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John M. Grogan

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Taxation—The Effect of Restrictive Stock Agreements in Determining the Value of Stock for Death Tax Purposes—After an attempt was made by outsiders to gain control of a family-owned corporation one stockholder agreed to sell his shares to another at forty dollars per share, the sale to be completed prior to September 30, 1953. Before the sale was effected the vendor died testate, leaving his entire estate to the purchaser, who appealed from a county court ruling that the contract price could not be taken into consideration in valuing the stock for state inheritance tax purposes. *Held:* Affirmed. The value of the legacy is not affected by the fact that the legatee holds an enforceable contract right to the stock which will not be exercised. The Wisconsin Inheritance Tax is based on the interest to which the living succeeds and that is valued at the clear market value. *Estate of Michel, 262 Wis. 432, 55 N.W. 2d 388 (1952).*

Contract rights to stock left by a decedent often arise from restrictive stock agreements. These agreements may take many forms but all are so designed that the stock held will not be disposed of without giving other stockholders or the corporation a chance to purchase it.[1] They are one of the means through which holders of closely held stock of small corporations can protect themselves from the risk of undesirable outsiders gaining control of stock. They may be also used for many other purposes such as to keep heirs from demanding larger dividends or exercising a voice in the management of the business. One of the most important reasons behind these agreements is to establish a valuation of the stock for death tax purposes when valuing it would be difficult due to its being seldom traded.[2] Thereby the burden of overcoming the presumption of correctness which attaches to the Commissioner's valuation is avoided. Hence these agreements are both useful and necessary for small corporations.

While the effect of these agreements on the valuation of the stock for Federal Estate Tax purposes has been rendered fairly certain by a number of decisions, the valuation for the Wisconsin Inheritance Tax is still largely undetermined since only a few such cases have arisen in Wisconsin. It is the purpose of this note to aid the lawyer in drafting these agreements by showing when the Commissioner of Internal Revenue will probably accept the value set in an agreement, and by attempting to predict, in the light of the few cases decided thus far, when the Wisconsin Tax Department might do so also.

In order for the price set in the agreement to be accepted for Federal Estate Tax purposes, it is necessary for the agreement to have bound the decedent up to the time of his death, at least if he wished to

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[1] Note, 5 A.L.R. 2d 1122 (1949).

[2] Pavenstedt, *The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements to Control Estate Tax Valuation,* 51 MICH. L. REV. 1 (1952).

dispose of the stock, and to bind his executor, after death, by at least conferring upon the other party to the agreement an irrevocable option to purchase the stock exercisable after the optionor's death. To more certainly establish the tax valuation, a fair and adequate consideration should be given for the right to purchase the stock, the agreement should not be apparently motivated by any tax avoidance scheme, and the price fixed should be fair at the time the agreement is made.

The nature of the contractual undertaking of the vendor or optionor should be the foremost concern of the attorney. Agreements containing merely first offer restrictions[3] binding both the stockholder and his estate have not been allowed to determine the tax valuation of the shares on the ground that a stockholder should not be able to fix the valuation of his shares by an agreement under which he is not absolutely bound to dispose of them.[4] However such a restriction may have an effect on the market value of the stock and thus be given effect indirectly.[5] This would be so where subsequent holders of the stock are also bound by the restriction, for example when it is included in the articles of incorporation. On the other hand, if the agreement absolutely binds the executor to sell but no restriction is made on inter vivos disposition, the price fixed again will not be accepted in determining the tax valuation on the ground that since the decedent could have disposed of his entire holdings at market value any time during his life, the agreement is intended to take effect at or after death and is includible in the gross estate at market value.[6]

However, a recent case made clear that the stock will be valued at the contract price for Federal Estate Tax purposes when a first offer restriction during life is combined with an irrevocable option arising on death binding the executor.[7] This case affirmed the rule laid down in two prior cases that the contract valuation will be adopted only when the decedent could not have disposed of the stock at other than the contract price and his executor is bound to do so at least at the election of the other party to the contract.[8] The decedent's undertaking must include these two covenants if the price set is to be accepted by the Commissioner.

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[3] First offer restrictions give the offeree a first option to purchase if the offeror decides to sell.

[4] Louise N. Schulz, 14 B.T.A. 419 (1928); Michigan Trust Company et al, 27 B.T.A. 556 (1933).

[5] Worcester County Trust Co. v. Commissioner, 134 F.2d 578 (1st Cir. 1943).

[6] INT. REV. CODE §811 (c) (1) (C); Mathews v. Commissioner, 3 T.C. 525 (1944). "The option indicates it was intended to take effect in possession and enjoyment at or after the optionor's death and therefore the fair market value of the property is includible in gross estate under the rationale of Helvering v. Hallock, 309 U.S. 106"; Hoffman v. Commissioner, 2 T.C. 1160 (1943).

[7] May v. McGowan, 194 F.2d 396 (2d Cir. 1951).

[8] Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932); Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936).

Other requirements must also be met to insure the adoption of the contract price. The agreement should be made by parties negotiating at arms length to promote individual and often also mutual interests in the best manner possible. In considering this, the court will look to the consideration given for the right to purchase the stock, the contract price, and the relation of the parties.

> "—while a bona fide contract, based on adequate consideration, to sell property for less than its value may fix the value of the property for the purposes of the estate tax, a mere gratuitous promise to permit some favored individual particularly the natural object of the bounty of the promissor, to purchase it at a grossly inadequate price can have no such effect."[9]

Where a full and adequate consideration has not been given for the contract, the stock has been valued at the market value on the grounds that a gift or legacy of the difference between it and the option price must have been intended.[10] Of course mutual options and promises to remain active in the business or to continue management policies will be considered adequate. Furthermore if the sole or dominant purpose for the agreement is determined to be a minimization of estate taxes, the present rule may well be disregarded. Although in the *May* case[11] the court said if a loophole was afforded it could be closed by the legislature, no purpose to evade taxes was found in that case and courts in other circuits may think differently on this point. In this respect also, the price set in the option has an important bearing in showing the contract to be bona fide, and though at the date of death there may be a wide discrepancy between it and the market value, it would seem that it should be a fair one at least on the day the option was given.[12]

The *Michel* case would apparently fulfill the test prescribed by the *May* case since an enforceable contract right existed at the date of death and no attempt to evade taxes was shown. Still the court said that the interest passed under the terms of the will rather than under the contract so no such rule needed to be applied, but if the legatee of the shares had been someone other than the optionee, the case would have been different. In such case apparently the court would have been required to adopt either the "Federal Rule" or the so-called "Pennsylvania Rule," the latter being that no agreement by property owners can be binding on the state's appraisers but it will be considered

[9] Hoffman v. Commissioner, 2 T.C. 1160 (1943).
[10] Armstrong's Estate v. Commissioner, 3 T.C.M. 77 (1944), 146 F.2d 457 (7 Cir. 1945).
[11] *Supra*, note 7.
[12] In Commissioner v. Bensel, 36 B.T.A. 246, 100 F.2d 639 (3d Cir. 1938) although at the time of death the market value of the stock was $60.00 per share while the option price was $5.90, the decision of the board indicates that this price was based on sales made approximately contemporaneously with the agreement.

along with other evidence in determining market value.[13] An opposite result on similar facts was reached in the *Wilson* case[14] where the Court of Appeals of the Second Circuit accepted the contract price holding that subsequent events should not be considered in determining value at the date of death. In setting the value as of the time of death regardless of whether the option was subsequently relinquished and the stock taken under the will, this decision seems to adhere closer to the statutory design. Although the Wisconsin Inheritance Tax is based on the interest to which the living succeeds as distinguished from an estate tax which is based on the interest which ceases by reason of the death, still the Wisconsin Court has determined that the tax should be imposed on the value of the property as it existed at the time of the death of the deceased.[15]

The Wisconsin Tax was patterned after a New York statute although the latter has been subsequently changed. Thus the Wisconsin Court has often cited decisions rendered by New York courts under their former law. New York had adopted a rule similar to the present "Federal Rule" before its statute was changed. *In Re Jones' Will*[16] which was cited in the *Michel* case as sustaining the proposition that the property passed under the will in turn was based on *In Re Howell's Estate.*[17] Both cases concerned contracts to include provisions in wills. In the *Howell* case the court said the testator merely agreed to bequeath a portion of his estate provided that he possessed one and he was free to consume his entire substance during his life. This same conclusion was reached by a New York court in a case concerning an agreement giving mutual options to purchase stock at death with no restriction on inter vivos disposition.[18] This latter case was later distinguished in a case in which inter vivos disposition was forbidden and on death or severance from the company by one party the others were given an option to purchase his stock.[19] The court there said that this contract was made in contemplation of withdrawal from the company, not of death, that it took effect on execution, and death created no rights but merely marked the time when they could be enforced.

Because the Wisconsin statute was copied from New York's and since the *Jones* case[20] was based on the New York rule that when inter vivos disposition is not limited the transfer is intended to take effect on death, it seems that Wisconsin would also follow the New

[13] McLures Appeal, 347 Pa. 481, 32 A.2d 885 (1943).
[14] *Supra,* note 8.
[15] Will of Stevens, 177 Wis. 500, 188 N.W. 484 (1922).
[16] 206 Wis. 482, 240 N.W. 186 (1932).
[17] 225 N.Y. 211, 174 N.E. 457 (1931).
[18] In Re Cory's Estate, 177 App. Div. 871, 164 N.Y.S. 956 (1917).
[19] In Re Fieux's Estate, 241 N.Y. 277, 149 N.E. 857 (1925).
[20] *Supra,* note 16.

York rule when inter vivos disposition is restricted. Although in the *Michel* case the contract was binding prior to death and the stock was held to have passed under the will, the court stressed that this was because of the fact situation there, the optionee being also made legatee of the shares. Regardless of the merits of this decision when considered in the light of the *Wilson* case[21] it seems safe to predict that at least where that peculiar fact situation does not exist, the court would probably adopt the New York or so-called "Federal Rule."

Thus until further decisions clarify the present situation, it would seem most advisable for the attorney in drafting one of these agreements to fix its provisions with an eye to making the price set acceptable to the Commissioner of Internal Revenue and probably the Wisconsin Tax Department will follow suit unless the option holder is bequeathed the shares.

JOHN M. GROGAN

Damages—Measure of Damages for Anticipatory Repudiation and Seller's Duty to Mitigate—By virtue of a binding contract the plaintiff was to sell 500 tons of scrap steel to the defendant, delivery to be made as specified in the contract. Prior to the time fixed for performance the defendant cancelled its order for the purchase, presumably because the market for scrap steel was rapidly descending. The plaintiff did not accept the repudiation as a breach of the contract and subsequently requested the defendant to accept the scrap steel. At the time of trial, about a year after the repudiation, the market value of the steel was $6.00 per ton higher than the agreed purchase price. Since the seller had retained the steel the defendant contended (1) that the plaintiff had not been injured by the breach and therefore was not entitled to any damages, and (2) the plaintiff had not discharged his duty to mitigate damages as he had not sold the steel on the rapidly descending market within a reasonable time after the repudiation. *Held:* The measure of damages is the difference between the contract price and the market price at the date of the breach of the contract minus any savings derived by the plaintiff due to the defendant's breach, such as transportation costs. *Friedman Iron & Supply Co. v. J. B. Beaird Co., Inc., 63 So. 2d 144 (La. 1953).*

The issue presented is: what is the measure of damages, and what is the seller's duty to mitigate, if any, in the case of an anticipatory repudiation that is not accepted by the seller when the market value of the goods is higher than the contract price at the time of trial?

The dissenting opinions in the instant case held that the plaintiff-vendor had a duty to resell the steel as a condition precedent to an action

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[21] *Supra,* note 8.