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of this standard in three respects. First, the classification itself was deemed arbitrary, despite the fact that it did to some extent accomplish the objectives of the statute. Second, the court questioned the propriety of the statutory objectives in relation to the burden imposed on individuals within the ambit of the statutory bar to recovery. Third, even if it is assumed that the objectives are legitimate and the classification is reasonable, the court demonstrated that the classification involved was an ineffective method of accomplishing the objectives of the guest statute. In sum, the court refused to submit to the presumption of validity which courts have traditionally given legislative enactments but rather examined the statute in terms of its internal rationality and its external effect.

Dana G. Kirk

United States v. Cartwright—A New Estate Tax Valuation Criterion for Mutual Fund Shares

In accordance with estate tax provisions requiring that the value of all property held by a decedent at the time of death be included in the gross estate, the executor of the decedent's estate reported the value of mutual fund shares held by the decedent at their net asset value, the price at which the fund will redeem its outstanding shares. Pursuant to Treasury Regulation section 20.2031-8(b) which provides that mutual fund shares are to be valued at their public offering price at the date of death, the Commissioner assessed a deficiency. The executor paid the deficiency and filed a timely claim for refund. Upon denial of this claim the executor initiated a refund action in federal district court, contending that Treasury Regulation section 20.2031-8(b) prescribed an unreasonable valuation criterion. The district court ruled in favor of the executor and declared the regulation invalid. The Court of Appeals for the Second Circuit affirmed. The Supreme Court, noting a conflict among the circuits, granted certiorari. Held affirmed: Treasury Regulation section 20.2031-8(b) is invalid and decedent's mutual fund shares should be valued at their redemption price, rather than the public offering price. United States v. Cartwright, 411 U.S. 546 (1973).

I. MUTUAL FUNDS AND THE FEDERAL ESTATE TAX

Mutual Funds. A mutual fund is an investment management company which continuously sells redeemable shares in itself and invests the proceeds in securities of various types. Mutual fund shares, although trans-

1 INT. REV. CODE of 1954, §§ 2031, 2033.
4 457 F.2d 567 (2d Cir. 1972).
ferable, are not traded in any securities market. Instead, shareholders wishing to dispose of their shares must have them redeemed by the fund. Redemption is generally upon demand at a price approximately equal to the net asset value per share on the day of redemption. Because of the structure and the activities of such companies, they are regulated under the provisions of the Investment Company Act of 1940.

The price at which the shares are offered to the public ordinarily includes a sales or “load” charge which passes to the underwriter as compensation for marketing the fund's shares. The load charge varies with the particular fund up to a maximum of about nine percent of the public offering price, with lesser percentages being charged for quantity sales. Thus, at a given time mutual fund shares reflect two prices, one at which the public may purchase the shares and another, lower price, at which the fund will redeem the shares, the difference between the two figures being equal to the sales charge.

The Treasury Regulation. Section 2033 of the Internal Revenue Code provides that for estate tax computation purposes, “[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.” “Value” is defined as “fair market value,” which, according to the test employed by the regulations, 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 the relevant facts.”

Prior to 1963 the Commissioner had no fixed policy for the valuation of mutual fund shares. Accordingly, estate tax returns valued them at various levels, including the redemption price, the mean between the redemption and public offering prices, and the public offering price. In response to the resulting confusion and in accordance with Internal Revenue Service demands for a public offering price valuation, the Treasury Department in that year promulgated Treasury Regulation section 20.2031-8(b):

5 Mutual funds are more properly termed “open-end” investment management companies. “Open-end” refers to the redemption characteristic. In contrast, “closed-end” companies do not redeem outstanding securities or engage in the continuous sale of new securities, and the shares of such companies are normally bought and sold in securities markets. See generally SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. (1966).

6 This figure is normally computed twice daily by subtracting the company's liabilities from the total market value of its assets, and dividing by the number of outstanding shares. It is listed on the financial pages as the “bid” price. H.R. REP. No. 2337, supra note 5, at 204 n.8.

7 15 U.S.C. §§ 80a-3-5 (1970). The Securities Act of 1933, Securities Exchange Act of 1934, and the Investment Advisers Act of 1940 all apply to investment companies, but are concerned primarily with disclosure and prevention of fraud. “Because the relatively liquid, mobile, and readily negotiable assets of investment companies afforded unusual opportunities to the unscrupulous, Congress determined the earlier statutes were inadequate . . . and passed a special regulatory statute—the Investment Company Act.” H.R. REP. No. 2337, supra note 5, at 9.

8 A distinct minority of mutual funds, referred to as “no-load funds,” do not include this charge and therefore the redemption and public offering prices are identical. Id. at 51.

9 INT. REV. CODE of 1954, § 2033.


11 Cf. REV. PROC. 64-18, 1964-1 CUM. BULL. 681-82.
"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."\(^{12}\)

II. JUDICIAL CONFLICT

In challenging the valuation criterion, taxpayers were initially disadvantaged by judicial policy with respect to treasury regulations. The Supreme Court has repeatedly stated that where the validity of a treasury regulation is in question, the role of the judiciary will be a limited one, and the regulations must be sustained unless they are unreasonable and plainly inconsistent with the revenue statute.\(^{13}\) "Congress has delegated to the Commissioner, not the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code."\(^ {14}\) Because of this delegation, the role of the courts "begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner."\(^ {15}\)

Despite a reluctance on the part of many courts\(^ {16}\) to disturb the judgment of the Commissioner in his delegated authority, a similar number\(^ {17}\) were sufficiently convinced of the contested regulation's inherent unreasonableness to declare it invalid. The first challenge produced perhaps the clearest illustration of the differing approaches. In Estate of Frances Foster Wells\(^ {18}\) the Tax Court narrowly upheld the validity of the regulation by a margin of seven/six. The majority, noting that mutual fund shares had been grouped in the regulations with certain insurance policies and annuity contracts\(^ {19}\) rather than with ordinary stocks and bonds,\(^ {20}\) rea-


\(^{15}\) Id.

\(^{16}\) See, e.g., Ruehlmann v. Commissioner, 418 F.2d 1302 (6th Cir. 1969), cert. denied, 398 U.S. 531 (1970), aff'd sub nom. Estate of Frances Foster Wells, 50 T.C. 871 (1968). While acknowledging that "[l]ogical argument can be made for either the bid price or the asked price as the criterion of value for mutual fund shares," the court determined that "if it [the Commissioner's chosen criterion] is a reasonable one, we are not at liberty to second guess him." Id. at 1304. See also Howell v. United States, 414 F.2d 45 (7th Cir. 1969) (identical gift tax regulation upheld); Norton v. United States, 70-1 U.S. Tax Cas. 83,831 (W.D. Wash. 1969); Estate of Lovina R. York, 28 CCH Tax Ct. Mem. 1271 (1969).

\(^{17}\) See, e.g., Davis v. United States, 460 F.2d 769, 772 (9th Cir. 1972), aff'd 306 F. Supp. 949 (C.D. Cal. 1969): "It [the sales charge] adds nothing to the value of the shares and does not thereafter constitute an element in computing actual worth. To apply the estate tax rate to the sales charge paid is to impose a tax on a non-existent interest of the decedent." See also Hicks v. United States, 335 F. Supp. 474, 480 (D. Colo. 1971), where the court said that "to include the fictitious sales commission in the value of the shares to the estate is to create an artificial value that cannot possibly be obtained by the estate in any readily accessible, realistic market."


\(^{19}\) Treasury Regulation § 20.2031-8, as amended in 1963, is entitled: "Valuation of certain life insurance and annuity contracts; Valuation of shares in an open-end investment company."

\(^{20}\) Fair market value for ordinary stocks and bonds is determined by the regulations to be the mean between the highest and lowest quoted selling prices on the date of death. Treas. Reg. § 20.2031-2 (1959).
soned that that was "recognition that investment company shares are a different breed of cats from ordinary stocks and bonds; and when it comes to valuing them, a different criterion can reasonably be applied, more nearly like that applied to life insurance and annuity contracts . . . ."\(^{21}\) Single-premium life insurance policies had presented a unique valuation problem and were therefore afforded special treatment in the regulations.\(^{22}\) Some courts\(^{23}\) when faced with the valuation problem of life insurance policies in a gift tax context, had decided that the cost of replacement was the proper criterion rather than the cash-surrender value because the policy holder or beneficiary's rights were more than the right to surrender. The policy could be retained and the face value realized upon the insured's death. "All the economic benefits of a policy must be taken into consideration in determining its value . . . ."\(^{24}\) Similarly, the \textit{Wells} court reasoned that "[t]he estate and the beneficiaries may continue to own the mutual fund shares, and if they do, they would enjoy all the benefits of ownership of the stock, including not only the right to redeem, but also the right to continue to hold the stock and to receive dividends."\(^{25}\) It was therefore considered appropriate to value them for tax purposes at their replacement cost, which, in the context of their market, was the public offering price.

Another argument in favor of the regulation's validity advanced by the majority in \textit{Wells} concerned the employment of the "willing buyer—willing seller" test of fair market value.\(^{26}\) The majority reasoned that, inasmuch as the fund was statutorily required to redeem the shares at the net asset value, it could not be considered a "willing buyer" at that price. The only bona fide willing buyer—willing seller situation was the original issue of the shares at the public offering price, and consequently that was the proper measure of value for estate tax purposes.\(^{27}\)

Judge Tannenwald's dissent in \textit{Wells}\(^{28}\) articulated the opposing viewpoint. He argued that mutual fund shares were not comparable to single-premium life insurance policies because such shares do not have any value over and above the redemption price offered by the company.\(^{29}\) He preferred to

\(^{21}\) 50 T.C. at 876.

\(^{22}\) The regulations specify that the cost of replacement rather than the cash-surrender value is proper measure of value for single-premium life insurance policies. Treas. Reg. § 20.2031-8(a) (1963).

\(^{23}\) See, e.g., Guggenheim v. Rasquin, 312 U.S. 254, 257 (1941).

\(^{24}\) Id.

\(^{25}\) 50 T.C. at 877. \textit{See also} Howell v. United States, 414 F.2d 45, 49 (7th Cir. 1969): "Although we recognize differences between single-premium life insurance policies and shares of an open-end investment company, we view Guggenheim as supporting the Commissioner's position that the valuation of shares in light of their public offering or replacement price is permissible."

\(^{26}\) 50 T.C. at 876.

\(^{27}\) \textit{See also} Howell v. United States, 414 F.2d 45, 48 (7th Cir. 1969): "[I]t is our opinion that, because from the donor's standpoint his mutual fund shares are not assets that can be readily sold on an open market, valuing the shares on the basis of their redemption price is not warranted."

\(^{28}\) 50 T.C. at 876.

\(^{29}\) \textit{See} Davis v. United States, 306 F. Supp. 949, 955 (C.D. Cal. 1969), aff'd, 460 F.2d 769 (9th Cir. 1972): "[Y]et unlike those life insurance and annuity contracts, shares in an open-end investment company do not have any value over and above the redemption price offered by the company. To value the shares of an open-end investment company at the public offering price rather than the redemption price is, in
analogize the mutual fund valuation problem with that of a stock or bond subject to a restriction, such as a right of first refusal. In that situation the treasury regulations specify that the contract price can be used to determine the value of the securities for estate tax purposes. Similarly, Tannenwald reasoned that mutual funds are subject to a restriction, in that they can be disposed of only at the redemption price, and therefore that price should dictate the value for tax purposes.

III. United States v. Cartwright

In United States v. Cartwright the Supreme Court agreed with previous decisions ruling the regulation invalid, resting its decision on the regulation’s inconsistency with the market scheme for mutual funds, as created and regulated by the Investment Company Act. Mr. Justice White, writing for the majority, perceived a fallacy in the simplistic application of the willing buyer—willing seller test of fair market value espoused by the Government. The argument that the public offering price was the only price at which a willing buyer and a willing seller met voluntarily, and that it, therefore, was the proper valuation “unrealistically bifurcates the statutory scheme for the trading in mutual fund shares.” The market actually consisted of not only the original purchase of the shares at the public offering price, but included as part and parcel of the sales contract the agreement to sell them back to the fund at the lesser redemption price. Inasmuch as each party was fully cognizant of these elements of the market, “the redemption price may thus be properly viewed only as the final step in a voluntary transaction between a willing buyer and a willing seller.” The Court reasoned that the shareholder could not, under the Investment Company Act, receive the public offering price from the fund, which in practicality was the only possible buyer. The fund used the public offering price in selling its shares to the public, but in fact never received that price, paying the difference between it and the net asset value directly to the underwriter. Therefore, the Court concluded that the regulation “purports to assign a value to mutual fund shares that the estate could not hope to obtain and that the fund could not offer.”

essence, an estate tax penalty for investing in open-end investment shares rather than some other type of property.”

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31 See Cartwright v. United States, 457 F.2d 567, 571 (2d Cir. 1972); Davis v. United States, 306 F. Supp. 949, 955 (C.D. Cal. 1969), aff’d, 460 F.2d 769 (9th Cir. 1972): “[A]lthough there is no binding contract in this case, the rationale of Treas. Reg. 20.2031-2(h) (1958) should apply to open-end investment shares because the redemption price offered by the company truly represents the only realistic value that the estate can obtain for the shares of an open-end investment company.”
33 Id. at 552.
34 Id.
35 Id. The artificiality of the valuation criterion was made evident under the fact situation in Cartwright. The decedent never actually paid the public offering price, because she acquired her shares by gift, inheritance, and under an option offered by most funds which allows purchase at the redemption price by re-investing capital gains and ordinary dividends. Cartwright v. United States, 323 F. Supp. 769, 772 (W.D.N.Y. 1971).
The Court expressed approval of Judge Tannenwald's analogy of mutual fund shares to an ordinary stock or bond subject to a restriction on sale, and conclusively disposed of the single-premium life insurance policy analogy. With regard to stocks and bonds, the logic was so persuasive the Court could see no difference between the two situations, certainly none meriting such diverse treatment in the treasury regulations. As for the insurance policies, the court perceived no similarities with respect to valuation problems. The Wells court, it felt, had correctly recognized that mutual fund shares were "a different breed of cats" from ordinary stocks and bonds, but erred in identifying the "breed" as similar to single-premium life insurance policies. These policies are subject to appreciation in value, and therefore clearly possess beneficial economic elements above their immediate cash-surrender value. The peculiar difficulty in valuing those benefits led the courts in the gift tax cases to defer to the replacement cost valuation because it more accurately reflected the "bundle of rights" incident to ownership. In contrast, mutual fund shares have no value, for tax purposes, above the redemption price, a figure obtainable "by turning the financial pages of a newspaper." The Court pointed out that there are certainly "investment virtues" to the shareholder, such as potential capital gains and dividends, but the same is true of any security, upon none of which are brokerage fees assessed. "The Commissioner cannot cross-breed life insurance and investment trust shares by the simple expedient of discussing them in separate paragraphs of a single regulation."

Finally, in resting their decision on the contested regulation's inconsistency with the statutory framework in which mutual funds operate, the Court apparently found sufficient ground to overcome the judicial "hands off" policy with respect to treasury regulations. Despite the fact that the taxpayer's argument had "the clear ring of common sense to it," many courts had stubbornly refused to declare Treasury Regulation section 20.2031-8(b) invalid because it was not "plainly inconsistent" with the revenue statutes. This judicial policy seemingly inflated the probative weight of rather ephemeral arguments. Judicial reluctance manifested itself again in Justice Stewart's dissenting opinion in Cartwright. It is suggested, however, that the majority did no damage to the integrity of the "unreasonable and plainly inconsistent" standard in declaring Treasury Regulation section 20.2031-8(b) invalid. While acknowledging that although the regulation might not be "on its face, technically inconsistent with Sec-

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36 The Court stated with regard to the "restriction" on mutual fund shares: "Those shares may not be 'sold' back at the public offering price. By statute, they must be 'sold' back to the mutual fund only at the redemption price. We see no valid justification for disregarding this reality..." 411 U.S. at 554.

37 See, e.g., Guggenheim v. Rasquin, 312 U.S. 254, 257 (1941).

38 411 U.S. at 556.

39 Hicks v. United States, 335 F. Supp. 474, 482 (D. Colo. 1971).

40 411 U.S. at 551.


42 411 U.S. at 557.
tion 2031 of the Internal Revenue Code," the Court determined that "it is manifestly inconsistent with the most elementary provisions of the Investment Company Act of 1940 and operates without regard for the market in mutual funds that the act created and regulates."\(^4\) The Court concluded:

We agree with Judge Tannenwald, who stated at the very outset of the dispute over Regulation Section 20.2031-8(b), that 'it does not follow that, because the Commissioner has a choice of alternatives, his choice should be sustained where the alternative chosen is unrealistic. In such a situation the regulations embodying that choice should be held to be unreasonable.'\(^4\)

IV. CONCLUSION

In resolving a decade of conflict, the Supreme Court in Cartwright laid down a rule of decision that will also affect the gift and income tax sections of the Internal Revenue Code. The former tax regulations contain an identical provision concerning valuation for gift tax purposes, and it is assumed that is now also invalid.\(^4\) Since for income tax purposes the value of property for estate and gift tax purposes becomes the basis for the heir or donee, the income tax is also affected with respect to recognition of gain or loss upon sale or transfer.\(^4\) Perhaps most important for the investor and estate planner, the Cartwright decision enhances the attraction of the already popular mutual fund investment medium.

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\(^4\) Id. At least one court stated that the regulation was inconsistent with § 2033, which provides that the gross estate shall include the value of all property "to the extent of the interest therein of the decedent . . . ." Int. Rev. Code of 1954, § 2033. "By no stretch of the imagination does the decedent have an 'interest' in the . . . sales load. He cannot make a transfer so that his transferee may realize this amount; he cannot realize it himself either as part of his own certificate or separated from it." Davis v. United States, 460 F.2d 769, 771 (9th Cir. 1972).

\(^4\) 411 U.S. at 557.
