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Martin H. Zern

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ESTATE TAX VALUATION OF A CLOSELY-HELD BUSINESS

By

Martin H. Zern *

I. INTRODUCTION

For federal estate tax purposes, asset valuation is a recurring issue that frequently results in litigation. Often, a dispute arises in determining the fair market value of a closely-held business interest as of the date of death of a stockholder. For a publicly traded corporation, valuation is fairly straightforward; the value of listed stock can readily be ascertained by reference to daily stock market reports. More specifically, Treasury regulations provide that "if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond."[1]

The value of real estate is more problematic due to its unique character. Good practice would seem to dictate that an appraisal be obtained from a qualified real estate appraiser. If the Internal Revenue Service (IRS) does not accept the appraisal, it should at least be a starting point for negotiating a settlement. If the controversy winds up in court, the testimony of the appraiser would be relevant, along with the testimony of the appraiser chosen by the IRS, in assisting the judge or jury

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*Professor, Lubin School of Business, Pace University, Pleasantville, New York

in determining the value. It may be noted that there is a section in the Internal Revenue Code (IRC) containing special, and quite technical, rules for the valuation of farms and real estate that are part of a closely-held business and that are significant part of an estate.[2]

Apart from the special valuation procedure just mentioned, which has its own complexities and uncertainties, the valuation of a closely-held business presents even more thorny issues than valuing real estate. For a closely-held corporation, technically one is valuing the stock. However, assuming that there are no bid-and-asked prices, the value of the stock must be determined by an analysis of the underlying business. Treasury regulations attempt to give some guidance in this area mentioning some of the factors that should be considered.[3] The basic factors mentioned in the regulations are the company's net worth, prospective earnings power, capability to pay dividends and other relevant factors. In this regard, "other relevant factors" set forth are: goodwill, economic outlook for the industry, position in the industry, management, degree of control represented by the block of stock being valued, and the value of stock in similar businesses for which market quotations are available. The regulations state the weight to be given to any one factor depends on the facts of each case. At perhaps a third level, the regulations state that consideration should be given to non-operating assets, such as, life insurance proceeds paid to the corporation, if not already considered. Complete financial information is required to be submitted with the estate tax return, including reports of accountants, engineers, or any other timely reports of experts.

The IRS provided further guidance regarding factors to be considered in valuing a closely-held business in a Revenue Ruling issued back in 1959.[4] In addition to the factors set forth in the regulations and the ruling, however, the courts over the

years have taken into account numerous other factors that were considered relevant.[5] These factors are described hereafter.

Because there is so much ambiguity in valuing a closely-held business, a stockholder whose estate may be subject to federal, and possibly state, estate taxes obviously has an interest in minimizing the value and avoiding a potential and costly battle with the IRS, which may have an uncertain outcome. Additionally, the stockholders in a closely-held corporation often want control to remain with the surviving stockholders. A commonly employed way to set value and assure that control remains with the survivors is by an agreement among the stockholders providing for a fair payment to the deceased stockholder's estate in exchange for a transfer of the stock of the stockholder to the surviving stockholder(s) or to the corporation. Life insurance on the stockholders is often carried in order to provide the funds necessary to achieve a buyout of the interest of the deceased stockholder. The beneficiary of the policy can be the corporation, which will then have funds to effect a redemption from the estate of the deceased stockholder, or each stockholder can take out a policy on the life of the other stockholder(s) in order to effect a purchase directly by the surviving stockholder(s) of the stock of the deceased stockholder(s).

A key provision in any buyout agreement is the method or methods laid out for valuing the interest of a deceased stockholder. Usually, a method is described for valuing the corporation as a whole. The value of a deceased's stockholder's interest is then calculated by simply multiplying his or her percentage interest in the corporation times the value established for the entire corporation. Some common methods utilized to set the value of the corporation upon a stockholder's death are: by reference to an annual written agreement of the stockholders establishing the value; by referring the matter to

the firm's current accountant; and by referring the matter to a panel of arbitrators. However, the agreement may set the value of the corporation at book value, which may not reflect its actual value. Further, a stockholder's agreement may set the value of the deceased stockholder's interest at the amount of life insurance carried on the stockholder. These are by no means all the methods of valuation, the stockholders being free to adopt any method of valuation they can conjure up. What has been of particular concern to the IRS over the years, however, were stockholder buyout agreements that set the value of a stockholder's interest at less than its actual fair market value.

IRC §2703. It is important to recognize that the basic rule for determining the value of an asset to be included in the gross estate of a decedent is the fair market value at date of death.[6] As noted, the IRS has issued regulations elaborating on this rule in the case of a closely-held business. Over the years, however, courts refined the regulatory guidance to provide an exception in the case of property subject to a valid buyout agreement, provided certain requirements were met.[7] In 1990, Congress enacted IRC §2703 in order to codify and limit the requirements articulated by the courts. This section states that, unless certain exceptions are applicable, as detailed in the next paragraph, the value of any property is to be determined without reference to any right to acquire property or the right to sell or use it. The section was enacted as part of overall legislation to overcome devices utilized to "freeze" the value of an asset.[8]

More specifically, in order for a provision in a buyout agreement setting value to be effective, the agreement must: (1) be a bona fide business arrangement, (2) not be a device to transfer assets to family members for inadequate consideration, and (3) have terms comparable to similar arrangements

negotiated at arm's length. Each of these requirements must be individually met. Further details are provided in Treasury regulations.[9] The section is applicable to all agreements created or substantially modified after October 8, 1990.[10] The applicability of §2703 to a specific fact pattern is illustrated by a recent decision.

II. ESTATE OF GEORGE BLOUNT

In *Blount*,[11] a 2005 decision of the Eleventh Circuit Court of Appeals, the Court considered whether §2703 permitting the value of an interest in a closely-held corporation to be determined by the agreed upon price in a stock buyout agreement was applicable, and whether life insurance proceeds paid to the corporation and used to redeem the stock of a deceased stockholder should be considered an asset of the corporation in determining its value. The Eleventh Circuit agreed with the Tax Court decision concerning the buyout agreement, holding it was inapplicable in determining the value of the corporation. With respect to the life insurance proceeds, which the Tax Court found should be included in valuing the corporation, the Circuit Court disagreed and reversed.

A. Facts

Blount Construction Company (BCC) is a closely-held construction company. It had two stockholders, William C. Blount (Blount) and James M. Jennings (Jennings), who had entered into a stock purchase agreement in 1981 under which stockholder consent was necessary to transfer the stock and the stock of a deceased stockholder had to be redeemed by BBC. The redemption price was set at an amount to be agreed upon or, lacking an agreement, at a price based on book value. In the early 1990s, BCC purchased insurance policies on the stockholders in the amount of $3 million each in order to provide funds for a stock redemption.

In 1992, BCC instituted an employee stock ownership plan (ESOP). A third party completed annual valuations of BCC to facilitate the ESOP. In early 1995, for example, BCC was valued at about $7.9 million.

Early in 1996, Jennings died owning 46% of BCC, which received about $3 million from insurance proceeds and paid a little less to Jennings' estate to redeem his stock. BCC determined the amount to be paid to the estate based upon the book value of BCC for the previous year.

In October 1996, Blount was diagnosed with cancer and given only a few months to live. Concerned that a buyout of his shares would deprive BCC of liquidity, he ordered studies to determine how much his estate could receive for his shares and still leave BCC in healthy financial condition. Apparently, Blount was not concerned about his family since they were independently wealthy.

In November 1996, Blount amended the buyout agreement binding BCC to purchase his interest from his estate locking the price at $4 million. A recent appraisal, however, valued BCC at $8 million suggesting that his interest was worth about $6.7 million based upon his then approximate 83% interest in BCC, which was his interest when he died in September 1997. On Blount's estate tax return, the value of BCC was declared at $4 million, the price fixed under the buyout agreement. The IRS assessed a deficiency claiming that BCC was worth in excess of $9.5 million and that Blount's interest was worth a little over $7.9 million.

The Tax Court concluded that the 1981 buyout agreement, as amended in 1996, should be disregarded. Further, it held

that the insurance proceeds received by BCC upon Blount's death should be included for purposes of determining the value of the corporation. At the trial, two experts testified for the estate. One expert used a cash flow approach resulting in a value of $4.5 million for BCC and $3.8 million for Blount's interest. The Tax Court completely rejected this valuation on the basis that it ignored non-operating assets, which the regulations require to be considered. The other expert offered by the taxpayer, using a blend of asset and income approaches, valued BCC at $6 million. The IRS expert, using essentially the same method, came up with a value for BCC of $7 million. He then added the insurance proceeds for a combined value of $10 million for the corporation. The estate's expert, however, did not add the insurance proceeds. Taking into account an adjustment for the ESOP, the Tax Court came up with a valuation for BCC in the amount of $6.75 million before taking into account the insurance paid to BCC in the amount of $3.1 million. Accordingly, it held that the value of the corporation was $9.85 million and that Blount's 83% interest was worth $8.2 million. On this basis, it held that there was a tax deficiency of $1.36 million.

B. Court Opinion

The Eleventh Circuit initially noted that it reviews factual determinations of the Tax Court only if clearly erroneous.[12] In this regard, it noted that it did not find clear error in the lower courts determination of a value of $6.75 million. However, the Court disagreed with the Tax Court's holding that the $3.1 million insurance proceeds should be included in determining the value of BCC.

Initially, the Court noted that prior to the enactment of §2703, the courts had carved out an exception to a fair market

value evaluation for property subject to a valid buyout agreement. The court exception, it observed, has three requirements: (1) the offering price must be fixed; (2) the agreement must be binding both before and after the death of the deceased stockholder; and (3) there must be a genuine business reason for the agreement that does not act as a substitute for a testamentary disposition.[13] This court articulated doctrine was codified by IRC § 2307, as previously mentioned. The court doctrine and § 2307 are similar except that the code section requires the buyout agreement to be similar to one negotiated at arm's length.

The Eleventh Circuit then addressed each of the estate's arguments on appeal. First, it considered whether the agreement as modified created a value binding on the IRS. Next, it considered the Tax Court's computation of the value of the BCC shares held by Blount at the time of his death.

The Circuit Court agreed with the Tax Court that the original agreement was substantially modified in 1996 thereby making it subject to IRC §2703. It agreed that the modification was substantial from several perspectives. Pursuant to the 1996 amendment, Blount's interest was frozen at $4 million. Based upon his 83% interest, the value of BCC was therefore set at $4.8 million. A 1997 appraisal, however, gave a book value of $8.5 million, which would have been the value under the original agreement without the modification. Accordingly, there were substantially different valuation methods before and after the modification. There were other modifications that the Court also agreed were substantial, for example, the ability of BCC to effect the redemption in installments was eliminated.

1. No Binding Agreement:

Finding §2703 applicable, the Court then considered the requirement under Treasury regulations that little weight will be given to an agreement under which the decedent is free to dispose of securities at any price he chooses during his lifetime.[14] Such an agreement is inconsistent with a bona fide business arrangement.[15] After the death of Jennings, Blount owned 83% of BCC and was its president and sole director. Accordingly, the buyout agreement could be changed at any time since the only parties necessary to change it were Blount and BCC, an entity he controlled. The Court found that the ESOP's approval was not necessary to change the agreement disagreeing with the estate's argument to that effect. Thus, it was held that Blount could unilaterally change the agreement during his lifetime, and in fact did modify it. The failure to meet this regulatory requirement meant that the exception to valuing the stock interest at less than fair market value was inapplicable.

2. Comparability:

Although perhaps not necessary, since it had decided that the agreement was not binding during Blount's lifetime, the Circuit Court also reviewed whether the agreement met the test under §2703 that the agreement be comparable to similar arrangements. The Tax Court had concluded that it did not. Under Treasury regulations, similar arrangements are those that "could have been obtained in fair bargain among unrelated parties in the same business dealing with each other at arm's length," where a bargain is one that "conforms with the general practice of unrelated parties under negotiated agreements in the same business."[16] Referring in some detail to the testimony of the experts who testified in the Tax Court, the Circuit Court disagreed with the conclusion of the Tax Court that the agreement did not meet the comparability test was clearly erroneous. Accordingly, it let stand the Tax Court's determination that the agreement failed the comparability requirement.

3. Fair Market Value:

As noted, the Tax Court had determined that the fair market value of BCC was $9.85 million including $3.1 million proceeds from life insurance payable to the corporation on Blount's death. The Circuit Court, however, held that the Tax Court erred when it included the life insurance proceeds. Accordingly, it held that the value of BCC on Blount's death was $6.75 million excluding the life insurance proceeds. Although Treasury regulations require that non-operating assets be considered in valuing a corporation, as earlier mentioned, the Circuit Court concluded that this regulation did not require the inclusion of the life insurance proceeds.

4. The Life Insurance Proceeds:

Although only a brief segment of the opinion, arguably the most important aspect of *Blount* was the Circuit Court's reversal of that part of the Tax Court's opinion dealing with the $3.1 million of life insurance proceeds that were paid to BCC on Blount's death. The IRS position was that the life insurance proceeds should be included in determining the value of BCC. The Tax Court agreed with the IRS and held that the life insurance proceeds increased the value of the corporation form $6.75 million to $9.85 million.

The underpinning of the Tax Court's holding is a provision in the regulations providing that in valuing corporate stock, consideration should be given to non-operating assets including, life insurance proceeds payable to the corporation.[17] However, the Eleventh Circuit pointed out that this provision is followed by a limiting phrase: "to the extent that such non-

operating assets have not been taken into account ...." In this regard, the Circuit Court concluded that the life insurance proceeds had been taken into account since there was an offsetting, dollar-for-dollar, contractual obligation[18] on the part of the corporation to pay the proceeds to Blount's estate in a stock buyout.[19]

5. Corporate Owned Life Insurance:

The gross estate of a decedent for estate tax purposes includes the proceeds of life insurance on the life of the decedent if the decedent possessed at death any of the incidents of ownership with respect to the policy.[20] Treasury regulations particularize what is meant by "incidents of ownership."[21] In this regard, the regulations provide that incidents of ownership held by a corporation (i.e., a corporate-owned policy) will not be attributed to a sole or controlling stockholder (one with more than 50% of the voting power) to the extent that the proceeds of the policy are payable to the corporation or on behalf of the corporation (such as to liquidate a corporate debt.)[22]

The regulations note, however, that the proceeds of the policy should be considered in determining the value of the decedent's stock.[23] Further, it is provided that if any part of the proceeds are not payable to the corporation and are not taken into account in valuing the corporate stock, any incidents of ownership held by the corporation as to that part of the proceeds will be attributable to the decedent based on stock ownership. For example, if a decedent is the controlling stockholder, and if a corporate-owned policy is paid to the decedent's spouse, the proceeds of the policy will be included in the decedent's gross estate. As a further example, if the proceeds are paid 60% to the corporation and 40% to the

decedent's spouse, only the 40% is includable in the decedent's gross estate.[24]

The IRS and the Tax Court apparently concluded that under the regulations the proceeds of the policy should be considered in determining the value of the gross estate. The Eleventh Circuit did not disagree that the policy should be considered in determining the value of the corporate stock. As noted, however, it concluded that there was an equal and offsetting liability on the part of the corporation to redeem Blount's stock, thus netting out to zero the receipt by BCC of the life insurance proceeds.

In summary, the Eleventh Circuit determined that the buyout agreement was invalid for purposes of determining the value of BCC and that fair market value was the proper basis for determining the value. Furthermore, the Circuit Court held that the Tax Court erred in ignoring the 1996 amended agreement at least to the extent it that it created a contractual obligation to redeem Blount's stock with the insurance proceeds.

III. CONCLUSION

Since buyout agreements are commonplace in closely-held corporations, the *Blount* decision is important for delineating the factors that must be present in order for a redemption price set in a buyout agreement to supercede a fair market value evaluation. It is the author's opinion that §2703 sets the bar quite high in order to meet the requirements of the section. It would seem that if a value set in a buyout agreement is too far removed from a strict fair market value determination, it probably would not meet the requirements of §2703.[25] If §2703 is found to be inapplicable, then the value of the corporation in a court proceeding will be determined by the

judge's evaluation of the testimony of the experts. In this regard, it is not necessarily a case of "splitting the baby in half." It is noteworthy that the Tax Court judge completely disregarded the testimony of one of the experts provided by the estate. Consequently, attorneys retaining an expert must do their due diligence to assure that the expert is knowledgeable about evaluation methods and about what methods are acceptable by a court.

Finally, *Blount* is important for clarifying how life insurance proceeds, which are payable to a corporation and which are required to be used to fund a buyout commitment, are to be treated. It is hoped that the IRS will accept the result in Blount and not litigate this issue further in view of the fact that both the Ninth and Eleventh Circuits disagree with its position. Insofar as the Tax Court is concerned, it is required to follow the "rule of the circuit."[26] Consequently, it could continue to side with the IRS in other circuits. With two circuits against it, however, there is a good chance that it will rule in the taxpayer's favor regardless of the circuit in which the litigation arose, assuming the IRS persists in litigating this issue.

ENDNOTES

[1] Treas. Reg. § 1.20.2031-2(b)(1) (as amended in 1992). The regulation goes on to provide that "[i]f there were no sales on the valuation date, but there were sales on dates within a reasonable period both before and after the valuation date, the fair market value is determined by taking a weighted average of the means between the highest an lowest sales on the nearest date before and the nearest date after the valuation date." The regulation provides further details and several examples.

[2] *See* IRC § 2032A. Whether reference to this section is advisable depends on the circumstances. In any event, the applicability of this section is beyond the scope of this paper.

[3] *See* Treas. Reg. § 20.2031-2(f)(2).

[4] Revenue Ruling 59-60, 1959-1 CB 237 (1959).

[5] *See, e.g.*, Estate if Yaeger v. Comm'r, 52 TCM 820 (1986) (effect of loss of services of deceased stockholder); Estate of Luton v. Comm'r, 64 TCM 1044 (1994) (whether the corporation will be liquidated or continue); Estate of Newhouse v. Murphy, 60 TCM 645 (1990) (discount for lack of marketability such as minority interest); and Tally v. United States, 78-1 USTC ¶ 13,228 (Ct.Cl. 1978) (effect of illegal activities).

[6] IRC § 2031(a).

[7] *See generally*, True v. Comm'r, 390 F.3d 1210, 1218 (10th Cir. 2004) (collecting cases).

[8] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(a), 104 Stat. 1388-1, 1388-498.

[9] Treas. Reg. § 20.2073-1 (1992).

[10] *See* Treas. Reg. 20.2073-1(c) regarding what constitutes a substantial modification.

[11] Blount v. Comm'r, 428 F. 3d 1338 (llth Cir. 2005).

[12] This is the general standard for appellate review. *See* Davenport Recycling Assocs. V. Comm'r, 220 F.3rd 1255, 1258 (11th Cir. 2000).

[13] *See generally*, True v. Comm'r, 390 F.3d, 1210, 1219 (10th Cir. 2004) (relevant cases cited therein).

[14] Treas. Reg. § 1.2031-2(h) (as amended in 1992).

[15] *Id.*

[16] Treas. Reg. § 25.2703-1 (b)(4)(i) (1992).

[17] Treas. Reg. § 20.231-2(f)(2) (as amended in 1992).

[18] In this regard, the Court deferred to state law in finding there was a binding contractual obligation to redeem the stock from Blount's estate, despite the fact that the buyout agreement was held invalid for purposes of valuing the corporation for estate tax purposes.

[19] In arriving at this conclusion, the Eleventh Circuit cited as precedent an opinion of the Ninth Circuit and an earlier decision of the Tax Court: Cartwright v. Comm'r, 183 F.3d 1034, 1038 (9th Cir. 1999) and Huntsman v. Comm'r, 66 T.C. 861, 875 (1976).

[20] IRC § 2042.

[21] Treas. Reg. § 20.2042-1(c) (as amended in 1979).

[22] Treas. Reg. § 20.2042-1(c)(6).

[23] Referring to Treas. Reg. § 20.2031-2(f).

[24] Treas. Reg. § 20.2042-1(c)(6).

[25] *See* True v. Comm'r, 390 F.3d 1210, 1239-41 (10th Cir. 2004) (collecting cases that both support and disregard provisions in buyout agreement setting value).

[26] Under the "rule of the circuit," the Tax Court is required to follow the rule of the circuit court in which the litigation arose (i.e., where the taxpayer resides). *See* Golsen v. Comm'r, 54 T.C. 742 (1970). Consequently, the circuit courts could split with respect to a particular issue. In such event, the United States Supreme Court might hear the case in order to resolve the issue.

REGULATING CONSENSUAL RELATIONSHIPS IN THE WORKPLACE—ARE "LOVE CONTRACTS" THE ANSWER?

by
Marlene Barken*
Joanne Barken*

With the entrance of woman into the workplace and the current American trend to spend more time at work, office dating is on the rise. Vault's 2005 Office Romance Survey revealed that fifty-eight percent of employees have been involved in an office romance, up from forty-six percent in 2003.[1] Another survey found that ninety-two percent of over 31,000 men and women questioned admitted to finding a coworker attractive and flirting with him or her.[2]

While the office may be evolving into the hottest singles scene, these statistics give employers plenty of reasons to fear potential lawsuits. Completely prohibiting dating among co-workers has proven impractical and difficult to enforce. One major concern is a sexual harassment claim following a bad breakup between two employees. Legal Assistant, Kramer Levin Naftalis & Frankel LLP, NYC
In light of the inevitability of romance in the workplace, many employers are experimenting with "love contracts" to protect themselves from potential sexual harassment claims.

*Associate Professor of Legal Studies
Ithaca College School of Business
*B.S. Cornell University, 2005