Federal Estate Taxation of Closely-Held Interests - Recent Decisions

Edward N. Polisher

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A. INTRODUCTION TO PROBLEM

1. General

The philosophy of the American political system has been based upon the dignity and the freedom of the individual. Our economy and wealth have been built largely by individual enterprise. This freedom of enterprise has expressed itself in the creation and development of business ventures. While many of these businesses are widely owned, by far the majority of them are held by individuals and small groups of business associates. The legal entity under which the latter are conducted may be a partnership or a corporation whose shares are closely-held.

In the estates of many decedents, the largest single asset to be found is often the business interest. This must be valued, together with other assets in the estate, to determine the amount of the net estate subject to federal estate and local death taxes. Since these taxes, and the debts and costs of administration of the estate, must be paid in cash within a limited time after death, it frequently becomes necessary to liquidate or dispose of the business interest to provide the necessary cash. This, because the financial structure of the average business, in which capital is an income-producing factor, is such that large sums of cash and liquid resources are not present normally beyond its reasonable needs for working capital. The remainder of its resources is usually invested in buildings, machinery, equipment, raw materials, accounts receivable, inventory, and other assets necessary to the successful operation of the business. Thus, the problem is two-fold: first, to ascertain the valuation which will be placed upon the business interest by the estate tax authorities, which in turn determines in part the amount of such taxes to become payable; and second, to take the necessary steps to assure the conversion into cash of the business interest at a fair and reasonable price without drastic sacrifice in values. It is with the first of these problems that this article will concern itself.
2. Valuation Date

Valuation is determined as of the date of the death or at the optional date of valuation, one year later, if the executor so elects. I. R. C. Sec. 811 (a) and (j); Regulations 105, Sections 81.10 and 81.11.

3. Standard of Valuation

The standard of valuation is the fair market value, which is 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. A forced sale price will not satisfy this provision. All relevant facts and elements of valuation as of the applicable date must be considered. Regulations 105, Section 81.10 (a).

4. Factors Affecting Valuation

Those assets in the estate which have a ready market for sale are valued at such sale prices. Thus, stocks, bonds and other securities listed upon recognized stock exchanges, or dealt in by brokers in over-the-counter transactions, are valued usually at the price for which such securities were sold at or near the applicable valuation date. Where, however, securities evidencing the ownership of the decedent's business interest are closely held and have no open market for sale, or where the decedent's interest is represented by his individual ownership thereof or by an interest in a partnership, the Regulations provide special treatment for valuation of such closely-held business interests.

The term "closely-held interest" for the purpose of this paper includes fractional interests in real estate as well as interests in business closely held.

The valuation of closely-held business interests is complicated by many factors. Among them are:

(a) Nature of the business;
(b) Whether a majority or minority interest is involved;
(c) The absence of a ready market;
(d) The existence of restrictive agreements which may or may not bind the estate to sell in the event of death;
(e) The presence or absence of good will and its valuation.

5. Interrelation of Estate, Gift and Income Taxes in Valuation Matters

Throughout this article, decisions of the courts and rulings of the Treasury Department in gift tax and income tax, as well as estate tax cases, are cited as authority. This, because the valuation of closely-held interests for all three federal taxes is governed by similar and reciprocal principles. Thus, the decision in a valuation matter under one of the several federal taxes may provide the standards for the determination of value for other federal tax purposes.
B. FRACTIONAL INTERESTS IN REAL ESTATE

The Regulations dealing with the valuation of real estate are negative in their approach. They provide simply that "the property should not be returned at the local assessed value thereof unless such value represents the fair market value as of the applicable valuation date." Regulations 105, Section 81.10 (b).

Many factors have been considered as elements in determining the value of real estate, such as rentals received, sales of similar property, price at which the property in question was sold, offers to purchase or to sell, the amount of a recent mortgage placed on the property, and appraisals by experts familiar with comparable property. See Polisher, Estate Planning and Estate Tax Saving (2nd Ed. 1948), p. 296.

Fractional interests in real estate, however, may be worth less than their proportionate share of the value of the entire property. This, because of the difficulty of marketing an undivided interest, the disadvantage of owning real estate jointly with others, and the expense and delay of a possible partition proceeding. Thus, decedent's undivided one-third interest in twenty parcels of real estate was valued at ten per cent less than its aliquot part of the total market value of the property. Estate of Sallie H. Henry, 4 TC 423 (1944), aff'd. 161 F. 2d 574 (CCA-3, 1947). This decision is in harmony with the prior decisions. See, William R. Stewart, Jr., 31 BTA 201 (1934), where a 15 per cent discount was allowed; and Estate of Nina M. Campanari, 5 TC 488 (1945), recognizing a 12 1/2 per cent discount. On the other hand, where the evidence indicated that such undivided fractional interests were actually sold in the market at a price equal to or in excess of the mathematical equivalent of the admitted value of the entire parcel, no discount was allowed. National City Bank of New York, et al., 2 BTA 696 (1925).

C. STOCK IN CLOSELY-HELD CORPORATIONS

Stock in closely-held corporations normally does not have a ready market for sale, in the absence of a pre-existing purchase agreement between parties in interest. The securities evidencing ownership of such business interests are not listed on securities exchanges and are rarely traded in by brokers in over-the-counter transactions. As a result, the recognized standards for determining the valuation of readily marketable securities have no application to stock in closely-held corporations. Thus, Regulations 105, Section 81.10 (c) states:

"If actual sales or bona fide bid and asked prices are not available, then, in the case of corporate or other bonds, the value is to be arrived at by giving consideration to the soundness of the security, the interest yield, the date of maturity, and other relevant factors, and in the case of shares of stock, upon the basis of the company's net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock. Among such other relevant factors to be considered are the values of securities of corporations engaged in the same
or a similar line of business which are listed on an exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case.

It is this section of the Regulations which provides the general rules for determining the valuation of shares of stock in closely-held corporations, although the term "close corporation" nowhere appears in the Regulations. Depending upon the facts and circumstances of each case, the elements of valuation indicated in the Regulations are applied, either individually or in combination, to arrive at the valuation for federal estate tax purposes. However, it has been held to be error, as a matter of law, to base the estimate of value for purposes of fair market value upon one factor to the exclusion of other relevant factors. See, Drayton Cochran, et al., TC Memo. Op., CCH Dec. 16, 431 (M) (1948).

1. Valuation Determined by Corporation's Underlying Assets

The tendency of the courts is to place special emphasis upon the earning power and dividend record of the corporation. This approach is not absolute. The stock of close corporations is frequently valued on the basis of its underlying or physical assets. Several recent cases have employed this measure of valuation. Thus, where a corporation had been paying dividends in excess of available earnings and its earnings were also misleading because they were diverted into interest-free loans for shareholders rather than into remunerative channels, the court valued the stock on the basis of the corporation's underlying assets as the only reliable criterion. Nathan Estate v. Commissioner, 166 F. 2d 422 (CCA-9, 1948).

Similarly, the Commissioner's valuation of stock in a closely-held corporation, whose sole asset was an apartment building, was approved by the court where it did not exceed the amount used as the basis of depreciation by the taxpayer for said building, or the par value of the outstanding stock (which had been yielding an 8 per cent dividend return). Estate of Thomas R. Tennant, T. C. Memo. Op., CCH Dec. 16, 839 (M) (1949).

The same formula for valuation was applied to shares in a closely-held corporation engaged in a highly competitive and speculative business: Estate of James Hogan, T. C. Memo. Op., CCH Dec. 13, 859 (M) (1944); and to the bonds held by the decedent in a brewery which was operated, though not very successfully, up to within six months of the valuation date: Agnes McCue, Transferee, T. C. Memo. Op., CCH Dec. 15,043 (M) (1946).

On the other hand, this method of valuation was not considered sound where the shares to be valued represented minority interests in a going concern. This, because such shares did not carry with them control of the corporation which would enable their owners to enforce liquidation and recover their proportionate share of the assets. Estate of Charles W. Heppenstall, Sr., T. C. Memo. Op., CCH Dec. 16,838 (M) (1949); Drayton Cochran, et al., T. C. Memo. Op.,
2. Valuation Based on Value of Listed Stock of Comparable Corporations

Section 501 of the 1943 Revenue Act added a new sub-section (k) to Section 811 of the Internal Revenue Code. It provides that where the value of stock and securities of a corporation, because of not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined on the basis of sales or bid and asked prices, the value of such unlisted stock and securities shall be computed by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange. See also, Regulations 105, Section 81.10 (c), supra.

It seems obvious that the purpose of Congress, in requiring comparison with the stock of other companies in the same or similar line of business, was based upon the underlying philosophy that the market value of stocks of such similar corporations is usually affected by the same economic conditions. In considering the effect of this element of valuation, however, attention is directed to the fact that listed securities as a rule sell at a higher price than comparable stocks which lack ready marketability because they are unlisted and closely held.

In Drayton Cochran, et al., T. C. Memo. Op., CCH Dec. 16,431 (M) (1948), the Tax Court took cognizance of this factor. It held that since unlisted stock in a close corporation lacks marketability, discount should be allowed for this fact from the value of listed stocks in comparable corporations.

3. Significance of Recent Sales

The valuation of closely-held stock may be determined by sales at or near the applicable valuation date, provided such sales are the result of arms-length transactions. Where the sale is between related parties, the transaction is closely scrutinized to determine whether the price paid represents the fair value of the stock. Several recent cases have illustrated this principle. Thus, the Tax Court recently held that intra-family sales generally do not give a dependable measure of value because they are not sales in a free and open market: Estate of Charles W. Heppens- stall, Sr., T. C. Memo. Op., CCH Dec. 16,838 (M) (1949). On the other hand, an arms-length sale by the vice president of a banking corporation to a director, both parties having full knowledge of the stock's value, was held to fix the fair market value, despite the higher valuation indicated by dividend history and book value: Estate of E. W. Hunt, 11 T. C. — No. 116 (1948). Similarly, the Tax Court held that the price realized by decedent's estate from the sale of 100 shares of stock in a closely-held corporation to the corporation's president shortly after the applicable valuation date was the fairest indication of what a willing buyer would pay a willing seller, notwithstanding this was the only sale of such stock in 22 years: Estate of Lillian M. Schroeder, 13 T. C. — No. 36 (1949).
4. Valuation Determined by Capitalization of Earnings

Earnings and dividend payments for preceding years are important elements in determining fair market value. Generally, earnings and dividends for a period of five years prior to the applicable valuation date are considered representative of the earning capacity of the corporation. These are averaged to determine its average annual earnings, and that figure is then capitalized at an appropriate rate. A. R. M. 34, 2 C. B. 31. The rationale of this ruling is that a going business concern which, over a representative past period, operated at a profit, in all likelihood would continue to do so for a sufficient period in the future to assure a stabilized return on the investment. Such profits represent, in part, a fair return for the invested capital employed in the business, and the remainder constitutes earnings attributable to intangibles, such as the good will of a proprietorship or a partnership and the earning capacity of a corporation as a going business.

However, where the five-year period is not truly representative of the earning capacity of the business, a longer period may be used. Thus, in Drayton Cochran, et al., TC Memo. Op., CCH Dec. 16,431 (M) (1948), a seven-year period was found to be representative for averaging earnings. Similarly, in computing average earnings, the results of abnormally good years within the period selected may first be adjusted downward: Plaut v. Smith, 82 F. Supp. 42 (USDC, Conn., 1949); or an unusually good or bad year may be disregarded: Estate of Frederick J. Kieser, BTA Memo. Op., CCH Dec. 11,089-C (1940).

While dividend payments for preceding years are normally regarded as important elements in determining fair market value, they do not provide a dependable basis for stock valuation where the corporation follows a highly abnormal system of dividend distribution. Nathan Estate v. Commissioner, 166 F. 2d 422 (CCA-9, 1948); see also, Bank of California v. Commissioner, 133 F. 2d 428 (CCA-9, 1943). Neither are past earnings considered a reliable index of prospective future earnings where the decedent was a controlling stockholder whose death would place the business under new and untried management. Estate of Charles E. Kimball, T. C. Memo. Op., CCH Dec. 15,485 (M) (1946).

D. PROPRIETORSHIP AND PARTNERSHIP INTERESTS AND GOOD WILL IN CONNECTION THEREWITH

1. Regulations

Where the decedent's business interest was a sole proprietorship or an interest in a partnership, the Regulations furnish a special formula for its valuation. Regulations 105, Section 81.10 (d) provides:

"... Care should be taken to arrive at an accurate valuation of any business in which the decedent was interested, whether as partner or proprietor. A fair appraisal as of the applicable valuation date should be made of all the assets of the business, tangible and intangible, including good will, and the business should be given a net value equal to the amount which a willing purchaser, whether an individual or corporation,
would pay therefor to a willing seller in view of the net value of the assets and the demonstrated earning capacity. Special attention should be given to fixing an adequate figure for the value of the good will of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money’s worth, that his interest therein shall pass at his death to his surviving partner or partners."

2. Definition of Good Will

The most troublesome part of this formula arises in the handling of good will.

Good will as a concept embraces many elements. A precise definition is difficult to formulate. It is not necessarily confined to a name. It may attach itself to a particular location wherein the business was transacted or to a list of customers or to other elements of valuation in a business as a going concern: C. C. Wyman & Co., 8 BTA 408 (1927); Theo. Planz, Inc., 10 BTA 1158 (1928).

Good will has been defined as, "The advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity or even from ancient partialities or prejudices." Story, Partnership, §99.


3. Existence of Good Will

The first issue which must be met is whether any good will exists which is attributable to the decedent’s business interest. If so, the next step must be the determination of the value of such good will for estate tax purposes. In resolving the question of whether good will exists, certain conditions must be present. Good will can exist only for a going concern. Where the business is liquidated, the good will is lost. Thus, where the decedent’s agreement with his partners stipulates, or the decedent whose business is conducted as a sole proprietorship directs in his will, that the business be liquidated in the event of his death, no good will attaches to the valuation of such business interest. Therefore, the first requirement is that there be a continuation of the business interest after death to warrant the addition of any value for good will: Metropolitan National Bank v. St. Louis Dispatch Co., 149 U. S. 436 (1893).

The mere fact that the books of the business enterprise do not include a value for good will is not conclusive that no good will exists: John R. Shunk, 10 TC 293,303 (1948). On the other hand, good will does not necessarily exist solely because a partnership is found to have enjoyed large earnings. The large earnings
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may be due to the efforts of the partners, to the exercise of business judgment, or to fortuitous circumstances in no wise related to good will: Estate of Leopold Kaffie, 44 BTA 843, 850 (1941).

Further, good will does not adhere to a business whose success is attributable almost entirely to the personal skill, ability, experience and wide acquaintance of one or two individuals connected with it: Estate of Arthur J. Brandt, TC Memo. Op., CCH Dec. 17,183 (M) (1949); D. K. MacDonald, 3 TC 720 (1944). See also, Crawford K. Stillwagon, et al., TC Memo. Op., CCH Dec. 17,102 (M) (1949), involving the valuation of corporate stock. This rule will not prevail, however, where the parties by their own acts acknowledge that good will does exist despite the presence of the personal element. In Estate of Samuel H. Strauss, TC Memo. Op., CCH Dec. 16,963 (M) (1949), the Tax Court held that good will attached to a retail cigar store business, although the deceased partner had always been the moving force in the operation and management of the partnership business. The agreement of the parties themselves indicated the presence of good will and directed that, in the event of the sale of the business to an outsider, good will should be compensated for. In another recent case, involving income tax, the Tax Court recognized, without discussion, that good will could exist in the sale of an accountant’s professional practice where the agreement of sale expressly transferred good will and contained a covenant on the part of the seller not to compete: Rodney B. Horton, 13 TC — No. 19 (1949).

4. Valuation of Good Will

The method of valuation previously discussed in respect of closely-held stock is likewise applied to sole proprietorship and partnership interests, where good will exists. The valuation is arrived at by capitalizing the excess average earnings of the business entity over a representative period of years, after allowing a reasonable return for invested capital. The period of earnings selected, as in the case of stock of closely-held corporations, must be fairly representative of the earning capacity of the business, and is not necessarily limited to the five-year period suggested in A. R. M. 34, 2 C. B. 31. Thus, in a recent Tax Court decision, the average of ten years’ earnings was used to strike an adequate balance of bad years with prosperous years: Estate of Kellar E. Watson, Sr., TC Memo. Op., CCH Dec. 16,262 (M) (1948); and in still another decision, 12 years of partnership net income was considered the proper representative span: Samuel H. Strauss Estate, TC Memo. Op., CCH Dec. 16,963 (M) (1949).

Moreover, certain adjustments have been recognized to reflect more fairly the average earnings of the business and the income attributable to tangible and intangible assets respectively. Thus, adjustments were made for inadequate rent and salaries before computing average annual earnings: Estate of Kellar E. Watson, Sr., supra; and excess capital, not required by business operations, was disregarded in computing the reasonable return on invested capital: Samuel H. Strauss Estate, supra.
Every case of valuation of intangibles must be considered in the light of its own facts. Good will cannot be exactly appraised. An approximation is the best that can be achieved: Schuh Trading Co. v. Commissioner, 95 F. 2d 404, (CCA-7, 1938); Mostman, Yarnelle & Co., 9 BTA 45 (1927).

5. Formulae for Valuation of Good Will

The method most commonly employed to determine the value of good will is known as the Income Tax Formula. Under this method, the objective is to apportion earnings from the business operation between the tangible assets used in the business and the intangibles; and then capitalize the latter at an appropriate rate to arrive at a value for good will. This is accomplished by first computing the average annual net earnings as described above, deducting therefrom an amount varying from 8 to 10 per cent of the average invested capital, which is regarded as earnings attributable to tangibles, and then capitalizing the remaining earnings, considered as attributable to intangibles, at a fixed rate, for example, 15 to 20 per cent. The sum of the net tangibles and the value of the intangibles, as thus determined, constitutes the value of the stock or the business interest: A. R. M. 34, 2 C. B. 31.

In two recent decisions, the Tax Court approved the Commissioner's application of this formula in arriving at the value of good will: John Q. Shunk, 10 TC 293 (1948); and Estate of Samuel H. Strauss, TC Memo. Op., CCH Dec. 16,963 (M) (1949).

A variation of this method, known as the Year's Purchase Formula, is also authorized in A. R. M. 34, 2 C. B. 31. Under this formula, a similar allowance for return on invested capital is made against average annual earnings, as above. Then, a value for intangibles is arrived at by multiplying the average annual net earnings attributable to intangibles by a figure (for example, 3, 4 or 5) representing the number of years' purchase of good will which is a reasonable basis under the circumstances. In a recent decision, the Tax Court approved a five years' purchase of good will for the decedent's partnership interest in a retail drug store, after allowing a ten per cent return on average tangibles, out of annual earnings averaged over a ten-year period: Estate of Kellar E. Watson, Sr., TC Memo. Op., CCH Dec. 16,262 (M) (1948). Where the business is of a hazardous nature or faces an uncertain financial future, compensation may be provided for these factors by using higher rates of return on capital and higher capitalization percentages. See A. R. M. 34, 2 C. B. 31, and Kellar E. Watson, Sr., supra.

The practical effect of adding an amount for the valuation of good will to the net worth of the business interest for federal estate tax purposes is to increase the burden of such taxation, without providing at the same time additional resources from which the tax can be paid. The amount fixed for the value of good will, in virtually all cases, is theoretical. It is rare indeed that a sale of decedent's business interest upon the open market will carry with it an addition to the sale price for good will.
E. EFFECT OF AGREEMENT OF SALE, OPTION TO PURCHASE, OR OTHER RESTRICTIVE AGREEMENT, UPON VALUATION OF CLOSELY-HELD BUSINESS INTEREST

1. Agreement of Sale or Option to Purchase in Survivor

Where the stock of the decedent in a close corporation or his interest in a business as an individual or as a 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 value for federal estate tax purposes is limited to such price; provided, the price was fair at the time it was established and the decedent could not have disposed of the property at any time prior to his death: Helvering v. Salvage, 297 U. S. 106 (1936); Commissioner v. Bensel, 100 F. 2d 639 (CCA-3, 1938), aff'd. 36 BTA 246 (1937); Lomb v. Sugden, 82 F. 2d 166 (CCA-2, 1936); Wilson v. Bowers, 57 F. 2d 682 (CCA-2, 1932); Claire G. Hoffman, 2 TC 1160 (1943); Estate of James H. Matthews, 3 TC 525 (1944). The logic of this rule lies in the fact that the decedent's estate cannot be benefited beyond the amount established in the agreement of the decedent or in the option granted by him during his lifetime. It would be unrealistic to place a greater valuation upon the business interest.

However, a word of caution should be uttered in respect of agreements of sale and options in favor of members of the decedent's family or other natural objects of his bounty. Such situations will be closely scrutinized to discover whether full and adequate consideration existed to support the agreement or option. See Commissioner v. Bensel, supra; Edwin R. Armstrong, TC Memo. Op., CCH Dec. 13,717 (M) (1944), aff'd. 146 F. 2d 457 (CCA-7, 1944); Claire G. Hoffman, supra, pp. 1178-79; Polisher, Estate Planning and Estate Tax Saving (2d Ed., 1948), Page 310 et seq.

2. First Offer, Restrictive Agreement

There is another type of agreement frequently used which may affect the value of shares of closely-held stock representing the business interest of the decedent. It is one which provides that in the event the holder of stock, during his lifetime, or his executor after his death, desires to sell or dispose of the same, it must first be offered to the corporation or shareholders 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 corporation or the remaining shareholders. However, if he desires to sell, he cannot sell to an outsider without first offering it to the corporation or shareholders, as the case may be. Such a provision does not restrict the right of the federal government to collect estate taxes upon the fair market value of the stock. The regular method of valuation of unrestricted closely-held stock, as discussed above, will apply to such stock but the effect of the restrictive agreement must be taken into consideration, in fixing the value of the shares for federal estate tax purposes: Behles v. Commissioner, 87 F. 2d 228 (CCA-7, 1937); Heiner v. Gwinner, 114 F. 2d 723 (CCA-3, 1940), cert. den.
311 U. S. 714 (1941); Worcester County Trust Co. v. Commissioner, 134 F. 2d 578 (CCA-1, 1943); Clarence P. Chamberlin, TC Memo. Op., CCH Dec. 13,381 (M) (1943).

3. The Strauss Case

The recent decision of the Tax Court in Samuel H. Strauss Estate, TC Memo. Op., CCH Dec. 16,963 (M) (1949) has provoked much discussion in this connection. There, a partnership agreement provided that decedent-partner's heir and daughter should first have an option to purchase the surviving partner's interest, failing which the surviving partner should have an option to acquire the decedent's interest. The purchase price in each case was to be based on book value alone without any charge for good will. If neither exercised such option, the business was to be sold as a going concern, taking good will into consideration. The Tax Court held that a value for partnership good will was to be included in valuing the decedent's business interest. Many erroneous interpretations of this decision have resulted. The Strauss case does not change the above-stated rules that the valuation of the decedent's business interest may be determined under certain circumstances by agreements between him and his business associates. As a matter of fact, a reference to the briefs filed by the petitioner in the Strauss case reveals that the petitioner made no contention that the type of agreement entered into in that case effectively controlled the valuation of the business interest. The importance of the decision lies only in the elements considered by the court in determining the existence of good will, the representative period for valuation, and the base figure to be used for invested capital.

Had the Strauss agreement created a fixed obligation on the part of the estate to sell the decedent's interest to the survivor at a price which was fair when agreed upon, and had it precluded the decedent from disposing of such interest during his lifetime, the price so fixed would have controlled the estate tax valuation.