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Wendy G. Gerzog
University of Baltimore School of Law, wgerzog@ubalt.edu

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By Wendy C. Gerzog

Wendy C. Gerzog is a professor at the University of Baltimore College of Law.

With the Sixth Circuit in *Negron*[1] now lined up with the Fifth Circuit,[2] the circuits are evenly split[3] on the issue of whether to value nonassignable lottery and other annuity payments using the IRS actuarial tables or whether that value needs to be adjusted further for nonmarketability.

Mildred Lopatkovich and Mary Susteric, two of the three joint winners of the 1991 Ohio Super Lotto $20 million jackpot, died in 2001 with 15 future payments taxable in their respective estates.[4] Carol Negron, executrix of the two estates, opted to take lump sum settlements for those periodic payments, as allowed under Ohio law. By making that election, each estate received $2,275,867, and Negron reported that amount on each estate tax return. However, by calculating the value of the payments using the annuity tables, the IRS determined that the value of Lopatkovich's remaining payments was $2,775,209 and the value of Susteric's was $2,668,118.[5]

Negron and the government filed cross-motions for summary judgment in the district court, which granted Negron's motion in part. She had contended that the annuity tables should not be used to value the remaining lottery payments because the tables produced ''unreasonable and unrealistic results,'' particularly because each estate was being taxed on an amount larger than the lump sum it received from the Ohio Lottery Commission.[6]

Acknowledging the apparent inequity, the Sixth Circuit explained the difference between the values calculated under the annuity tables and the Ohio commission's payment to each estate. The IRS's figures are calculated using the rate in effect on the decedent's date of death, whereas the state's lump sum payment amounts reflect the rate in effect on the date the lottery was won, 10 years earlier.[7] Thus, the appellate court held that the state's valuation did not make the IRS's valuation unreasonable, and it considered the estates' argument an equitable claim rather than a legal position. As such, the court emphasized that it was the estates' choice to cash in the remaining payments with the state and accept the lump sum amounts. ''Furthermore,'' it said, ''equity arguments are insufficient to invalidate properly enacted Treasury Regulations, such as those requiring the use of the IRS annuity tables.''[8]

The Sixth Circuit explained that the general estate tax valuation rule is the date of death fair market value, which is defined in the regulations.[9] ''However,'' it continued, ''the specific rule for valuing annuities is that they shall be valued 'under tables prescribed by the Secretary,' unless the regulations provide otherwise.''[10] Here, the lottery payments constituted annuities. The FMV of annuities, the court said, ''is the present value of such annuities, determined using the standard IRS annuity tables in Treas. Reg. § 20.2031-7(d), if the valuation date is after April 30, 1999.''[11] The tables incorporate both an interest rate and a mortality factor. The court noted Treasury's explanation that the regulations conform to the principles of prior case law and IRS published positions, which Congress did not intend to overturn when it enacted section 7520.[12]

The estates had argued that nonmarketability made the payments ''restricted beneficial interests''[13] that, according to the regulations, may be computed under a

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[1]*Negron v. United States,* 553 F.3d 1013 (6th Cir. 2009), *Doc 2009-1820, 2009 TNT 17-6*, *rev'g and rem'g*, 502 F. Supp.2d 682 (N.D. Ohio 2007), *Doc 2007-13499, 2007 TNT 110-13*.

[2]*Anthony v. United States,* 520 F.3d 374 (5th Cir. 2008), *Doc 2008-4733, 2008 TNT 45-18*; *Cook v. Commissioner,* 349 F.3d 850 (5th Cir. 2003), *Doc 2003-24599, 2003 TNT 220-7*.

[3]The district court ''noted that there was a circuit split on whether the IRS annuity tables accurately reflect the fair market value of future lottery payments with marketability restrictions: the Second and Ninth Circuits have held that they do not, and the Fifth Circuit along with two other district courts have held that they do.'' *Negron*, 553 F.3d at 1015. *See Estate of Gribauskas v. Commissioner,* 342 F.3d 85 (2d Cir. 2003), *Doc 2003-19321, 2003 TNT 167-12*; *Shackleford v. United States*, 262 F.3d 1028 (9th Cir. 2001), *Doc 2001-22753, 2001 TNT 169-5*.

[4]Each of the three winners was entitled to 26 annual payments totaling $6,666,666.67. *Negron,* 553 F.3d at 1014.

[5]*Id.*

[6]*Id.* at 1014-1015.

[7]*Id.* at 1016.

[8]*Id.*

[9]Reg. section 20.2031-1(b) (''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'').

[10]*Negron*, 553 F.3d at 1016 (citing section 7520(a) and (b)).

[11]*Id.* at 1016-1017.

[12]*Id.* at 1017 (citing T.D. 8630).

[13]A restricted beneficial interest may refer to an annuity ''subject to any contingency, power, or other restriction.'' *See* reg. section 20.7520-3(b)(1)(ii) and (iii).

facts and circumstances analysis. The Sixth Circuit, however, disagreed with the estates' characterization of the payments. The court examined the apparent uniformity in the circuits' statement of the applicable law. All have found that the remaining lottery payments were annuities and have agreed that the actuarial tables must be used unless:

> the result is so unrealistic and unreasonable that either some modification in the prescribed method should be made, or complete departure from the method should be taken, and a more reasonable and realistic means of determining value is available. The party challenging applicability of the tables has the substantial burden of demonstrating that the tables produce an unreasonable result.[14]

The split among the circuits centers on whether the tables produce an unrealistic and unreasonable value when future lottery payments are subject to limitations on their marketability.[15]

Disagreeing with the Second and Ninth circuits, the Fifth Circuit in *Cook v. Commissioner* emphasized that the actuarial tables assume the nonmarketability of a private annuity and that an annuity represents "the right, independent of market forces, to receive a certain amount of money annually for a certain term."[16] In *Anthony v. United States*,[17] the Fifth Circuit interpreted the restricted beneficial interest regulation in the context of an unmarketable structured settlement and held that, under *Cook*, a departure from the annuity tables was unjustified.[18]

Moreover, in *Estate of Donovan v. United States*,[19] the Massachusetts district court rejected the notion that a marketability restriction constituted a restricted beneficial interest under the regulations. Instead, it agreed with *Cook* that nonmarketability is an assumption underlying the actuarial tables. The *Donovan* court reasoned that the "unassignable nature of the lottery winnings does affect a value of the property, simply not the relevant one."[20] The relevant value was the property's value as held by the decedent and not by a hypothetical buyer who would hold "a very different property interest with substantially greater risks."[21] Addressing an unmarketable right to future lottery payments, the New Hampshire district court similarly held in *Davis*[22] that the actuarial tables produced a reasonable value for those payments.[23]

The Sixth Circuit in *Negron* clearly aligned itself with the courts that place a large burden on the party seeking not to have the annuity tables apply. That party is required to establish (1) that the value derived from the tables is unrealistic and unreasonable and (2) that an alternative valuation method is more reasonable and realistic. According to the Sixth Circuit, the "unrealistic and unreasonable results" exception guarantees proper deference to the regulations while allowing for a different rule when their application "would be arbitrary, capricious, or manifestly contrary to the statute."[24] Under *Negron*, the regulations, as well as "the principles of well-established case law," require that rule.[25]

Unlike the lower court, the Sixth Circuit embraced the Fifth Circuit's interpretation of the annuity tables: that they incorporate the concept of nonmarketability. Citing *Davis* and *Cook*, the court explained:

> The property right at issue is a legally enforceable, virtually risk-free right to receive annual payments that cannot be assigned to a third party. A marketability factor is not necessary to determine the value of a guaranteed income stream; the value of the decedent's interest at the time of death is readily ascertainable and fairly reflected by the present value of the remaining payments using the IRS annuity tables in effect on the date of death.[26]

Therefore, because the IRS actuarial tables do not create an unrealistic and unreasonable valuation, the court reversed and remanded the case to the district court.[27]

Cook and *Anthony*

The Fifth Circuit in both *Cook* and *Anthony* emphasized that because nonmarketability did not jeopardize or affect the right to the stream of the annuity payments, there was no reason to adjust the section 7520 value of the annuity. Moreover, the Fifth Circuit noted that all the case law before *Shackleford v. United States* and *Estate of Gribauskas v. Commissioner* allowed for a departure from the

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[14] *Negron,* 553 F.3d at 1017 (citing *Cook,* 349 F.3d at 854-855, quoting *O'Reilly v. Commissioner,* 973 F.2d 1403 (8th Cir. 1992), and quoting *Weller v. Commissioner,* 38 T.C. 790, 803 (1962)).

[15] *Negron,* 553 F.3d at 1017-1018.

[16] *Cook,* 349 F.3d at 856.

[17] *Anthony,* 520 F.3d 374. *See* Wendy C. Gerzog, "*Anthony*: Absolute Actuarial Tables," *Tax Notes*, Oct. 27, 2008, p. 485, *Doc 2008-21926*, or *2008 TNT 209-24*.

[18] *Negron,* 553 F.3d at 1019.

[19] *Estate of Donovan v. United States,* No. Civ.A. 04-10594-DPW, 2005 WL 958403 (D. Mass. Apr. 26, 2005), *Doc 2005-9281*, *2005 TNT 86-15*. *See* Gerzog, "*Donovan* and *Davis*: Two More Lottery Cases," *Tax Notes*, Jan. 30, 2006, p. 543, *Doc 2006-981*, or *2006 TNT 20-36*.

[20] *Donovan*, 2005 WL 958403, at *3 (quoted in *Negron,* 553 F.3d at 1019).

[21] *Id.*

[22] *Davis v. United States,* 491 F. Supp.2d 192 (D.N.H. 2007), *Doc 2007-14324, 2007 TNT 117-12*. In 2005 the court denied the parties' cross-motions for summary judgment. *Davis v. United States*, No. 04-cv-273 (D.N.H. Dec. 19, 2005), *Doc 2005-25954, 2005 TNT 250-8* [2005 op.].

[23] *Negron,* 553 F.3d at 1019.

[24] *Negron,* 553 F.3d at 1020.

[25] *Id.*

[26] *Id.* (citations omitted). The district court in *Negron* had been persuaded by the positions of the Second and Ninth circuits, which the Sixth Circuit rejected. *Id.* at 1015. However, the appellate court held that the district court did not err in its failure to address the regulation dealing with restricted beneficial interests, even though the regulation was effective on the dates of the decedents' deaths, because the motion for partial summary judgment had been based on Negron's argument that the "unrealistic and unreasonable results" exception applied. *Id.* at 1020-1021.

[27] *Id.* at 1021.

actuarial tables only when those values were ''substantially at variance with factual assumptions underlying the tables.''[28] Discounts for nonmarketability are inappropriate, it observed, when values are required to be calculated by means of the tables ''independent of market forces.''[29]

In *Anthony*, the estate had tried to distinguish its case from *Cook*. It argued that the restricted beneficial interest exception in the 1995 regulation required a different result because that regulation defines a restricted beneficial interest as an interest ''that is subject to any contingency, power, or other restriction,'' which, the estate had asserted, includes nonmarketability. However, the *Anthony* court rejected the estate's interpretation and explained that the restrictions in the regulation reflect the possibility that the tables' assumptions could be undermined. The examples in the regulations highlight that view: A minimal life expectancy of the terminally ill measuring life, invasion of the corpus, and premature exhaustion of the fund all defeat the interest itself.[30]

Anthony and *Cook* held that although markets value assignable and nonassignable annuities differently, the tax code does not. While the estates had contended that the actuarial tables produced an unreasonable and unrealistic value, the Fifth Circuit emphasized that for this exception to apply, the taxpayer had a substantial burden of proof, which in each case the taxpayer did not sustain. In *Anthony*, the estate calculated the value of the annuity at approximately 50 percent less than the table amount. Comparing that disparity with the discounts asserted by the experts in *Cook* (29 percent and 47 percent) and in *Donovan* (66 percent), the court rejected any need for a departure from the actuarial tables.[31]

Donovan and *Davis*

The decedent in *Donovan* died after receiving the first of 20 lottery payments. Applying a discount for nonmarketability, his estate argued that the remaining 19 payments had an actual value of approximately one-third their actuarial value.[32] However, because nonmarketability did not convert the payments into a restricted beneficial interest, the district court held that the future lottery payments constituted an annuity ''presumptively governed'' by section 7520.[33] By contrast, the court explained that the willing buyer/willing seller definition of FMV applies only when the amount a buyer would pay reflects the amount of wealth a seller has at his death.[34] The *Donovan* court, like the *Cook* court, held that when the payments represent the right to receive money annually over a specified number of years, valuation is made ''independent of market forces'' and a nonmarketability discount is therefore immaterial.[35]

In *Davis*, the estate contended that the value of the remaining annual lottery payments was approximately one-half the value produced by the tables.[36] The district court held that to depart from the tables' calculations, the estate had the burden of proving that value was unrealistic and unreasonable and that the discounted value applied by the estate produced a more reasonable and realistic FMV.[37]

The *Davis* court, however, found flaws in the report prepared by the estate's valuation expert. It was based on an erroneous assumption that ''the estate would 'sell' the (non-assignable) annuity to a third party, who would depend on the estate to continue receiving payments from the Commonwealth and then remit those payments to the third party.''[38] Thus, a hypothetical buyer would also be subject to the risk that its asset would be uncollectible. The district court preferred the position of the government's expert, who stated that the estate's valuation was premised ''on the incorrect assumption that the hypothetical buyer could not gain legal rights to the ten-payments annuity even if they were the highest bidder in the auction.''[39] Rather, according to that expert, valuation should be based on what that hypothetical buyer would pay for the annuity if the buyer ''could not resell those rights.''[40] Accepting the government's view that that value was ''something very close to the present value of those 10 payments,''[41] the court held that the estate had not sustained its burden of proof for an exception to the general application of the actuarial tables.[42]

Ithaca Trust

In *Ithaca Trust*,[43] a pre-1969 split interest estate tax charitable deduction case, the Supreme Court held that annuity tables alone must be used to value a life estate

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[28]*Anthony*, 520 F.3d at 379 (citing *Cook*, 349 F.3d at 854-855). By contrast, the Ninth Circuit in *Shackleford* and the Second Circuit in *Gribauskas* allowed the estates to discount the section 7520 annuity value for nonmarketability when the variances from that value were 50 percent and 26 percent, respectively. *See Shackleford*, 262 F.3d at 1030, and *Gribauskas*, 342 F.3d at 86-87.

[29]*Cook*, 349 F.3d at 856.

[30]*Anthony*, 520 F.3d at 380-381. *See, e.g.*, reg. section 20.7520-3(b)(2)(v), Example 4; and reg. section 20.7520-3(b)(4), Example 1.

[31]*Anthony*, 520 F.3d at 384.

[32]*Donovan*, 2005 WL 958403, at *2.

[33]*Id.* at *8-9.

[34]*Id.* at *14-15.

[35]*Id.* at *19 (citing *Cook*, 349 F.3d at 856).

[36]*Davis*, 491 F. Supp.2d at 193. (Under the annuity tables, their value was $1,607,164; under the estate's expert's application of a marketability discount, they were worth $803,582. *Id.*)

[37]*Id.* at 194. In its 2005 ruling on the parties' cross-motions for summary judgment, the court had surmised that nonmarketable payments were less valuable because they could not be freely exchanged for a flat lump sum and that, because of the payments' illiquidity, the estate might incur additional costs. *Davis*, 2005 op. at 15.

[38]*Davis*, 491 F. Supp.2d at 196.

[39]*Id.*

[40]*Id.*

[41]*Id.* at 197. Indeed, the court stated, ''In light of the virtually non-existent risk of default by the Commonwealth, however, it is entirely possible that the estate's annuity actually has a fair market value slightly in excess of the value ascribed to it by the IRC tables.'' *Id.* at 198.

[42]*Id.* at 199.

[43]*Ithaca Trust v. United States*, 279 U.S. 151 (1929). *See* Gerzog, ''Annuity Tables Versus Factually Based Estate Tax Valuation: *Ithaca Trust* Re-visited,'' 38 *Real Prop., Prob. & Tr. J.* 745 (2004).

given to the decedent's widow because Congress mandated their use. That rule applied even though the widow died before the due date for the decedent's estate tax return and the actual amount received by her was therefore calculable. The widow's life estate preceded a gift to charity and, because of her premature death, the payments to the widow were worth approximately 8 percent of the value that was computed under the annuity tables. By applying the tables to value the widow's life estate rather than by using her shorter actual life span, the estate's charitable deduction was much less than the amount that the charity received. Despite the large divergence between the values calculated under the tables and the actual value of the payments received by the widow and the charity, the Supreme Court held that the actuarial tables alone must be used to value the life interest. According to the Court, the use of the tables indicates ''the intention of the lawmakers . . . that the computation of the tax should be made . . . on the basis of a law of averages.''[44]

The Regulations

The exceptions in the regulations that allow for a deviation from mandated use of the actuarial tables reflect prior case law in which the actual values of the interests were minimal or nonexistent. In those cases, the values calculated under the tables were held by courts to be ''wildly unrealistic''[45] and ''substantially unrealistic and unreasonable.''[46] In *O'Reilly*, a pre-section 2702 gift tax case, a donor unsuccessfully attempted to use the tables to inflate the value of his retained income interest, whose actual value was less then 2 percent of the value calculated under the tables. In *Froh*,[47] a gift tax case in which gas reserves and the resulting income stream would have been exhausted before the end of the annuity's term, the Tax Court held that use of the tables was inappropriate. In *Lion*,[48] the wife's life estate was valueless (because she had died in the same airplane accident as her husband).

Specifically, reg. section 20.7520-3(b)(2)(i) requires that a trust that will be exhausted before all the payments can be made, like in *Froh*, must be recalculated as an annuity for a term consistent with its actual payout period. Likewise, reg. section 20.7520-3(b)(2)(v) exempts ''unproductive property'' from use of the actuarial tables if the beneficiary does not have the right to make the corpus productive, and it similarly exempts an income interest in a trust that can be terminated at any time for any reason. Reg. section 20.7520-3(b)(3)(iii) makes an exception for instances, like in *Lion*, in which the estate must value the life estate of the presumptive survivor of a simultaneous death. Finally, reg. section 20.7520-3(b)(3)(i) denies the availability of the actuarial tables when an individual who is the measuring life is ''terminally ill'' at the decedent's death.[49]

Thus, under the regulations that embody prior case law, the taxpayer has a significant burden of proving that the actuarial tables mandated by section 7520 produce such a wildly unrealistic value that they should not apply to value nonmarketable future lottery payments.

Conclusion

When section 7520 requires use of the actuarial tables to value certain interests, like an annuity, the tables provide a substitute for a facts and circumstances determination. The tables offer the benefits of simplicity and ease, but not accuracy or equivalence to FMV, in any particular case. Therefore, facts that merely individualize valuation rather than undermine the factors integral to the tables' assumptions are ignored.

With *Negron*, the circuits are evenly split, but the Fifth and Sixth circuits have the better argument. When section 7520 mandates the use of the actuarial tables, it is inappropriate to discount that value for nonmarketability. Moreover, calculating the value of a sure thing like state lottery payments, marketable or not, solely by the actuarial tables can not create a value that is *wildly* unrealistic and unreasonable in light of the regulations and the prior case law on which those regulations are based.

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[44]*Ithaca Trust*, 279 U.S. at 155.

[45]*O'Reilly*, 973 F.2d at 1406.

[46]*Id.* at 1408.

[47]*Estate of Froh v. Commissioner*, 100 T.C. 1 (1993), *Doc 93-497, 93 TNT 5-15*, *aff'd* 46 F.3d 1141 (9th Cir. 1995), *Doc 95-1890, 95 TNT 27-16*.

[48]*Estate of Lion v. Commissioner*, 438 F.2d 56 (4th Cir. 1970).

[49]That same regulation defines being terminally ill as being ''known to have an incurable illness or other deteriorating physical condition [when] there is at least a 50 percent probability that the individual will die within 1 year.''