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Anatomy of Valuing Stock in Closely Held Corporations: Pursuing the Phantom of Objectivity into the New Millennium

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THE ANATOMY OF VALUING STOCK IN CLOSELY HELD CORPORATIONS: PURSUING THE PHANTOM OF OBJECTIVITY INTO THE NEW MILLENNIUM

Stephen J. Leacock*

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"[A] court . . . passes judgment according to the law. "[1]

I. INTRODUCTION[2]

Valuing stock in closely-held corporations[3] is one of the most perplexing problems[4] facing the courts.[5] Valuation

[1] Franz Kafka, *Advocates*, *reprinted in* FRANZ KAFKA, THE COMPLETE STORIES AND PARABLES 450 (Nahum N. Glatzer ed., 1983).

[2] Throughout this paper, it is hereby acknowledged that Tax Court Memo decisions are *not* accorded the same precedential authority by the courts as Tax Court decisions. Furthermore, the "Golsen Rule" based upon Golsen v. C.I.R., 54 T.C. 742 (1970), mandates that the Tax Court (T.C.) follow the Court of Appeals that has direct jurisdiction over the particular taxpayer whose case is being adjudicated. If, however, the Court of Appeals that has direct jurisdiction over the particular taxpayer has *not* ruled on the specific issue, the T.C. is then free to decide based upon its own interpretation. The "Golsen Rule" inevitably means that the T.C. could conceivably make diametrically-opposed decisions -- even if based upon identical facts -- depending upon the particular taxpayer's geographical location. However anomalous it may seem, the "Golsen Rule" still remains in force. For example, with regard to a taxpayer living in Texas, if the Fifth Circuit Court of Appeals determined that *no* tax deduction were allowed in the particular case, such taxpayer would *not* be entitled to successfully claim the disputed deduction, even if the Seventh Circuit Court of Appeals had allowed such a deduction. Of course, if the Fifth Circuit Court of Appeals had *not* ruled on the specific issue, and a favorable Seventh Circuit Court of Appeals decision had already been made, then the T.C. could properly make a decision based upon the Seventh Circuit Court of Appeals decision (Professor Harold S. Peckron, in his Critique to the author of Nov. 30, 1999).

[3] A close corporation is generally characterized by (i) ownership held by a small number of shareholders, routinely consisting of members of the same family, (ii) lack of a public market for the transfer of its shares -- usually because of restrictions on the transfer of shares in its articles of incorporation -- and usually, (iii) ownership and management of the corporation are vested in the same persons. 1 O'NEAL & THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.02 (3d ed. 1992) [hereinafter O'NEAL & THOMPSON]. *See also* Rev. Rul. 59-60, 1959-1 C.B. 237, 237. *See, e.g.*, DEL. CODE ANN. tit. 8, § 342 (1967).

[4] "The determination of the value of closely held stock . . . is a matter of judgment, rather than of mathematics." Chiechi, J., Estate of

techniques are complex.[6] Furthermore, the courts may not be sufficiently familiar with accounting and financial theory to effectively resolve the intractable details in a manner satisfactory to all constituents.[7]

Davis v. Comm'r, 110 T.C. 530, 537 (1998) (citing Hamm v. Comm'r, 325 F.2d 934, 940 (8th Cir. 1963), *aff'g* 20 T.C.M. (CCH) 1894 (1961)). *See also* Richard J. Salem v. Comm'r, 75 T.C.M. (CCH) 1798, 1804 (1998). BENJAMIN N. CARDOZO, THE NATURE OF THE JUDICIAL PROCESS 161-62 (1963):

> [T]he duty of a judge becomes itself a question of degree, and he is a useful judge or a poor one as he estimates the measure accurately or loosely. He must balance all his ingredients, his philosophy, his logic, his analogies, his history, his customs, his sense of right, and all the rest, and adding a little here and taking a little there, must determine, as wisely as he can, which weight shall tip the scales.

[5] "Valuation is a question of fact, and the trier of fact must weigh all relevant evidence to draw the appropriate inferences." Gale, J, Estate of Helen Bolton Jameson v. Comm'r, 77 T.C.M (CCH) 1383, 1390 (1999). *See also* Laro, J., Estate of Alice Friedlander Kauffman v. Comm'r, 77 T.C.M. (CCH) 1779, 1782 (1999). "A determination of fair market value . . . [is] a question of *fact* . . . ." Rev. Rul. 59-60, 1959-1 C.B. 237, 238 (emphasis added). "[D]etermin[ing] the value of shares of stock in a closely-held corporation . . . [is] a science which, to use [Sir] Winston Churchill's words, usually results in a 'gross terminal logical inexactitude.'" Dawson, J., Maris v. Comm'r, 41 T.C.M. (CCH) 127, 137 (1980). "[T]he process is so much *a matter of sheer opinion* . . . ." Warren E. Banks, *A Selective Inquiry into Judicial Stock Valuation*, 6 IND. L. REV. 19, 19 (1972) (emphasis added) [hereinafter "Banks"]. Over twenty-one years ago, two commentators extensively analyzed and evaluated judicial approaches to this corporate problem. W. Terrance Schreier & O. Maurice Joy, *Judicial Valuation of "Close" Corporation Stock: Alice In Wonderland Revisited*, 31 OKLA. L. REV. 853 (1978) [hereinafter "Schreier & Joy"]. *See also* Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895 (1978) [hereinafter "Fellows & Painter"]; Comment, *Valuation of Shares in a Closely Held Corporation*, 47 MISS. L.J. 715 (1976). And yet, today similarly thorny issues remain unresolved.

[6] "There are probably few assets whose valuation imposes as difficult, intricate and sophisticated a task as interests in close corporations." Lavene v. Lavene, 372 A.2d 629, 633 (N.J. Super. Ct. App. Div. 1977).

[7] Schreier & Joy, *supra* note 5, at 857.

In fact, valuation of stock in close corporations is required, *inter alia*, in order to assess income taxes when buying or selling such stock[8], and also when such corporations are being reorganized.[9] Moreover, when someone dies and bequeaths shares in a closely held corporation, for estate tax purposes, the IRS is required to assess the value of such shares in determining how much the decedent's estate is worth.[10] Similarly, gifts of shares in a closely-held corpora-

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[8] William J. Rands, *Closely Held Corporations: Federal Tax Consequences of Stock Transfer Restrictions,* 7 J. CORP. L. 449, 450-54 (1982) [hereinafter "Rands: Stock Transfer"]. *See also* William J. Rands, *The Closely Held Corporation: Its Capital Structure and the Federal Tax Laws,* 90 W. VA. L. REV. 1009, 1111-17 (1988).

[9] Use of stock transfer restrictions in this context may prove useful - for tax purposes - in reducing the value of the restricted stock. "[S]tock transfer restrictions affect the value of the underlying stock, more often than not *reducing its value.*" Rands: Stock Transfer, *supra* note 8, at 466 (emphasis added).

[10] *E.g.* In May 1990, the estate of Chicago Bears' late founder, George S. Halas, settled with the IRS after a two-year battle over the taxable value of Halas' share of the football team.

The settlement was the culmination of a protracted tax dispute triggered by a 1981 estate and corporate reorganization, intended to keep the Bears team under family control, while avoiding potentially disastrous tax liabilities for both the Halas' estate and the Bears team. Upon the advice and under the guidance of the Chicago law firm of Kirkland and Ellis, Halas created a holding company and exchanged his Bears stock for preferred stock of the new holding company. The holding company then issued common stock to thirteen separate corporations owned by trusts for Halas' grandchildren.

Since the Bears corporation was a closely held private corporation, there were several methods available for valuing the stock at the time of the reorganization. This being the case, upon Halas' death in 1983, his estate apparently paid tax on his Bears stock based upon a value of approximately $8 million. Yet, according to some estimates, the stock would have been worth $35-$40 million on the open market. The IRS contended that the reorganization placed an artificially low value on the stock held in Halas' name and claimed that the estate owed more than $26 million in back taxes and penalties because of the alleged under-assessment. The May 1990 settlement finally laid all these matters to rest. James Warren, *Tax Victory for Bears' Owners -- IRS Settlement Nets $1.4 Million Refund,* CHI. TRIB., May 15, 1990, § Sports, at 1.

tion - the value of which exceed the annual gift tax exclusion - are subject to taxation.[11] Clarity is therefore critical.[12]

In these contexts, the IRS has defined "value" as connoting "the price at which the property would change hands between a willing buyer and a willing seller - when the former is not under any compulsion to buy; and the latter is not under any compulsion to sell - both parties having reasonable knowledge of relevant facts."[13] However, the concept of value is relative and dependent upon the goals of the particular valuer.[14] There is no objective standard on which judges, academic commentators and practitioners agree.[15]

For instance, with respect to utilizing fair market value, two commentators have concluded that it is appropriate to construct a fair market value, rationally and justifiably, only in circumstances where there exists a market in which

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[11] 26 U.S.C. § 2503(b) (1988).

[12] *See generally* Alan L. Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares,* 122 U. PA. L. REV. 934 (1974).

[13] Rev. Rul. 59-60, 1959-1 C.B. 237, *modified by* Rev. Rul. 65-193, 1965-2 C.B. 370, *modified by* Rev. Rul. 68-609, 1968-2 C.B. 327, *amplified by* Rev. Rul 77-287, 1977-2 C.B. 319, *amplified by* Rev. Rul. 80-213, 1980-2 C.B. 101, *amplified by* Rev. Rul. 83-120, 1983-2 C.B. 170. "[T]he willing buyer - willing seller method posits not only a hypothetical buyer, but also a hypothetical seller." Tashima, J., Estate of McClatchy v. C.I.R, 147 F.3d 1089, 1094 (9th Cir. 1998), *rev'g* 106 T.C. 206 (1996). "The willing buyer and the willing seller to which section 20.2031-1(b), Estate Tax Regs., refers are *hypothetical persons,* rather than specific individuals or entities, and the individual characteristics of those hypothetical persons are not necessarily the same as the individual characteristics of the *actual seller* and the *actual buyer.*" Chiechi, J., Estate of Lynn M. Rogers v. Comm'r, 77 T.C.M. 1831, 1836 (1999) (emphasis added). *See also Estate of Davis,* 110 T.C., *supra* note 4, at 535; Schreier & Joy, *supra* note 5, at 854.

[14] "The hypothetical willing buyer and the hypothetical willing seller are *presumed* to be dedicated to achieving *the maximum economic advantage.*" Chiechi, J., *Estate of Davis,* 110 T.C., *supra* note 4, at 535 (emphasis added).

[15] "In [*Bowen v. Bowen*] the court did not mandate any particular method of valuation or establish one method as generally suitable in valuing interests in close corporations." Allen, C.J., Goodrich v. Goodrich, 613 A.2d 203, 206 (Vt. 1992) (citing Bowen v. Bowen, 473 A.2d 73 (N.J. 1984)).

the stock to be valued is traded.[16] In contrast, a closely held corporation has no definable market[17] and expert testimony is of necessity required in order to generate hypothetical sales transaction prices based upon financial valuation theory.[18]

The problem is that, although both the IRS and the courts strive to conform to meaningful financial theories and adhere to legal precedents, the resulting valuations differ depending upon the type of tax that is imposed and whether the tax law has provided for exceptions to the general valuation approach set out in Rev. Rul. 59-60, 1959-1 C.B. 237.[19] Furthermore, determinations of value with respect to shares in closely-held corporations may differ, depending upon the purposes for which the taxpayer is asserting the particular valuation.[20]

This paper discusses a number of different valuation approaches that the courts have followed, particularly with respect to contested valuations in income, estate, and gift taxation cases.[21]

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[16] Schreier & Joy, *supra* note 5, at 854-55. *See also* Banks, *supra* note 5, at 22. Of course an element of "fairness" must exist in the market, but in modern times, this is presumed by virtue of the assumption that actual sales prices reflect the fair worth of the pertinent stocks. This is reinforced by Professor Banks' observation that: "A 1934 court's distrust of market price seemed to have been *tied to the financial times*, . . ." *Id.* (emphasis added). This is quite convincing, because of the domination of that era by the 'great financial-market crash' of 1929.

[17] "A lack of marketability discount reflects the absence of a recognized market for closely held stock." Mandelbaum v. Comm'r, 69 T.C.M. (CCH) 2852 (1995); *see also* Estate of Trenchard v. Comm'r, 69 T.C.M. (CCH) 2164 (1995); Rev. Rul. 77-287, 1977-2 C.B. 319; Vasquez, J., Estate of William J. Desmond v. Comm'r, 77 T.C.M. (CCH) 1529, 1533 (1999).

[18] Banks, *supra* note 5, at 37-42.

[19] *See supra* note 13.

[20] For example, with the more recent laws in estate planning, taxpayers may no longer have the same incentives that they had in the past to consistently argue for low valuations.

[21] Since valuation of closely-held stock is arguably not a science at all and each case turns on its own unique facts, considerable room to maneuver exists for commentary and criticism by legal and financial

II. VALUATION OF CLOSE CORPORATION STOCK[22]

On principle, valuation of closely-held corporate stock must begin with a full and complete analysis of any restrictive agreements in effect between the shareholders, or any such agreements between the shareholders and the corporation.[23] If, however, the "fair market value" has not been agreed upon contractually between the shareholders in an existing restrictive agreement, then "intrinsic factors"[24] become quintessential. In effect, whereas the determination of 'fair market value' by reference to restrictive agreements is fundamentally contractual in nature, in contrast, a determination based upon "intrinsic factors" more closely resembles a battleground refereed by the courts, on which battles rage between competing financial theories.[25]

III. RECENT CHANGES RELATING TO VALUATION

Very often, judges are not experts in financial theory and as a result, courts have very frequently struck a compromise between, on the one hand, the tendency of the IRS to present overly high valuation estimates to the courts;

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commentators as to whether or not judicial precedent and financial theory are converging or moving farther apart.

[22] "Investors consider transferability restrictions as a factor in determining the worth of that company's stock." *Mandelbaum*, 69 T.C.M. (CCH) at 2868 (citing Harwood v. Comm'r, 82 T.C. 239, 260, 263-64 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986)).

[23] This is essentially a function of construing contracts that have been reduced to writing and is therefore purely a question of law for the court to decide. As a result, the courts have tended to quite strictly enforce any clauses or terms relating to specific values included in such agreements.

[24] *Viz.* Factors relating fundamentally to the financial health and condition of the company (*i.e.*, earning capacity, dividend-paying capacity, and other intangible financial variables).

[25] Schreier & Joy, *supra* note 5, at 857.

and on the other, the taxpayer's preference, usually motivated by self-interest, for overly low estimates.

This practice of "splitting the difference"[26] has no conceptual, theoretical or intellectually convincing basis and tends to be grounded, quite simply, in expediency.[27] Continued adherence to this practice tends to transform the quest for substantive principles into essentially a form of mediation conducted by attorneys, seeking to resolve the differences between the parties on a pragmatic and opportunistic basis. The question is whether or not this is a desirable outcome.

In *Sirloin Stockade, Inc. v. Commissioner*,[28] however, the Tax Court showed significant reluctance to adopt this practice in its valuation of closely-held stock for precisely the reasons mentioned in the preceding paragraph.[29] In *Sirloin Stockade*, an income tax valuation case, Judge Tannenwald adopted the taxpayer's valuation, rather than the more apparently orthodox compromise method. Judge Tannenwald seemed persuaded that the IRS' case was even weaker than the taxpayer's and that apparently, pursuit of a compromise valuation was the IRS' basic goal.[30] If Judge Tannenwald's

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[26] *See, e.g.*, Righter v. United States, 439 F.2d 1204 (Ct. Cl. 1971). The taxpayer proposed $424.90 per share and the Commissioner of Internal Revenue's experts both estimated the per share value at $1,000.00. The Court then determined the per share value to be $700.00.

[27] *Id.* at 1224. (Davis, J., dissenting): "In rendering a [verdict] of $700 per share, the court seems to me to have *no sound basis at all* for its finding . . . ." (emphasis added).

[28] 40 T.C.M. (CCH) 929 (1980). "The sole issue presented is the fair market value of a share of Sirloin common stock . . . -- an issue that should never have gone to trial." *Id.* at 931 (citing Buffalo Tool & Die Mfg. Co. v. Comm'r, 74 T.C. 441 (1974) (slip. op. at 18-19)).

[29] *Id.* at 934. "The overtones of respondent's presentation suggest that he counted on the fact that we would find some middle ground between the values of [petitioner's contentions] and [respondent's contentions]. If that was his objective, he has missed his mark." *Id.*

[30] *Id.* The court concluded that satisfactory proof of the stock values used by both parties had not been properly presented, because neither side had properly produced expert witnesses to provide appropriate testimony on valuation. Indeed, although petitioner's valuation methods were not sufficiently precise, the court seemed even less persuaded by the IRS' approach, which essentially involved attacks on petitioner's valuation methods (rather than presenting its own expert

approach is emulated generally, it will disrupt the current relatively widespread practice of making arbitrary compromises with respect to valuation. In fact, such an approach would unavoidably require arguments based upon demonstrated research and expert testimony before reaching decisions.

Additionally, implementation of the Economic Recovery Tax Act of 1981 (ERTA)[31] is promoting and reinforcing changes in the courts' perception of the most appropriate means of developing fair and just methods of valuation. In interpreting and applying ERTA, the traditional roles of the taxpayer and the IRS are often reversed, with the taxpayer, rather than the IRS, seeking the higher valuation.

For example, ERTA has, in appropriate circumstances, established an unlimited marital deduction,[32] thereby potentially exempting considerable property from otherwise applicable estate tax provisions. As a result, a relatively young widow who inherits securities in a closely-held corporation, which she wishes to sell, can benefit rather favorably from a high valuation. This is the case because such high valuation can then be used as her income tax basis which, on the sale of the business later on, can reduce or even eliminate any capital gains that would have been subject to capital gains tax.[33]

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testimony) apparently in anticipation that the court would strike a compromise by splitting the difference between the two valuations.

[31] Pub. L. No. 97-34 (1981).

[32] "[B]equests of property from a predeceasing spouse to the surviving spouse are *in certain circumstances* eligible for an *unlimited* marital deduction." Colvin, J., Estate of Letts v. Comm'r, 109 T.C. 290, 295 (1997) (emphasis added). "*[W]ith certain limitations*, . . . in computing the value of the estate subject to estate tax a deduction from the gross estate is allowed of an amount equal to *the value of any interest in property* which passes or has passed from the decedent to the surviving spouse." Scott, J., Estate of Bond v. Comm'r, 104 T.C. 652, 655-56 (1995) (emphasis added).

[33] Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403, 95 Stat. 172, 301 (codified as amended at I.R.C. § 2056 (1982)). Other examples where the taxpayer may prefer to argue for a higher valuation might include situations where the estate is attempting to qualify for one or more special relief provisions of the Internal Revenue Code. *See, e.g.*,

IV. RESTRICTIVE AGREEMENTS AND INTRINSIC FACTORS

Before a financial analyst can properly initiate a comprehensive examination of financial and accounting data to determine the value of closely held stock, certain significant factors should be considered. First, if any restrictive agreements:[34] (i) among shareholders, (ii) between shareholders and the corporation, or (iii) expressly included in the corporation's articles of incorporation or by-laws exist, they must be carefully scrutinized, to determine whether such restrictive agreements play a role in the valuation process.[35]

I.R.C. § 303 (1988) (relating to redemptions used to pay death taxes); I.R.C. § 2032A (1988) (relating to special use valuation); I.R.C. § 6166 (1988) (relating to deferred payment of estate taxes), all of which require that the closely-held business interests constitute a certain percentage of the adjusted gross estate.

[34] *Mandelbaum,* 69 T.C.M. (CCH) 2852.

[35] Such restrictions tend to be treated as restraints on alienation under state law and tend to be strictly construed. Crowder Constr. Co. v. Kiser, 517 S.E.2d 178 (N.C. App. 1999). As a result, they may frequently be declared invalid unless limited to a *reasonable* period or to *specific transferees*. Of course, such restrictive agreements can be formulated in a number of ways, but generally can be classified into the following categories: (i) *absolute* prohibitions against transfer ("Absolute restrictions on transfer . . . have almost without exception been held invalid." O'NEAL & THOMPSON, *supra* note 3, §7.07 at 28), prohibitions on transfer to designated persons or classes of persons (if not unreasonable, may be valid, *see, e.g.*, Model Business Corp. Act § 6.27(d)(4) (1994)); (ii) consent restraints (which tend to require the consent of the other shareholders or the corporation before a valid transfer can be effected, *see, e.g.*, *id.* § 6.27(d)(3)); (iii) first refusal rights (these require that any shares to be sold must first be offered to the corporation or to the other shareholders at the proposed sale price, *see, e.g.*, *id.* § 6.27(d)(1)); (iv) options to purchase by the corporation or other shareholders (the option price is usually a fixed one or one determinable by a stated formula, governed by triggering events such as: death, termination of employment, proposed transfer by the stockholder, *see, e.g.*, *id.* § 6.27(d)(1)); (v) mandatory buy-sell agreements (which typically require the estate of the deceased to sell and the corporation to buy the decedent's shares at a fixed price or one based upon a predetermined formula, *see, e.g.*, *id.* § 6.27(d)(2)). *See generally* O'NEAL & THOMPSON, *supra* note 3, at §7.06. *See also* F. Hodge O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting,*

Essentially, the type of restriction in issue, if any, and the nature of the tax to be assessed by the IRS determine the courts' approach in valuing the stock of a closely-held corporation.

V. INCOME TAX CASES

In appropriate instances, closely-held corporation stock is taxable in the hands of the recipient. The tax is levied on the fair market value of such stock received,[36] unless the stock is so subject to restrictions that free and immediate alienation is disabled.[37] The courts' apparent disparate treatment of cases in this context results significantly from the fact that a court may conclude, in appropriate circumstances, that a particular stock has no readily ascertainable[38] fair market value.[39] If so, the court will decline to value the particular stock altogether.[40] In such a situation, the court would postpone realization of income to such time when the restrictions on the stock lapse; or alternatively, until the stock is exchanged pursuant to an arm's-length transaction.[41]

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65 HARV. L. REV. 773, 776 (1952); Schreier & Joy, *supra* note 5, at 865; Jerald D. August & C. Wells Hall, III, 56TH N.Y.U. INSTITUTE ON FEDERAL TAXATION §8.11, 8-119 (1998); Rands: Stock Transfer, *supra* note 8.

[36] "[T]he fair market value of property for tax purposes is . . . a question of fact. . . ." LeVant v. C.I.R., 376 F.2d 434, 442 (7th Cir. 1967).

[37] Schuh Trading Co. v. Comm'r, 95 F.2d 404 (7th Cir. 1938).

[38] Of course, a "locked-in" minority stockholder is legally entitled to inspect appropriate books and records of the close corporation for the limited purpose of determining the value of her/his investment. Thomas & Betts Corp. v. Leviton Mfg. Co., 681 A.2d 1026 (Del. 1996).

[39] In contrast, in those circumstances where the effect of the pertinent restriction merely obligates the taxpayer to satisfy specified requirements prior to sale, such restrictions may have the effect of reducing the present market value of the stock in the close corporation, rather than eliminating all value entirely. Victorson v. C.I.R., 326 F.2d 264, 266-67 (2d Cir. 1964).

[40] Helvering v. Tex-Penn Oil Co., 300 U.S. 481, 499 (1937).

[41] 26 C.F.R. § 1.421-1(d)(2) (stock option provisions). In cases where stock was received as compensation for services rendered, the recipient of the stock is generally taxed when the shares are transferable

Furthermore, when the stock exchanged is of a speculative nature, the courts have tended to treat restrictive agreements between potentially adverse parties differently from those entered into between non-adverse parties.[42] For example, in *Schuh Trading Co. v. Commissioner*,[43] the Court of Appeals for the Seventh Circuit reasoned that speculative stock, which was subject to restrictions and received in an exchange for stock traded on a national stock exchange, cannot be valued effectively so as to determine gain or loss.[44] Additionally, in *United States v. State Street Trust Co.*,[45] the First Circuit Court of Appeals held that certain publicly held utility stock had no ascertainable fair market value when it was received in an exchange transaction because of its highly speculative nature combined with a twelve month restriction on its sale.[46]

In contrast, in *Newman v. Commissioner*,[47] three shareholders of a closely-held corporation agreed among themselves that stock, if received in an exchange transaction, would not be sold without the consent of the other two. The Court of Appeals for the Tenth Circuit declined to rule that the existence of such a restriction deprived the stock of an ascertainable fair market value, reasoning that none of the three shareholders would unreasonably withhold the necessary consent.[48]

The difference in the courts' treatment is essentially controlled by the posture of the parties towards each other. If the parties are potentially adverse, then the courts may very well postpone valuation until a future exchange takes place. Whereas, with respect to closely held corporations, a

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or are not subject to a substantial risk of forfeiture (*i.e.* the courts will not affirm "taxing a phantom"). I.R.C. § 83(a) (1988).

[42] This is more typical in closely-held corporations.

[43] 95 F.2d at 411-12 (finding the restriction on the stock was for six months).

[44] *Id.* at 412.

[45] 124 F.2d 948 (1st Cir. 1942).

[46] *Id.* at 951.

[47] 40 F.2d 225 (10th Cir. 1930).

[48] *Id.* at 227.

restrictive agreement between seemingly non-adverse parties will not necessarily render the valuation unascertainable.

Interestingly enough, while some courts have declined to rule that restrictions cause stock valuation to be unascertainable, a number of courts have decided that restrictions do indeed determine -- or in any event -- affect the fair market value for income tax purposes. In this sense, *Helvering v. Salvage*,[49] is instructive.

In *Helvering v. Salvage*, the U.S. Supreme Court held that the fair market value of stock cannot be in excess of par value, when the stock is issued subject to an option to repurchase the same at par value.[50] This basic principle has subsequently been partially applied by the Second Circuit Court of Appeals, in upholding the Board of Tax Appeals decision in *Goldwasser v. Nunan*.[51]

First, in *Goldwasser*, the Court of Appeals for the Second Circuit affirmed the Board of Tax Appeals holding that the particular one-year restriction upon the sale of stock in issue[52] depressed the value of the stock.[53] The Court of Appeals, however, declined to adopt the taxpayer's argument in its entirety.[54] The Court of Appeals reasoned that, under the terms of the agreement, although a public offering was unavailable to her during the pertinent one year period, nevertheless, she could conceivably have made a private offering; or alternatively, she could have used the stock as collateral for a loan.[55]

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[49] 297 U.S. 106 (1936).

[50] *Id.* at 109.

[51] 142 F.2d 556 (2d Cir. 1944) (per curiam).

[52] Goldwasser v. Comm'r, 47 B.T.A. 445, 456 (1942), *aff'd*, 142 F.2d 556 (2d Cir. 1944) (per curiam) (finding that the restriction did not absolutely prohibit a sale of the stock but rather, forbade the taxpayer from making a *public* offering).

[53] *Id.* at 457.

[54] The taxpayer had asserted that the value of the stock for income tax purposes must be depressed to the market value of the stock (*after the one-year restriction had ended*) which was lower than the value of the stock when it was issued to her. *Goldwasser*, 47 B.T.A. at 454-56.

[55] *Id.* at 456-57.

Second, the basic principal enunciated in *Helvering v. Salvage* was also applied in *Deutsch v. Commissioner.*[56] In *Deutsch*, certain stock worth $1 per share was placed in escrow in 1958 and the taxpayers agreed to sell the shares for $1 per share when released from escrow.[57] In 1960, when the stock was released from escrow, it was worth $8 per share.[58] Nevertheless, the Tax Court held that with respect to the taxpayers, since the taxable event was the release of the stock from escrow, and since under the terms of the agreement, at the time of release the stock was to be sold at $1 per share, the value of the stock for purposes of assessment was $1 per share.[59]

More recently, in *Eastern Service Corp. v. Commissioner*,[60] the Court of Appeals for the Second Circuit appears to have distanced itself somewhat from the basic principle enunciated in *Helvering v. Salvage.* In *Eastern Service Corp.*, the Court of Appeals for the Second Circuit held that a statutory restriction requiring mortgage sellers desiring to sell mortgages to the Federal National Mortgage Association (FNMA) to hold a minimum number of FNMA shares did not depress the value of these shares.[61]

In *Eastern Service Corp.*, the taxpayer[62] purported to deduct, as a business expense, a percentage of the price that he had paid for the FNMA stock.[63] The Tax Court ruled that the restriction affected the marketability of the shares and therefore discounted the market price seventy-five percent.[64] The Court of Appeals for the Second Circuit re-

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[56] 26 T.C.M. (CCH) 649 (1967).

[57] The stock was intended by the officers of a foundation to serve as compensation. Additionally, it could not be released without the consent of the California Corporations Commissioner. *Id.* at 650-51, 653-54.

[58] *Id.* at 652-53.

[59] *Id.* at 655.

[60] 650 F.2d 379 (2d Cir. 1981).

[61] *Id.* at 386.

[62] A "seller-servicer" of mortgages. *Id.* at 380.

[63] *Id.* at 380-81. (required to purchase in order to be able to sell mortgages to the FNMA.)

[64] Eastern Serv. Corp. v. Comm'r, 73 T.C. 833, 844-46 (1980), *rev'd*, 650 F.2d 379 (2d Cir. 1981).

versed, holding that the FNMA shares were *not* legally restricted for purposes of valuation,[65] in light of the fact that the shares were freely transferable.[66] Moreover, the court also held that, notwithstanding the fact that the taxpayer had significantly compelling economic reasons for not selling its FNMA stock,[67] these reasons were not dispositive in determining whether the stock was sufficiently restricted.

Arguably, therefore, the courts will first acknowledge the power of a restriction -- as discussed above -- to depress the value of shares subject to such restriction, but only to the level of the price at which the corporation may repurchase the shares.[68] Secondly, certain provisions involving some other restrictions[69] would presumably be treated similarly by the courts.

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[65] *Eastern Serv. Corp.*, 650 F.2d at 384 (citing Kolom v. Comm'r, 644 F.2d 1282, 1286 (9th Cir. 1981)) (involving *subjectively* imposed restrictions pursuant to section 16(b) of the Securities Act of 1934, which the Court ruled to be irrelevant to valuation for tax purposes); Harrison v. United States, 475 F.Supp. 408, 415 (E.D. Pa. 1979), *aff'd*, 620 F.2d 288 (3d Cir. 1980) (dealing with shares similarly subject to the acknowledged genuine disincentive to sell because of the penalty effects of section 16(b) of the Securities Act of 1934 implicate *subjective* taxpayer considerations, but establish no legal basis for discounting). *See also supra* note 13; Chiechi, J., Estate of Lynn M. Rodgers v. Comm'r, 77 T.C.M. 1831, 1836 (1999); Estate of Davis v. Comm'r, 110 T.C. 530, 535 (1998).

[66] In spite of the fact that, had the taxpayer sold the shares, it would thereupon no longer qualify to continue servicing FNMA mortgages. *Eastern Serv. Corp.*, 650 F.2d at 384.

[67] *I.e.*, primarily in order to qualify to continue servicing FNMA mortgages. *Id.*

[68] *E.g.* in *Mandelbaum*, 69 T.C.M. (CCH) at 2868, Judge Laro ruled: "In the instant case, we do not regard the Shareholder Agreements as a major factor *because they specify no price (or formula to determine price)* for the right of first refusal." (emphasis added).

[69] Such as, for example, a mandatory buy-sell agreement.

VI. ESTATE TAX CASES[70]

Unlike income tax cases discussed above, the valuation of closely-held corporation stock, which is subject to restrictions, *must* be ascertained for estate tax purposes. The courts must therefore, without postponement, face up to the difficulties of valuation posed by this dilemma, no matter how difficult the task proves to be.

First, the IRS very closely scrutinizes restrictions which tend to limit share value; and although the IRS Regulations do not affirmatively state the types of restrictions that will pass muster in setting a definite value on shares, they do identify the types of restrictions that do *not*.[71]

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[70] "Property is included in a decedent's gross estate at its fair market value as of the date of the decedent's death or, if the executor elects, as of the alternate valuation date. *See* §§ 2031(a), 2032(a); § 20.2031-1(b), Estate Tax Regs. Under § 2032(a)(2), the alternate valuation date is the date 6 months after the decedent's death." Vasquez, J., Estate of William J. Desmond v. Comm'r, 77 T.C.M. (CCH) 1529, 1530 (1999). A modification in this area of law was made by P.L. 105-206 which repealed and replaced the § 2033A exclusion with a deduction under § 2057, applicable to decedents who died after Dec. 31, 1997, however, the valuation criteria of Rev. Rul. 59-60 are still applicable to the § 2057 deduction. 3 FEDERAL ESTATE AND GIFT TAX REPORTER, CCH 80, 117-80, 119-7 (1998).

[71] Treas. Reg. § 20.2031-2(h) (as amended in 1992), which provides:

> (h) *Securities subject to an option or contract to purchase.* Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is

Furthermore, Revenue Ruling 59-60 takes a more affirmative position on this issue, although it is not necessarily more dispositive.[72] Revenue Ruling 59-60 states that where the option or buy-sell agreement is: (i) the result of voluntary conduct by the stockholders; and (ii) (a) is binding during the life and (b) on the death of the stockholders, the agreement may or may not -- depending on the circumstances -- fix the value for estate tax purposes. In any event, the agreement will at least serve as some evidence in determining fair market value.[73]

The distinctions between options reserved by the issuing corporation, on the one hand, and agreements which are the result of voluntary conduct by the shareholders, on the other, are not as clear and precise in the case of a closely-held corporation as one would prefer. Undoubtedly, the shareholders can readily execute either of these two types of agreements, without any significant difficulty at all. This being the case, shareholders in a closely held corporation should probably select agreements and reserve to the issuing corporation the option to repurchase at a particular price.[74]

A number of court decisions have analyzed the effect of restrictive agreements on estate tax decisions.[75] Thus, in order to ensure that an agreement will definitely set a ceil-

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> determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

[72] Rev. Rul. 59-60 § 8, 1959-1 C.B. 237, which provides:

> Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes.

[73] *Id.*

[74] Rands: Stock Transfer, *supra* note 8, at 449.

[75] Jerald D. August & C. Wells Hall, III, 56TH NEW YORK UNIVERSITY - PROCEEDINGS OF THE FIFTY-SIXTH INSTITUTE ON FEDERAL TAXATION 8-123 (1998).

ing on estate tax values,[76] the following requirements must be met.[77]

First, the price must either be fixed or determinable according to a specified formula.[78] Moreover, the estate must be obligated to sell at this fixed price at death.[79] Second, the obligation to sell at the agreed price must be legally binding upon the decedent during his lifetime,[80] as well as upon his estate after his death.[81] Third, the agreement must be a bona fide business arrangement, rather than a device to pass the decedent's shares to the natural objects of his bounty[82] for less than adequate and full consideration in money or money's worth.[83]

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[76] "[T]hey may be effective to freeze estate tax values . . . ." *Id.* at 8-119.

[77] *Id.* at 8-122. *See also Valuation of Shares of Closely Held Corporations*, 221 TAX MGMT. (BNA), May 20, 1991, at A-5–A-9 [hereinafter "*Valuation of Shares*"].

[78] Estate of Gloeckner v. Comm'r, 152 F.3d 208, 213 (2d Cir. 1998).

[79] *Id.* This obligation would be created by an option exercisable by the optionee or under a *mandatory* buy-sell agreement. Unmistakably, restrictions applicable *only* during a party's lifetime (but *not* at death) would be insufficient and therefore ineffective.

[80] *Id.*

[81] Estate of Caplan v. Comm'r, 33 T.C.M. (CCH) 189, 192 (1974).

[82] "Although the regulations do not define "natural objects of [decedent's] bounty," certain clues may be gleaned from the 1990 Act's legislative history. When the IRS promulgated its new regulations following the passage of the Act, it explained why it omitted a definition for this particular phrase. The agency said "[t]his concept has long been part of the transfer tax system and cannot be reduced to a simple formula or specific classes of relationship. The class of persons who may be the objects of an individual's bounty is not necessarily limited to persons related by blood or marriage." *Gloeckner*, 152 F.3d at 214-15 (quoting Special Valuation Rules, 57 Fed. Reg. 4250, 4253 (1992)). "[W]hen there is no blood or marital tie between the decedent shareholder and the other parties to the restrictive agreement, a declaration that the agreement does *not* evince a testamentary intent *is greeted with considerably less skepticism*." *Id.* at 215 (emphasis added).

[83] *Id.* at 213. *See also* August & Hall, *supra* note 75, at 8-121. This subjective requirement depends to a significant degree upon the relationship of the parties involved. *E.g.*, in St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982), *rev'g* Roth v. United States, 511 F. Supp. 653 (E.D. Mo. 1981), the court held that the requisite bona

Most of the cases have arisen when particular shareholders entered into reciprocal options to purchase the shares of the other shareholders at death, and on a decision to sell. For example, in the leading case of *Wilson v. Bowers*,[84] essentially followed by most courts,[85] the Court of Appeals for the Second Circuit held that the contract price in such circumstances is binding, undoubtedly because of the clear intent objectively evidenced by the mutually binding covenants. In *Wilson*, three stockholders of a closely held corporation agreed among themselves that none would sell or assign their respective shares without first offering their fraction of the shares to the others at a price fixed in the agreement; and additionally, that each shareholder would have the option to purchase the stock on the death of any one of the other shareholders.[86] The Second Circuit Court of Appeals held that when the first shareholder died the option price fixed in the contract established the estate tax value, in spite of the fact that (i) the option was never *voluntarily* exercised and (ii) the shares had in fact been bequeathed[87] to the other shareholders.[88]

In contrast, where only one shareholder is granted an option to purchase, the courts tend to scrutinize more closely the transaction than they do when the pertinent options are reciprocal.[89] Thus, in *Commissioner v. Bensel*,[90] although the Court of Appeals for the Third Circuit held that the option price was controlling, the Court seemed constrained to fully and completely justify its holding. In *Bensel*, a father transferred shares to a trustee under terms

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fide business arrangement was missing because the family relationship, changes in the nature of the business following the agreement, and the fact that the agreement was invoked when another family member had died, led to the inference that the agreement was merely a testamentary tax-avoidance device. *Id.* at 1210.

[84] 57 F.2d 682 (2d Cir. 1932).

[85] *See, e.g.*, *Gloeckner*, 152 F.3d at 208.

[86] *Wilson*, 57 F.2d at 683.

[87] Presumably an *involuntary* exercise by operation of law.

[88] *Wilson*, 57 F.2d at 683-84.

[89] Comm'r v. Bensel, 100 F.2d 639 (3d Cir. 1938).

[90] *Id.*

whereby his son was given an option to buy the stock -- at a fixed price -- from the trustee upon the father's death.[91] The Court treated a number of factors as significant. First, the Court noted that the father and son were estranged and that furthermore, the son was needed in the business. Secondly, the Court concluded that the price set in the option was not unreasonably low.[92] Undoubtedly, it can therefore be argued that the bona fide business arrangement requirement is satisfied, if the price is not unreasonably low, in light of all the circumstances. In any event, a reciprocal option will allow more freedom in the price selection than will a unilateral one.

Where restrictions in shareholder agreements do not conclusively establish a stock's value for estate tax purposes, the price in the restrictive agreement may, nevertheless, serve as a factor in the valuation.[93] For example, in *Mathews*, stockholders in a family corporation entered into an agreement, whereby each of them was barred from transferring her/his stock to anyone -- other than a lineal descendant -- until the other shareholders were first afforded the opportunity to exercise the right to buy the stock at book value (i.e., a right of first refusal).[94] The district court adopted the IRS' argument that the agreement did *not* control the value of the stock for estate tax purposes, because by virtue of its terms, the agreement could only be exercised during the lifetime of the shareholders; and unquestionably, *not* also on their deaths as required by law.[95] Apparently, as a compromise gesture, the Court decided that the restrictions in the agreement effectively depressed the value of the stock.[96]

Mathews has been followed in a more recent case,[97] where the Tax Court determined that a restrictive stock

[91] *Id.* at 639.

[92] *Id.*

[93] Mathews v. United States, 226 F. Supp. 1003 (E.D.N.Y. 1964).

[94] *Id.* at 1004-05.

[95] *Id.* at 1008.

[96] *Id.* at 1009.

[97] Estate of Obering v. Comm'r, 48 T.C.M. (CCH) 733 (1984).

agreement which conferred upon a corporation - and its shareholders - the right to purchase the corporation's stock at a set price, before it could be offered to third parties,[98] did not conclusively fix the value of the stock for estate tax purposes. The Court reached this decision because the agreement did not completely foreclose the possibility of a sale of the stock to another shareholder at a different price altogether.[99]

In valuing the stock, however, the Court did consider the price fixed in the agreement as a factor,[100] reasoning that the restrictions set out in the agreement would depress the value of the stock[101] to a willing purchaser.[102]

Additionally, in some cases, in setting the estate tax value for tax purposes, the courts have actually increased the price per share set in the restrictive agreement.[103] Besides, where the price adopted by the agreement is based upon book value per share, the courts will often add an additional amount representing goodwill.[104]

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[98] *Id.* at 740-41, 746.

[99] *Id.* at 746.

[100] *Id.* at 756. Other factors played a role as well. As the court explained:

> These factors include the threat of Indonesian expropriation or production contract changes, the difficulties of working and drilling offshore in the Third World, the changing mix and bureaucracy of the Indonesian government, the marketing problems of the oil industry in 1976 (including better sources of oil in the North Slope of Alaska and the North Sea, etc.), and the financial cash flow problems that Warrior found so difficult.

Id.

[101] *Id.* "Appropriate discounts may then be applied thereafter for . . . the stock restriction agreement."

[102] *Id.* at 756.

[103] *See, e.g., Gloeckner*, 71 T.C.M. (CCH) 2548 (1996), *rev'd,* 152 F.3d 208 (2d Cir. 1998).

[104] Estate of Trammell v. Comm'r, 18 T.C. 662, 668 (1952); City Bank Farmers' Trust Co. v. Bowers, 68 F.2d 909 (2d Cir. 1934).

VII. GIFT TAX CASES[105]

Rulings involving valuation for gift tax purposes are a different story altogether. Indeed, with regard to stock governed by restrictive agreements, comparing decisions regarding valuation for gift tax purposes with those involving valuation for estate tax purposes, one can safely conclude that the courts tended to make essentially opposite determinations. Furthermore, in light of these rulings, the Treasury has adopted the position that restrictive agreements do not conclusively fix stock value for gift tax purposes.[106]

In beginning this discussion, *Krauss v. United States*[107] is invaluable. In *Krauss*, a restrictive agreement, granting a right of first refusal to designated optionees and other shareholders, failed to place a ceiling on the value of those shares for gift tax purposes. In fact, suing for a gift tax refund, appellants contended that the value of the shares donated should conform to the corporate charter, which limited it to 60% of book value.[108] The Fifth Circuit Court of Appeals treated as determinative the fact that the charter provision imposed neither an absolute obligation to sell, nor an absolute option to buy. The Court observed that the provision was purely conditional. Thus, if a stockholder decided to sell, he had first to inform the other stockholders, who had a right of first refusal to buy within sixty days at a stated price. Essentially, the restrictive provision was not the sole determining factor.[109]

Krauss was followed in *Driver v. United States*,[110] where the Tax Court went further and held that under the facts

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[105] Where appropriate, minority and lack of marketability discounts apply in this tax area. Steven A. Horowitz, *Toiling in King Solomon's Mine: A Study in Business Valuation For Transfer Tax Purposes (Part II)*, TAXES, Nov. 1998, at 13, 14.

[106] Rev. Rul. 59-60 § 8, 1959-1 C.B. 237; Rev. Rul. 189, 1953-2 C.B. 294.

[107] 140 F.2d 510 (5th Cir. 1944).

[108] *Id.* at 511.

[109] *Id.*

[110] Driver v. U.S., No. 73-C-260, 1976 WL 1188 (W.D. Wis. 1976).

presented, the restrictive agreement had no impact at all upon the value of the shares for gift tax purposes. In *Driver*, the transferor of the stock made the gift to her nephew, on condition that the corporation adopt a by-law granting to the shareholder owning the most shares a right of first refusal with respect to the purchase of the stock of any other shareholder who desired to sell, the price to be determined by arbitration.[111]

Based upon an assertion of lack of marketability of the stock - as a result of the existence of the by-law restriction - the taxpayer argued for a 10% discount on the valuation, allegedly representing the reduced value by dint of the alleged lack of marketability.[112] The district court denied any discount because the donor's nephew was the beneficiary of the restriction, and as a direct result of the gift, became the shareholder who owned the most shares. Unquestionably, therefore, the restriction was merely an enabling device to empower the nephew to control access to becoming a stockholder in the corporation.[113]

Had the court recognized this "lack of marketability" discount as a component in valuing the stock in this closely-held corporation, the court would have facilitated the double benefit to the aunt and nephew of a lower gift tax, as well as the right to control incoming stockholders of the corporation.

Arguably, the rationale for the disparate treatment in valuing shares of stock for purposes of estate tax, on the one hand, and gift tax on the other, could be the fact that, at the time of estate tax valuation for tax purposes, any pertinent options must of necessity be treated as exercisable immediately. For, based upon the objective intention of the parties to the contract, they must have, irrefutably, intended to fix the value of the stock on the death of the owner.

In contrast, with respect to gift tax valuation issues, there is no binding obligation on the donee - in the restric-

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[111] *Id.* at *2.
[112] *Id.* at *4.
[113] *Id.* at *6.

tive agreement - to sell the shares on the valuation date, imposed for tax purposes. The donee is free to retain the shares and exercise all the rights of a shareholder. Thus, focusing upon the objective intention of the parties to the restrictive agreement, there is clearly no expectation that the shares should be valued at the time of a gift.[114]

VIII. INTRINSIC FACTORS

If determining the value of the shares from the restrictive agreement itself proves insurmountable, intrinsic factors become more significant.[115] Moreover, courts also consider whether a discount should be applied to the valuation, because of the lack of marketability[116] of the shares; as well as whether or not a discount, because of minority share-

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[114] *Valuation of Shares*, *supra* note 77, at A-10. *See also* Comm'r v. McCann, 146 F.2d 385 (2d Cir. 1944) (although the corporation was *obligated to purchase* the shares at book value, the court nevertheless held that for gift tax purposes, the benefits of *inter alia* retaining the shares and receiving dividends negated the validity of book value as the appropriate valuation method); *but cf.* Krauss v. United States, 140 F.2d 510 (5th Cir. 1944) (finding that there was merely an *option to buy*).

[115] The following factors are considered fundamental by the Treasury Department, requiring careful analysis in each case: (i) the nature of the business and the history of the enterprise from its inception; (ii) the economic outlook in general and the condition and outlook of the specific industry in particular; (iii) book value of the stock and the financial condition of the business; (iv) earning capacity of the corporation; (v) dividend paying capacity of the corporation; (vi) whether or not the enterprise has goodwill or some other intangible value; (vii) sales of the stock and the size of the block to be valued; (viii) the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market (whether on an exchange or over-the-counter). Rev. Rul. 59-60 § 4.01, 1959-1 C.B. 237.

[116] "The Service has long been hostile to the use of lack of marketability and lack of control discounts when the transferor and the transferee are family members. . . . The courts have almost uniformly held otherwise." Gary A Zwick, *Family Business Consulting Revisited*, 30 TAX ADVISER 38, 39 (1999).

holder status,[117] is justified in light of the facts of the particular case.[118]

IX. VALUATION METHODS

There are no universally accepted valuation methods.[119] Nevertheless, financial analysts may agree that, with respect to valuation of intrinsic factors, three approaches predominate: (a) asset appraisal, (b) discounted income and (c) comparative appraisal.[120]

A. Asset Appraisal Approach

The asset appraisal approach is quite routine.[121] Each asset (or group of assets) is individually valued and the individual values are combined and then reduced by the total amount for all existing liabilities. This approach is recognizably the "liquidation value"[122] concept in accounting the-

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[117] *Id.* "The IRS now concedes that discounts for *minority interests* are available even if the enterprise as a whole is controlled by family members." Nancy E. Howard & C. David Anderson, 2 U.S.C. LAW SCHOOL FIFTIETH ANNUAL TAX INSTITUTE § 1501.3, 15-13 (1998) (citing Rev. Rul. 93-12 (1993)) (emphasis added).

[118] *See id.*

[119] The fundamental legal basis on which closely-held stock is valued remains Rev. Rul. 59-60. *See supra* note 13. However, the valuation methods selected for discussion in this paper are not at all exhaustive, and indeed, a multiplicity of revenue methods may be utilized, including, *e.g.*, the comparable sales method. *See, e.g.*, Estate of McClatchy v. Comm'r, 147 F.3d 1089 (9th Cir. 1998), *rev'g* 106 T.C. 206 (1996). As Professor Harold S. Peckron commented to the author (Critique dated Nov. 30, 1999): "[A]ll [valuation] methods must run the gauntlet of Rev. Rul. 59-60 to support or contradict the results."

[120] Schreier & Joy, *supra* note 5, at 858.

[121] *See, e.g.*, Rakow v. Comm'r, 77 T.C.M. (CCH) 2066 (1999) (petitioner's expert).

[122] "[A]s soon as an entity anticipates that it will no longer continue to operate, conventional accounting under GAAP [Generally Accepted Accounting Principles] is no longer appropriate . . . [t]hese cases call for liquidation accounting, under which all items on the balance sheet are accounted for at net realizable amounts . . . ." D. Edward Martin, ATTORNEY'S HANDBOOK OF ACCOUNTING, AUDITING AND FINANCIAL REPORTING, § 2.03[2], 2-9 (1998) [hereinafter "ATTORNEY'S HANDBOOK"].

ory, usually associated with liquidation of an on-going enterprise, in which assets are individually valued in anticipation of liquidation.[123]

Unquestionably, current assets[124] are less difficult to value than fixed assets, because, of necessity, they will be payable, or will have been paid off, proximate to their acquisition. In contrast, fixed assets are more problematic and tend to generate more litigation because the divergence between book value and market value is potentially more significant.[125] Accounting adjustments for depreciation and the effects of inflation and/or deflation aggravate the problem.[126]

Moreover, the potential for inaccurate valuations and the fact that accounting practices do not always mirror future economic realities lead financial theorists to accord less credence to this valuation method. Admittedly, in this regard, the IRS has tended to give substantial weight to the book value method[127] in valuing the stock of closely-held corporations. The courts, however, have tended to undercut its utility by requiring that other valuation methods be used to reinforce the asset appraisal method in order to justify rulings that valuation evidence is conclusive.[128]

See also ROBERT B. DICKIE, FINANCIAL STATEMENT ANALYSIS AND BUSINESS VALUATION FOR THE PRACTICAL LAWYER 43 (1998) [hereinafter "DICKIE"]: "A company cannot *simultaneously* . . . operate the business and liquidate its assets . . . if the company is being valued on a *liquidation basis* . . . the difference between book value and market value of a particular asset [is] relevant." *Id.* (emphasis added).

[123] *Id.*

[124] "Current assets are those expected to be converted into cash within a year . . . ." DICKIE, *supra* note 122, at 31.

[125] "Present GAAP do not cover the phenomenon of inflation price-level changes because U.S. inflation is traditionally low." ATTORNEY'S HANDBOOK, *supra* note 122, at 2-10.

[126] Schreier & Joy, *supra* note 5, at 861.

[127] "The corporation's net worth, or book value, has sometimes been the *pivotal* element." Schreier & Joy, *supra* note 5, at 871.

[128] Wallace v. United States, No. 71-254-CH, 1973 WL 552 (S.D. W. Va. 1973) (holding that the IRS' valuation based solely on book value was erroneous because it failed to take other relevant factors into account. In fact, the I.R.S. had not followed Rev. Rul. 59-60). *See also* Rev. Rul. 59-60

B. Discounted Income Approach[129]

Determination of the present value of future cash flows is the goal of the discounted income approach.[130] However, the courts have differed as to which cash flows are to be discounted. More often than not, the courts have tended to discount a company's ability to generate a discernible net earnings stream. This net earnings stream should represent the average annual net revenues generated, appropriately adjusted for (i) unusual gains or losses, (ii) capital expenditures, and (iii) nonoperating sources of income.[131]

In fact, Rev. Rul. 59-60, Section 5(a) has led most courts to treat the discounted income approach as the most reliable and determinative measure of a stock's intrinsic worth.[132] Thus, valuation experts pursue a figure that a hypothetical, willing buyer would pay to a hypothetical, willing seller, based upon the anticipated future earning power of the business. In contrast, both the courts and the Treasury have tended to rely on the historical performance of the corporation, utilizing prior after-tax earnings as their guide.[133]

Revenue Ruling 59-60 also states that, in predicting earnings, five or more prior years' earnings should be taken

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§ 4.02(c), 1959-1 C.B. 237, which provides: "when making book value computations, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly."

[129] Also referred to as a "Discounted Cash-flow Approach." *See, e.g., Rakow*, 77 T.C.M., *supra* note 121, at 2070.

[130] *See generally* DICKIE, *supra* note 122, at 199 *et seq.*

[131] *Id.*

[132] Section 5(a) provides: "In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public." Rev. Rul. 59-60 § 5(a), 1959-1 C.B. 237. As Judge Learned Hand explained in an earlier case: "Every one knows that the value of shares in a commercial or manufacturing company depends chiefly on what they will earn . . . ." Borg v. Int'l Silver Co., 11 F.2d 147, 152 (2d Cir. 1925).

[133] "Prior earnings records usually are the most reliable guide as to the future expectancy . . . ." Rev. Rul. 59-60 §4.02(d), 1959-1 C.B. 237.

into account.[134] In fact, some cases have taken into consideration ten or more years of prior earnings.[135] Furthermore, the period of prior earnings is not merely averaged in order to arrive at predicted future earnings. Essentially, analysts try to identify a trend if possible, and frequently, the courts will then treat prior earnings in such a way as to give effect to any discerned trend in valuing future earnings.

For example, in *Central Trust Company v. United States*,[136] the Court of Claims gave effect to a favorable earnings trend by relating the earnings from the most recent year to the preceding five years multiplying those earnings by 5, 4, 3, 2, and 1 respectively.[137]

Financial analysts -- who are essentially future-oriented -- do not generally favor this practice of sometimes relying solely on past data and then extrapolating in order to predict future results, because it is based upon the fundamental assumption that history will repeat itself. Life is not

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[134] *Id.* The section states that the profit and loss statements considered should show:

> (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expenses on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions . . . that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet.

[135] *See, e.g.*, Bartol, Jr. v. Comm'r, 11 T.C.M. (CCH) 527, 528 (1952); Estate of Montgomery v. Comm'r, 12 T.C.M. (CCH) 1380 (1953).

[136] 305 F.2d 393 (Ct. Cl. 1962).

[137] *Id.* at 403, 423-24. *But see* Rev. Rul. 59-60 § 4.02(d), 1959-1 C.B. 237 (section 4.02(d) sanctions this: "If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power.").

that monodimensional. So, whereas the courts have tended to emphasize the past earnings stream as highly influential in determining a stock's value; on the contrary, financial analysts have tended to place greater emphasis on the more difficult task of trying to discern future cash flows. Their philosophical posture is based upon the inherent uncertainty of the future, rather than on forecasted earnings based upon past data.[138]

Apparently, financial theorists prefer to rely on total future cash flow predictions because, arguably, the value of any business to a potential investor is -- of necessity -- the present value of those future cash flows. It appears that the practice of forecasting cash flows as net income, plus depreciation, provides the analyst with a more realistic figure with regard to the resources with which the company can pay its bills. In contrast, forecasting earnings provides the analyst with less useful information, since the accountant can include several variables in the term "earnings,"[139] which may have reduced future potential.

Moreover, a loss in one or more prior years can prove to be problematic for the courts. Of course, where the loss was a result of a nonrecurring event such as an accounting adjustment, that year's earnings could be disregarded or normalized.[140] On the other hand, where the loss was the result of a poor profit performance, it may be used as a negative figure in averaging.[141] Conceivably, inaccuracies could be exacerbated and "loom large" where the court relies on a weighing procedure, if that particular year's negative earnings are multiplied by an arbitrary factor.

For example, in *Hooper v. Commissioner,*[142] the Board of Tax Appeals appreciated this problem and therefore gave consistent losses comparatively little weight in setting a valuation. In fact, the Board focused on economic pressures

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[138] M. Gelman, *An Economist-Financial Analyst's Approach to Valuing Stock of a Closely-Held Company,* 36 J. TAX'N 353 (1972).

[139] *Id.*

[140] Estate of Clarke v. Comm'r, 35 T.C.M. (CCH) 1482, 1504 (1976).

[141] Fitts' Estate v. Comm'r, 237 F.2d 729 (8th Cir. 1956).

[142] 41 B.T.A. 114 (1940).

bearing upon the company in justifying their reliance on only one year's loss in finalizing their estimate. Since abandonment of the gold standard caused fear of inflation in 1933, the court concluded that these major economic forces would have more impact on future earnings or losses than would prior years of losses.[143]

In estate tax valuation cases, the decedent-shareholder may well have been the founder and prime-mover with regard to the close corporation. Such a decedent will therefore have been a particularly important employee in the closely-held corporation. Thus, consideration must be given to whether the loss will affect future earnings, and perhaps more importantly, whether the loss was adequately covered by life insurance.[144]

Furthermore, in *Diefenthal v. United States*,[145] the District Court for the Eastern District of Louisiana considered the effect of collateral corporations' earnings on the valuation of another corporation's stock. First of all, the decedent's corporation was involved in shipping scrap metals overseas.[146] More importantly, a number of other corporations - wholly owned by decedent's son - that had a close and profitable relationship with decedent's corporation, were engaged in chartering vessels.[147] In this factual context, the District Court reasoned that, since it was likely that a prospective purchaser of the stock in the decedent's corporation would consider the relationship between the pertinent corporations and their concomitant profitability,

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[143] *Id.* at 129. *See also Bartol*, 11 T.C.M. at 528; Central Trust Co. v. United States, 305 F.2d 393, 403 (Ct. Cl. 1962) (adjusting the earnings for a particular year because of abnormal economic periods, in addition to nonrecurring factors which had a material effect on earnings).

[144] *See* Rev. Rul. 59-60 § 4.02(b), 1959-1 C.B. 237, which provides: "The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise." *See also* Estate of Huntsman v. Comm'r, 66 T.C. 861 (1976), *acq.*, 1977-1 C.B. 1.

[145] 343 F. Supp. 1208 (E.D. La. 1972).

[146] *Id.* at 1211.

[147] *Id.* at 1212.

therefore, the decedent's per share value should be increased above the "base value," which would have been calculated with reference to the earnings of the decedent's corporation alone.[148]

Interestingly enough, under the discounted income approach, once the future expected earnings per share have been established, that figure is multiplied by a price-earnings multiplier to determine the expected per share value based upon those earnings. Determining the appropriate multiplier is difficult and continually subject to litigation. This is because the rate represents the owners' anticipated rate of return, based upon careful evaluation of the risks involved in receiving the estimated income stream, as well as upon analysis of the future impact upon the company of current management decisions.[149]

In this respect, the multiplier is the reciprocal of the capitalization rate. So, if an investor concluded that his investment should be earning 12 ½% (his capitalization rate), that would mean that he would be willing to pay eight times the future earning power per share for each share of stock (eight being the multiplier).[150] Admittedly, the determination of the capitalization rate, as well as the multiplier, for any hypothetical purchaser must -- of necessity -- be somewhat arbitrary, in spite of the analyst's expertise or her/his knowledge of past valuation decisions.[151]

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[148] *Id.* at 1214.

[149] Schreier & Joy, supra note 5, at 864-65.

[150] *Valuation of Shares, supra* note 77, at A-24.

[151] Rev. Rul. 59-60 § 6 sheds little light in this regard:

> Capitalization Rates.
>
> In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the

In general, the greater the risks of the business undertaken by the particular corporation, the smaller the ratio between past earnings and present value (i.e., a higher capitalization rate is required to compensate for increased risk). The converse is also true: the greater the stability of the business, arguably, the less significant the management decision-making as a prerequisite to success, and the greater the ratio between past earnings and present value (i.e., a lower capitalization rate).[152]

C. Comparative Appraisal Approach[153]

A number of courts have concluded that the best approach to ascertaining the appropriate price-earnings multiple includes analysis of the price-earnings multiples of other companies. This is the comparative appraisal approach, which requires expert comparison of the closely held corporation under scrutiny, with a comparable public-issue company -- if any -- in terms of: (i) relative size, (ii) growth characteristics, (iii) product line, (iv) market area, (v) profitability and (vi) overall general financial condition.[154]

Inevitably, the most critical task is to locate a corporation that satisfies these criteria. In the event that an acceptable publicly-held corporation is located, analysts then determine the average market price of its publicly-traded

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> ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

Rev. Rul. 59-60 § 6, 1959-1 C.B. 237.

[152] *See* DICKIE, *supra* note 122, at 206.

[153] *See, e.g., Rakow*, 77 T.C.M. at 2070.

[154] Schreier & Joy, *supra* note 5, at 862.

securities and their related financial data.[155] The financial data from comparable companies, as well as the financial data used to predict the future earnings power and dividend payout capacity of the shares being valued, must be taken from the same period. Therefore, each ratio would imply one market price.[156] After that, all the market prices implicitly determined from the ratios (which are frequently at variance with each other) would then be analyzed and narrowed in order to arrive at a single market value.[157]

Unavoidably, a serious predicament is that a genuinely comparable publicly-traded corporation is practicably impossible to locate.[158] Moreover, an equally important problem is the arbitrariness of assigning weights to the different financial ratios, on the footing that they are influential in determining the value of the pertinent corporation's stock.

Furthermore, the comparative appraisal approach also requires assessment of the future dividend-paying capacity of the corporation whose stock is being valued. Therefore, when the comparative appraisal estimate is finalized, it is usually weighted and averaged with the per share value, obtained by estimating future earnings capacity, as well as book value per share of comparable companies. In this respect, the Court of Claims in adopting the comparative appraisal approach in its landmark decision, *Central Trust Company v. United States*,[159] has come as close as any court in attempting to harmonize a number of financial theories.

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[155] Financial data to be considered would include P/E ratios, average dividend payout ratios, and market value divided by book value ratios. *See, e.g.*, DICKIE, *supra* note 122, at 111-13.

[156] *Id.* If P/E = 10, 10 times earnings will yield an implicit market price.

[157] A number of courts and some financial analysts have used relative weights to accomplish the narrowing outcome. Schreier & Joy, *supra* note 5, at 863.

[158] Rev. Rul. 59-60 abates this problem by providing that if comparable publicly held companies cannot be found, then comparable companies whose shares are traded in an active and free over-the-counter market can be successfully used. Rev. Rul. 59-60 § 4.02(h), 1959-1 C.B. 237.

[159] 305 F.2d 393, 408 (Ct. Cl. 1962).

In *Central Trust*, petitioners sought a refund of federal gift taxes after the IRS claimed a federal gift tax deficiency based upon an asserted under-valuation of stock in the Heekin Can Company, a closely-held corporation.[160] The Court of Claims applied a modified analysis derived from *Bader v. United States*,[161] adopting a weighted average of the future anticipated earnings stream, using (i) the past five years' financial data, (ii) the future anticipated dividend yield, capitalizing the average dividend paid out over the last three years by an arbitrary 7%, and (iii) book value based upon recent data. Deviating from *Bader*, the Court of Claims in *Central Trust* fully adopted the comparative appraisal approach.[162] The court found persuasive the approach of a CPA, testifying as an expert witness, who had calculated the P/E ratios of assertedly comparable publicly-held companies in the container industry and had correlated the results in deducing a P/E for Heekin. The selected comparable corporations were substantively similar with respect to business purposes and operational characteristics. Moreover, all of the values derived from *Bader* were weighted and used to calculate an average. This average was then discounted in cognizance of Heekin's lack of marketability.[163]

One conceivable flaw in the *Central Trust* decision is the actual, or potential, bias in favor of historic performance in the capitalization of actual past dividends, rather than the capitalization of the future dividend-paying capacity, which financial theorists might propose as being more appropriate. There may have been non-recurrent sound business reasons, for example, justifying retention by the corporation of an unusually high percentage of earnings in the business for future expansion, where an analysis of past dividends paid or future earning capacity might be insufficient to identify that need. A prospective purchaser of the shares of

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[160] *Id.* at 394-95.

[161] Bader v. United States, 172 F. Supp. 833, 838 (S.D. Ill. 1959).

[162] *Central Trust*, 305 F.2d at 406.

[163] *Id.* at 400-01. *See, e.g.*, IRS VALUATION TRAINING FOR APPEALS OFFICERS (CCH) 9-3 – 9-6 (1998).

that corporation would need that information in order to more accurately assess the value of that corporation's shares.[164]

The more influential value of *Central Trust* rests, however, in the fact that a number of financial analysts apparently agree that a comparative approach is essential to valuation, despite the concession that the quest for a genuinely comparable publicly-traded firm may quite honestly be one for the holy grail.[165] Indeed, while a perfectly comparable company is probably never found, it is arguably possible to obtain a representative sample of sufficiently comparable public corporations. Whereas the accurate intrinsic worth of a stock may be impossible to determine on a theoretical basis, in light of the imperfections of any market selected, nevertheless, the determination of market value,

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[164] The Treasury agrees:

> Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. *It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.*

Rev. Rul. 59-60 § 4.02(e), 1959-1 C.B. 237 (emphasis added).

[165] Gelman, *supra* note 138, at 353.

with respect to what investors in a real world setting would be willing to pay, may indeed be easier to ascertain.[166]

X. DISCOUNTS[167] FROM COMPUTED VALUATION[168]

Typically, where a valuation has been made by the use of intrinsic factors, the valuation ratios used (price-earnings multiplier and the capitalized dividend stream) have been based on ratios derived from equity security information of companies in comparable businesses with shares that are actively traded. Since the pertinent close-corporation shares being valued are not actively traded, courts have recognized that an adjustment is generally essential, in order to account for the diminished value of the stock as a result of its lack of marketability.[169]

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[166] *Id.*

[167] "The IRS has raised a large number of arguments in an attempt to reduce, limit or obliterate discounts. Most of these arguments have failed . . . ." Michael Schulman & Jonathan C. Lurie, 57TH N.Y.U. INSTITUTE ON FEDERAL TAXATION §18.03, 18-8 (1999). "The Service has long been hostile to the use of lack of marketability and lack of control discounts when the transferor and the transferee are family members. . . . The courts have almost uniformly held otherwise." Gary A Zwick, *Family Business Consulting Revisited*, 30 TAX ADVISER 38, 39 (1999). *But see* Howard & Anderson, *supra* note 117. "Where appropriate, this Court has on numerous occasions applied a discount for lack of marketability in valuing shares of stock in a closely held company." Gale, J., Estate of Helen Bolton Jameson v. Comm'r, 77 T.C.M (CCH) 1383, 1397 (1999). "We further find that the total lack-of-marketability discount that should be applied in this case and that we have found should include $9 million . . . ." Estate of Davis v. Comm'r, 110 T.C. 530, 560 (1998), *per* Chiechi, J.

[168] "When determining the value of unlisted stock by reference to listed stock, a discount from the listed price is typically warranted in order to reflect the unlisted stock's *lack of marketability*." *Mandelbaum*, 69 T.C.M. (CCH) 2852 (emphasis added).

[169] "Marketability discount" may be defined as: "An amount or percentage, deducted from an equity interest to reflect lack of marketability." IRS VALUATION GUIDE FOR INCOME, ESTATE AND GIFT TAXES: VALUATION TRAINING FOR APPEALS OFFICERS, Glossary-8 (1994) [hereinafter "IRS VALUATION GUIDE"]. *See Central Trust*, where the court stated:

> It seems clear . . . that an unlisted closely held stock of a corporation such as Heekin, in which trading is

The methodology used to determine this discount - necessary because of the lack of marketability - can be more computational, rather than dependent upon "expert opinion." Irrefutably, public information is available pertaining to publicly-traded securities which are subject to market-imposed factors as to marketability.[170] An appropriate discount can therefore be deduced by looking at (a) the discounts actually received by professional investors who bought these securities under the restrictions of an investment letter, (b) comparisons between other publicly-held

> infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public.

305 F.2d at 405. "We also think that a discount of 30 percent for *lack of marketability* is appropriate in these circumstances." Maris v. Comm'r, 41 T.C.M. (CCH) 127, 139 (1980) (emphasis added). Discounts for *lack of control* are different and separate from discounts for lack of marketability. Michael L. Johnson, *All in the Family: Should the Attribution Concept Apply to Disallow a Minority Discount for Lack of Control,* 16 CREIGHTON L. REV. 669, 670 (1983). *See also* J. Michael Maher, *An Objective Measure for a Minority Interest and a Premium for a Controlling Interest,* 57 TAXES 449 (1979). However, although discounts for lack of control are allowed in appropriate circumstances, unfortunately the distinctions between these two different types of discounts are too often blurred. *See, e.g.,* Comment, *Valuing Closely Held Stock: Control Premiums and Minority Discounts,* 31 EMORY L.J. 139, 152-53 (1982) [hereinafter "Comment"].

[170] *E.g.* "A control premium may be necessary when valuing an interest which gives its holder unilateral power to direct corporate action, select management, decide the amount of distributions, rearrange the corporation's capital structure, and decide whether to liquidate, merge or sell assets." Vasquez, J., Estate of William J. Desmond v. Comm'r, 77 T.C.M. (CCH) 1529, 1534 (1999). "[A] controlling shareholder may receive a control premium for its shares." John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?* 21 DEL. J. CORP. L., 359, 360 (1996). *See also* E. Elhauge, *The Triggering Function of Sale of Control Doctrine,* 59 U. CHI. L. R. 1465, 1465 (1992). The corollary is that a minority shareholder should enjoy a *discount* for his *lack of control.* "Courts have recognized the importance of control in determining fair market value, and they typically have used the concepts of majority premium and minority discounts in valuing, respectively, controlling and noncontrolling interests in corporations." Fellows & Painter, *supra* note 5, at 908-09.

securities also restricted by an investment letter, and comparing them with the stock of the closely-held corporation that is being valued.[171]

Shares of stock subject to restrictive agreements may be quite unmarketable. Where the restrictive agreement definitively sets the value of the shares, intrinsic factors need not be resorted to and lack of marketability discounts would arguably not be relevant. If, however, the restrictive agreement is merely an evidentiary factor, then the argument in favor of discounting is certainly more meritorious. Clearly, double discounting -- once for the restrictive provision and a second time for lack of marketability -- has been ruled improper.[172] Nevertheless, expert witnesses have successfully argued for significantly high discounts justified by the lack of marketability of the particular stock under scrutiny.[173]

Additionally, courts have applied a minority interest discount[174] in appropriate circumstances.[175] Such instances

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[171] Gelman, *supra* note 138, at 354.

[172] In Baltimore Nat'l Bank v. United States, 136 F. Supp. 642, 658 (D. Md. 1955), the court concluded:

> There is merit to the government's contention that all of taxpayer's witnesses . . . were inconsistent in making allowances for high price per share and low marketability, and then making further allowances on the theory that the shares were not marketable at all under the terms of the depository agreement.

[173] *Bader*, 172 F. Supp., *supra* note 161, at 838 (10%); Central Trust Co. v. United States, 305 F.2d 393, 405, 433 (Ct. Cl. 1962) (12.17%); Obermer v. United States, 238 F. Supp. 29 (D. Haw. 1964) (33 1/3%); Estate of Pinkerton v. Comm'r, 33 T.C.M. (CCH) 342 (1974) (50%). The lack of marketability discount is not automatically granted. Sufficiently persuasive expert testimony based upon credible evidence must prove the asserted lack of marketability.

[174] "Minority discount" may be defined as: "The reduction, from the pro rata share of the value of the entire business, to reflect the absence of the power of control." IRS VALUATION GUIDE, *supra* note 169, at Glossary-8. *See generally* William S. Blatt, *Minority Discounts, Fair Market Value and the Culture of Estate Taxation,* 52 TAX L. REV. 225 (1997). *See also* James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation,* 50 TAX L. REV. 415 (1995); Hamid K. Kordestani, *Section 2701*

require proof by valuation experts that a decrease in the value of the shares is justified because the shares being valued represent a minority interest in the business.[176] This minority interest discount principle is distinguishable from the lack of marketability discount, because lack of marketability can exist whether or not a minority or controlling interest is involved. Unfortunately, the courts have tended to discount intellectual distinctions between the lack of marketability status of stock in a close corporation and the minority holding posture of a particular stockholder in such corporations. Courts tend to combine them and apply a single discount.[177]

XI. CONCLUSION

The analytical intractability of valuing stock in closely-held corporations is inescapable. Moreover, such valuations are definitely not -- and perhaps will never become -- an exact science. At this juncture, in my view, the efficacy of straightforward bargaining between taxpayers and the IRS

Valuation Issues in a Transfer of Family Business Interests, TAXES, Aug. 1995, at 403, 407.

[175] *See* Comment, *supra* note 169, at 152-54.

[176] The corollary is allowing an increase in the value of the shares being valued because the shares represent a controlling interest in the corporation. *See* Comment, *supra* note 169, at 147-52, 180-89. The courts have been predictable in determining whether a given block of shares represents a controlling or minority interest -- more than 50% of the voting shares constitutes a controlling interest while less than 50% constitutes a minority interest. *Valuation of Shares, supra* note 77, at A-37. These concepts necessarily imply the existence of a normative value of the shares which must be determined by analyzing intrinsic factors. *Id.* at A-33.

[177]
> A closely held stock of such a corporation as Heekin which lacks marketability is [far] less attractive to investors than a similar stock which has ready access to the general public, a consideration which affects the market value of Heekin stock. This is especially true when, as here, each block of stock involved in the gifts made on each valuation date represented only a minority interest . . . .

Central Trust, 305 F.2d at 432.

in valuing stock in close corporations may be supported. The goal of an agreed upon valuation could be achieved essentially by analogy to contract, by offers, counter-offers and ultimately acceptance, leading to an agreement in the manner in which sale/purchase prices of real estate are struck. This could be economically more efficient.[178] Then, if the parties reached an impasse, mandatory mediation could be statutorily imposed.[179]

Undoubtedly, increasing reliance upon effectively drafted restrictive agreements may well prove helpful and tend to alleviate the litigation logjam, but is unlikely to be a panacea particularly in the income and gift tax arena. Enhancing the accuracy of valuing the intrinsic factors of a closely-held corporation will be a persistent neuron-tester. Yet, a historical evaluation of cases up to the present indicates that both judges and lawyers are becoming increasingly more respectful of substantive financial theory, and are progressively implementing valuation concepts based upon future-oriented components. Perhaps, too great an emphasis continues to be placed upon historical data -- relying upon the theory and conception that it is objective[180] and, therefore, more valuable. Nevertheless, courts are accepting the reliability of discounted, future cash-flow analysis, more readily than they did in the past.

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[178] "The efficiency theory of the common law is not that *every* common law doctrine and decision is efficient. That would be completely unlikely, given the difficulty of the questions that the law wrestles with and the nature of judges' incentives. The theory is that the common law is best (not perfectly) explained as a system for maximizing the wealth of society." Richard A. Posner, J., ECONOMIC ANALYSIS OF LAW 21 (Little, Brown & Co., 3d ed. 1986).

[179] "Statutory . . . as distinct from common law fields are less likely to promote efficiency, yet even they . . . are permeated by economic concerns and illuminated by economic analysis." *Id.*

[180] *Recorded* is to be distinguished from *objective*. It is not necessarily objective at all (i.e., with respect to predictability about the *future* performance of the corporation in issue), it is simply *recorded past performance.*

Indeed, a comparative appraisal approach emulating *Central Trust*,[181] coupled with a discounted future cash-flow analysis advocated by a number of financial theorists, could conceivably surpass other alternatives in valuing the stock of closely-held corporations. In fact, the idea that a comparative approach need not be expressly confined to the three financial variables used in *Central Trust*[182] and *Bader*[183] is particularly attractive. For example, dividends may be of reduced significance in valuing a close corporation's stock. Frequently or even routinely, close corporations decline to pay dividends, adopting instead the alternative of paying salaries to management/owners[184] and thus attaining a more strategic tax position.[185] Furthermore, book value is largely inequitable in computing an accurate valuation,[186] and ought not be used where other methods are more credible.[187]

Finally, *Central Trust*[188] in adopting and implementing a comparative appraisal approach, ought to be the point of departure in future quests for the holy grail of more accurate and innovative valuation methods.

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[181] 305 F.2d 393 (Ct. Cl. 1962).

[182] *Id.*

[183] 172 F. Supp. 833 (S.D. Ill. 1959).

[184] *See, e.g.*, Kruger v. Gerth, 16 N.Y.2d 802 (1965); Clark v. Dodge, 269 N.Y. 410 (1936).

[185] Since salaries are a cost of doing business and, on principle, deductible for tax purposes whereas dividends are a disposition of profits and are therefore not deductible for tax purposes.

[186] It essentially takes no cognizance of inflation.

[187] Book value of private corporations tends to be overstated relative to that of public companies because closely-held corporations generally pay fewer dividends and this tends to inflate the retained earnings component of book value. *See* Gelman, *supra* note 138, at 353.

[188] 305 F.2d 393 (Ct. Cl. 1962).