the common shares of other corporate enterprises. For the typical business corporation, common stock is the vehicle by which capital funds are channeled from the investor to the corporation which will use the funds to produce a marketable product or service. After the initial issuance and sale of such shares to the public, the shares are transferred in the securities markets from one individual to another; the corporation is neither a party to nor directly involved in the transactions.[11] The market price of a company's shares is arrived at by an auction procedure in which buyers and sellers negotiate, directly or through a broker, the price at which each transaction will take place. The price of a particular security at any given time generally reflects the collective judgment of investors as to the present value of future dividends and expected appreciation in the price of the security, taking into consideration such factors as the financial strength of the company, its history of sales, earnings and dividends, its competitive position within its industry, and the quality of its management.[12] Differences of opinion among investors as to these factors or their relative importance lead some to purchase a security while others are selling it. On any given day, the mean between the highest and lowest prices at which transactions occur provides a fair indication of the market value of a particular stock. If the shares are not traded on a registered securities exchange, no record of daily transactions is centrally maintained. However, the actual market value may be assumed to lie somewhere between the highest quoted bid and lowest price offered by those registered broker-dealers making a public market in the stock as reported by the National Quotation Service.[13] The mean between these figures is acceptable as a fair approximation.

A mutual fund is a financial institution issuing its shares to the public and investing the proceeds primarily in securities of other corporations. Such funds are engaged in a continuous offering of their shares through a continuous underwriting process, and stand ready to issue as many shares as are necessary to meet the public demand.[14] Except for a negligible number of transfers, all transactions in a fund's shares take place between the shareholder-investor and the fund itself; although there are no legal restrictions on the transferability of these

[11] While under certain circumstances a corporation may reacquire a number of its own shares through market purchase or donation, such "treasury stock" accounts for a very small fraction of all transactions in a company's shares.

[12] See, e.g., B. Graham, D. Dodd, & S. Cottle, Security Analysis, pt. IV (1962). The discussion in ch. 32 is especially helpful.

[13] The "pink sheets," published by the National Quotation Service, supply daily quotations for over-the-counter securities by all dealers currently making a public market in each security.

[14] It is because of this unlimited capitalization that mutual funds are unable to obtain a listing on the major security exchanges.

shares, they are ordinarily disposed of by redemption.[15] Section 22 of the Investment Company Act of 1940 requires a mutual fund to redeem, *at current net asset value,* all shares presented by shareholders for redemption.[16] The net asset value of a share is computed by adding the market value of all securities and other assets owned by the fund, subtracting the liabilities of the fund, and dividing the remainder by the then total outstanding shares.[17] The net asset value per share, or redemption value, becomes the "bid" side of a price quotation for the fund. The "asked" side, or public offering price, is arrived at by adding to the net asset value a "load" or sales charge which is used to cover the costs and expenses of marketing the shares.[18] Although the loading charge may vary among funds, the prevailing rate is 8.5 percent of the total offering price including the load.[19] Thus the bid and asked prices in a mutual fund quotation do not delineate a range within which negotiated transactions occur in an auction-like procedure, but rather they are the specific prices at which all transactions in the fund on that day will occur. All sales of shares by the fund to the public will take place at the asked price; all sales by the public to the fund—redemptions—will occur at the bid price. It is this dual pricing structure for mutual funds that gives rise to the problem of legal valuation in the estate tax context.

The typical fact pattern emerging from the relevant cases is quite simple.[20] Mutual fund shares held by the decedent at the time of death are valued by his executor at the bid price on the estate tax return so as to minimize the tax liability. The Commissioner of Internal Revenue values the shares at the asked price and assesses a deficiency. The executor pays the deficiency and brings suit in federal district court

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15 Estate of Wells v. Commissioner, 50 T.C. 871, 872-73 (1968); Ruehlmann v. Commissioner, 418 F.2d 1302, 1303 (6th Cir. 1969). There is a small over-the-counter resale market in mutual fund shares. This market is not widely known and has very little or no effect on the general market. Mutual fund shares are bought by dealers in this market at a price slightly above redemption value, but are resold by the dealers at the public offering price. J. Clendenin, Introduction to Investments 398-99 (4th ed. 1964).

16 15 U.S.C. § 80a-22 (1970).

17 See, e.g., Romanski, The Role of Advertising in the Mutual Funds Industry, 13 B.C. Ind. & Com. L. Rev. 959 n.1 (1972).

18 The mutual fund receives no portion of the loading charge. It is divided between the underwriter and the selling broker to cover their expenses and profit. Shares of some mutual funds may be purchased at a public offering price equal to the net asset value per share. There is no loading charge because these funds maintain no dealer organization or staff of sales representatives. Investors are not solicited but must apply directly to the underwriter. Such funds, however, account for only a small fraction of mutual fund industry assets and shareholder accounts. Securities and Exchange Commission, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 204 (1966).

19 Romanski, The Role of Advertising in the Mutual Funds Industry, 13 B.C. Ind. & Com. L. Rev. 959, 966 n. 41 (1972).

20 See Davis v. United States, 460 F.2d 769, 770 (9th Cir. 1972); Cartwright v. United States, 457 F.2d 567, 568 (2d Cir. 1972); Howell v. United States, 414 F.2d 45, 46 (7th Cir. 1969).

for a refund. In the course of litigation, each party attempts to convince the court of the appropriateness of various analogies upon which they rely. None of the problems represented by these analogies is precisely like the valuation of mutual fund shares, and all are sufficiently different to give rise to serious disagreement among learned members of the bench and bar. It is through consideration of the offered analogies, and of some additional standards of value, that one can best understand the various aspects of the controversy over mutual fund valuation.

II. The Willing Buyer-Willing Seller Test[21]

The application of the willing buyer-willing seller test has been at issue in each of the mutual fund valuation cases. The *Howell* and *Ruehlmann* courts, upholding valuation by the Commissioner at the asked price, have argued that the statutory duty of the fund to repurchase shares prevents the fund from ever being a willing buyer.[22] Accordingly, these courts reason, only the original sale of the shares to a public purchaser constitutes a willing buyer-willing seller transaction.[23] Since this transaction takes place at the public offering or asked price, the shares are properly valued at that price.

The *Davis* and *Cartwright* courts, holding valuation by the Commissioner at the asked price to be improper, have taken a different view of the application of the willing buyer-willing seller test.[24] The existence of a willing buyer and a willing seller, they point out, ordinarily results in a single price. Once the willing buyer and willing seller have agreed, the price is the same for both. In the case of mutual funds, however, there are two prices. Transactions entered into by a willing public purchaser and a willing public seller, each dealing directly with the fund at the same moment, take place at different prices. Hence the test is inappropriate to the determination of fair market value in the mutual fund context.

Still other courts have used the willing buyer-willing seller test to argue in favor of valuation at the *bid* price. For example, in *Hicks v. United States*[25] the court notes that there are *not* two separate markets for mutual fund shares; rather, a sale by the fund in the original issue market includes an agreement to repurchase at the redemption price, which the parties agree will be set with reference to a fixed standard—the net asset value of the shares. Because the fund was not compelled to sell in the first place, but did so with knowledge

[21] See text at note 2 supra.

[22] 414 F.2d at 45; 418 F.2d at 1304.

[23] Estate of Wells v. Commissioner, 50 T.C. at 876; Howell v. United States, 414 F.2d at 48; Ruehlmann v. Commissioner, 418 F.2d at 1304.

[24] Davis v. United States, 460 F.2d at 771; Cartwright v. United States, 457 F.2d 567, 570-571 (2d Cir. 1972). See also Note, 21 Buffalo L. Rev. 256, 264 (1971); Note, Valuation of Shares in Open-End Investment Companies for Federal Estate Tax Purposes Held to be Replacement Cost, 44 N.Y.U.L. Rev. 416 (1969).

[25] 335 F. Supp. 474 (D. Colo. 1971).

of its subsequent duty to repurchase, it may be viewed as a willing buyer at the time of such repurchase.[26] It is this net asset value standard, then, that should be used to value the mutual fund shares: "The touchstone of fair market value has always been the price which a willing seller could reasonably be expected to obtain from a disposition of the property in question."[27]

In the light of these contradictory arguments, each possessing some degree of validity, it appears that the willing buyer-willing seller test does not hold a definitive answer to the mutual fund valuation problem. As one commentator has observed, "the classic definition of fair market value, although conceptually appealing, tends to elicit a nebulous array of theoretical arguments, while failing to solve the majority of valuation problems."[28]

III. Single Premium Life Insurance Policy Analogy

The principal analogy utilized by the Commissioner[29] has been a comparison of mutual funds to single premium life insurance policies. The initial purchase price of such a policy—cost—is always in excess of the price at which the policy may be immediately redeemed—cash surrender value. As time elapses after the initial purchase, the cash surrender value will grow and eventually exceed the original cost of the policy, but it will never become as great as the cost of duplicating the policy at that point in time—replacement cost. The relationship between the cost of such a policy and its cash surrender value is said to be analogous to the relationship between the asked and bid quotations for a mutual fund share.

The leading case of *Guggenheim v. Rasquin*[30] declares the law with respect to the valuation of single premium life insurance policies in the context of a federal gift tax return. Provisions in the Internal Revenue Code relating to gift taxes are generally construed to be ***in pari materia*** with those relating to estate taxes.[31] In *Guggenheim*, the United States Supreme Court held the value of single premium life insurance policies to be their replacement cost. All of the economic benefits of a policy must be taken into consideration, reasoned the Court, in determining its value.[32] The holder of a fully paid life insurance policy has the right to surrender it or to retain it for its investment value and to collect the face amount upon the death of the insured.

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[26] Accord, Cartwright v. United States, 323 F. Supp. at 772. See also discussion in Note, 21 Buffalo L. Rev. 256, 260-61 (1971).

[27] Estate of Wells v. Commissioner, 50 T.C. at 878 (dissenting opinion).

[28] 44 N.Y.U.L. Rev., supra note 24, at 442.

[29] Davis v. United States, 460 F.2d 769, 772 (9th Cir. 1972); Cartwright v. United States, 457 F.2d 567, 570 (2d Cir. 1972); Howell v. United States, 414 F.2d 45, 48 (7th Cir. 1969).

[30] 312 U.S. 254 (1941).

[31] Harris v. Commissioner, 340 U.S. 106, 107 (1950); Merrill v. Fahs, 324 U.S. 308, 313 (1945); Estate of Sanford v. Commissioner, 318 U.S. 39, 44 (1939).

[32] 312 U.S. at 257.

Only the replacement cost can properly reflect the value to the owner of this entire bundle of rights in a single premium policy.[83] Liquidation value is not an appropriate measure because it assumes destruction of these important features, which may be valued in terms of the difference between the cash surrender value and the replacement cost.

The mutual fund shareholder, the Commissioner has argued, acquires rights and benefits of a similar nature. The purchaser acquires the right to share in future dividends and capital gains distributions and obtains diversification of his investment portfolio and professional investment management. The value of these rights to the shareholder may be measured by the amount of money above the liquidation value —that is, above the bid price—that he is initially willing to pay to acquire those rights. This amount is equal to the sales load and is included only in the asked price. At least two courts have found this analogy sufficiently persuasive to make valuation of mutual funds at the asked price reasonable and permissible.[84] The rationale appears to be that when the price which individuals are willing to pay in order to acquire an asset is in excess of the asset's liquidation value in the hands of the public, the asset must possess an element of value in addition to its liquidation value which, in the opinion of the purchasers, justifies the difference between that value and the cost of acquisition.

A different court found that the Commissioner's attempt to remold the facts and law of *Guggenheim* to fit the mutual fund valuation problem was unrealistic and unreasonable.[85] Other courts, in sympathy with this view, reasoned that there were essential differences between single premium policies and mutual funds that rendered the analogy useless.[86] First, the value of the life insurance policy is rooted in the eventual collection of the face amount.[87] Thus the value of the policy at any given time depends primarily upon the age and health of the insured. Advancing age or intervening illness may decrease or eliminate the chance of obtaining another policy and will of course increase the cost of such a policy. As one approaches the hypothetical point of uninsurability, then, the right to retain an existing policy grows in value. Any computation of the real value of such a policy is at best imprecise, and, under these circumstances, valuation at replacement cost may be justified.[88] In contrast, computing the net asset value of a mutual fund share on any given day involves no such uncertainty. That value may be computed exactly, and there is no additional value in the right of retention itself.

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[83] Id.

[84] Howell v. United States, 414 F.2d 45, 49 (7th Cir. 1969); Ruehlmann v. Commissioner, 418 F.2d 1302, 1304 (6th Cir. 1969). See also the district court opinion in *Howell*, 290 F. Supp. 690, 694 (N.D. Ind. 1968).

[85] Cartwright v. United States, 323 F. Supp. 769, 773 (W.D.N.Y. 1971).

[86] Davis v. United States, 306 F. Supp. 949, 956 (C.D. Cal. 1969).

[87] Id. See also 44 N.Y.U.L. Rev., supra note 24, at 419.

[88] Guggenheim v. Rasquin, 312 U.S. at 258; cf. Ruehlmann v. Commissioner, 418 F.2d at 1304.

A second difference is that an insurance policy may be readily disposed of by assignment at a negotiated price in the ordinary course of business, but a mutual fund share is usually redeemed by the fund. Third, although a mutual fund purchaser acquires with his share the right to future dividends and possible capital gains, this is no more than is acquired by the purchaser of any corporate security. In both cases, the amount paid for the shares above liquidation value is for expenses of advertising and marketing only and adds nothing to the value of the share itself.[39] The Commissioner has never argued for the inclusion of brokerage fees in valuing other securities, and to do so for mutual funds, said the *Davis* court, would impose an estate tax penalty for investing in mutual funds rather than in some equivalent security.[40]

Weighing the arguments in regard to this analogy, it appears that the precedential value for mutual fund valuation cases of the Supreme Court's decision with respect to single premium life insurance policy valuation is, at best, questionable.

IV. The Inclusion of Acquisition Costs in Fair Market Value

A. *Excise Tax on Jewelry Analogy*

Another analogy, offered by the Commissioner in *Howell*, compares the excise tax levied on jewelry at the time of purchase with the sales load which comprises the difference between the bid and asked price for mutual fund shares.[41] The excise tax is, in general, a levy on certain consumer items, calculated as a fixed percentage of the purchase price.[42] In *Estate of Gould v. Commissioner*,[43] the Tax Court considered whether such an excise tax ought to be included in valuing jewelry for gift tax purposes. As noted above, the Code provisions relating to estate and gift taxes are to be similarly construed.[44] In *Gould*, the taxpayer bought a ring which he then gave as a gift to his wife. The retail price of the ring was $58,000 and the federal excise tax amounted to $5,800, making a total purchase price of $63,800. On his gift tax return, the taxpayer valued the ring at $58,000. The Commissioner determined the fair market value of the ring to be $63,800, and assessed a deficiency. The taxpayer paid the tax and sued for a refund. He argued that a person or estate could realize only $58,000 if it sold the ring, since no tax would be imposed on the resale. The Commissioner

39 Estate of Wells v. Commissioner, 50 T.C. at 880 (dissenting opinion); Cartwright v. United States, 457 F.2d at 571.

40 306 F. Supp. at 949.

41 Estate of Wells v. Commissioner, 50 T.C. at 876-877 (1968). See also Howell v. United States, 414 F.2d 45, 49 (7th Cir. 1969).

42 Int. Rev. Code of 1939, § 2400. This tax was subsequently repealed, Act of June 21, 1965, Pub. L. No. 89-44, § 101(a), 79 Stat. 136.

43 14 T.C. 414 (1950). See also Duke v. Commissioner, 200 F.2d 82 (2d Cir. 1952).

44 See note 31 supra.

answered that the very existence of a tax on all new rings sold by dealers would increase the second-hand price to something between $58,000 and $63,800. The court held that since there was no acceptable market in which such a ring could normally be disposed of by a taxpayer and no evidence of what price might have been realized upon a sale, alternative means of valuation could properly be considered. The court then held that the value of the ring must include the excise tax, since the donee would have had to pay the tax had she purchased a similar ring herself.[45]

In the mutual fund cases, the Commissioner has pressed the analogy on the basis that the total purchase price of the jewelry is equivalent to the asked price for a mutual fund share, while the resale price of the jewelry free of the excise tax is equivalent to the bid or redemption price of the shares. At least one taxpayer sought to discredit the analogy on the ground that the cases following *Gould* are all limited to situations where no other probative evidence of fair market value exists.[46] In such cases, it may be argued, valuation at the purchase price is reasonable; but since there is other evidence of fair market value in the mutual fund situation, cases involving mutual fund share value are distinguishable from the jewelry cases. It is submitted, however, that such a restricted reading of the jewelry cases is not mandatory, and that the cases may be properly used to support the general proposition that acquisition costs are includible in estate tax property valuation.[47]

B. *Analogy to Other Corporate Securities*

Taxpayers in the mutual fund cases have responded to the argument favoring inclusion of acquisition costs with an analogy of their own. In *Howell*, the taxpayer asserted that the sales load which represents the difference between the bid and asked price for mutual fund shares is of precisely the same nature as the commission and fees associated with the purchase of a listed security.[48] The Commissioner, he argued,

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[45] 14 T.C. at 417. The court mentioned but did not deal extensively with the related argument that if the donor had chosen to give a cash gift to the donee for the purpose of purchasing a ring, he would have given an amount equal to the purchase price of the ring including the tax. This argument is self-serving, for if the donee chooses to give the ring to another, the value must be determined by an alternative means, there being no thought or possibility of a cash alternative.

[46] Publicker v. Commissioner, 206 F.2d 250 (3d Cir. 1953), cert. denied, 346 U.S. 924 (1954). The court held that where there existed an irreconcilable conflict in evidence regarding valuation of a large diamond in a limited dealers' market and the price which the diamond would bring at retail, the cost of an item may be considered as the best evidence of value. See also Duke v. Commissioner, 200 F.2d 82 (2d Cir. 1952), cert. denied, 345 U.S. 906 (1953).

[47] See, e.g., 44 N.Y.U.L. Rev., supra note 24, which, although generally supportive of the taxpayer's position, points out that "these cases [including *Gould*] would seem to support the . . . position for the inclusion of acquisition costs in estate tax valuation." Id. at 420.

[48] 414 F.2d 45, 49 (7th Cir. 1969).

has never sought to include these fees in the valuation of such securities in spite of the fact that they *are* part of the replacement or acquisition cost of such securities.

The *Howell* court responded that since the bid and asked prices on listed stocks are identical, the willing buyer-willing seller test may be applied and there is no necessity to resort to replacement or acquisition cost as a standard. This answer, however, appears overly simple, for it ignores the compromise valuation required by regulation with respect to over-the-counter securities and the exclusion of brokerage fees in the valuation of such securities. It is submitted that there is a better answer that the court overlooked. First, in the case of other corporate securities, even over-the-counter securities, the brokerage fees do not reflect the difference between the current bid and asked prices but represent an additional charge above the asked price. In addition, such brokerage fees are not commonly included in the quotation of a corporate stock and are not generally considered to be part of the price at which the stock is trading, whereas with a mutual fund such fees *are* part of the price quotation and in fact comprise the difference between the bid and asked quotation.

Thus there are some important distinctions between the acquisition costs associated with mutual fund shares and those associated with other securities which appear to destroy the effectiveness of the *Howell* taxpayer's analogy. The cases holding that the excise tax should be included in the valuation of jewelry provide a considerably more persuasive analogy. However, they constitute the only authority for the proposition that acquisition costs borne by the purchaser must be included in determining value at a later time.[49]

V. Restricted Stock Analogy

Another analogy used by the taxpayers in the mutual fund cases views the purchase of mutual fund shares as essentially similar to the purchase of any corporate securities subject to restrictive agreements regarding resale.[50] The treasury regulation applicable to valuation of such restricted stock[51] applies to situations in which such shares are subject to a binding contractual agreement that they may not be sold to the general public without first being offered to a specified party at a certain price. If the restriction is the product of an arm's length transaction, then the price specified in the agreement is the maximum

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[49] A distinction might be made between those acquisition costs which are clearly separable from the underlying price and those which are inseparably a part of the retail price. In the former category are brokerage commissions, bank charges for setting up a trust, and title insurance on real estate; in the latter are such things as the underwriting commission on a new stock issue, and the salesman's commission on a new automobile or other consumer good.

[50] See, e.g., Estate of Wells v. Commissioner, 50 T.C. at 878 (dissenting opinion), cited in Cartwright v. United States, 457 F.2d at 571.

[51] Treas. Reg. § 20.2031-2(h) (1958).

at which the shares may be valued for estate tax purposes.[52] The *Davis* court found the rationale of this regulation applicable to mutual fund share transactions because, realistically, the fund is the only buyer for the taxpayer's shares, and the redemption price represents the only value which can be obtained for the shares.[53]

There appear to be several reasons for finding this analogy invalid. First, the mutual fund situation does not involve an option by the fund to purchase the shares. On the contrary, redemption is at the option of the shareholder. Second, in the case of the mutual fund there is no definite price mutually agreed upon by the parties; rather, there is only a standard—net asset value—with respect to which the price will be set.[54] Third, there is no legal restriction upon the right of the mutual fund shareholder to transfer his shares to another individual without offering them to the fund, and to do so at a price above the redemption price offered by the fund.[55] While such a buyer would no doubt be difficult to locate, there is nothing to prevent a would-be seller of fund shares from taking whatever steps he might to seek out a buyer other than the fund. If such a buyer could be found, he would probably be willing to pay something above the bid price of the shares but less than the asked price as quoted by the fund.[56] The infirmities of the restricted stock analogy are thus numerous and apparent.

VI. Argument for Realizable Value

When their analogies failed, taxpayers in *Howell* and *Cartwright* fell back on the argument that the bid price is the only fair and proper measure of valuation.[57] Property held by an estate should not be valued

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[52] Where another person holds an option or a contract to purchase securities owned by a decedent at the time of his death, the effect that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such would be the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. Rev. Bull. 59-60, 1959-1 Cum. Bull. 237; see 2 Casner, Estate Planning 945-951 (1961 ed.).

[53] 306 F. Supp. at 955.

[54] See text at notes 16-17 supra.

[55] See text at note 15 supra. See also Note, Valuation of Mutual Fund Shares for Federal Estate Tax Purposes, 22 Baylor L. Rev. 348, 356 (1970).

[56] Compare the argument of the Commissioner in *Gould*, discussed at notes 43-45 supra, that the resale price of a ring subject to excise tax when originally purchased lies somewhere between the price including the excise tax and the price free of the tax.

[57] Howell v. United States, 290 F. Supp. at 692; Cartwright v. United States, 457 F.2d at 570-572.

at an amount greater than that for which the property could be sold by the estate in the only readily accessible market in the ordinary course of business.[58] However, since the mutual fund shares in question will not be liquidated and since the estate tax is intended to be a tax on value transferred at death,[59] the question arises whether the value transferred can be viewed as greater than the liquidation value at the time of transfer. The answer to this appears to depend essentially upon the personal preference of the transferee. If the transferee is not interested in retaining the mutual fund shares but intends immediately to liquidate them for cash, or instructs the executor to do so prior to distribution, the value he receives is limited in a real sense to the bid price. The right to retain the shares is worth nothing *to him*. If, however, the transferee desires to own the fund shares and would even have used a bequest of cash to purchase such shares, the argument that he receives property properly valued at the asked price is strong. The *Cartwright* court stated that *the* widely accepted principle of valuation embodied in the applicable treasury regulation is that "all relevant facts and elements of value as of the applicable application date shall be considered in every case."[60] However, there are no grounds for assuming that the Treasury or indeed the courts would accept an argument for a taxation standard based upon the transferee's personal preference: there must be a known standard of value for mutual fund shares common to all holders.

The Code declares that the value of a decedent's gross estate will be the value of all property "to the extent of the interest therein of the decedent."[61] The *Davis* court found in this regard that the decedent acquires no interest in that portion of the purchase price of a fund share which represents the sales load.[62] The shareholder cannot realize this amount, said the court, nor can he make a transfer so that his transferee may realize it. The fund receives only the net asset value, and the remainder of the purchase price is used for commissions to sales representatives and other expenses incidental to the distribution and sale of mutual fund shares. To apply an estate tax on the sales load is to tax a non-existent "interest" of the decedent.[63]

In opposition to this view it has been argued that the transformation of a cash asset into a less liquid form should not markedly affect the taxable value of the non-cash asset.[64] These arguments bring us no closer to a common agreement. While some courts viewing them have

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[58] Cartwright v. United States, 323 F. Supp. at 772; Davis v. United States, 306 F. Supp. at 955. See also Note, 21 Buffalo L. Rev. 256, 263 (1971).

[59] Int. Rev. Code of 1954, § 2001.

[60] Cartwright v. United States, 457 F.2d at 571. The court is citing Treas. Reg. 20.2031-1(b).

[61] Int. Rev. Code of 1954, § 2033.

[62] 460 F.2d at 771.

[63] Id. at 772; accord, Hicks v. United States, 335 F. Supp. 474, 482 (D. Colo. 1971).

[64] Note, Internal Revenue—Gift Taxation—Valuation of Mutual Fund Shares, 20 Case W. Res. L. Rev. 917, 924 & n.22 (1969).

found that logic permits no conclusion other than that the regulation is unreasonable,[65] others have heard the same arguments and found the regulation to be manifestly reasonable and appropriate.[66] After all the arguments and analogies have been heard, the legal question is in fact reduced to an inquiry into the reasonableness of the regulation in question.

VII. Conclusion: Administrative Regulations and the Presumption of Validity

Perhaps the most important factor to consider in evaluating the decisions relating to mutual fund valuation for estate tax purposes is that the courts have not been completely free to listen to all the suggested alternative bases of valuation and their supporting arguments and analogies, and then choose the best alternative. They have been constrained to reach a decision in the context of an existing treasury regulation which already prescribed a particular method of valuation. It is submitted that the pre-existence of this treasury regulation in fact presents the strongest argument for its retention. Regulations issued in interpretation of a particular federal statute by the administrative agency charged with enforcement of the statute are accorded special judicial respect.

The United States Supreme Court has ruled that if a challenged regulation is reasonable and consistent with the statute under which it is promulgated, it must be sustained.[67] If several methods of valuation are permissible and one of these is chosen by the Commissioner, it may not be set aside.[68] The role of a court in such a case is merely to insure that the Commissioner is within his authority and has acted in a reasonable manner. Beyond that, the court is not at liberty to "second guess" the Commissioner.[69]

In ruling on the validity of a treasury regulation in *United States v. Correll*,[70] the Supreme Court said:

> Alternatives to the Commissioner's . . . rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. In this area of limitless factual variations "it is the

[65] See, e.g., Hicks v. United States, 335 F. Supp. 474, 482 (D. Colo. 1971).

[66] Howell v. United States, 414 F.2d 45 (7th Cir. 1969); Ruehlmann v. Commissioner, 418 F.2d 1302 (6th Cir. 1969).

[67] Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948).

[68] Howell v. United States, 414 F.2d at 48, citing DuPont's Estate v. Commissioner, 233 F.2d 210 (3d Cir.), cert. denied, 352 U.S. 878 (1956); Mearkle's Estate v. Commissioner, 129 F.2d 386 (3d Cir. 1942).

[69] Ruehlmann v. Commissioner, 418 F.2d at 1304.

[70] 389 U.S. 299 (1967).

> province of Congress and the Commissioner, not the courts, to make the appropriate adjustments. The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner."[71]

A heavy burden is on the taxpayer who would rebut such a judicial presumption of validity. He must not only present an alternative which is better than that chosen by the Commissioner, but must also prove the existing regulation to be unreasonable and intolerable in the context of the statute under which it was promulgated. It is submitted that, in order to be "reasonable," a regulation must meet only minimum standards of acceptibility, appropriateness, fairness and suitability. It must not be arbitrary and must have some rational basis in the statute. In short—if one may make value judgments about tax regulations—it need not be a "good" regulation. It is submitted that the regulation in controversy here is *not* good but that it *is* reasonable.

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[71] Id. at 306 (citation omitted).