Notre Dame Law Review

Volume 49 | Issue 3 Article 10

2-1-1974

Cartwright v. United States: The Clear Ring of Common Sense

Phil Lauro

CARTWRIGHT V. UNITED STATES: THE CLEAR RING OF COMMON SENSE

The Supreme Court of the United States in a May 8, 1973 decision invalidated a 1963 Treasury regulation which attempted to value mutual fund shares for estate tax purposes at the public offering price rather than the lower redemption price.[1] The Court in *Cartwright v. United States* held that the regulation in question was "manifestly inconsistent with the most elementary provisions of the Investment Company Act of 1940 and . . . (operated) without regard for the market in mutual fund shares that the Act created and regulates."[2]

This article is an attempt to examine the historical background of the *Cartwright* decision, analyze both the taxpayer and Government arguments, study the rationale of the Court's holding, and finally, suggest the long- and short-term implications of the case.

I. History of the Regulation

Treasury Regulation § 20.2031-8(b) was formulated in 1963 in response to a controversy that had erupted during the early 1960's over the proper method of valuation of mutual fund shares for estate tax purposes.[3]

Originally the Internal Revenue Service had not established a definitive policy in this area and taxpayers were using any one of three methods in valuating their mutual fund shares: bid price, ask price, or the mean between the two.[4] However, the Service began requiring taxpayers to use either the ask or mean price method, which resulted in a number of taxpayer suits. This, in turn, led to the formulation of Treasury Regulation § 20.2031-8(b) which provided that the fund shares were to be valued at the ask price exclusively.[5] Needless to say, further taxpayer suits resulted and the stage was set for judicial resolution of the dispute.

Normally the executor for the decedent's estate would report the value of the mutual fund shares of the decedent at their redemption price. The Commissioner of the Internal Revenue Service would then assess a deficiency based upon his valuation of the same shares at the public offering (or asked) price. Then the executor would pay the deficiency and file a timely claim for a refund. When the refund claim was denied, he would bring action in the appropriate federal district court, arguing that the valuation based on Treasury Regulation § 20.2031-8(b) was unrealistic and unreasonable.[6] In some instances the district court

1 Cartwright v. United States, 411 U.S. 546 (1973).
2 *Id.* at 557.
3 Treas. Reg. § 20.2031-8(b) (1963) provides in part:

> 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.

4 Wilkins, *The Supreme Court's* Cartwright *Decision: Does It Signal New Valuation Disputes?*, 39 J. Taxation 2, 4 (1973).
5 *Id.*
6 Cartwright v. United States, 323 F. Supp. 769 (W.D.N.Y. 1971), *aff'd*, 457 F.2d 567 (2d Cir. 1972).

would agree and hold the regulation invalid with the court of appeals affirming.[7] In other instances the district court would determine that the Commissioner had acted reasonably and that the regulation was valid, again the court of appeals affirming.[8] Faced with the conflict among several of the circuits, the Supreme Court granted certiorari.[9]

II. Mutual Fund Operations

Most business corporations will use common stock to elicit capital funds from investors to develop their products or implement their services. After the initial sale of these shares to the public, the shares are usually transferred in the securities market from one individual to another. Normally the corporation is not a participant in these subsequent transactions.[10] Business organizations that do participate in these subsequent transactions include open-end investment companies, popularly referred to as "mutual funds."[11] Mutual funds are financial institutions that issue their shares to the public and invest the proceeds primarily in the securities of other corporations.[12] The funds, which are regulated by the Investment Company Act of 1940, may offer their shares to the public continuously but are required to be prepared to redeem outstanding shares at any time.[13]

Mutual funds offer the individual investor a chance to participate in a single fund having a large investment diversification thus providing him with greater financial stability and protection than he might otherwise have with individual securities.[14] The funds also provide the investor with professional investment expertise:

> . . . to take advantage of fluctuations in market values of the fund's investments, and . . . provide special privileges and services, such as dividend

7 Davis v. United States, 306 F. Supp. 949 (C.D. Cal. 1969), *aff'd*, 460 F.2d 769 (9th Cir. 1972); Cartwright v. United States, 323 F. Supp. 769 (W.D.N.Y. 1971), *aff'd*, 457 F.2d 567 (2d Cir. 1972); Hicks v. United States, 335 F. Supp. 474 (D. Colo. 1971), appeal pending in the tenth circuit, No. 72-1360.

8 Estate of Wells v. Comm'r, 50 T.C. 871 (1968); *aff'd sub nom.*, Ruehlmann v. Comm'r, 418 F.2d 1302 (6th Cir. 1969), *cert. denied*, 398 U.S. 950 *reh. denied*, 400 U.S. 856 (1970). The companion gift tax regulation was upheld in Howell v. United States, 290 F. Supp. 690 (N.D. Ind. 1968), *aff'd*, 414 F.2d 45 (7th Cir. 1969).

There have only been a handful of cases concerning the validity of these Treasury regulations and even these have tended to rely on each other for support of their arguments. One commentator has noted the chronological order of some of the opinions and their "snowball" effect:

> *Wells* was the first opinion. Then *Howell* was decided based on the logic of *Wells*. Finally, *Wells* was affirmed in *Ruehlmann*, but that opinion cited *Howell* as its authority. It seems that *Wells* is the pivotal case and *Howell* and *Ruehlmann* simply reinforce themselves by ultimate reliance on *Wells*.

Note, *Estate Tax Valuation of Mutual Fund Shares: Is Treasury Regulation § 20.2031-8(b) Reasonable?*, 6 CREIGHTON L. REV. 79 (1972).

9 Cartwright v. United States, 409 U.S. 840 (1972).

10 Comment, *Valuation of Mutual Fund Shares for Federal Estate Tax Purposes*, 14 B.C. IND. & COM. L. REV. 134, 136 (1972).

11 Note, *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAWYER 736, 742 (1969); *see also* Note, 6 CREIGHTON L. REV., *supra* note 8, at 74 n.2.

12 Comment, 14 B.C. IND. & COM. L. REV., *supra* note 10, at 136.

13 Investment Company Act of 1940, 15 U.S.C. § 80a-22(e) (1970).

14 Note, 44 NOTRE DAME LAWYER, *supra* note 11, at 741.

> reinvestment plans without sales charges, periodic investment plans, retirement plans for self-employed, and periodic remittance plans.[15]

The investor's funds are invested by the funds in other securities in exchange for a pro rata interest in the assets of the fund.[16] Normally the funds will employ an underwriter to market the shares in return for a sales fee.[17]

There are two prices involved in the trading of these mutual funds: a redemption (or "bid") price and a public offering (or "ask") price. The bid price is the price a shareholder would normally receive based upon the fractional value per share of the net assets of the mutual fund at the time of redemption.[18] The ask price, on the other hand, is the price at which the fund offers its shares on the public market. The ask price consists of two elements: the net asset value per share at the time of the sale and the sales charge (or "sales load") of the fund's underwriter.[19] The net asset value is calculated on the New York Stock Exchange twice a day by subtracting the total outstanding liabilities from the total assets and dividing by the number of mutual fund shares outstanding.[20] The sales charge is usually a percentage of the public offering price, but this percentage may vary depending upon the size of the transaction.[21]

A couple of features of this dual price structure bear special mention at this time. First, the bid and ask prices do not correspond to the "high" and "low" prices normally associated with the daily trading in a common stock; rather they are the specific "buy" and "sell" prices at which all transactions in the particular fund take place.[22] Second, a tax valuation based on the public offering price will yield a higher tax than a similar valuation based on the redemption price; the underwriter's sales charge accounts for the difference.[23] It is this "discrepancy" that is the source of the controversy in *Cartwright v. United States*. Private trading in mutual fund shares is virtually non-existent despite the fact there are no legal restrictions on the transferability of these shares.[24] The normal process of redemption involves a sale back to the mutual fund which is required to repurchase the shares upon demand, paying the net asset value without the original sales load.[25] This guaranteed redemption feature provides greater liquidity which, in turn, increases the marketability of the shares.[26]

---

15 Annot., 11 A.L.R. FED. 940, 945 (1973).
16 Note, 44 NOTRE DAME LAWYER, *supra* note 11, at 740.
17 *Id.* at 883.
18 Cartwright v. United States, 411 U.S. 546, 547 (1973).
19 *Id.*
20 Comment, *Estate and Gift Tax Valuation of Mutual Funds: The Mythical Market Value for Shareholders,* 10 HOUST. L. REV. 463 (1973).
21 W. CASEY, MUTUAL FUND DESK BOOK 34 (1965). These commissions generally ranged from 7.5 to 8.5 percent of the public offering price to as low as 1.0 percent, depending upon the size of the purchase. There are also a number of so-called "no-load" mutual funds which offer their shares for sale at net asset value without a sales charge. Cartwright v. United States, 411 U.S. 546, 548 n.3 (1973).
22 Comment, 14 B.C. IND. & COM. L. REV., *supra* note 10, at 137.
23 Comment, 10 HOUST. L. REV., *supra* note 20, at 464.
24 Cartwright v. United States, 457 F.2d 567, 569 (2d Cir. 1972); Estate of Wells v. Comm'r, 50 T.C. 871, 872-73 (1968). This phenomenon can be largely attributed to the fact that not only the fund underwriter but also all other dealers must sell at the current public offering price. Investment Company Act of 1940 § 22(d), 15 U.S.C. § 80a-22(d) (1970).
25 Cartwright v. United States, 323 F. Supp. 769, 771 (W.D.N.Y. 1971); Investment Company Act of 1940, 15 U.S.C. §§ 80a-2(a)(32), -22(a)(1) (1970).
26 Note, 6 CREIGHTON L. REV., *supra* note 8, at 85.

A tax valuation of mutual fund shares based on the controversial Treasury regulations causes no difficulty for the living investor because his gain or loss on a sale is measured by the original ask price and the bid price he receives at the time of sale.[27] However, the system does not work so well for the decedent's estate because Treasury Regulation § 20.2031-8(b) requires the executor to report the mutual funds shares at the ask price for estate tax purposes although if the estate were to sell the shares at that time, it could only realize the bid price.[28]

III. Summary of Arguments and the Court's Reaction

A. *Willing Buyer-Willing Seller Test*

Treasury Regulation § 20.2031-1(b) attempts to provide guidelines as to the valuation of estate property in general.[29] The regulation specifies that property includible in the decedent's gross estate is to be valued at its fair market value at the time of the decedent's death. Further, the test for fair market value is to be that of a willing buyer and a willing seller and the price at which the property would change hands if both parties had a reasonable knowledge of the facts of the transaction.

The "willing buyer-willing seller" test was not at issue in the *Cartwright* case, as the Supreme Court itself noted, "[This] test of fair market value is nearly as old as the federal income, estate and gift taxes themselves, and is not challenged here."[30] What was at issue was the interpretation of the test in a particular situation. Very frequently the practical realities of valuation are lost in a labyrinth of conceptually appealing, but very theoretical, arguments.[31] The area of mutual fund valuation for estate tax purposes has proven no exception.

Since the implementation of Treasury Regulation § 20.2031-8(b) in 1963, the Internal Revenue Service has argued that the original sales of mutual fund

27 *Id.* at 75.
28 *Id.*
29 Treas. Reg. § 20.2031-1(b) (1958), *as amended,* Treas. Reg. § 20.2031-1(b) (1965), provides in part:

> The value of every item of property includible in a decedent's gross estate . . . is its fair market value at the time of the decedent's death . . . (unless an alternate date is used). 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 . . . is not to be determined by a forced sales price. Nor is . . . (it) to be determined by the sales price of the item in a market other than that in which such item is most commonly sold to the public. . . . Thus, in the case of an (includible) item of property . . ., which is generally obtained by the public in the retail market, the fair market value of such an item . . . is the price at which the item or a comparable item would be sold at retail.
>
> The Government attempted through the 1965 amendment to establish that retail price should represent the fair market value of all items generally sold at retail, including household effects, personal effects as well as mutual fund shares.

Id., T.D. 6826. Cum. Bull. 367 (1965).
30 411 U.S. at 551.
31 *See* 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, 422 (1969).

shares are the ones to be determinative of fair market value.[32] The Commissioner contended that the willing buyer-willing seller test should be applied to the public offering price, rather than the lower redemption price, because in the latter situation the mutual fund was required by statute to redeem the shares upon demand and thus could hardly be considered a "willing" buyer;[33] and as noted earlier, the only practical means of disposal of the mutual fund shares is a resale from the investor back to the mutual fund.[34] Therefore, the mutual fund shares are properly valued at the public offering or ask price.[35]

However, the Commissioner's position has received heavy criticism both in and out of court. The American Bar Association Committee on Estate and Gift Taxes has criticized Treasury Regulation § 20.2031-8(b) as being a departure from the fair market value concept envisioned by the willing buyer-willing seller test.[36] The Second Circuit Court of Appeals, in reviewing the *Cartwright* case, noted:

> [O]ther factors can affect the price which a willing seller reasonably could expect to receive from a sale of that particular unit, and if these other factors cause the retail price to be an unreasonable or unrealistic value standard, the retail price has not always been followed in valuation disputes as the sole criterion of value.[37]

In support of their contention that the willing buyer-willing seller test should be applied to the redemption price, some taxpayers have argued that the proper way to view mutual fund transactions is as an overall sales contract providing for an investor to buy at one price (including a sales load) and to sell at another price (without a sales load).[38] The district court in *Hicks v. United States* concluded that such a contract was thoroughly consistent with the willing buyer-willing seller test:

> The "willing buyer" is the fully informed person who agrees to buy the shares, agreeing at that time to sell them to the fund—the only available purchaser—at the redemption price. The "willing seller" is the fund which sells the shares at market value plus a load charge, and which agrees to buy the shares back at market less the load charge. That is the market, and it is the only market. It is a market made up of informed buyers and an informed seller, all dealing at arm's length.[39]

Other courts maintained that the willing buyer-willing seller test had to be

32 Estate of Wells v. Comm'r, 50 T.C. 871, 876 (1968).
33 Cartwright v. United States, 411 U.S. 546, 551-52 (1973).
34 Cartwright v. United States, 411 U.S. 546, 560 (1973) (dissenting opinion).
35 Estate of Wells v. Comm'r, 50 T.C. 871, 876 (1968); Howell v. United States, 414 F.2d 45, 48 (7th Cir. 1969); Ruehlman v. Comm'r, 418 F.2d 1302, 1304 (6th Cir. 1969).
36 Thatcher, *Valuation of Mutual Funds for Federal Estate Tax Purposes,* 48 L.A.B. Bull. 24, 25 (1972).
37 457 F.2d at 571; *see also* Note, 6 Creighton L. Rev., *supra* note 8, at 80.
38 Cartwright v. United States, 411 U.S. 546, 552 (1973); Hicks v. United States, 335 F. Supp. 474, 481 (D. Colo. 1971); *see also* the district court's opinion in Cartwright v. United States, 323 F. Supp. 769, 772 (W.D.N.Y. 1971); Comment, 10 Houst. L. Rev., *supra* note 20, at 468.
39 335 F. Supp. at 481; Davis v. United States, 460 F.2d 769, 772 (9th Cir. 1972).

modified slightly for mutual fund transactions because of their dual pricing structure.[40] Practically speaking, there were three parties to the transaction: the seller receiving the bid price, the buyer paying the ask price, and the mutual fund mediating the exchange.[41] Within such a framework the estate should be treated as the "willing seller."[42] The rationale for this interpretation is relatively straightforward. Upon the death of the decedent the property goes into the hands of the estate, which acquires a power of disposition.[43] In the normal course of events a large portion of the estate's assets may be liquidated to meet the cost of death taxes and administrative expenses or to effect distribution of the estate.[44]

The Supreme Court in *Cartwright* endorsed the *Hicks* interpretation of the applicability of the willing buyer-willing seller test because in light of the Investment Company Act of 1940 the redemption price may be properly viewed as the final step in a voluntary transaction between a willing buyer and a willing seller.[45]

B. *Bundle of Rights Theory*

The Government attempted to overcome the effect of the willing buyer-willing seller argument offered by the taxpayers by putting forth an analogy of its own—the "bundle of rights" theory.[46] This argument was made most forcefully in a series of 1941 Supreme Court cases beginning with *Guggenheim v. Rasquin,* which held that the cash surrender value of a single-premium life insurance policy did not necessarily represent its only taxable value for estate tax purposes.[47] The owner of such a policy had additional rights, such as the right to retain the policy for its investment virtues as well as the right of the beneficiary to the face amount of the policy upon the insured's death.[48] Because this "bundle of rights" is so difficult to give a realistic value to, the courts are willing to defer to the Commissioner's estimation and permit valuation to be based on the replacement cost as reasonable evidence of the value.[49] It has been argued that the rationale underlying this approach is that:

---

40 Davis v. United States, 460 F.2d 769, 771 (9th Cir. 1972); Cartwright v. United States, 457 F.2d 567, 570-71 (2d Cir. 1972).

41 Note, *Treasury Regulation Valuing Mutual Fund Shares for Estate Tax Purposes as the Replacement Cost Held Invalid,* 21 BUFFALO L. REV. 256, 264, (1971).

42 *Id.* at 265.

43 Note, *Treasury Regulation Section 20.2031-8(b) Invalid—Mutual Fund Shares Valued at Redemption Price for Estate Tax Purposes,* 23 VAND. L. REV. 898, 902 (1970), *citing* 2 BONBRIGHT, VALUATION OF PROPERTY 695 (1937).

44 *Id.*

45 411 U.S. at 552.

46 Cartwright v. United States, 411 U.S. 546, 554 (1973).

47 Guggenheim v. Rasquin, 312 U.S. 254 (1941); Powers v. Comm'r, 312 U.S. 259 (1941); United States v. Ryerson, 312 U.S. 260 (1941). A similar logical analysis has been employed in a number of jewelry valuation cases, such as Estate of Gould, 14 T.C. 414 (1950) where the Tax Court held that for gift tax purposes the value of an item of jewelry includes the excise tax since the donee would have had to pay the tax had he purchased the same ring.

48 Wilkins, 39 J. TAXATION, *supra* note 4, at 2. The cash surrender value will grow steadily after the initial purchase until it eventually will 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, because the cost of coverage increases as the individual grows older. Comment, 14 B.C. IND. & COM. L. REV., *supra* note 10, at 139.

49 Cartwright v. United States, 411 U.S. 546, 555 (1973); *see* Guggenheim v. Rasquin, 312 U.S. 254, 257-58 (1941). The cash surrender value is not the most realistic measure of value, because it involves the elimination of the future rights which ordinarily account for the difference between the cash surrender value and the replacement cost. Comment, 14 B.C.

> [W]hen 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 opinions of the purchasers, justifies the difference between that value and the cost of acquisition.[50]

The Commissioner has asserted that the "bundle of rights" theory can be extended to mutual fund shares because of inherent future characteristics similar to those of the single-premium life insurance policy.[51] The dissent in the *Cartwright* case supported the Commissioner's position, noting that redemption at net asset value was only one of a number of rights incident to the ownership of mutual fund shares that the decedent's estate acquired: the right to normal dividends and capital gains; other rights acquired were the right to further share purchases below the public offering price, and the right to exchange shares in one fund for another fund managed by the same corporation (without a sales load).[52] Other future benefits include diversification of investment and continual professional investment supervision on the part of the mutual fund.[53]

As further evidence of the reasonableness of the regulations the Commissioner has pointed out that their effect may be mitigated in some circumstances where they might otherwise be harsh and arbitrary.[54] Specifically, Treasury Regulation § 20.2053-3(d)(2) prevents hardship to the estate by allowing in instances where there is a loss in the sale of the shares a deduction as an administrative expense to the extent of the loss.[55]

The Supreme Court in *Cartwright* did not find the Government's "bundle of rights" theory persuasive. First, the same bundle of rights inherent in mutual funds can be found in any corporate security; yet, mutual funds are the only ones valued at an "unrealistic" replacement cost which includes commissions while other stocks are valued without regard to such commissions.[56] Second, the Supreme Court contended that valuation of mutual fund shares was not nearly as difficult as insurance policies since the value could readily be calculated on any given day.[57]

IND. & COM. L. REV., *supra* note 10, at 140. *See also* Duke v. Comm'r, 200 F.2d 82 (2d Cir. 1952), *cert. denied*, 345 U.S. 906 (1953); Publicker v. Comm'r, 206 F.2d 250 (3rd Cir.), *cert. denied*, 346 U.S. 974 (1953).

50 Comment, 14 B.C. IND. & COM. L. REV., *supra* note 10, at 140.

51 Estate of Wells v. Comm'r, 50 T.C. 871, 877 (1968); *accord*, Howell v. United States, 414 F.2d 45, 49 (7th Cir. 1969).

52 411 U.S. at 560.

53 Comment, 10 HOUST. L. REV., *supra* note 20, at 469-70.

54 Estate of Wells v. Comm'r, 50 T.C. 871, 877 (1968); *see* Comment, 10 HOUST. L. REV., *supra* note 20, at 472.

55 Treas. Reg. § 20.2053-3(d) (1965) provides in part: "Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedents' debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution." *See* Estate of Huntington v. Comm'r, 36 B.T.A. 698 (1937). The value of shares in an ongoing activity is not solely dependent upon the liquidation value of its assets. Commissioner v. McCann, 146 F.2d 385, 385-86 (2d Cir. 1944).

56 411 U.S. at 556.

57 *Id.* at 555-56; *see also* Davis v. United States, 460 F.2d 769, 772 (9th Cir. 1972) to the effect that:

> We cannot equate the valuation of shares in a mutual fund with the necessarily abstract valuation of a single-premium life insurance policy. On any given day, the net value of the mutual fund may be computed exactly.

Mutual funds can also be distinguished from insurance policies in terms of transferability; the former is most often redeemed by the mutual fund while the latter may be easily assigned at a negotiated price in the ordinary course of business.[58] Further, these single-premium insurance policy cases may be interpreted as holding only that replacement cost may be one factor used in determining fair market value; it is not necessarily conclusive.[59] The district court in *Cartwright* noted yet another flaw in the analogy of the single-premium life insurance policies, "[W]hen a death occurs, the insurance company pays under the policy, the tax is paid, and that is the end of it. Mutual fund shares can pass from estate to estate with a tax paid on each transfer."[60] The result is a repetitive tax on a value which does not exist.[61] Finally, even the mitigating provision of Treasury Regulation § 20.2053(d)(2) is of no benefit if there is any gain on the sale or if there is no sale by the estate.[62] The court also observed, "[i]f the regulation setting fair market value is unreasonable, this unreasonableness cannot be cured by a regulation which limits the hardship upon the taxpayer."[63]

C. *Restrictive Stock Agreement Analogy*

In noting the similarities between mutual fund shares and other corporate securities, especially listed stock, some courts have argued that the fund contract arrangements should be treated similarly to restrictive stock purchase agreements because of the compulsory nature of the redemption price in a resale back to the fund.[64] The chief distinction between corporate stock and mutual fund shares in terms of valuation appears to be that commissions are not included in the quoted price for the former but are included in the ask price for the latter.[65] A restrictive stock purchase agreement is one in which the shares are subject to a binding restriction that they may not be sold without first being offered to a specific party at a specified price.[66] Assuming that the transaction is at arm's length, the Treasury regulations will value the stock for estate tax purposes at the price specified in the restrictive agreement.[67] The taxpayers urge that a similar approach be adopted for mutual fund shares with the redemption price being the one used for valuation.

The Government argued that the restrictive stock agreement analogy is not appropriate because the mutual fund shareholder is not required to sell his shares back to the fund.[68] Further, the option here, unlike the situation with the

58 Comment, 14 B.C. IND. & COM. L. REV., *supra* note 10, at 141.
59 Report of the Committee on Estate and Gift Taxes, 19 ABA TAXATION SECTION No. 4, at 74 (1966).
60 323 F. Supp. at 773.
61 Note, 21 BUFFALO L. REV., *supra* note 41, at 262.
62 Cartwright v. United States, 323 F. Supp. 769, 773 (W.D.N.Y. 1971).
63 *Id.*
64 Cartwright v. United States, 457 F.2d 567, 571 (2d Cir. 1972); Estate of Wells v. Comm'r, 50 T.C. 871, 878 (1968) (dissenting opinion).
65 Note, 6 CREIGHTON L. REV., *supra* note 8, at 89, *citing* the Brief of the Appellee in Cartwright v. United States, 457 F.2d 567 (2d Cir. 1972).
66 Comment, 14 B.C. IND. & COM. L. REV., *supra* note 10, at 143.
67 Treas. Reg. § 20.2031-2(h) (1958).
68 Wilkins, 39 J. TAXATION, *supra* note 4, at 3.

restrictive stock agreement, belongs to the shareholder rather than the mutual fund.[69] Nor has there been a definite price set in the arrangement.[70]

The Supreme Court felt that the restrictive stock agreement analogy was appropriate because the stocks *were* held subject to a restriction:

> Those shares may not be "sold" at the public offering price. By statute they may be "sold" back to the fund only at the redemption price. We see no valid justification for disregarding this reality connected with the ownership of mutual fund shares.[71]

D. *The Argument for Realizable Value*

The heart of the taxpayer's objection to Treasury Regulation § 20.2031-8(b) can be summarized as follows: Fair market valuation includes a number of considerations and not solely the retail price. In the case of mutual fund shares the decedent's estate can realistically expect to receive only the net asset value of the shares upon disposition, not the price the general public would have to pay for them.[72] As a Colorado district court commented in *Hicks v. United States*:

> This regulation (§ 20.2031-8(b)), which is of 1963 origin, must be read against the basic concept (that) valuations are based on fair market value as is emphasized by the older § 20.2031-1 of the regulations, and the government's problem, simply stated, is to justify a regulation which taxes mutual fund shares at a value higher than any owner can realistically expect to receive for them.[73]

The Ninth Circuit Court of Appeals sought to further bolster the argument for realizable value through its extrapolation of Sections 2031 and 2033 of the Internal Revenue Code.[74] Section 2031(a) provides that the value of the estate will include any property owned by the decedent at the time of death.[75] Section 2033 further provides this value will include all property to the extent of the decedent's interest in the property at the time of death.[76] The effect of these two sections has been that "*any* property in which the decedent had an interest at the time of his death will be included in the gross estate."[77] The *Davis* court thought that the sales load in a mutual fund transaction could not be an interest

69 Comment, 14 B.C. IND. & COM. L. REV., *supra* note 10, at 144.
70 *Id.*
71 Cartwright v. United States, 411 U.S. 546, 554 (1973).
72 Cartwright v. United States, 457 F.2d 567, 572 (2d Cir. 1972). One commentator has suggested that much of the controversy and confusion could be avoided if the Commissioner and the courts concentrated on ascertaining the shares' "worth" rather than their difficult-to-define "fair market value," *i.e.*, what the shares would be "worth" to the estate. Note, *Under Treasury Regulation Section 20.2031-8(b), Value of Shares in Mutual Funds Is Public Offering Price on Date of Death Rather Than Redemption Price,* 22 VAND. L. REV. 429, 433 (1969).
73 335 F. Supp. at 477.
74 Davis v. United States, 460 F.2d 769, 771 (9th Cir. 1972).
75 INT. REV. CODE OF 1954, § 2031(a).
76 INT. REV. CODE OF 1954, § 2033.
77 Comment, 10 HOUST. L. REV., *supra* note 20, at 466; *see* Davis v. United States, 460 F.2d 769, 771 (9th Cir. 1972).

of the shareholder any more than would a broker's commission in the ordinary corporate stock transaction:

> The sales load is a charge for service which is paid by the buyer at purchase and never recovered. It adds nothing to the value of the shares and does not thereafter constitute an element in computing actual worth. To apply the estate tax to the sales charge paid is to impose a tax on a non-existent "interest of the decedent."[78]

The dissenting opinion in *Estate of Wells v. Commissioner* also argued for a realizable value approach when it observed that if the open-market price of United States Government bonds is less than par, but the bonds can be applied at par in payment of the taxes owed by the decedent's estate, the par value is includible in the gross estate.[79] Since the bonds could be redeemed at par in payment of estate taxes, they are worth more than the discounted price in the open market.[80] It would seem that the willingness of the Government to depart from market price in favor of realizable value in these bond situations would strengthen the taxpayer's argument for realizable value and give an indication of the possible arbitrariness of Regulation § 20.2031-8(b).[81]

The Supreme Court also felt itself compelled to accept the taxpayer's argument for realizable value, noting somewhat wryly that it had "the clear ring of common sense" to it.[82] Further,

> [T]he only price that a shareholder may realize and that the fund—the only buyer—will pay is the redemption price. In the teeth of this fact, Regulation § 20.2031-8(b) purports to assign a value to mutual fund shares that the estate could not hope to obtain and that the fund could not offer.[83]

The Court felt that such a valuation method was inconsistent with established Treasury practices and possibly contrary with the principles of valuation in the Internal Revenue Code.[84] In line with the *Davis* court and the lower *Cartwright* courts, the Supreme Court took issue with the Commissioner's attempt to include a commission in the "hypothetical purchase" of mutual fund shares already held by the estate, arguing that such logic (if applied to the corporate stock transaction) would require a share selling at $100 to be valued at $102 so as to include the fee that a person buying the stock on the day of the decedent's death would have had to pay.[85]

The Court found further evidence of the unrealistic nature of Treasury Regulation § 20.2031-8(b) when it compared the Commissioner's treatment of "load" funds with that afforded "no-load" funds. Even assuming that there

78 460 F.2d at 771. Both the district court and the court of appeals in *Cartwright* interpreted the sales load as a device for paying advertising marketing expenses. Cartwright v. United States, 323 F. Supp. 769, 773 (W.D.N.Y. 1971); 457 F.2d 567, 570 (2d Cir. 1972).

79 50 T.C. at 878, *citing* Bankers Trust Co. v. United States, 284 F.2d 537 (2d Cir. 1960), *cert. denied*, 366 U.S. 903 (1961).

80 *Id.* at 878-79.

81 Note, 23 VAND. L. REV., *supra* note 43, at 901.

82 Cartwright v. United States, 411 U.S. 546, 551 (1973).

83 *Id.* at 552-53.

84 *Id.* at 553.

85 *Id.*

were significant differences between mutual fund shares and corporate stocks, there are no such distinctions between "load" and "no-load" funds, except for the sales charge of the former; yet, a share in a "no-load" fund is valued at its net asset value while a share in a "load" fund is valued at its net asset value plus sales charges.[86]

The Supreme Court was not completely agreed that the regulation was unreasonable and unrealistic. The dissent noted that a number of assets have been taxed for estate tax purposes on amounts in excess of what the estate could realistically realize from the sale of the assets; e.g., real property is taxed at fair market value even though the estate will usually have to pay some proportion of the amount in broker's fees if it decides to sell the property.[87] Similarly, if the estate wants to sell securities, it will normally pay a commission on the sale and have to deduct the charge from the amount realized on the sale; yet, if it were selling mutual fund shares, it would pay no commissions.[88]

E. *The Presumption of the Validity of Treasury Regulations*

Even when one has considered all the pros and cons of the Commissioner's position on the valuation of mutual fund shares for estate tax purposes, the Commissioner still has one more argument working in his favor—the presumption of the validity of Treasury regulations. The Supreme Court acknowledged this situation when it noted that Congress, through the Secretary of the Treasury, administers the tax laws and that the rules the Treasury Department formulates must be upheld if they implement Congressional directives in a reasonable manner.[89] In speaking to this issue in 1948 in *Commissioner v. South Texas Lumber Co.*, the Supreme Court said, "[t]reasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes."[90] The Court attempted to define the judicial function in regard to administrative construction of the tax statutes in the case *United States v. Correll*:

> 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. 26 U.S.C. § 7805(a).[91]

The Commissioner's position is even stronger in light of the general rule that where there are several possible methods of valuation, any permissible one selected by the Commissioner may not be set aside.[92] Thus, if it appeared that there was a reasonable basis for both the bid and ask price bases of valuation of

86 *Id.* at 556.
87 *Id.* at 561 (dissenting opinion).
88 *Id.* at 562 (dissenting opinion).
89 *Id.* at 550; United States v. Correll, 389 U.S. 299, 307 (1967); *see also* Bingler v. Johnson, 394 U.S. 741 (1969); Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948).
90 333 U.S. at 501.
91 389 U.S. at 306-07.
92 Dupont's Estate v. Comm'r, 233 F.2d 210, 214 (3rd Cir.), *cert. denied*, 352 U.S. 878 (1956); *see also* Mearkle's Estate v. Comm'r, 129 F.2d 386, 388-89 (3rd Cir. 1942).

mutual fund shares, the courts were willing to defer to the Commissioner to choose a method reasonable and consistent with the revenue laws.[93] In short, it need not be *good* as long as it is *reasonable*.[94]

Notwithstanding the presumption of the validity of Treasury regulations, the Supreme Court held that Treasury Regulation § 20.2031-8(b) was inconsistent and unreasonable and therefore affirmed the judgment of the court of appeals.[95] It endorsed the view expressed in the dissent of *Wells* that simply because the Commissioner has a choice of alternatives, this does not mean his selection should be validated where the alternative selected is unrealistic; rather, the regulation stipulating that alternative should be held to be unreasonable.[96]

There are probably at least three theoretical ways in which a regulation may be unreasonable:

> First, a regulation may be arbitrary or patently inconsistent with the general terms of the statute under which it is promulgated. Second, it is possible that a regulation, although reasonable on its own, is irreconcilable with another regulation promulgated under the same statutory provision.[97]

Third, the regulation may conflict with existing legislation in a related field. The Supreme Court in *Cartwright* indicated that this third explanation was the most compelling, but that the first proposition was also an important consideration as well:

> But even if the Regulation contested here is not, on its face, technically inconsistent with § 2031 of the Internal Revenue Code, it is manifestly inconsistent with the most elementary provisions of the Investment Company Act of 1940. . . .[98]

The courts have also attacked the presumption of the validity of Treasury Regulation § 20.2031-8(b) in a second, more subtle fashion, noting its lack of contemporaneity and consistency with Treasury Regulation § 20.2031-1.

IV. § 25.2512-6(b): The Companion Gift Tax Regulation

In 1963 the Commissioner formulated a gift tax regulation to govern the valuation of gifts of mutual fund shares for gift tax purposes. Treasury Regulation § 25.2512-6(b) was a virtual duplication of the estate tax regulation at issue in *Cartwright*.[99]

The Seventh Circuit Court of Appeals upheld the validity of the gift tax

---

93 Ruehlmann v. Comm'r, 418 F.2d 1302, 1304 (6th Cir. 1969); Howell v. United States, 414 F.2d 45, 48 (7th Cir. 1969).

94 Comment, 14 B.C. IND. & COM. L. REV., *supra* note 10, at 147.

95 Cartwright v. United States, 411 U.S. 546, 550 (1973).

96 *Id.* at 557; *see also* Estate of Wells v. Comm'r, 50 T.C. 871, 878 (1968).

97 Comment, 44 N.Y.U. L. REV. *supra* note 31, at 416 n.19.

98 411 U.S. at 557.

99 Treas. Reg. § 25.2512-6(b) (1963) provides in part:

> 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 included in the particular gift.

regulation in *Howell v. United States*, saying that a gift of shares of a mutual fund was properly valued for federal gift tax purposes on the basis of the public offering price.[100] The reasoning followed by the *Howell* court was virtually identical to that of the Tax Court in *Wells* and the sixth circuit in *Ruehlmann*. First, the court held that the public offering price was the most appropriate measure in terms of the willing buyer-willing seller criterion.[101] Second, it agreed that the *Guggenheim* decision supported the Commissioner's position that valuation of mutual fund shares in terms of their public offering or replacement cost was permissible.[102] Finally, the *Howell* court noted that its decision coincided with the estate tax valuation determination made by the Tax Court in *Wells*, adding that the "estate and gift tax laws should be construed *in pari materia* in absence of a clear expression of Congressional intent to the contrary."[103]

V. Conclusions

One practical short-run consideration to flow from the *Cartwright* decision is that for estates where the estate return has already been filed and the statute of limitations has not run, a refund claim should be filed if the mutual fund shares had been valued at the public offering price rather than the redemption price.[104] In addition, instructions to the federal estate tax return (Form 706) have dropped the requirement that mutual fund shares must be valued at the ask price.[105] It would also seem that the companion gift tax regulation upheld in *Howell* would now also be in jeopardy since its rationale is virtually identical with that of the now invalidated estate tax regulation.

As one writer has observed, the Government's petition for a writ of certiorari to resolve the valuation controversy in *Cartwright* was made partly to bring about a uniform method of valuation that could be applied in the three contexts of taxation—estate, gift, and income.[106] Even though the decision went against the Government, this does not change the fact there would still be benefits to be derived from the uniform method of valuation.[107]

It has also been suggested that decisions such as *Cartwright* represent a setback to the Government's efforts to establish retail price, when available, as the presumptive measure of value for estate tax purposes and perhaps even for retail price valuation in general.[108] As noted earlier, Treasury Regulation § 20.2031-1(b) had been amended in 1965 in an attempt to establish retail price as a presumptive measure of fair market value in a general context.[109] However,

100 Howell v. United States, 290 F. Supp. 690 (N.D. Ind. 1968), *aff'd*, 414 F.2d 45 (7th Cir. 1969).
101 414 F.2d at 48.
102 *Id.* at 48-49.
103 *Id.* at 49; *see* Merrill v. Fahs, 324 U.S. 308, 311-13 (1945).
104 Thatcher, 48 L.A.B. Bull., *supra* note 36, at 30 (1972).
105 Instructions to Form 706 (Rev. April 1973).
106 Wilkins, 39 J. Taxation, *supra* note 4, at 3.
107 *Id.* at 5.
108 Note, *Mutual Fund Shares Must Be Valued for Estate Tax Purposes at Net Asset Value Rather Than Public Offering Price*, 86 Harv. L. Rev. 629, 630-31 (1973).
109 *See* note 27 *supra; see also* Note, 86 Harv. L. Rev., *supra* note 108, at 631.

the Government had limited its efforts at enforcement to mutual fund shares.[110] Although the Supreme Court did not rule out the possibility that there might be situations where it would be realistic and appropriate under the Regulation to use the retail price approach, it declined to suggest any situations where this method would be permissible.[111] Further, the second circuit, determining that the retail price standard of the 1965 amendment conflicted with the older valuation provisions of § 20.2031-1(b), ruled that the true method of value was the use of all relevant facts.[112]

The *Cartwright* decision may also have an impact upon valuation disputes in areas other than mutual funds, for example, automobiles. The executor of a decedent's estate might argue that there are two separate automobile markets: (1) individuals selling to dealers, and (2) dealers reselling to the general public after first adding on their expenses and profit margins (the equivalent of a mutual fund's "sales load").[113] These dealers represent the most realistic market for resale and their "mark-up" or "sales load" becomes an amount which would never be realized by the decedent's estate.[114] The difficulty with this argument is that the markets for automobiles and other household and personal effects are far more fragmented than for mutual fund shares, making retail price or realizable value more difficult to determine with accuracy.[115] Thus, the Commissioner might reasonably select any one of these methods of valuation.[116] In any case, the *Cartwright* case would seem to bode well for future taxpayer efforts to obtain valuations based on realizable value in situations other than mutual funds, at least in those instances where their arguments have "the clear ring of common sense" behind them.

Phil Lauro

---

110 Note, 86 HARV. L. REV., *supra* note 108, at 631, *citing* Brief for Appellee at 21-24, Cartwright v. United States, 457 F.2d 567 (2d Cir. 1972).
111 Cartwright v. United States, 411 U.S. 546, 553 n.8 (1973).
112 Cartwright v. United States, 457 F.2d 567, 572 (2d Cir. 1972); *see* Note, 6 CREIGHTON L. REV., *supra* note 8, at 82.
113 Wilkins, 39 J. TAXATION, *supra* note 4, at 5.
114 *Id.*
115 Note, 86 HARV. L. REV., *supra* note 108, at 631-32 n.24.
116 Wilkins, 39 J. TAXATION, *supra* note 4, at 5.