3-1-1944

Valuation of Business Interests for Federal Estate Tax and Pennsylvania Transfer Inheritance Tax

Edward N. Polisher

Follow this and additional works at: https://ideas.dickinsonlaw.psu.edu/dlra

Recommended Citation
Available at: https://ideas.dickinsonlaw.psu.edu/dlra/vol48/iss3/1

This Article is brought to you for free and open access by the Law Reviews at Dickinson Law IDEAS. It has been accepted for inclusion in Dickinson Law Review by an authorized editor of Dickinson Law IDEAS. For more information, please contact lja10@psu.edu.
VALUATION OF BUSINESS INTERESTS FOR FEDERAL ESTATE TAX AND PENNSYLVANIA TRANSFER INHERITANCE TAX

By

Edward N. Polisher, of the Philadelphia Bar. Author of Estate Planning and Estate Tax Saving; Lecturer, 1943 Institute of Federal Taxation, New York University.

TYPES OF DEATH TAXES

Death taxes are computed upon the valuation of the decedent's property transmitted at death. There are two types of such taxes. One is the estate tax which is levied against the estate itself. The Federal estate tax is its prototype. The other is the inheritance tax, imposed upon the recipient of the decedent's property, whether distributed by will or under the intestate laws. The Pennsylvania transfer inheritance tax is of this pattern. For the purposes of both types of taxes the net valuation of the property included in the decedent's estate at death determines their amount. It is evident, therefore, that the principles governing the valuation of the decedent's property play a decisive role in ascertaining the burden of death taxation.

The Federal estate tax is assessed upon the decedent's net estate at progressively increasing, graduated rates. The net estate is arrived at by computing in the gross estate the value of all property includible therein under the provisions of the Internal Revenue Code and subtracting therefrom all deductions allowable by law plus the applicable general exemptions. As the net estate increases in value, it is taxed progressively at larger rates. The extent by which the valuation of the decedent's property may be reduced lawfully will determine the amount of the estate tax saving.

GENERAL RULES OF VALUATION FOR FEDERAL ESTATE TAX

The problem is to fix the fair market value of each item in the decedent's estate on the date of valuation. Fair market value is broadly defined in the Regulations as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell: Regulations 105 Section 81. 10.
An asset frequently found in the decedent's estate at death is his interest in a business. It may be one which he owned entirely or jointly in association with others. The entity under which it was conducted during his lifetime may have been a sole proprietorship, a copartnership, or a corporation. If a corporation, it may have been one whose stock has a ready market for sale and is traded in on a securities exchange or in "over the counter" transactions; or, the decedent's interest may be shares of stock in a closely held corporation which have no available market for sale. The Regulations prescribe the method for establishing the valuation of each such type of business interest. The decisions of the Federal Courts and the Tax Court have furnished clearer definition when further clarification has become necessary.

Where the business interest of the decedent is in a corporation whose stock is traded in on a securities exchange, its value can be fixed readily by the prices at which the stock was quoted on the date of valuation; or, in the absence of any sales on that day, the quotations on the nearest date. The Regulations prescribe formulae for determining the value of traded securities where the last sale was remote from the valuation date, or the number of shares owned by the estate too large to permit realization of market prices through the usual channels of sale. Regulations 105, Section 81.10 (C).

However, if actual sales or bona fide bid and asked prices are not available, the valuation of shares of stock is determined upon the basis of the company net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock: Regulations 105, Section 81.10 (c). Among the "relevant factors" considered to have bearing upon the value of the stock are: dividend payment experience for preceding years, if normal: Weber vs. Rasquin, 101 F (2d) 62; the liquidating value of each share: Forbes vs. Hassett, 124 F (2d) 925; the past history and future outlook for the business involved: Worcester County Trust Co. vs. Commissioner, 134 F (2d) 578. See also Polisher, on Estate Planning and Estate Tax Saving, p. 65.

The Revenue Act of 1943, by its section 501, adds another element which the Commissioner must take into account in computing the value of stock and securities not listed on an exchange. It provides that where the value of such securities cannot be determined on the basis of sales or bid and asked prices, because they are not listed on an exchange or because of the absence of sales, the Commissioner shall take into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or similar line of business which are listed on an exchange.

As between book value and capitalization of earnings as the determining factor for valuation, the preference of the courts is for the latter: Estate of Daniel Guggenheim, 39 B.T.A. 251, 300 supplemental opinion 40 B.T.A. 181, modified 117 F (2d) 469 cert. den. 314 U. S. 621; Mathilde Hooper 41 B.T.A. 114; Polisher on Estate Planning and Estate Tax Saving, p. 67.
If the business interest of the decedent is that of a partner or sole proprietor, it is valued by making a fair appraisal of all the assets of the business including good will at the applicable date. All other elements which are factors in establishing the fair market value such as net assets, earning capacity, etc., enter into the calculation: Regulations 105, Section 81-10 (d). However, where the partnership agreement transfers the good will to the surviving partner, it does not constitute a factor: Estate of Leopold Kaffie, 44 B.T.A. 834.

Valuation Dates For Federal Estate Tax

Under the Internal Revenue Code, the property of the decedent includible in his gross estate may be valued as of the date of his death or at the option of the decedent's representatives as of the date of one year after the decedent's death, with certain exceptions not pertinent to this discussion: Internal Revenue Code, Section 811 (j). Furthermore, the courts have recognized still another date as of which the valuation of certain property of the decedent may be determined. It is the date of the agreement which a decedent made under which he agreed to sell, or granted an option to others to purchase his interest in his business in the event of his death.

Stock or Business Interests Subject to Agreement of Sale or Option

Where the stock of the decedent in a close corporation or his interest in a business as partner is subject at his death to an agreement of sale or to another's legally binding option to purchase at a fixed price, the fair market value for Federal estate tax purposes is limited to such price, provided the price was fair at the time it was established: Helvering vs. Salvage, 297 U. S. 106 (1936); Wilson vs. Bowers, 57 F (2d) 682 (1932; Lomb vs. Sudgen, 82 F (2d) 166 (1936); Polisher, Estate Planning and Estate Tax Saving, p. 67, 69. See also Hoffman vs. Commissioner, 2 TC No. 143, decided December 20, 1943.

In Helvering vs. Salvage, supra, Salvage, an employee of the Viscose Company in 1922 acquired 1500 shares of its stock for $100 a share. The market value of the shares at that time was $1,164.70 each. The acquisition was made pursuant to an agreement giving the corporation an option to repurchase 5/7 of the stock at $100 per share and Salvage's covenant not to engage in a competing business without the company's consent. These shares were subsequently exchanged for stock in another corporation, part of which were redeemed in 1929. One of the questions involved was the basis of Salvage's stock in 1922 for determining his capital gain in 1929. The Supreme Court held that the fair market value of 5/7 of the stock in 1922 could not be in excess of $100 per share since the corporation had the right to repurchase the same at that price.
The fact that the option exists in favor of a member of the decedent's family does not militate against this rule: *Commissioner vs. Bensel*, 100 F (2d) 639 (1938); *Estate of John Q. Strange*, TC. Memo. op., C.C.H. Dec. 12516 D (1942); *Estate of Anna D. Childs*, TC. Memo. op., C.C.H. 13345 (m) (June 30, 1943). Polisher, Estate Planning and Estate Tax Saving, p. 68.

In *Estate of John Q. Strange*, supra, there was an agreement dated April 11, 1917, between two brothers engaged in business together in a close corporation providing that upon the death of either brother, the survivor might acquire the stock of the other upon payment of $10,000 to the decedent's estate. Payment was so made at the decedent's death. The agreed fair market value of the stock was $238,126.54 as of the date of death. The Tax Court held that the option price was adequate when fixed on April 11, 1917 and is the proper amount to be included in the decedent's gross estate for the stock.

A word of caution should be uttered in respect of agreement of sale and options affecting business interests in favor of members of the decedent's family. In *Commissioner vs. Bensel*, supra, a father and son engaged in business together, were hostile to each other. The father had no desire to make any gift to his son. Each party was represented by separate counsel and the contract was entered into at the insistence of the son, whose valuable services to the corporation the father desired to retain. Protracted negotiations took place before the contract was executed. The option price fixed in the contract bore a relationship to the value of the stock at that time. At the time of the father's death, his business interest had materially increased in value. The Commissioner argued that the difference in value between the price fixed in the agreement and its fair market value at the father's death, represented a gift taking effect at or after death. (Internal Revenue Code, Sec. 811-(c). The Board of Tax Appeals implied that this section might be applicable except for the hostile relationship between the father and the son and stated the section should not be applied where a decedent, at the time of his death, was the owner of the business interest which is subject to an option to purchase by one not the object of his bounty. (Underscoring supplied.) The Circuit Court of Appeals also put emphasis on the peculiar relationship which existed between the father and the son and affirmed the decision of the Board of Tax Appeals.

In the absence of an authoritative decision by the Supreme Court on this question, discretion might be the better part of valor and clients should be cautioned that where a close normal relationship exists between the parties to such a contract, one should not be too sanguine about the Federal estate tax fate of such agreements. Perhaps, the better rule should be that irrespective of the relationship between the parties to such agreements, if they are bona fide and were entered into for a legitimate business purpose, they should be sustained.
The reasoning of the Federal and Tax Courts in arriving at their decisions in these cases is that the decedent was committed to the sale of stock or business interest or that it was subject to a binding option in favor of another at the price fixed. When death occurs, the limit which the decedent's estate can or may expect to receive is the amount established in agreement of the decedent or in the option granted by him during his lifetime. The estate cannot be benefited beyond that amount. The price so fixed will determine the value of the business interest for Federal estate tax calculations.

This result seems not to be dependent upon the actual exercise of the option. Nowhere in the decisions is there any condition precedent that the sale be consummated. The existence of the agreement of sale or binding option is sufficient: Estate of Anna D. Childs, T.C. Memo. op. C.C.H. 13,345 (M) (June 30, 1943).

There is an exception which has been grafted on to this rule. Where the option granted to purchase the stock of an employee, fixed a price based upon a varying scale of percentages of its book value depending upon stated circumstances, (such as 33-1/3% if employee was discharged, 50% if employee's severance from employment was under circumstances unacceptable to the Board of Directors and 75% in all other situations) the commissioner is not bound to accept the lower valuation placed on the stock by the taxpayer but can adopt an alternate, higher valuation which conforms more nearly to the circumstances under which the option would be exercised: Kline vs. Commissioner, 130 F (2d) 742 (1942), a gift tax case.

**STOCK SUBJECT TO RESTRICTIVE AGREEMENT**

There is another type of agreement frequently used which may affect the value of stock representing the business interest of the decedent. It is one which requires that in the event the holder of stock, during his lifetime or his executors after his death, should desire to sell or dispose of the same, it first be offered to the corporation or stockholders at a stated price. The holder of the stock, or his representative in the event of his death, is under no obligation to sell the stock to the remaining stockholders or the corporation except that if he desires to sell, he cannot do so to an outsider without first offering it to the corporation or stockholders as the case may be. Such a provision does not restrict the right of the Federal government to collect taxes upon the actual value of the stock. The regular method of valuation of corporate stock as discussed above will apply to such stock but the restrictive agreement must be taken into consideration in fixing the value for Federal estate tax purposes: Behles vs. Commissioner, 87 F (2d) 228 (1937); Heimer vs. Gwinner, 114 F (2d) 723 (1940); Estate of James Smith, 46 B.T.A. 337 (1942); Clarence P. Chamberlain vs. Commissioner, T. C. Memo. op. C.C.H. Dec. 13,381 (M) (July 19, 1943); Polisher on Estate Planning and Estate Tax Saving, p. 68.
This rule has been relaxed in a case involving special circumstances. Where the stock subject to the restrictive agreement was highly speculative and the restriction against transfer was such as to make the sale thereof impossible, the stock did not have a fair market value capable of being ascertained with reasonable certainty. The value fixed in the restrictive agreement was accepted: *Helvering vs. Tex Penn Oil Co.* 300 U. S. 481 (1937).

**Valuation Under Pennsylvania Inheritance Tax.**

The estate of a decedent who was a resident of Pennsylvania will be subject also to inheritance taxation at the hands of this Commonwealth. It is interesting, therefore, to examine the principles of valuation which control in Pennsylvania and to ascertain whether they coincide with those recognized by the Federal authorities or, if they differ, in what respects the divergencies exist.

The Pennsylvania Act of June 20, 1919, P.L. 521, 72 PS Section 2301, as amended, imposes an inheritance tax "upon the clear value of the property subject to tax" at the rates set forth for the various relationships of the beneficiaries to the decedent. The clear value "at death" determines. There is no optional date of valuation other than this.

In respect of business interests of the decedent which form a part of his estate, their valuation is determined according to the form of the legal entity under which the decedent operated his business enterprise. If the business interest is evidenced by shares of stock which are listed upon a securities exchange, the market quotations at the decedent's death are evidence of value: *Clabby's Estate*, 308 Pa. 287 (1932).

Where the decedent's business interest consists of unlisted, inactive and closely held stock having no ready market value, its value is established by proving the value of the property and business of the corporation less its liabilities: *McClure Appeal*, 347 Pa., 481 (1943); *Wood's Estate*, 29 Dist. R. 960 (1920); *Leiper's Estate*, 40 D. & C. 633 (1941); Polisher, Estate Planning and Estate Tax Saving, p. 200.

The value of partnership and sole proprietorship interests is determined in the same manner as closely held stock. Good Will is seldom considered in the appraisement for inheritance tax purposes: C.C.H. Pennsylvania Tax and Procedure, Sections 1820, 1830.

**Stock or Business Interests Subject to Option in Favor of Another**

The clear value of the decedent's business interest will not be controlled, for computing the Pennsylvania Transfer Inheritance Tax, by the price fixed in an agreement to which the decedent was a party granting an option to a third
person to purchase his stock in a closely held corporation: *McClure Appeal*, 347 Pa. 481 (1943); *Dellone Appeal*, 347 Pa. 486, (1943); Polisher, Estate Planning and Estate Tax Saving, p. 201.

In *McClure Appeal*, supra, decided June 30, 1943, the decedent was an officer of Lavino and Company. By several gifts, he became the owner of 7500 shares of Lavino Company, by whom he was then employed, subject to an agreement that he would not sell without the company's consent; that is if he died, or severed his connection with the company, under conditions acceptable to the directors, his personal representatives in the one case, and he in the other, would offer the stock to the company at 75% of the book value, determined as specified in the agreement, and that the company should have the option, for a period of six months, to purchase all or part at the price stated. If the company declined to purchase, the owner might sell the stock elsewhere. The price at which the stock was sold was $57.045 per share which was 75% of its book value. The evidence adduced indicated that the stock was unlisted, was closely held and that there were no sales in the market. The lower court accepted the "book value" as the clear value for computing the inheritance tax due the Commonwealth. The outstanding option agreement to which the decedent was a party granting an option to the Company to acquire the shares on his death at 75% of their book value was entirely disregarded.

Mr. Justice Linn, speaking for the Court, said at page 485: "No agreement by a property owner fixing the value can oust the jurisdiction of or control of the Commonwealth but it will be considered with the other evidence. The Federal decisions referred to are binding in the application of the Federal estate law but do not prevent the authorities, required to apply the state law, from attributing to the option agreement less probative force in the valuation inquiry than is accorded such agreements by the Federal Courts in applying the Federal law."

The decision of the Supreme Court in *McClure Appeal*, supra, is to be regretted. In the first place, it is not realistic. The agreement granting the option was bona fide and the price fixed was fair under the circumstances of the acquisition of the stock by the decedent. The decedent's estate at his death was under an enforceable option to sell the stock to the Company at the price established in the agreement. In fact, it actually did so sell. In effect, the stock was converted into a cash asset in the amount of the proceeds of the sale received by the estate from the Company for the stock. What measuring rod of value could be more accurate and reliable than the actual sale price?

True, the Court in its opinion declares that the probative force of such an option agreement "will be considered with the other evidence." What was the purpose of this "lip service" when the Court obviously ignored the terms of the agreement?
Another reason why the McClure Appeal decision is to be lamented is that in an era where there are such concerted and sincere efforts being exerted to bring about a greater harmony of the decisions on like issues in the various courts of the nation, this conflict is injected on what seems to be an arbitrary and categorical basis without any attempt to appraise the equities of the situation or to be influenced by a sense of realism.

The conclusions which derive from the foregoing discussion are:

1. For Federal estate tax:

   (a) The fair market value of the decedent's business interest determines the amount of its inclusion in his estate.

   (b) The date of valuation may be as of the decedent's death, or at the end of one year after death, at the option of decedent's representative, or, as of the date, prior to death, of a bona fide agreement or option to sell the business interest, to which the decedent was a party.

   (c) Where the decedent's business interest consists of shares of stock listed on a securities exchange, the market quotation of sales on the date of the valuation prevails except under some circumstances where large blocks of stock are involved. In the absence of such sales, then according to the formulae set forth in the Regulations founded upon the average price of sales nearest the valuation date.

   (d) If the business interest of the decedent is a sole proprietorship, a partnership or shares of stock in a closely held corporation, the value is determined upon the basis of the Company's net worth earning power, dividend paying capacity and all other relevant factors bearing upon the value. Good will is an important element of value in sole proprietorships and partnerships.

   (e) Where the stock of the decedent in a close corporation or his interest in business as a partner is subject at his death to an agreement of sale or to a legal binding option in favor of another to purchase at a fixed price, this will be the fair market value if the price was fair at the time it was established.

   (f) Should the business interest of the decedent be subject to a restrictive agreement requiring that it be first offered to the corporation or its shareholders at a stated price before being sold to an outsider, this will not control the price of the stock. The regular method of valuation will prevail although the restrictive agreement will be considered as an element for its depressing effect, if any, on the market value of the stock.
2. For Pennsylvania Transfer Inheritance Tax:

(a) The clear value of the decedent’s business interest determines the amount of its inclusion in his estate.

(b) The date of valuation is the decedent’s death.

(c) Where the decedent’s business interest consists of shares of stock listed on a securities exchange, the market quotations are evidence of their value.

(d) If the decedent’s business interest is comprised of unlisted, inactive and closely held stock having no ready market value, its value is determined by deducting the liabilities from the value of the property and business of the corporation.

(e) Partnership and sole proprietorship business are valued under the same formula as closely held stock. Good will is seldom considered.

(f) The value of the decedent’s business interest will not be controlled by any agreement outstanding at his death to which he was a party, granting a legally binding option to sell the business interest at a price fixed in such agreement.