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LUCKY FOR LIFE: A MORE REALISTIC AND REASONABLE ESTATE TAX VALUATION FOR NONTRANSFERABLE LOTTERY WINNINGS

Kyla C.E. Grogan

Abstract: When a lottery winner dies after receiving only a few annuity payments from the state, the winner's estate must pay federal estate tax on the balance of the annuity. If the lottery prize is not legally transferable, the winner's estate cannot sell or pledge the right to future payments in order to generate funds to pay the estate tax. The estate tax value of an annuity is generally based on valuation tables that discount the future payments to present value. However, these valuation tables do not control when they produce an unrealistic and unreasonable result. The United States Courts of Appeals are split as to the proper method of valuing nontransferable lottery winnings. The Ninth and Second Circuits have held that the valuation tables produce an unreasonable and unrealistic valuation result for nontransferable lottery winnings because the tables do not consider lack of marketability. The Fifth Circuit departed from this precedent by holding that the valuation tables were controlling and no marketability discount was appropriate for nontransferable lottery winnings. Although stability and lack of transferability are two factors integral to the lottery winnings' value for estate tax purposes, none of the circuits have considered both of these factors. This Comment proposes a new approach to valuing nontransferable lottery prizes. First, courts should use the valuation tables to calculate the annuity's present value. Second, courts should modify the tables' value with a limited-percentage marketability discount calculated by weighing the stable payment structure of the lottery prize against the legal restrictions on its transfer. This approach gives proper weight to the two most fundamental characteristics of nontransferable lottery prizes.

Lotteries are the most common form of gambling in the United States and the only form of gambling operated as a state government monopoly.[1] The state's backing gives lottery payments great stability because there is very little risk that the state will default.[2] Despite this stability, a lottery winner's untimely death may create an estate tax dilemma[3] if the decedent's estate lies in a state where lottery winnings

1. *See* NATIONAL GAMBLING IMPACT STUDY COMMISSION, NATIONAL GAMBLING IMPACT STUDY COMMISSION FINAL REPORT 2-3 (1999), *available at* http://govinfo.library.unt.edu/ngisc (last visited Aug. 28, 2004).

2. *See* Cook v. Comm'r, 349 F.3d 850, 855 (5th Cir. 2003).

3. A comprehensive discussion of this dilemma and strategies to reduce the burden on the winner's estate are beyond the scope of this Comment. For a thorough discussion of the topic, albeit one that predates the lottery cases discussed in this Comment, see generally M. Eldridge Blanton III, Note, *Who Gets a Dead Man's Gold? The Dilemma of Lottery Winnings Payable to a Decedent's Estate*, 28 U. RICH. L. REV. 443 (1994).

are assignable only to the estate or pursuant to a court order.[4] When a lottery winner dies while receiving winnings in the form of an annuity from a state with such rules, the winner's estate owes tax on the present value of the future annuity payments.[5] Thus, the estate owes tax on the total remaining balance of the lottery winnings, but can pay the tax using only the annual annuity payments.[6]

The standard method for determining the value of an annuity for estate tax purposes uses valuation tables[7] contained in the U.S. Treasury Regulations and Internal Revenue Service publications.[8] The Treasury Regulations specify certain situations where the tables do not apply.[9] Additionally, courts have held that the tables do not control when they produce an "unrealistic and unreasonable" result.[10]

Recently, three U.S. Courts of Appeals have considered the issue of how to value nontransferable lottery winnings.[11] However, the circuits have used different methods of calculating the value of nontransferable lottery winnings.[12] The Ninth and Second Circuits departed from the

4. A number of states that operate lotteries have such restrictions. *See, e.g.*, DEL. CODE ANN. tit. 29, § 4808 (2003) (allowing assignment only to a decedent's estate or pursuant to a court order); N.M. STAT. ANN § 6-24-21(C)(5) (Michie 2002) (same); R.I. GEN. LAWS § 42-61-7 (1998) (same); TEX. GOV'T CODE ANN. § 466.406 (Vernon Supp. 2004–2005) (same); *see also* IDAHO CODE § 67-7437 (Michie 2001) (stating that lottery winnings may be paid to the winner's estate, but lacking an allowance for assignment pursuant to a court order). Other states have fewer restrictions. *See, e.g.*, CAL. GOV'T CODE § 8880.325(c) (West Supp. 2004) (allowing assignment as collateral); MASS. ANN. LAWS ch. 10, § 28(3) (Law. Co-op. Supp. 2004) (permitting "assignment of prizes for purposes of paying estate and inheritance taxes").

5. *See* Shackleford v. United States, 262 F.3d 1028, 1030 (9th Cir. 2001) [hereinafter *Shackleford II*].

6. *See id.*

7. 26 U.S.C. § 7520 (2000); Treas. Reg. § 20.2031-7 (as amended in 2000).

8. Treas. Reg. § 20.7520-1(c) (as amended in 2000).

9. Treas. Reg. § 20.7520-3(b)(1)(iii) (as amended in 1995). The Treasury Regulations provide that it is inappropriate to use the tables in circumstances such as when an annuity could be exhausted before the end of the defined payment period. *See* Treas. Reg. § 20.7520-3(b)(2)(i). In contrast, the rule that the tables are inappropriate when they produce an unrealistic and unreasonable result comes from case law, rather than from the Treasury Regulations. *See* O'Reilly v. Comm'r, 973 F.2d 1403, 1407 (8th Cir. 1992) (quoting Weller v. Comm'r, 38 T.C. 790, 803 (1962)).

10. *O'Reilly*, 973 F.2d at 1407 (quoting *Weller*, 38 T.C. at 803).

11. *See* Cook v. Comm'r, 349 F.3d 850, 851 (5th Cir. 2003); Estate of Gribauskas v. Comm'r, 342 F.3d 85, 86 (2d Cir. 2003) [hereinafter *Gribauskas II*]; *Shackleford II*, 262 F.3d at 1029. Under the "*Golsen* rule," the Tax Court must follow the rulings of the circuit court of appeals for the taxpayer's jurisdiction. *See* Golsen v. Comm'r, 54 T.C. 742, 757 (1970). However, if the relevant court has not yet ruled on an issue, the Tax Court need not consider rulings from other circuits. *See id.*

12. *Compare Gribauskas II*, 342 F.3d at 88–89 (departing from the valuation tables and allowing

valuation tables because the tables failed to consider lack of marketability.[13] In contrast, the Fifth Circuit valued nontransferable lottery winnings according to the valuation tables and without applying a discount for lack of marketability.[14]

A valuation approach derived from the balancing process used by the Tax Court and affirmed without published opinion by the U.S. Court of Appeals for the Third Circuit to value privately held stock in *Mandelbaum v. Commissioner*[15] produces a more realistic valuation for nontransferable lottery winnings. When valuing an asset requires a marketability discount, courts have discretion to determine the appropriate percentage for this discount.[16] In *Mandelbaum*, the Tax Court demonstrated how to calculate the appropriate percentage for a marketability discount when valuing privately held stock.[17] The court began with the stipulated value of freely traded stock.[18] The court then weighed factors favoring a high marketability discount against factors favoring a low marketability discount in order to determine the appropriate degree of discount to apply to the stock's stipulated value.[19]

This Comment argues that modifying the valuation tables' value with a limited-percentage marketability discount calculated using the *Mandelbaum* balancing approach will produce a more realistic and reasonable valuation for nontransferable lottery winnings than the approach of either side of the current circuit split. Part I of this Comment describes how courts value lottery winnings as private annuities. Part II discusses marketability discounts and the balancing approach the *Mandelbaum* court used to calculate the appropriate degree for a marketability discount for privately held stock. Part III summarizes the cases that led to the current circuit split. Finally, Part IV argues that courts should modify the valuation tables' value with a limited-percentage marketability discount to produce a more realistic and

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a marketability discount), *and Shackleford II*, 262 F.3d at 1032–33 (same), *with Cook*, 349 F.3d at 856–57 (applying the valuation tables and refusing to allow a marketability discount).

13. *See Gribauskas II*, 342 F.3d at 88–89; *Shackleford II*, 262 F.3d at 1032–33.

14. *Cook*, 349 F.3d at 855–57.

15. 69 T.C.M. (CCH) 2852, 2862–64 (1995), *aff'd without published op.*, 91 F.3d 124 (3d Cir. 1996).

16. *See, e.g.*, *id.* at 2867 (rejecting the experts' opinions and calculating a new marketability discount).

17. *See id.* at 2864.

18. *See id.*

19. *See id.* at 2864, 2867–69.

reasonable valuation for nontransferable lottery winnings.

I. COURTS USE VALUATION TABLES TO VALUE ANNUITIES WHEN THE TABLES PRODUCE REALISTIC AND REASONABLE RESULTS

All facts affecting an asset's value are relevant in the estate tax valuation process for the asset.[20] If the Internal Revenue Service (the Service) and a taxpayer[21] disagree about the proper valuation for an asset, courts have considerable discretion in determining the asset's value.[22] For estate tax valuation purposes, courts treat nontransferable lottery prizes paid over time as private, noncommercial annuities.[23] Valuation tables set forth in the Treasury Regulations provide the standard method for valuing private annuities,[24] except in situations where courts determine that the tables produce an "unrealistic and unreasonable" result.[25]

A. *When Parties Disagree About the Estate Tax Valuation of an Asset, Courts Have Discretion to Determine Its Fair Market Value*

The estate tax is an excise tax on the transfer of property after the owner dies.[26] The taxable estate generally includes all of the decedent's property interests at death.[27] The Internal Revenue Code describes how to value the assets comprising the taxable estate.[28]

Generally, the fair market value of the asset at the time of the decedent's death provides the basis for its estate tax valuation.[29] The

20. *See* Treas. Reg. § 20.2031-1(b) (as amended in 1965).

21. This Comment uses the term "taxpayer" interchangeably with the term "estate." In the lottery cases discussed in this Comment, the taxpayer will always be the decedent's estate.

22. *See* Anderson v. Comm'r, 250 F.2d 242, 249 (5th Cir. 1957); Estate of Newhouse v. Comm'r, 94 T.C. 193, 217 (1990) (describing a court's power to accept or reject experts' opinions).

23. *See* Cook v. Comm'r, 349 F.3d 850, 855 (5th Cir. 2003); Shackleford II, 262 F.3d 1028, 1031 (9th Cir. 2001).

24. 26 U.S.C. § 7520 (2000).

25. O'Reilly v. Comm'r, 973 F.2d 1403, 1407 (8th Cir. 1992) (quoting Weller v. Comm'r, 38 T.C. 790, 803 (1962)).

26. *See* Estate of Bright v. United States, 658 F.2d 999, 1001 (5th Cir. 1981).

27. 26 U.S.C. § 2033 (2000).

28. *Id.* § 2031; *see* John A. Miller & Jeffrey A. Maine, *Fundamentals of Estate Tax Planning*, 32 IDAHO L. REV. 197, 200 (1996).

29. Treas. Reg. § 20.2031-1(b) (as amended in 1965). The exception is when the estate elects to use the alternate valuation method provided by 26 U.S.C. § 2032. *Id.*

Treasury Regulations define fair market value 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 knowledge of relevant facts."[30] Even a completely nonmarketable asset may have a fair market value.[31] Any factor with the potential to affect the asset's value is relevant to the fair market value calculation.[32]

When the Service and a taxpayer disagree about the proper valuation for an asset, courts have considerable discretion in determining the asset's value.[33] Although courts presume that the Service's assessment of value is correct,[34] a taxpayer may overcome this presumption by producing credible evidence of an alternate valuation.[35] However, if a court disagrees with the expert valuations provided by both the taxpayer and the Service, then the court may perform its own valuation of the asset.[36] The only constraint on the court's discretion is that the evidence must reasonably support its valuation of the asset.[37] A court thus may take an active role in determining the proper valuation for an asset.

B. Valuation Tables Provide a Standard Method for Valuing Annuities, Unless the Tables Produce an Unrealistic and Unreasonable Result

Courts characterize lottery prizes as private or noncommercial annuities.[38] The most common method of valuing an annuity is the

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30. *Id.*

31. *See* Bank of Cal. v. Comm'r, 133 F.2d 428, 433 (9th Cir. 1943) (stating "we are required to assume the existence of a willing buyer and a willing seller, regardless of whether they actually existed or not, and to assume that the property could and would change hands, even though such a change could not in fact occur"). Thus, lack of marketability does not mean that an asset has no fair market value. However, lack of marketability may reduce an asset's fair market value. *See* Mailloux v. Comm'r, 320 F.2d 60, 62 (5th Cir. 1963); *see also infra* Part II.A (discussing how a marketability discount reduces an asset's fair market value).

32. *See* Treas. Reg. § 20.2031-1(b) (as amended in 1965).

33. *See* Anderson v. Comm'r, 250 F.2d 242, 249 (5th Cir. 1957); Estate of Newhouse v. Comm'r, 94 T.C. 193, 217 (1990) (describing a court's power to accept or reject experts' opinions).

34. *See* Estate of Gilford v. Comm'r, 88 T.C. 38, 51 (1987) (citing Welch v. Helvering, 290 U.S. 111, 115 (1933)).

35. *See id.*

36. *See Anderson*, 250 F.2d at 249; *Newhouse*, 94 T.C. at 217.

37. *See Anderson*, 250 F.2d at 249 ("It is not necessary that the value arrived at by the trial court be a figure as to which there is specific testimony, if it is within the range of figures that may properly be deduced from the evidence.").

38. *See* Cook v. Comm'r, 349 F.3d 850, 855 (5th Cir. 2003); Shackleford II, 262 F.3d 1028, 1031 (9th Cir. 2001).

income capitalization approach.[39] This approach uses a discount rate to calculate the present value of each future payment and adds these present values to determine the annuity's total present value.[40]

Section 7520 of the Internal Revenue Code explains that the Service uses a series of valuation tables (§ 7520 tables) contained in the Treasury Regulations to determine the value of different assets, including annuities.[41] Different tables apply depending on whether the annuity lasts for a fixed term or for the period of a single life.[42] For annuities that last for a fixed term, the valuation table considers only two factors: the term of years and the applicable interest rate.[43]

Valuation tables do not control when their 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."[44] The Tax Court first articulated this principle in *Weller v. Commissioner*,[45] and the U.S. Court of Appeals for the Eighth Circuit adopted the principle when disregarding the valuation tables in *O'Reilly v. Commissioner*.[46] Because the valuation tables significantly undervalued a retained interest in stock shares, the *O'Reilly* court held that the value produced by the tables was "not anywhere close to" the proper valuation of the retained interest,[47] and remanded the case to the

39. JOHN A. BOGDANSKI, FEDERAL TAX VALUATION 3-56 (1996).

40. *See id.* at 3-49.

41. 26 U.S.C. § 7520 (2000); Treas. Reg. § 20.7520-1(c) (as amended in 2000); *see also* I.R.S. Notice 89-24, 1989-1 C.B. 660 (providing guidance on how to value annuities according to § 7520). For an excellent description of the valuation procedure, see REGIS W. CAMPFIELD ET AL., TAXATION OF ESTATES, GIFTS AND TRUSTS 165–67 (21st ed. 1999).

42. *See* I.R.S. Notice 89-60, 1989-1 C.B. 700.

43. I.R.S. Notice 89-24, 1989-1 C.B. 660; *see* Cook v. Comm'r, 349 F.3d 850, 854 (5th Cir. 2003).

44. O'Reilly v. Comm'r, 973 F.2d 1403, 1407 (8th Cir. 1992) (quoting Weller v. Comm'r, 38 T.C. 790, 803 (1962)); *see* Estate of Green v. Comm'r, 22 T.C. 728, 736 (1954) (explaining that departure from the regulations could be required under "[s]pecial circumstances"). Although § 7520 states that the value of an annuity "shall be determined . . . under tables prescribed by the Secretary," it does not explicitly state that valuation must be based *solely* upon these tables. *See* 26 U.S.C. § 7520. For the argument that the tables always control when valuation is based solely upon the tables, see Wendy C. Gerzog, *Actuarial Tables Versus Factually Based Estate Tax Valuation:* Ithaca Trust *Re-Visited*, 38 REAL PROP. PROB. & TR. J. 745, 773–74 (2004).

45. 38 T.C. 790, 803 (1962).

46. 973 F.2d 1403, 1407 (8th Cir. 1992). Although *O'Reilly* is a gift tax case, the same valuation rules and precedents generally apply to both gift and estate tax cases. *See* BOGDANSKI, *supra* note 39, at 2-159.

47. *O'Reilly*, 973 F.2d at 1408.

Tax Court to determine its proper value.[48]

Courts have interpreted the Treasury Regulations to allow similar departures from the § 7520 valuation tables.[49] Annuities are valued according to the § 7520 tables unless another regulation permits departure from the tables.[50] The general fair market value regulation in the Treasury Regulations permits departure from the valuation tables when the tables do not provide a reasonable and realistic approximation of the fair market value of the annuity.[51] If the tables are not used to determine the value of an annuity, its value is its fair market value based on the relevant facts and circumstances.[52] Although courts may depart from the tables, the tables are presumptively correct.[53] Accordingly, a party seeking to depart from the tables bears the burden of proving that they produce an unrealistic and unreasonable valuation result.[54]

In sum, courts have significant discretion when determining the proper estate tax valuation for an asset.[55] For valuation purposes, courts treat nontransferable lottery prizes like private annuities.[56] The Service instructs taxpayers to use valuation tables contained in the Treasury Regulations to value annuities.[57] However, when the tables produce an unrealistic and unreasonable result, courts should modify or depart completely from this result when a more realistic and reasonable valuation method is available.[58] When the valuation tables are not used to value an asset, its valuation depends upon the relevant facts and circumstances of the case.[59]

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48. *Id.* at 1409.

49. *See* Shackleford II, 262 F.3d 1028, 1031 (9th Cir. 2001).

50. *See id.*

51. *See Shackleford II*, 262 F.3d at 1031 (citing Treas. Reg. § 20.2031-1(b) (as amended in 1965)). The *Gribauskas* court also mentioned this regulation, but departed from the tables solely on the basis of case law. *See Gribauskas II*, 342 F.3d 85, 87–89 (2d Cir. 2003).

52. *See* Treas. Reg. § 20.7520-3(b)(1)(iii) (as amended in 1995).

53. *See Shackleford II*, 262 F.3d at 1033; *O'Reilly*, 973 F.2d at 1408–09.

54. *See Shackleford II*, 262 F.3d at 1033.

55. *See* Anderson v. Comm'r, 250 F.2d 242, 249 (5th Cir. 1957); Estate of Newhouse v. Comm'r, 94 T.C. 193, 217 (1990).

56. *See* Cook v. Comm'r, 349 F.3d 850, 855 (5th Cir. 2003); *Shackleford II*, 262 F.3d at 1031.

57. *See* 26 U.S.C. § 7520 (2000); Treas. Reg. § 20.7520-1(c) (as amended in 2000); *see also* I.R.S. Notice 89-24, 1989-1 C.B. 660 (providing guidance on how to value annuities according to § 7520).

58. *O'Reilly*, 973 F.2d at 1407 (quoting Weller v. Comm'r, 38 T.C. 790, 803 (1962)).

59. *See* Treas. Reg. § 20.7520-3(b)(1)(iii) (as amended in 1995).

II. MARKETABILITY DISCOUNTS DECREASE THE VALUE OF ASSETS THAT ARE NOT FREELY TRANSFERABLE

A marketability discount lowers the initial valuation of an asset[60] to account for the fact that an asset with restrictions on its transfer is inherently less valuable in the free market than an asset with no such restrictions.[61] In *Mandelbaum*, the Tax Court illustrated how to calculate a limited-percentage marketability discount for privately held stock by weighing factors favoring a high marketability discount against factors favoring a low marketability discount.[62] The Tax Court has used a similar approach to calculate limited-percentage marketability discounts for other types of assets.[63]

A. A Marketability Discount Reduces an Asset's Value to Account for Restrictions on Its Transferability

After determining an asset's initial value, the next step is to consider whether the valuation warrants a discount and, if so, how large the discount should be.[64] A marketability discount decreases the value of an asset that has restrictions on its transferability or liquidity[65] because a buyer will pay less for a restricted asset than for an identical asset with no such restrictions.[66] The most common method of applying a marketability discount is to follow the standard valuation method appropriate for the asset, and then apply a percentage marketability discount to the preliminary valuation result.[67]

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60. *See, e.g.*, *Newhouse*, 94 T.C. at 249 (lowering the initial valuation of stock for lack of marketability).

61. *See* Mailloux v. Comm'r, 320 F.2d 60, 62 (5th Cir. 1963); Cooley v. Comm'r, 33 T.C. 223, 225 (1959); *see also* Youpee v. Babbitt, 67 F.3d 194, 197 (9th Cir. 1995) (describing the right to transfer as an essential property right), *aff'd*, 519 U.S. 234 (1997).

62. *See* Mandelbaum v. Comm'r, 69 T.C.M. (CCH) 2852, 2867–69 (1995), *aff'd without published op.*, 91 F.3d 124 (3d Cir. 1996).

63. *See, e.g.*, Estate of Barudin v. Comm'r, 72 T.C.M. (CCH) 488, 494 (1996) (valuing a partnership interest); Estate of Luton v. Comm'r, 68 T.C.M. (CCH) 1044, 1055 (1994) (valuing a trust with a note as its principal asset).

64. *See Newhouse*, 94 T.C. at 249.

65. *See* Blanton, *supra* note 3, at 447.

66. *See Mailloux*, 320 F.2d at 62; *Cooley*, 33 T.C. at 225; *see also* CAMPFIELD ET AL., *supra* note 41, at 207 (explaining that "[t]he willing buyer–willing seller approach can produce unrealistically high values if the market is thin, buyers are few, or the asset has unusual infirmities").

67. *See* BOGDANSKI, *supra* note 39, at 3-74 (describing the marketability discount process for closely held stock); *see also Barudin*, 72 T.C.M. (CCH) at 492–94 (valuing a partnership interest by first applying a capitalization rate to reduce lease income to present value, then applying minority

Courts have discretion to determine the appropriate percentage for a marketability discount.[68] Although parties may rely on experts to calculate their proposed marketability discounts, courts are not bound to give these expert opinions any particular weight.[69] If a court disagrees with the parties' proposed discounts, it may weigh various factors to determine the appropriate marketability discount for an asset.[70] The Tax Court illustrated this balancing approach in *Mandelbaum*, a memorandum decision.[71]

B. *The* Mandelbaum *Court Used a Fact-Specific Balancing Approach to Calculate the Appropriate Degree for a Marketability Discount*

In *Mandelbaum*, the Tax Court utilized a balancing approach in order to determine the appropriate marketability discount when valuing privately held stock for gift tax purposes.[72] Members of the Mandelbaum family were the sole shareholders of "Big M," a privately held corporation.[73] The Tax Court determined that a marketability discount was necessary in valuing the shares because privately held shares are not readily marketable.[74] The marketability of Big M shares was further restricted because shareholders' agreements prohibited transfers outside

and marketability discounts to the per-unit liquidation value of the interest).

68. *See, e.g.*, Estate of Desmond v. Comm'r, 77 T.C.M (CCH) 1529, 1532–34 (1999) (rejecting the experts' opinions and calculating a new marketability discount).

69. *See id.*; Mandelbaum v. Comm'r, 69 T.C.M. (CCH) 2852, 2862–63 (1995), *aff'd without published op.*, 91 F.3d 124 (3d Cir. 1996).

70. *See, e.g.*, *Desmond*, 77 T.C.M. (CCH) at 1533–34 (weighing factors to determine the appropriate discount); *Mandelbaum*, 69 T.C.M. (CCH) at 2867–69 (weighing factors to determine the appropriate discount). See *infra* note 82 for the *Mandelbaum* factors. The *Desmond* factors were nearly the same, although they included potential environmental liabilities rather than the cost of a public offering and modified the factor comparing the values of publicly and privately held stock to the availability of a public market. *See Desmond*, 77 T.C.M. (CCH) at 1532–34. The average marketability discount is between fifteen and forty percent. RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION INCLUDING THE GENERATION-SKIPPING TRANSFER TAX 4-40 (8th ed. 2002).

71. *See Mandelbaum*, 69 T.C.M. (CCH) at 2852. Memorandum decisions are not binding authority. *See* Nico v. Comm'r, 67 T.C. 647, 654 (1977), *rev'd in part on other grounds*, 565 F.2d 1234 (2d Cir. 1977). However, courts often cite them as persuasive authority. *See* BOGDANSKI, *supra* note 39, at 1-30. The Service has specifically endorsed the *Mandelbaum* approach for calculating a marketability discount for closely held stock. *See* U.S. INTERNAL REVENUE SERV., IRS VALUATION TRAINING FOR APPEALS OFFICERS COURSEBOOK 9-6 (1998).

72. *See Mandelbaum*, 69 T.C.M. (CCH) at 2867–69.

73. *See id.* at 2854.

74. *See id.* at 2864.

the family unless the other family members had a right of first refusal.[75] Although both the Mandelbaum family and the Service proposed marketability discounts, the Tax Court found neither party's expert convincing.[76] The Tax Court thus exercised its discretion to determine the appropriate marketability discount for the shares of Big M stock,[77] and applied this discount to the stock's stipulated value.[78]

The Tax Court took a two-step approach to determine the fair market value of the privately held shares.[79] The parties first stipulated to the value the stock shares would have if they were freely traded.[80] This figure was the base upon which the court applied the marketability discount to account for the fact that the stock was not freely tradable.[81]

The court weighed various factors to determine the appropriate marketability discount as part of the second *Mandelbaum* step.[82] For each factor, the court determined whether the evaluation was neutral or favored an average, above-average, or below-average discount.[83] Big M's financial statements, dividend policy, economic outlook, and management were uniformly strong, which favored a low marketability discount.[84] In contrast, the restrictions on transferability of the shares and the high costs of a public offering favored an average to above-average

75. *See id.* at 2856, 2866 (describing the shareholders' agreements and explaining that the agreements affect value, although this effect is "not necessarily substantial").

76. *See id.* at 2866.

77. *See id.* at 2867–69.

78. *See id.* at 2869.

79. *See id.* at 2864; *see also* Estate of Kaufman v. Comm'r, 77 T.C.M. (CCH) 1779, 1784 (1999) (describing the two-step process to determine the fair market value of privately owned shares), *rev'd on other grounds sub nom.* Morrissey v. Comm'r, 243 F.3d 1145 (9th Cir. 2001).

80. *See Mandelbaum*, 69 T.C.M. (CCH) at 2864.

81. *See id.*

82. *See id.* at 2867–69. These factors included:

> (1) The value of the subject corporation's privately traded securities vis-a-vis its publicly traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation's public and private stock); (2) an analysis of the subject corporation's financial statements; (3) the corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends; (4) the nature of the corporation, its history, its position in the industry, and its economic outlook; (5) the corporation's management; (6) the degree of control transferred with the block of stock to be valued; (7) any restriction on the transferability of the corporation's stock; (8) the period of time for which an investor must hold the subject stock to realize a sufficient profit; (9) the corporation's redemption policy; and (10) the cost of effectuating a public offering of the stock to be valued.

Id. at 2864.

83. *See id.* at 2867–69.

84. *See id.* at 2867–68.

marketability discount.[85] After weighing these factors, the Tax Court rejected the seventy to seventy-five percent marketability discount proposed by the Mandelbaums,[86] and arrived at a limited-percentage marketability discount of thirty percent.[87]

C. *The Tax Court Has Used a Flexible Balancing Approach Similar to the* Mandelbaum *Approach to Calculate the Appropriate Marketability Discount for Other Types of Assets*

The Tax Court has used a balancing approach similar to its approach in *Mandelbaum* to determine the appropriate marketability discount for assets other than privately held stock.[88] This balancing approach weighs factors favoring a higher marketability discount against factors favoring a lower marketability discount.[89] However, the particular factors considered in each case may change[90] depending on the nature of the asset being valued.[91]

The Tax Court took a balancing approach when determining the appropriate marketability discount for a partnership interest in *Estate of Barudin v. Commissioner*,[92] and for a trust having a note as its principal asset in *Estate of Luton v. Commissioner*.[93] The assets in both cases had stable payment structures.[94] However, despite their stability, the Tax Court held that transfer restrictions on the assets made marketability

85. *See id.* at 2868–69.

86. *Id.* at 2866.

87. *Id.* at 2869. Although this was the same percentage discount the Service allowed, the court arrived at this percentage using different reasoning and calculations. *See id.* at 2867–69.

88. *See, e.g.*, Estate of Barudin v. Comm'r, 72 T.C.M. (CCH) 488, 494 (1996) (calculating the appropriate marketability discount for a partnership interest by weighing the stable management and distribution history against the lack of a public market and restrictions on transfer of the interest to reach a marketability discount of twenty-six percent); Estate of Luton v. Comm'r, 68 T.C.M. (CCH) 1044, 1052–55 (1994) (upholding a ten percent marketability discount for a trust having a note as its principal asset when the restrictions on the note's transferability weighed against its low credit risk).

89. *See Barudin*, 72 T.C.M. (CCH) at 494; *Luton*, 68 T.C.M. (CCH) at 1052–55.

90. *See Mandelbaum*, 69 T.C.M. (CCH) at 2864 (describing its list of factors as "nonexclusive").

91. *See id.* (describing "the fundamental elements of value" considered by investors); *see, e.g.*, Estate of Desmond v. Comm'r, 77 T.C.M. (CCH) 1529, 1532–33 (1999) (accepting an expert's modification of the *Mandelbaum* factors where the expert included potential environmental liabilities that a hypothetical buyer would consider rather than the cost of a public offering and also modified the factor comparing the values of publicly and privately held stock to the availability of a public market).

92. 72 T.C.M. (CCH) 488, 494 (1996).

93. 68 T.C.M. (CCH) 1044, 1052–55 (1994).

94. *See Barudin*, 72 T.C.M. (CCH) at 494; *Luton*, 68 T.C.M. (CCH) at 1052–55.

discounts necessary in both cases.[95]

In order to use the *Mandelbaum* balancing process to determine the appropriate degree for a marketability discount, the taxpayer must provide sufficiently detailed evidence in the record for the court to evaluate.[96] If the taxpayer does not do so, the court will decline to use the balancing process.[97] Thus, the *Mandelbaum* balancing process does not alter the fundamental presumption that the Service's valuation is correct.[98]

III. THE FIFTH CIRCUIT CREATED A CIRCUIT SPLIT OVER HOW TO VALUE NONTRANSFERABLE LOTTERY PRIZES

The question of the proper method of valuing a nontransferable lottery prize for estate tax purposes first arose when the U.S. Court of Appeals for the Ninth Circuit affirmed a departure from the § 7520 tables after holding that the tables produced an unrealistic and unreasonable result by failing to consider the lack of marketability of nontransferable lottery winnings.[99] The Second Circuit agreed.[100] However, the Fifth Circuit created a circuit split when it held that an estate must use the § 7520 tables to value nontransferable lottery winnings without a marketability discount.[101]

A. *The Ninth and Second Circuits Departed from the Section 7520 Valuation Tables and Allowed a Marketability Discount for Nontransferable Lottery Prizes*

The Ninth and Second Circuits confronted similar fact patterns in

95. *See Barudin*, 72 T.C.M. (CCH) at 494; *Luton*, 68 T.C.M. (CCH) at 1053–55.

96. *See, e.g.*, Estate of Kaufman v. Comm'r, 77 T.C.M. (CCH) 1779, 1789–90 (1999) (refusing to apply the *Mandelbaum* factors because of the insufficient record), *rev'd on other grounds sub nom.* Morrissey v. Comm'r, 243 F.3d 1145 (9th Cir. 2001); Estate of Scanlan v. Comm'r, 72 T.C.M. (CCH) 613, 615 (1996) (affirming the Tax Court's prior refusal to apply the *Mandelbaum* factors because of the insufficient record); Estate of Cloutier v. Comm'r, 71 T.C.M. (CCH) 2001, 2003 (1996) (refusing to apply the *Mandelbaum* factors when the expert's report contained "no meaningful discussion of any of the factors of valuation").

97. *See Kaufman*, 77 T.C.M. (CCH) at 1789–90.

98. *See* Estate of Gilford v. Comm'r, 88 T.C. 38, 51 (1987) (citing Welch v. Helvering, 290 U.S. 111, 115 (1933)) (explaining the presumption that the Service's assessment of value is correct).

99. *See* Shackleford II, 262 F.3d 1028, 1032–33 (9th Cir. 2001).

100. *See* Gribauskas II, 342 F.3d 85, 88–89 (2d Cir. 2003).

101. Cook v. Comm'r, 349 F.3d 850, 857 (5th Cir. 2003).

Shackleford v. United States[102] and *Estate of Gribauskas v. Commissioner.*[103] The lottery winners in both cases received their winnings as twenty-year annuities and died after receiving only two and three payments, respectively.[104] In both jurisdictions, the right to receive these lottery winnings was nontransferable.[105] In light of these facts, both circuits ultimately departed from the valuation tables and applied a marketability discount to the nontransferable lottery winnings.[106]

In *Shackleford*, the estate paid the tax computed by the § 7520 tables, but later claimed the tables overvalued the winnings and sued the Service for a refund in federal district court.[107] At trial, the estate's primary valuation expert disregarded the § 7520 tables' interest rate of 10.4%; instead, he studied the discount rates for other comparable assets in order to arrive at a thirty-five percent discount rate.[108] This gave the lottery prize a value of only $1,900,000,[109] in contrast to the tables' value of $4,023,903.[110]

The district court stated that "[t]he 'reality' of a decedent's economic interest" in the asset was a major component of its value,[111] and accordingly held that the lack of marketability must be considered when valuing the lottery prize for estate tax purposes.[112] The court thus concluded that the estate's departure from the valuation tables was warranted because the tables produced an unrealistic and unreasonable result by failing to consider lack of marketability.[113] However, the court declined to accept the estate's valuation because the estate did not make adjustments for various other factors, including the lack of risk of the lottery payments.[114]

The Ninth Circuit affirmed the district court's conclusion that the

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102. 262 F.3d 1028 (9th Cir. 2001).

103. 342 F.3d 85 (2d Cir. 2003).

104. *See id.* at 86; *Shackleford II*, 262 F.3d at 1030.

105. *See Gribauskas II*, 342 F.3d at 86; *Shackleford II*, 262 F.3d at 1030.

106. *See Gribauskas II*, 342 F.3d at 88–89; *Shackleford II*, 262 F.3d at 1032–33.

107. *See Shackleford II*, 262 F.3d at 1030.

108. Brief for the Appellees at 10–11, *Shackleford II* (No. 99-17541).

109. *Id.* at 11.

110. *See* Shackleford v. United States, No. CIV.S.96-1370LKKPAN, 1999 WL 744121, at *2 (E.D. Cal. Aug. 6, 1999) [hereinafter *Shackleford I*], *aff'd*, 262 F.3d 1028 (9th Cir. 2001).

111. *See id.* at *4 (citing Helvering v. Safe Deposit Trust Co., 316 U.S. 56, 58 n.1 (1946)).

112. *See id.* at *5.

113. *See id.*

114. *See id.* at *3.

nontransferability of the lottery winnings justified a marketability discount.[115] The court explained that the right to transfer is an important property right, and that the transfer restrictions on the remaining lottery payments accordingly reduced their fair market value.[116] The court noted that the case law authorizes either a modification of the tables' value or a complete departure from the tables when they produce an unrealistic and unreasonable result that does not reasonably approximate fair market value.[117] The Ninth Circuit affirmed the district court's conclusion that the tables produced an unrealistic and unreasonable result because the tables did not consider the important element of marketability,[118] and held that this result justified the district court's departure from the tables.[119]

In *Gribauskas*, the estate valued the lottery winnings using a higher discount rate than the § 7520 rate, and the Service assessed a tax deficiency against the estate.[120] In response, the estate filed a petition in Tax Court contesting the Service's valuation.[121] The parties disagreed about how to value the lottery annuity.[122] While the Service used the § 7520 discount rate of 9.4%, the estate calculated a discount rate of fifteen percent.[123] The value produced by the § 7520 tables was more than $900,000 over the estate's valuation.[124] The Service stipulated that the estate's figure would be correct if the tables were not used.[125] The Tax Court held that the § 7520 tables provided the proper method for valuing the winnings and that the winnings should not receive a marketability discount.[126] The Tax Court emphasized that the valuation tables serve the important function of increasing consistency and efficiency, and that courts have narrowly construed any exceptions to

115. *See* Shackleford II, 262 F.3d 1028, 1032–33 (9th Cir. 2001).

116. *See id.* at 1032.

117. *See id.* at 1031–32.

118. *See id.* at 1032–33.

119. *See id.* at 1029.

120. *See* Gribauskas II, 342 F.3d 85, 86–87 (2d Cir. 2003).

121. *See id.* at 87.

122. Estate of Gribauskas v. Comm'r, 116 T.C. 142, 148 (2001) [hereinafter *Gribauskas I*], *rev'd*, 342 F.3d 85 (2d Cir. 2003).

123. *Id.* In arriving at the fifteen percent rate, the expert considered "risk, inalienability, illiquidity, and lack of marketability." *Id.*

124. *See Gribauskas II*, 342 F.3d at 86–87.

125. *See id.* at 87.

126. *Gribauskas I*, 116 T.C. at 163–65.

their use.[127]

On appeal, the Second Circuit reversed the Tax Court's decision.[128] The Second Circuit recognized that the pre-*Shackleford* cases in which courts allowed departures from the tables involved situations where there was an inconsistency between a factual assumption of the tables and the facts of the case.[129] However, the Second Circuit held that the same reasoning that required departures from the tables in those cases also required departures from the tables in cases involving a substantial error in the tables' ultimate valuation result.[130] The court explained that the party seeking to depart from the tables has the considerable burden of proving that the tables' value is unrealistic and unreasonable; this burden preserves the consistency the tables provide in most cases.[131] Thus, both the Ninth and Second Circuits departed from the strict use of the valuation tables because the tables produced an unrealistic and unreasonable result by failing to consider the lack of marketability of nontransferable lottery winnings.[132]

B. *The Fifth Circuit Held that Nontransferable Lottery Prizes Must Be Valued Using the Section 7520 Tables Without a Marketability Discount*

In contrast to the Second and Ninth Circuits, the Fifth Circuit held in *Cook v. Commissioner*[133] that a marketability discount was inappropriate for nontransferable lottery winnings.[134] Cook and her sister-in-law won the lottery as joint participants in a partnership devoted to the purchase of lottery tickets.[135] Cook died after the partnership had received only one annual payment from a twenty-year annuity,[136] and the state

127. *See id.* at 162.

128. *Gribauskas II*, 342 F.3d at 86.

129. *See id.* at 88. For an example where the interest rate assumption of valuation tables was inconsistent with the facts of the case, see, e.g., Berzon v. Comm'r, 534 F.2d 528, 532 (2d Cir. 1976) (explaining that the taxpayers could not use the tables because they would produce a clearly erroneous valuation for an asset that would produce no income).

130. *See Gribauskas II*, 342 F.3d at 89.

131. *See id.*

132. *See id.* at 88–89; Shackleford II, 262 F.3d 1028, 1032–33 (9th Cir. 2001).

133. 349 F.3d 850 (5th Cir. 2003).

134. *See id.* at 857.

135. *Id.* at 852. The partnership element did not alter the core issue of how the court valued the lottery winnings. *See id.* at 853–54.

136. *Id.* at 851–52.

prohibited assignment of the right to receive the lottery winnings without a court order.[137] Cook's valuation expert used a discounted cash flow method that incorporated a marketability discount to value the estate's interest in the partnership at $1,529,749.[138] The Service assessed a deficiency judgment against the estate after determining that the tables' valuation of the interest was $3,222,919.[139] The Tax Court held that the § 7520 tables provided the appropriate method for valuing the lottery winnings.[140] The estate appealed to the Fifth Circuit.[141]

The Fifth Circuit affirmed, holding that the § 7520 tables provided the appropriate method for valuing nontransferable lottery winnings payable to a decedent's estate.[142] According to the *Cook* court, the § 7520 tables provide certainty in valuation that is more important than accuracy in individual cases, except in those cases where the tables' value is unrealistic and unreasonable.[143] The court criticized the *Gribauskas* and *Shackleford* courts' departures from the tables on the grounds that, before *Shackleford*, courts had departed from the tables only when those tables made incorrect factual assumptions.[144] The *Cook* court determined that the tables did not make an incorrect factual assumption about marketability, and refused to apply the exception for unrealistic and unreasonable results on the basis of its conclusion that marketability was not an appropriate factor to consider in determining the value of the lottery winnings.[145]

The *Cook* court opined that a marketability discount is inappropriate for any asset that involves the right to receive a stream of payments that are not affected by market forces.[146] It stated that marketability should be considered only when capital appreciation is relevant to value or when value is otherwise difficult to calculate in the absence of a market

137. *Id.* at 851.

138. *Id.* at 852.

139. *Id.*

140. *See id.*

141. *Id.* at 851–52.

142. *Id.* at 851.

143. *Id.* at 854 (citing O'Reilly v. Comm'r, 973 F.2d 1403, 1407 (8th Cir. 1992)).

144. *See id.* at 856.

145. *See id.* at 856–57. In contrast, Judge Davis argued in his dissenting opinion that "the better rule, as recognized by the 2nd and 9th Circuits, is to consider any factor that affects the annuity's fair market value, including its nonmarketability." *Id.* at 859–60 (Davis, J., dissenting).

146. *Id.* at 856.

exchange.[147] The court reasoned that because the § 7520 tables could reduce the remaining annuity payments of the lottery prize to present value, their value was readily ascertainable and a marketability discount was inappropriate.[148]

IV. COURTS SHOULD MODIFY THE SECTION 7520 TABLES' VALUE WITH A LIMITED-PERCENTAGE MARKETABILITY DISCOUNT

Neither side of the current circuit split correctly values nontransferable lottery winnings because neither side considers both of the factors that are fundamental to their value:[149] the stability of the payments and their lack of legal transferability.[150] An approach derived from *Mandelbaum*[151] provides a more realistic and reasonable method of valuing nontransferable lottery winnings. This approach begins with the tables' valuation and weighs stability against lack of transferability to determine the appropriate degree for a limited-percentage marketability discount to modify the § 7520 tables' value.[152]

A. *Both Sides of the Circuit Split Are Incorrect in Their Approaches to Valuing Nontransferable Lottery Winnings*

Neither side of the circuit split correctly values nontransferable lottery winnings because neither side considers both of the key elements affecting their value:[153] stability and lack of transferability.[154] The

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147. *See id.* at 857.

148. *See id.*

149. *Compare id.* at 856–57 (prohibiting a marketability discount for lack of transferability), *with* Gribauskas II, 342 F.3d 85 (2d Cir. 2003) (failing to mention any adjustment for stability), *and* Shackleford II, 262 F.3d 1028 (9th Cir. 2001) (same).

150. *See Cook*, 349 F.3d at 856–57 (focusing on stability as the primary reason to prohibit a marketability discount); *Gribauskas II*, 342 F.3d at 88 (focusing on transferability to justify a marketability discount); *Shackleford II*, 262 F.3d at 1032–33 (same).

151. *See* Mandelbaum v. Comm'r, 69 T.C.M. (CCH) 2852, 2867–69 (1995), *aff'd without published op.*, 91 F.3d 124 (3d Cir. 1996) (describing the court's process in determining an appropriate marketability discount).

152. *See infra* Part IV.B.

153. *Compare Cook*, 349 F.3d at 856–57 (prohibiting a marketability discount for lack of transferability), *with Gribauskas II*, 342 F.3d 85 (failing to mention any adjustment for stability), *and Shackleford II*, 262 F.3d 1028 (same).

154. *See Cook*, 349 F.3d at 856–57 (focusing on stability as the primary reason to prohibit a marketability discount); *Gribauskas II*, 342 F.3d at 88 (focusing on transferability to justify a marketability discount); *Shackleford II*, 262 F.3d at 1032–33 (same).

Second and Ninth Circuits departed from the valuation tables when they held that a marketability discount was appropriate for nontransferable lottery winnings due to their lack of legal transferability.[155] However, these circuits did not require the stable payment structure of the lottery winnings to limit the degree of this marketability discount.[156] In contrast, the Fifth Circuit held that a marketability discount was unwarranted for the lottery payments due to their stability and predictability, despite their lack of legal transferability.[157] Thus, neither side of the circuit split correctly valued nontransferable lottery winnings because neither side considered both of the fundamental elements of stability and lack of legal transferability as part of the valuation process.

1. The Second and Ninth Circuits' Approaches Are Incorrect Because They Do Not Require Use of the Section 7520 Tables and Do Not Limit the Degree of the Marketability Discount

The Second and Ninth Circuits erred in valuing nontransferable lottery winnings because they did not explicitly require the use of the valuation tables and did not require any limitation on the marketability discount for these winnings.[158] First, the Second and Ninth Circuits erred by failing to require the use of the valuation tables as a starting point from which to value nontransferable lottery winnings.[159] These tables create efficiency and consistency in most cases, and courts narrowly construe any exceptions to their use.[160] However, use of the tables alone is inappropriate when they produce an unrealistic and unreasonable result.[161] In such a case, modifying the tables' value produces a more realistic and reasonable result than abandoning the tables completely because the tables perform the important task of reducing the future

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155. *See Gribauskas II*, 342 F.3d at 88–89; *Shackleford II*, 262 F.3d at 1029, 1033.

156. *See generally Gribauskas II*, 342 F.3d 85 (failing to mention any adjustment for stability); *Shackleford II*, 262 F.3d 1028 (same).

157. *See Cook*, 349 F.3d at 857.

158. *See generally Gribauskas II*, 342 F.3d 85 (failing to require use of the valuation tables and failing to mention any adjustment for stability); *Shackleford II*, 262 F.3d 1028 (same).

159. *See generally Gribauskas II*, 342 F.3d 85 (failing to require use of the valuation tables); *Shackleford II*, 262 F.3d 1028 (same).

160. *See* Gribauskas I, 116 T.C. 142, 162 (2001), *rev'd on other grounds*, 342 F.3d 85 (2d Cir. 2003).

161. *See* O'Reilly v. Comm'r, 973 F.2d 1403, 1407 (8th Cir. 1992) (quoting Weller v. Comm'r, 38 T.C. 790, 803 (1962)).

stream of annuity payments to present value,[162] a necessary step in any lottery valuation case.[163]

Second, while the Second and Ninth Circuits allowed marketability discounts for nontransferable lottery winnings,[164] these circuits erred in ignoring the element of stability[165] that should limit the degree of such marketability discounts. The district court in *Shackleford* recognized the importance of stability when it refused to accept the estate's valuation because the estate did not adjust for factors including the lack of risk of the lottery payments.[166] The Tax Court also demonstrated in *Mandelbaum* that elements of stability limit the appropriate marketability discount for stock.[167] The Tax Court has extended this principle to other types of assets.[168] Thus, requiring the use of the tables as the base from which to apply a marketability discount and limiting the degree of this marketability discount to account for the stability of the lottery payments produces a more realistic and reasonable result than the Second and Ninth Circuits' approach.

2. *The Fifth Circuit's Approach Is Incorrect Because It Does Not Allow a Marketability Discount to Account for Lack of Transferability When Valuing Nontransferable Lottery Winnings*

The Fifth Circuit erred in refusing to allow a marketability discount

162. *See* I.R.S. Notice 89-24, 1989-1 C.B. 660 (1989).

163. *See* Cook v. Comm'r, 349 F.3d 850, 857 (5th Cir. 2003); EDWARD P. WOJNAROSKI, JR., PRIVATE ANNUITIES AND SELF-CANCELING INSTALLMENT NOTES A-93 (Tax Mgmt., Inc., Estates, Gifts, & Trusts Portfolio Series 805-2d, 2002) (explaining that "the federal estate value of lottery payments equals the present value of the right to receive periodic annuity payments").

164. *See Gribauskas II*, 342 F.3d at 88–89; *Shackleford II*, 262 F.3d at 1033.

165. *See generally Gribauskas II*, 342 F.3d 85 (failing to mention any adjustment for stability); *Shackleford II*, 262 F.3d 1028 (same).

166. *See* Shackleford I, No. CIV.S.96-1370LKKPAN, 1999 WL 744121, at *3 (E.D. Cal. Aug. 6, 1999), *aff'd*, 262 F.3d 1028 (9th Cir. 2001). Although the Ninth Circuit affirmed the district court's decision, *see Shackleford II*, 262 F.3d at 1032–33, it did not discuss the importance of limiting the marketability discount for lottery winnings due to their stability. *See generally Shackleford II*, 262 F.3d 1028.

167. *See* Mandelbaum v. Comm'r, 69 T.C.M. (CCH) 2852, 2867–68 (1995), *aff'd without published op.*, 91 F.3d 124 (3d Cir. 1996) (discussing how Big M's strong financial statements, dividend policy, economic outlook, and management favored a low marketability discount).

168. *See, e.g.*, Estate of Barudin v. Comm'r, 72 T.C.M. (CCH) 488, 494 (1996) (weighing stable management and distribution history against lack of a public market and restrictions on transfer of a partnership interest); Estate of Luton v. Comm'r, 68 T.C.M. (CCH) 1044, 1053–55 (1994) (weighing low credit risk against restrictions on transferability for a note that was the primary asset of a trust).

for nontransferable lottery winnings.[169] When the right to receive lottery winnings is not legally transferable, this limitation justifies a marketability discount.[170] The right to transfer is an important property right, and the legal absence of this right reduces the fair market value of nontransferable lottery winnings accordingly.[171] Because the § 7520 tables do not consider the element of marketability, they produce an unrealistic and unreasonable result for nontransferable lottery winnings.[172]

The Fifth Circuit's rationale—that a marketability discount is inappropriate because the present value of the lottery prize is readily ascertainable[173]—fails to consider the purpose of a marketability discount.[174] The purpose of a marketability discount is not simply to determine value that is difficult to ascertain, but to recognize that an asset with limited transferability is inherently less valuable than an asset with no transferability restrictions.[175] While nontransferable lottery winnings have an intrinsically stable value,[176] their lack of legal transferability significantly limits this value.[177] Thus, courts should not value nontransferable lottery winnings without considering the limitation on their transferability.

B. *Courts Should Modify the Section 7520 Tables' Value with a Limited-Percentage Marketability Discount to Produce a More Realistic and Reasonable Valuation*

Courts should modify the § 7520 tables' value with a limited-percentage marketability discount, calculated by weighing stability against lack of transferability, in order to produce a more realistic and

169. *See* Cook v. Comm'r, 349 F.3d 850, 856–57 (5th Cir. 2003) (denying a marketability discount because of the stability and predictability of payments).

170. *See Shackleford II*, 262 F.3d at 1029.

171. *See id.* at 1032–33.

172. *See id.*

173. *See Cook*, 349 F.3d at 856–57 (denying a marketability discount because of the stability and predictability of payments).

174. *See* Cooley v. Comm'r, 33 T.C. 223, 225 (1959) (explaining that marketability is relevant when valuing an asset to account for the fact that an asset is inherently less valuable when its marketability is restricted).

175. *See id.*

176. *See Cook*, 349 F.3d at 855 (noting the low risk of lottery payments and their immunity from market forces).

177. *See Shackleford II*, 262 F.3d at 1032–33.

reasonable valuation result for nontransferable lottery winnings. Courts have the discretion to modify an unrealistic and unreasonable result of the valuation tables.[178] Because lack of marketability is the factor that makes the tables' valuation of nontransferable lottery winnings unrealistic and unreasonable,[179] a marketability discount is the appropriate method of modifying the tables' value. A balancing approach derived from *Mandelbaum* weighs the stability of lottery winnings against restrictions on their transfer in order to create a limited-percentage marketability discount, which modifies the tables' value[180] and produces a more realistic and reasonable valuation for nontransferable lottery winnings.

1. Courts Should Modify the Section 7520 Tables' Value When Valuing Nontransferable Lottery Winnings

When valuing nontransferable lottery winnings, courts should use their discretion to modify the § 7520 tables' value.[181] When the valuation tables produce an unrealistic and unreasonable result, courts have the discretion to modify this result rather than disregarding the tables entirely.[182] Although the § 7520 tables do not consider marketability, they provide the interest rate component necessary to reduce payments over a term of years to present value.[183] Thus, a court should not disregard the tables entirely when valuing nontransferable lottery winnings because the tables are still capable of performing the important function of reducing the stream of future annuity payments to present value.

Before *Shackleford*, courts departed from the valuation tables in cases where the tables made incorrect factual assumptions.[184] If a fundamental

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178. *See id.* at 1031; O'Reilly v. Comm'r, 973 F.2d 1403, 1407 (8th Cir. 1992) (quoting Weller v. Comm'r, 38 T.C. 790, 803 (1962)).

179. *See Cook,* 349 F.3d at 855–56 (explaining that the only difference between the tables' valuation and the experts' valuation of the lottery prize was that the experts used marketability discounts).

180. *See infra* Part IV.B.3.

181. *See O'Reilly,* 973 F.2d at 1407 (quoting *Weller,* 38 T.C. at 803) (noting the court's discretion to modify the tables' value).

182. *See Shackleford II,* 262 F.3d at 1031; *O'Reilly,* 973 F.2d at 1407 (quoting *Weller,* 38 T.C. at 803).

183. *See* I.R.S. Notice 89-24, 1989-1 C.B. 660.

184. *See Cook,* 349 F.3d at 856 (explaining that prior to *Shackleford II,* courts had departed from the valuation tables only where those tables made incorrect factual assumptions); Gribauskas II, 342 F.3d 85, 88–89 (2d Cir. 2003) (acknowledging that prior to *Shackleford II,* courts had departed from

assumption of the tables is incorrect, it is reasonable to disregard the tables' value because the tables are no longer capable of correctly performing their primary function of reducing a stream of future payments to present value.[185] However, this does not hold true when the tables produce an unrealistic and unreasonable result for a reason unrelated to one of their fundamental assumptions.[186]

When the tables produce an unrealistic and unreasonable result for a reason unrelated to one of their fundamental assumptions, they should retain an important role in the valuation process.[187] The § 7520 tables perform the important function of reducing the future payment stream of an annuity to present value.[188] This step is necessary in any lottery valuation case.[189] The only elements the § 7520 tables consider are interest rate and term of years.[190] Thus, if there are no flaws in the tables' assumptions regarding either of these elements, the tables correctly perform a necessary valuation step by reducing future lottery payments to present value, and there is no reason to disregard their result entirely.

2. *A Marketability Discount Is the Appropriate Way to Modify the Section 7520 Tables' Value Because Lack of Marketability Makes the Tables' Unmodified Valuation Unrealistic and Unreasonable*

The § 7520 tables may produce an unrealistic and unreasonable result for nontransferable lottery winnings because of their failure to account for marketability.[191] Therefore, a marketability discount is the appropriate method to modify this result. Modifying the tables' value

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the valuation tables only where those tables made incorrect factual assumptions, but concluding that the same reasoning was applicable to cases where the tables produce an unrealistic and unreasonable result).

185. *See, e.g.*, Berzon v. Comm'r, 534 F.2d 528, 532 (2d Cir. 1976) (explaining that the taxpayers could not use the tables to value an asset because the tables would produce a clearly erroneous valuation for an asset that would produce no income).

186. *See, e.g.*, *Gribauskas II*, 342 F.3d at 88–89 (holding that the tables produced an unrealistic and unreasonable result because they did not consider marketability, not because one of their fundamental assumptions was incorrect).

187. *See Cook*, 349 F.3d at 857 (describing the tables' role in reducing the stream of future lottery payments to present value).

188. *See* I.R.S. Notice 89-24, 1989-1 C.B. 660.

189. *See Cook*, 349 F.3d at 857; WOJNAROSKI, *supra* note 163, at A-93 ("[T]he federal estate value of lottery payments equals the present value of the right to receive periodic annuity payments.").

190. *See* I.R.S. Notice 89-24, 1989-1 C.B. 660.

191. *See Cook*, 349 F.3d at 856.

through a marketability discount is particularly appropriate because a discount can be applied on top of an existing valuation result; it does not require a new method of valuation.[192] The use of the tables to complete the initial valuation step thus does not preclude modification by a marketability discount. The tables discount a future stream of annuity payments to their present value,[193] which is a necessary step in valuing the lottery winnings.[194] A marketability discount acknowledges that a nontransferable asset is inherently less valuable than a freely transferable asset.[195] Thus, once the tables complete the first step in the valuation process, courts should apply a marketability discount to modify the tables' value.

3. *The* Mandelbaum *Balancing Process Calculates an Appropriate Limited-Percentage Marketability Discount by Weighing the Two Fundamental Attributes of Nontransferable Lottery Winnings*

The *Mandelbaum* approach of balancing factors favoring a high marketability discount against factors favoring a low marketability discount[196] is particularly appropriate for nontransferable lottery winnings because it requires the stability of the lottery winnings to limit the degree of the marketability discount.[197] The stability of the payments and the statutory restrictions on their transfer are the two fundamental factors considered by courts in determining whether to apply a marketability discount to nontransferable lottery winnings for estate tax valuation purposes.[198] Accordingly, balancing these two factors produces a limited-percentage marketability discount that can modify the § 7520

192. *See* BOGDANSKI, *supra* note 39, at 3-74 (describing the marketability discount process for closely held stock); *see, e.g.*, Estate of Barudin v. Comm'r, 72 T.C.M. (CCH) 488, 493–94 (1995) (valuing a partnership interest by first applying a capitalization rate to reduce lease income to present value, then applying minority and marketability discounts to the per-unit liquidation value of the interest).

193. *See* I.R.S. Notice 89-24, 1989-1 C.B. 660.

194. *See Cook*, 349 F.3d at 857.

195. *See* Mailloux v. Comm'r, 320 F.2d 60, 62 (5th Cir. 1963); Cooley v. Comm'r, 33 T.C. 223, 225 (1959); Blanton, *supra* note 3, at 447.

196. *See* Mandelbaum v. Comm'r, 69 T.C.M. (CCH) 2852, 2867–69 (1995), *aff'd without published op.*, 91 F.3d 124 (3d Cir. 1996).

197. *See id.* at 2867–68 (discussing how Big M's strong financial statements, dividend policy, economic outlook, and management favored a low marketability discount).

198. *See Cook*, 349 F.3d at 856 (focusing on stability as the primary reason to prohibit a marketability discount); Gribauskas II, 342 F.3d 85, 88 (2d Cir. 2003) (focusing on transferability to justify a marketability discount); Shackleford II, 262 F.3d 1028, 1032–33 (9th Cir. 2001) (same).

tables' value and produce a more realistic and reasonable valuation for nontransferable lottery winnings.

The Tax Court weighs stability against transfer restrictions to reach an appropriate marketability discount to value various types of assets.[199] In cases where the court has applied this approach, it has reached a limited-percentage marketability discount.[200] Because Tax Court precedent supports weighing stability against transfer restrictions for various types of assets,[201] this process is appropriate for nontransferable lottery winnings as well.

The *Mandelbaum* approach for determining an appropriate discount for privately held stock is particularly appropriate for nontransferable lottery winnings because the assets share several common elements. In *Mandelbaum*, there was no recognized public market for shares,[202] which corresponds to lottery winnings that are not legally transferable.[203] While the restrictive shareholders' agreements in *Mandelbaum* prevented shares from being transferred outside the family without the right of first refusal,[204] the transfer restrictions on nontransferable lottery winnings prevent them from being legally transferred to anyone.[205] Finally, the stock in *Mandelbaum* had elements of stability that limited its marketability discount.[206] Because lottery payments are stable,[207] their stability should similarly lower their marketability discount.

For nontransferable lottery winnings, the result from the § 7520 tables

199. *See, e.g.*, Estate of Barudin v. Comm'r, 72 T.C.M. (CCH) 488, 494 (1996) (calculating the marketability discount for a partnership interest by weighing stable management and distribution history against lack of a public market and restrictions on transferability); *Mandelbaum*, 69 T.C.M. (CCH) at 2867–69 (calculating the marketability discount for privately held stock); Estate of Luton v. Comm'r, 68 T.C.M. (CCH) 1044, 1053–55 (1994) (allowing a marketability discount for trust having a note as its principal asset when the restrictions on the note's transferability weighed against its low credit risk).

200. *See Barudin*, 72 T.C.M. (CCH) at 494 (applying a twenty-six percent discount); *Mandelbaum*, 69 T.C.M. (CCH) at 2869 (applying a thirty percent discount); *Luton*, 68 T.C.M. (CCH) at 1055 (reaching a ten percent discount).

201. *See Barudin*, 72 T.C.M. (CCH) at 494; *Mandelbaum*, 69 T.C.M. (CCH) at 2867–69; *Luton*, 68 T.C.M. (CCH) at 1053–55.

202. *See Mandelbaum*, 69 T.C.M. (CCH) at 2864.

203. *See Gribauskas II*, 342 F.3d at 86; *Shackleford II*, 262 F.3d at 1030.

204. *See Mandelbaum*, 69 T.C.M. (CCH) at 2856.

205. *See Gribauskas II*, 342 F.3d at 86; *Shackleford II*, 262 F.3d at 1030.

206. *See Mandelbaum*, 69 T.C.M. (CCH) at 2867–68 (discussing how Big M's strong financial statements, dividend policy, economic outlook, and management favored a low marketability discount).

207. *See* Cook v. Comm'r, 349 F.3d 850, 855 (5th Cir. 2003).

is equivalent to the result from the first of the two *Mandelbaum* steps.[208] The first *Mandelbaum* step arrives at a base value from which the court can apply an appropriate marketability discount.[209] In *Mandelbaum*, the parties agreed on this base value by stipulating the value of freely traded stock.[210] For nontransferable lottery winnings, the § 7520 tables provide the mechanism for discounting the aggregate remaining annuity payments to present value.[211] The tables' value is thus the starting point equivalent to the first *Mandelbaum* step because it provides a base to which the court can apply a marketability discount.

The second *Mandelbaum* step, which involves determining the relevant factors and calculating an appropriate marketability discount,[212] requires modification in order to value nontransferable lottery winnings. The *Mandelbaum* court's nonexclusive list of elements of value included ten factors.[213] However, some of the *Mandelbaum* factors are not suitable for the valuation of a lottery prize because the *Mandelbaum* case dealt with the valuation of stock.[214] Stock issued by a private corporation and lottery winnings paid by a state government are inherently different.[215]

A majority of the *Mandelbaum* factors relate to the two fundamental attributes of nontransferable lottery winnings: stability and lack of legal

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208. For an explanation of why the tables should be used initially, see *supra* Part IV.B.1.

209. *See Mandelbaum*, 69 T.C.M. (CCH) at 2864.

210. *See id.*

211. *See Cook*, 349 F.3d at 857.

212. *See Mandelbaum*, 69 T.C.M. (CCH) at 2864; *see also* Estate of Kaufman v. Comm'r, 77 T.C.M. (CCH) 1779, 1784 (1999) (describing the two-step process), *rev'd on other grounds sub nom.* Morrissey v. Comm'r, 243 F.3d 1145 (9th Cir. 2001).

213. *Mandelbaum*, 69 T.C.M. (CCH) at 2864; *see also supra* note 82 (listing *Mandelbaum* factors).

214. *See Mandelbaum*, 69 T.C.M. (CCH) at 2864.

215. *See id.* at 2864 (listing the ten factors the Tax Court considered in valuing Big M's stock). For example, the factor comparing the difference in value between publicly and privately traded stock does not apply to nontransferable lottery winnings because there is no equivalent to public and private markets for assets that are not legally transferable. A "gray market" for these winnings at a significant discount may exist. Shackleford I, No. CIV.S.96-1370LKKPAN, 1999 WL 744121, at **2–3 (E.D. Cal. Aug. 6, 1999), *aff'd*, 262 F.3d 1028 (9th Cir. 2001); *see* Gribauskas II, 342 F.3d 85, 86 (2d Cir. 2003). However, the Tax Court held that this market is irrelevant where the winner cannot legally transfer an enforceable right to payment during his or her lifetime. *See* Gribauskas I, 116 T.C. 142, 164 (2001), *rev'd*, 342 F.3d 85 (2d Cir. 2003). Factors involving the degree of control of the corporation transferred with the stock, the period of time for which an investor must hold stock to realize a profit, and the cost of a public stock offering, *Mandelbaum*, 69 T.C.M. (CCH) at 2864, likewise have no meaningful equivalent in the valuation of a nontransferable lottery prize.

transferability.[216] Four of the *Mandelbaum* factors relate to the stability of the asset being valued: the analysis of the corporation's financial statements; its dividend-paying capacity and history; the nature, history, and economic outlook of the corporation; and its management.[217] Two *Mandelbaum* factors relate to impediments to the transfer of the asset being valued: restrictions on transferability[218] and the corporation's redemption policy.[219] Thus, for the valuation of nontransferable lottery winnings, the *Mandelbaum* factors can be distilled to a two-factor balancing test that focuses on only the two fundamental elements of stability and lack of legal transferability.

This approach furthers the policies of consistency and judicial economy because it increases the burden on the taxpayer, not the burden on the courts.[220] The estate is responsible for submitting sufficient evidence to support the factors favoring a marketability discount for the court to evaluate.[221] Otherwise, the *Mandelbaum* approach is inapplicable,[222] and the unmodified tables remain a reasonable default solution.

V. CONCLUSION

The current circuit split over the estate tax valuation of nontransferable lottery winnings resulted from each circuit's focus on only one of the two equally important characteristics of these prizes—stability and lack of marketability. The *Mandelbaum* approach allows courts to weigh both of these characteristics to achieve an appropriately limited marketability discount. Courts should then apply this discount to the present value of the lottery winnings calculated by the § 7520 tables.

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216. *See Mandelbaum*, 69 T.C.M. (CCH) at 2864.

217. *See id.* All of these factors will likely enhance the value of nontransferable lottery winnings because state-funded lottery payments are quite stable. *See* Cook v. Comm'r, 349 F.3d 850, 855 (5th Cir. 2003).

218. *See Mandelbaum*, 69 T.C.M. (CCH) at 2864.

219. *Id.* This factor is relevant to transferability because the winners of nontransferable lottery winnings paid in the form of an annuity in these cases had no ability to "redeem" the right to receive the annuity payments in exchange for a lump sum payment. *See Cook*, 349 F.3d at 851; *Gribauskas II*, 342 F.3d at 86; *Shackleford I*, 1999 WL 744121, at *1.

220. *See* Estate of Kaufman v. Comm'r, 77 T.C.M. (CCH) 1779, 1789–90 (1999), *rev'd on other grounds sub nom.* Morrissey v. Comm'r, 243 F.3d 1145 (9th Cir. 2001); Estate of Scanlan v. Comm'r, 72 T.C.M. (CCH) 613, 615 (1996).

221. *See Kaufman*, 77 T.C.M. (CCH) at 1789–90 (1999); *Scanlan*, 72 T.C.M. (CCH) at 615.

222. *See Kaufman*, 77 T.C.M. (CCH) at 1789–90.

This approach allows courts to modify unrealistic and unreasonable results of the § 7520 tables by applying a limited-percentage marketability discount that gives appropriate weight to the two fundamental characteristics of nontransferable lottery winnings.