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Options and Valuation of Property for Federal Tax Purposes

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OPTIONS AND VALUATION OF PROPERTY FOR FEDERAL TAX PURPOSES

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INTRODUCTION

In *Estate of John Q. Strange*,[1] there was an agreement between two brothers, engaged in business in a close corporation, which provided that upon the death of either, the survivor might acquire the stock of the other upon payment of $10,000 to his estate. Payment was so made following the decedent's death. The fair market value of the stock on the date of death was stipulated to be $238,126.54. The Board of Tax Appeals held that the option price of $10,000 was the proper amount to be included in the decedent's gross estate as the value of his stock.

In *Lomb v. Sugden*,[2] the decedent owned at death a number of shares of stock which she bequeathed to her husband as part of her residuary estate. About a year prior to death she had entered into an agreement with the other stockholders of the company that none would sell his stock without first offering it to the other stockholders, who were to have the right to purchase "in proportion to their then respective common stockholdings" at approximately $69 per share.[3] The controversy involved the question whether the Commissioner might value the stock at its fair market value of $100. It was held that because of the agreement the decedent could not have secured a greater price than $69 at the time of her death and, therefore, the value for estate tax purposes could not exceed that sum.

One further case may be noted. In *Commissioner v. Bensel*,[4] a father and son had become estranged. The father, a majority stockholder, and the son, an employee of a corporation, entered into a contract in which the son agreed to continue to work for the company in return for an option to purchase his father's stock at the latter's death at a price which turned out to be considerably less than the value of the stock at the later date. The option price was held to fix the value for estate tax purposes.

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1. P-H 1942 TC MEM. DEC. SERV. ¶ 42,247 (1942).
2. 82 F. 2d 166 (C. C. A. 2d 1936).
3. "It also provided that any stockholder might give away his stock to any of the other shareholders and, if he died without issue, might bequeath it to any of the other shareholders and might also bequeath 10 per cent of his holdings to outsiders. If he left no issue and to the extent that he made no such bequests, his executors or administrators must offer the stock at the limited price to the other members of the group in proportion to their stockholdings." 82 F. 2d at 167.
4. 100 F. 2d 639 (C. C. A. 3d 1938).

These and other cases of like import[5] suggest an investigation into the present status of the law relating to the effect of restrictive agreements upon values in the gift and estate tax fields. Close analysis of all the factors involved in these cases and a study of the judicial landmarks which in recent years have extended the tax collector's reach beyond what a too literal reading of the statute might suggest may help in marking the narrow limits within which option prices may be expected to fix values.

The granting of an option or the transferring of property subject to a restrictive repurchase agreement will frequently have income, gift and estate tax consequences.[6] The creation of a binding option may itself be treated as the receipt of taxable income to the optionee when it is given for services rendered.[7] If the transaction is wholly or partly donative in character, gift tax liability may be incurred.[8] Either tax may also be imposed when property already burdened with sale restrictions is transferred. With respect to the imposition of an estate tax the two situations must be carefully distinguished. Where the property was acquired by the decedent subject to a repurchase option, the problem is solely one of valuation, *i.e.,* whether the option price fixes its maximum worth or merely has a depressing effect on its value.[9] In those cases, however, where the decedent himself created the option in favor of another, the provision requiring the inclusion in the gross estate of transfers "intended to take effect in possession or enjoyment at or after . . . death"[10] may result in a valuation of the property which totally disregards the admittedly adverse effects which such resale limitations have.

Restrictions on resale of stock and business interests are especially common in enterprises where the number of owners is small. Considerations wholly unrelated to tax avoidance have more frequently than not motivated such provisions. Corporate stock sold to employees or members of their immediate families is frequently subject to repurchase options in favor of the corporation whenever the employer-employee relationship ceases or efforts are made to transfer the stock outside the group. Conversely, the discontinuance of employment may require repurchase by the corporation. Other agreements may limit resale to outsiders until stockholders have been given a first opportunity

5. In Helvering v. Salvage, 297 U. S. 106, 56 Sup. Ct. 375, 80 L. Ed. 511 (1936) (an income tax case), Salvage, an employee of Viscose Company acquired 1500 shares of its stock in 1922 for $100 per share. The market value of the shares at that time was $1,164.70 per share. The acquisition was made pursuant to an agreement giving the corporation an option to repurchase prior to 1924 5/7 of these shares at $100 per share. The Supreme Court held that the fair market value of 5/7 of the shares in 1922 could not be in excess of $100 per share since the corporation had the right to repurchase them at that price.

6. Note, 46 YALE L. J. 272 (1936).

7. *Cf.* Commissioner v. Smith, 324 U. S. 177, 65 Sup. Ct. 591, 89 L. Ed. 830 (1945).

8. INT. REV. CODE § 1002. An option given in consideration of marriage would constitute a taxable gift. *Cf.* Commissioner v. Wemyss, 324 U. S. 303, 65 Sup. Ct. 652, 89 L. Ed. 958 (1945).

9. Worcester County Trust Co. v. Commissioner, 134 F. 2d 578 (C. C. A. 1st 1943).

10. INT. REV. CODE § 811(c).

to purchase. An exact price may be specified, but more usually it is determined by an application of an agreed formula which omits consideration of intangible worth. The prime objective is generally to avoid the formidable task of valuing such interests when good will and other intangible factors are involved.

Valuation constitutes a difficult problem,[11] to be avoided whenever conveniently possible. The problem it poses in the estate and gift tax fields is simply another illustration of the wisdom of utilizing the option device to the extent permissible, not to reduce or avoid taxes, but to make the amount of such taxes reasonably predictable. The variety of factors affecting the value of business interests, except in the relatively small number of companies whose stock is widely held and frequently traded on stock exchanges, are numberless. The composite judgment in any specific instance will always be made up of many imponderables. Satisfactory analysis or articulate reasoning of the appraiser's conclusion is rare. The end result is always "a conjecture, a guess, a speculation, a prophecy." [12]

Every community in the country has its quota of successful merchants, manufacturers and businessmen who, as a result of management and planning, have brought about the growth and expansion of their enterprises to the point where in any discussion of national industrial or economic problems they fall within the classification of small business. Each of these enterprises has an individuality that renders comparison with similar companies for the purpose of finding the common ground which the traditional willing-buyer, willing-seller test of valuation assumes, a futile gesture. Among these substantial businesses there is no standardization of policies. Too many decisions have found their motivating influence in what was dictated by the individual interests of the owner or small group of owners.

When the owner of such a business first considers the problems involved in the devolution of his property on death and the impact thereon of estate taxes, he finds himself in a bewildering labyrinth of uncertainty. His sole substantial asset is his interest in the business. This must be valued to estimate his estate and inheritance taxes. The lawyer or accountant whose counsel he seeks, and the industrial engineer or economist who comes in to aid in the valuation, after examining all the available data, applying the standard formulas and weighing the countless imponderables, may suggest a low of $500,000 or a high of $2,000,000 and still be within a permissible range for difference of opinions.[13]

11. See generally PAUL, FEDERAL ESTATE AND GIFT TAXATION § 18.03 (1942); Wynn, *Valuation of the Family Controlled Business for Estate Tax Purposes*, 2 VAND. L. REV. 250 (1949).

12. Commissioner v. Marshall, 125 F. 2d 943, 946 (C. A. A. 2d 1942). "Anyone who wants to avoid uncertainties from 'value' will have a sad time getting along in this world. All aspects of living are chancy. We cannot, by the use of a symbol, 'value,' convert the risky into risklessness, Canute restless change out of existence. Businessmen sometimes pay cash for value which exists only in 'moonshine or dreamland.'"

13. In Estate of Henry T. Sloane, P-H 1944 TC MEM. DEC. SERV. ¶ 44,206 (1944), there was involved an asserted deficiency in estate tax in the approximate amount of

The difference in his estimated estate taxes, assuming $160,000 of other assets and excluding consideration of the marital deduction, between the low and high valuations suggested is $619,000 at present rates. He will need a minimum of $179,000 and a maximum of $802,000 to meet his estimated death taxes.[14] Unless he makes adequate provisions for this unpredictable sum, the tax will be paid in costly dollars since the sale of a partial interest in his business, if this becomes necessary, is almost certain to be at a sacrifice price. Nor is it economically feasible to purchase insurance to cushion the blow. He would need not merely $800,000 of insurance to pay the top estate tax of $802,000, but $1,600,000 since the insurance proceeds themselves become taxable.[15] Annual premiums on $1,600,000 of insurance on the life of a man aged 55 amount to ap-

$3,007,000, a large portion of which was attributable to adjustments made by the Commissioner with respect to the values of the stocks of four corporations. The variations between the Commissioner's determinations and the Tax Court's findings of values were as follows:

	Approximate Values Per Share As Determined by Commissioner	As Established by the Tax Court
Corp. A., common	$ 35.00	$ 16.00
Corp. A., pfd.	65.00	37.50
Corp. B., common	51.00	1.30
Corp. B., pfd.	100.00	5.00
Corp. B., pr. pfd.	100.00	30.00
Corp. C., capital	60.00	28.00
Corp. D., capital	6,232.00	2,600.00

The above chart was taken from Pierce, *The Preparation of a Valuation Case*, in 4TH ANN. INST. ON FED. TAXATION 373, 380 (N. Y. U. 1946). See generally, Bunge, *Death Taxes and Closely Held Business*, 23 TAXES 205 (1945).

14.

Estimated Net Estate		
Business Interest	$500,000	
Other Assets	160,000	
Total	$660,000	
Less Specific Exemption	60,000	
Taxable Estate	$600,000	
Estate Tax (including 80% Fed. Credit)		$179,000
Estimated Net Estate		
Business Interest	$2,000,000	
Other Assets	160,000	
Total	$2,160,000	
Less Specific Exemption	60,000	
Taxable Estate	$2,100,000	
Estate Tax (including 80% Fed. Credit)		$802,000

15.

Estimated Net Estate		
Business Interest	$2,000,000	
Insurance Proceeds	1,600,000	
Other Assets	160,000	
Total	$3,760,000	
Less Specific Exemption	60,000	
Taxable Estate	$3,700,000	
Estate Tax (including 80% Fed. Credit)		$1,661,000

proximately $80,000. Assuming he needs $25,000 of income for living expenses, he would require gross income of $600,000 to put this plan into effect at existing income tax rates.[16]

His bewilderment will be due less to his inability to reduce or avoid his share of the tax burden than to its uncertainty and his consequent inability to make adequate provision to avoid the sacrifice to his business. His problem is somehow to freeze the value of his business interest, be it high or low; and a search for the solution to this problem will suggest some exploration of the tax decisions dealing with the effect on value of options and sale restrictions.

Gift Taxes

When property transferred by gift is subject to resale restrictions, the option or contract price at which it may be repurchased upon the happening of some future event will rarely, if ever, fix its value for gift tax purposes. The existence of the option will normally have a depressing effect on the value of the property and hence it will be one, but only one, of the many factors to be considered. The weight to be given it will vary with the circumstances. While the courts have adopted this approach it is difficult to square with the test of market value.[17] In the *McCann* case,[18] a by-law restriction required an employee-owner of stock to resell it to the corporation on termination of employment. In addition, the corporation was required to repurchase at a defined book value. In limiting the value of shares of this stock transferred by inter vivos

16.

Gross Income		$ 600,000
Marital Division	$ 300,000	
Tax on $300,000	247,000	
Tax on other $300,000	247,000	
Total Tax		494,000
Spendable Income		$ 106,000
Insurance Premiums		80,000
		$ 26,000

17. The Income Tax Title of the Internal Revenue Code uses the term "fair market value," (INT. REV. CODE §§ 111, 112, 113), whereas the Estate (*Id.* § 811) and Gift (*Id.* § 1005) Tax Titles speak only of "value." The difference has been said to be without significance. PAUL, FEDERAL ESTATE AND GIFT TAXATION § 18.02 (1942). This view may be justified by the regulations, which provide in all three instances for the test of market value, the willing-buyer, willing-seller concept. U. S. Treas. Reg. 111, § 23.111; U. S. Treas. Reg. 105, § 81.10; U. S. Treas. Reg. 108, § 86.10. But there is one marked difference between value for estate and gift tax purposes and value for income tax purposes. In transactions which involve the valuation of properties in the assessment of income taxes, the regulations and decisions recognize that in some cases there may be such a complete absence of any market with respect to property of substantial worth as to require the deferring of the imposition of the tax until some later event or transaction occurs to which the mythical seller-buyer test is applicable. *Cf.* Helvering v. Wallbridge, 70 F. 2d 683, 684 (C. C. A. 2d 1934), *cert. denied,* 293 U. S. 594 (1934). But the very nature of an estate or gift tax requires a valuation as of a specific date and place, whether or not there is any market. This inexorable demand of a valuation if there is any value, however speculative, may mean that the difference in phraseology in the Titles is not as inadvertent as has been supposed.

18. McCann v. Commissioner, 2 T. C. 702 (1943), *rev'd,* 146 F. 2d 385 (C. C. A. 2d 1944).

gift to the price fixed by the by-law the tax court said there was "but one market, comprised of one buyer, the corporation, and the bylaw fixed the price in that market. ... and prevented the seller from asking or agreeing upon any more and required the buyer to pay that price." [19] But the circuit court of appeals held that the by-law price did not control. No one knew when the donor-employee would discontinue his employment. Meanwhile the shares would be entitled to dividends, and when he retired the book value would be different from that at the time of the gift. It indicated that in addition to the existence of the option, other factors to be considered were prospective earnings, the likelihood that the donor would not retire, his life expectancy, his power to change the by-laws, and his opportunity to obtain corporate consent to sell to other employees.[20]

A similar result was reached in the *Moore* case.[21] There the petitioner had created an inter vivos trust for the sole benefit of his wife. The property transferred to the trust consisted of shares of stock of a corporation which were held under a stockholders' agreement that prohibited the owner from disposing of the stock without first offering it at the adjusted book value to the directors in their individual capacity and, if they refused it, then to the other stockholders. All stockholders had consented to the creation of the trust upon the condition that the shares should still be subject to the restrictive agreement. The petitioner returned the shares for gift tax purposes in his gift tax return reporting their value as equal to the adjusted book value of $1,763.04 per share. The commissioner on the basis of all relevant factors determined that the shares were worth $3,636.34 per share and assessed a deficiency accordingly. It appeared that average annual earnings available for dividends and dividend payments over the preceding five-year period were $620.18 and $615.70 respectively. These earnings and dividends were equivalent to a rate of 17% on the value of the shares as found by the commissioner. In its opinion, the tax court said: "We think that a security upon which a return of in excess of $600 per year can be realized for a period of years, so far as anything can be seen to the contrary, has a value in excess of the adjusted book value of the shares as determined under the restrictive agreement." [22]

Here the use value, rather than the market value, was stressed. The worth of property is not limited solely to its exchange value on sale; the ability to sell is only one of the advantages of ownership. The right to share in company earnings and participate in the control of company policies may in many instances be of greater value. Further the likelihood of revision of by-laws, rescision of agreements or waivers of their requirements in particular instances where all of the parties are closely related by family or business ties justifies, if indeed it does not demand, this realistic approach.

19. 2 T. C. at 703.
20. Commissioner v. McCann, 146 F. 2d 385 (C. C. A. 2d 1944).
21. Moore v. Commissioner, 3 T. C. 1205 (1944).
22. *Id.* at 1211.

Thus there seems little likelihood of avoiding a difficult valuation problem on a gift of such a business interest even if subject to option restrictions. And where no accurate estimate of the tax is possible, the prospective donor may well stay his hand. Further, where the property given consists solely of binding option rights created by the donor to purchase his interest after his death at a favorable price, there is the additional deterrent that the full value of the property at the date of death may be included in the gross taxable estate of the optionor as a transfer intended to take effect in possession or enjoyment at or after death, thus necessitating a second valuation. As will be shown later, this type of gift, like the *Hallock* transfers,[23] effects no reductions in estate taxes.

INCOME TAXES

While this article does not purport to deal thoroughly with the income tax difficulties which may arise from the granting of stock options, the problem should be noted. In *Commissioner v. Smith,*[24] Smith as part compensation for services, was given an option to purchase from his employer certain shares of stock in another corporation at a price not then less than its market value. Two years later when he exercised the option the market price had risen substantially. The difference between the market price on the date of purchase and the amount paid by Smith pursuant to the terms of the option was held to be additional compensation and therefore taxable income to him.

At the time it was given, the option had no readily measurable value since the option and market prices were identical. Without an option Smith could have bought as cheaply as with one. But the option contract had real economic worth. With no investment of capital, Smith stood to benefit by increases in the price of the stock without any risk of loss. The theory of the Supreme Court was that since "the option was not found to have any market value when given, it could not itself operate to compensate" Smith but merely represented a means of securing to him future compensation. The Court indicated that the problem might have been different had the option had a market value at the time it was given. It further recognized that an option may be property in the hands of the option holder for some purposes. "When the option price is less than the market price . . . it may have present value and may be found to be itself compensation for services rendered." [25]

Thus the creation of the option if the consideration is personal service may subject the holder to immediate income tax if the present worth of the shares

23. Helvering v. Hallock, 309 U. S. 106, 60 Sup. Ct. 444, 84 L. Ed. 646 (1940).
24. 324 U. S. 177, 65 Sup. Ct. 591, 89 L. Ed. 830 (1945). In connection with this case, see generally, Bastedo, *Taxing Employees on Stock "Purchases,"* 41 COL. L. REV. 239 (1941); Notes, 50 HARV. L. REV. 500 (1937), 1 TAX L. REV. 225 (1946); Baker, *Stock Options for Executives,* 19 HARV. BUS. REV. 106 (1940); Dillavaou, *Employees' Stock Options,* 20 ACCOUNTING REV. 320 (1945); Seghers, *Stock Purchase Options under the New Treasury Rules,* 81 J. OF ACCOUNTANCY 452 (1946).
25. 324 U. S. at 181.

measurably exceeds the market price or if the option itself has market value. Since the receipt of the option under such circumstances constitutes a taxable event, no further income tax should be assessed on any subsequent increase in the value of the property between the date of the option and the date of its exercise. However the point is still unsettled and such authority as there is looks the other way.[26] In any event, the decision in the *Smith* case seriously limits the effective use of the option device in situations similar to the *Bensel* case.[27] There the father to induce his son to continue in the employ of his controlled corporation gave the latter an option to purchase the father's shares on his death. The option price was held to control the estate tax value. But in view of the probable income tax consequences where the option may be found to be compensation for services the present practicability of such an arrangement to freeze estate tax values is doubtful. If all increase in the value of the stock between the date of the option and the date of purchase must be included as part of the optionee's taxable income and taxed at ordinary rather than capital gains tax rates because received as payment for services, the optionee will in the great majority of cases find that his potential income tax liability makes the exercise of the option economically prohibitive. Even where the price fixed is less than the current market value and the recipient pays income tax immediately on the difference, there is no certainty that the Treasury will not assess additional income tax when the option is exercised.[28] In addition to the income tax pitfalls a finding of any substantial difference between the option price and the economic worth of the interest may suggest the likelihood of a transfer for less than full and adequate consideration in money or money's worth, and thus come within the ban of Section 811(c) of the Estate Tax Title, discussed below.

Estate Taxes

Here under some circumstances the pertinent valuation factors may differ from those involved in inter vivos transactions. When the restriction originates from someone besides the owner and permits the owner to transmit his stock at death to other stockholders, employees or members of his immediate family, without first offering it to the optionee at the price fixed, the valuation problem is identical with that presented by the inter vivos gift cases discussed above. His beneficiary, even though he continues to be bound by the agreement, will enjoy all of the benefits of ownership other than full sale rights. Therefore, there is no reason to limit the value to the option price. The time and circumstance of any future sale are uncertain. The existence of the option may have a depressing

26. Van Dusen v. Commissioner, 166 F. 2d 647 (C. C. A. 9th 1948); T. D. 5507, 1946-1 Cum. Bull. 18; I. T. 3795, 1946-1 Cum. Bull. 15.
27. 100 F. 2d 639 (C. C. A. 3d 1938).
28. Van Dusen v. Commissioner, 166 F. 2d 647 (C. C. A. 9th 1948); T. D. 5507, 1946-1 Cum. Bull. 18.

effect on value but this is only one of the many factors to be considered. In *Worcester County Trust Co. v. Commissioner* [29] the court held that a provision in the articles of incorporation that shareholders desirous of transferring shares should first offer them to the directors, who might buy them for the use of the corporation at their book value, did not fix the market value of the stock but that such restriction would have a depressing effect upon its value in the market and should have been considered in fixing the value for estate tax purposes.

> "The taxpayers contend that the effect of this amendment is to fix the market value of the stock at its book value. The Board, however, took the position that it had no effect whatever on market value. With respect to it the Board said: 'Only if a shareholder chose to sell was he required to make an offer to the corporation at book value of the time. The corporation had no absolute right to demand sale—it had no "call"—which fixed the price at which the shareholder could be required to sell. If the corporation wanted his shares before the shareholder wanted to sell at book value, it could dicker with him for a price and book value would not be a determinant of the price. He and the corporation would be the ordinary willing seller and buyer, and fair market value would be the price upon which they would agree, with a presumed knowledge of the facts. The restriction leaves the value unaffected and only restricts the field of available purchasers in the first instance, if the shareholder should wish to sell. It cannot be said that such a restriction necessarily affects the fair market value.'
>
> "We cannot agree with taxpayers that the amendment set the value of the shares at their book value on the critical date. The amendment did not prohibit sales of the stock except at book value, nor did it fix book value as a call price at which at the behest of the corporation the stock must be sold. It fixed a limitation on the price obtainable by a shareholder for his shares only if he wished to sell and if the corporation at that time wished to buy. The Board's comments quoted above dispose of the taxpayers' contention. But we do not believe that the Board was correct in saying that the 'restriction leaves the value unaffected' for the reason that it 'only restricts the field of available purchase in the first instance.' In our view it must be said that the restriction necessarily has a depressing effect upon the value of the stock in the market.
>
> "A commodity freely salable is obviously worth more on the market than a precisely similar commodity which cannot be freely sold. To be sure the restriction does not affect the value of the stock so long as the owner does not wish to sell, but it is not this value which, under the regulations, is to be used as the basis for computing the tax. The value to be used for this purpose is 'the fair market value,' at the critical date, that is 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 to sell.' While it may be true that the stock of the Company was so held that decedent's son could, and maybe would, force a vote of the directors waiving compliance with the restrictions in the event that the petitioners wished to sell, still the fact remains that the stock in a buyer's hands would be subject to the restriction and there is nothing to indicate that in his hands the directors would be disposed, or could be forced, to waive for his benefit. Upon purchase, then, a buyer would own a stock which if he ever elected to sell, he might well have to sell at book value, and this undoubtedly would tend to reduce its value on the market. It seems to us that in reason it must be said that the restriction affected the market value of the stock, and this being so it should have been considered as one of the 'relevant factors having a bearing' on that question." [30]

And where the restriction whether stemming from decedent or another re-

29. 134 F. 2d 578 (C. C. A. 1st 1943).
30. *Id.* at 581.

quires his estate to sell all of the shares owned at his death to another at an agreed price but does not hamper their free transferability during his life, the full value of the shares will be included in his gross taxable estate for the reason that the optionee's rights arise only with, and solely because of death.[31]

The types of agreements discussed above are to be distinguished from the contracts or options which give the optionee a vested right to purchase the property on death. Where decedent was not the creator of the option but merely owned the burdened property at his death, the stipulated price governs. Since the restriction is in no way traceable to decedent this situation has presented no difficulty and caused no litigation. If on death the employee's estate must sell to the employer at a predetermined price that price is the maximum value of this property to his estate, even though it had a greater value while he lived and enjoyed its other-than-sale benefits. The situation here is analogous to ownership of a life estate. True, if the employer fails to exercise the option, the decedent's beneficiaries will be enriched. But the enriching event is the failure to exercise the option, not the death; and this has all the earmarks of an inter vivos gift. The courts have properly held that the waiver of such rights is not significant in fixing the estate tax value.[32]

The difficult problem presents itself when the decedent created the option in an inter vivos transaction. Here, as illustrated by the cases noted in the opening paragraph of this article, the option device may be used to freeze values at death. But the developing law in the field suggests limitations on its use. The significance of Section 811(c) in taxing transfers intended "to take effect in possession or enjoyment at or after death," has only been hinted at in the opinions.[33] But the scope of that Section and the disastrous consequences to the estate of one who retains a reversionary interest in an inter vivos gift, how-

31. Estate of Mathews v. Commissioner, 3 T. C. 525 (1944); Hoffman v. Commissioner, 2 T. C. 1160 (1943).

32. Wilson v. Bowers, 57 F. 2d 682 (C. C. A. 2d 1932).

33. *Cf.* Commissioner v. Bensel, 100 F. 2d 639 (C. C. A. 3d 1938); Armstrong's Estate v. Commissioner, 146 F. 2d 457 (C. C. A. 7th 1945); Hoffman v. Commissioner, 2 T. C. 1160, 1178 (1943); Estate of Strange, P-H 1942 TC Mem. Dec. Serv. ¶ 42,247 (1942). See also, Paul, Supplement to Federal Estate and Gift Taxation § 18.34 (1946): "And in conclusion, a distinction should be noted between valuation for estate tax purposes and valuation for gift tax purposes. In the latter type of valuation, one is simply obtaining the value of property at the date of gift. There is no question, as there may be in connection with estate tax valuation, whether an optional arrangement is in effect a transfer by the decedent 'intended to take effect in possession or enjoyment at or after death' within the meaning of Section 811(c) of the Code. This question has been suggested in some cases, and it may be that an option price in favor of a natural object of the decedent's bounty may be held to have the quality of a testamentary gift or legacy in the absence of a sale or adequate consideration in money's worth during decedent's lifetime. This phase of the subject needs further development and will no doubt receive consideration in future decisions."

ever nominal and unintended, as illustrated by the *Spiegel* opinion,[34] may well prove troublesome in this type of stock-option situation.[35]

Assume that a father owning 500 shares and his son owning 100 shares in a corporation enter into an agreement that neither will offer his shares for sale without giving the other a first opportunity to buy at book value less whatever worth may be attributable to good will and that in the event of the death of either the other may purchase the decedent's interest within 90 days at the same price.

That the father may have made a taxable gift immediately suggests itself. The consideration is clearly disproportionate. What the son has given up with his lesser number of shares, and longer life expectancy, is measurably and substantially less than what he gained. While his rights under the agreement are contingent they would bring many times what the father's rights would bring in the open market. The relationship normally precludes the supposition of an arm's-length transaction. Because the rights acquired by the father are substantially less than the consideration given, a taxable gift in the amount of the difference results.[36] Under the agreement the father retains his stock interest until death. Only at that time will the rights created by the contract in favor of the son come into enjoyment. This, of course, would be equally true were the transaction between strangers at arm's-length and the consideration given by each substantially equal; but Section 811(c) is, by its very words, inapplicable to transfers for a full and adequate consideration in money or money's worth.[37]

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34. Spiegel's Estate v. Commissioner, 69 Sup. Ct. 301 (1949). The settlor's possible reversionary interest in the $1,000,000 trust corpus in this case had a value of $70 at the time of his death. Nevertheless a tax of $450,000 was assessed thereon because the court held that the retained interest required the inclusion of the full value of the corpus of the trust, not the value of decedent's interest therein.

35. Reliance may not be placed on Commissioner v. Childs' Estate, 147 F. 2d 368 (C. C. A. 3d 1944). In that case Mrs. Childs in 1935 had granted to her stepson an option for ten years to purchase 400 shares of H. Childs & Co., Inc., for $10 per share. The option recited that he had managed and operated the company since 1917, had rendered exceptional services during the depression and that she desired to give him an opportunity to increase his holdings. At the time of her death the option was still outstanding and unexercised. The fair market value of each share was then $100. The Tax Court found an estate tax value of $10 per share. P-H 1943 TC MEM. DEC. SERV. ¶ 43,320 (1943). The case is peculiar in that Commissioner failed to raise any question as to the validity of the option in view of the possible absence of consideration or to urge upon the court the applicability of Section 811(c). While these points were raised on appeal the circuit court of appeals refused to consider contentions not advanced in the court below.

36. INT. REV. CODE § 1002.

37. "*Transfers in contemplation of, or taking effect at death.* To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, or of which he has at any time made a transfer, by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; except in case of a bona fide sale for an adequate and full consideration in money or money's worth." INT. REV. CODE, § 811(c).

Because of the gift element in the father-son contract, the full value of the shares at the date of death must be included in the father's gross taxable estate.

The results reached in the decisions noted in the opening paragraphs of this article may still be regarded as sound holdings with the possible exception of the *Lomb* opinion.[38] In the *Bensel* case,[39] the father and son dealt at arm's length and the value of the option "was high" [40] in relation to the worth of the stock at the time of the contract. Thus there was no element of gift or inadequacy of consideration and hence Section 811(c) [then 302(c)] was held inapplicable. Similarly in the *Strange* case [41] the Tax Court found that "the option figure of $10,000 was an adequate price for the stock on April 11, 1917," the date of the original agreement. Therefore the option price rather than the fair market value ($238,126.56) of the shares on the date of death governed. The agreement in the *Lomb* case appears to have been an arm's-length transaction.[42] It contained substantial gift as well as sale restrictions [43] but query if the rationale of that opinion has not been undermined by the later cases,[44] since the decedent could within narrow limits bequeath the property in such a way as to stay the hand of the optionee.

As the objective of many of these restrictive agreements is to keep ownership in the hands of surviving partners, associates or stockholders and to avoid the intervention of the deceased's beneficiaries or other outsiders, the contracts will often be made at arm's length and the donative element which Section 811(c) contemplates will be absent. But because close family and business ties beget acts of generosity and because the line between the arm's-length transaction and the donative one may become shadowy in particular cases caution will dictate that the interests of each participant in any restrictive agreement be impartially valued and where any plausible contention may be made that the agreement may not have been at arm's length the parties will be well advised to err on the liberal side in fixing the option price or formula from which it is to be determined.

In addition to fixing the purchase price by reference to current market worth, the consideration presently given to make the option binding must be the fair monetary equivalent of the market value of the irrevocable privilege to buy at a future date. In other words, the option itself has a value, as was pointed out in the discussion of *Commissioner v. Smith.* With no investment

38. Lomb v. Sugden, 82 F. 2d 166 (C. C. A. 2d 1936).
39. 100 F. 2d 639 (C. C. A. 3d 1938).
40. 36 B. T. A. 246, 253 (1937).
41. P-H 1942 TC MEM. DEC. SERV. ¶ 42,247 (1942).
42. 11 F. Supp. 472, 477 (W. D. N. Y. 1935). "There is no evidence in this case, nor is there any claim, nor can any inference be properly drawn, that the agreement in question here was made for the purpose of evading taxation. Its sole purpose was obviously to enable those who had built up Bausch & Lomb industry from its infancy or their successors, to continue control of the corporation."
43. See note 3 *supra.*
44. Worcester County Trust Co. v. Commissioner, 134 F. 2d 578 (C. C. A. 1st 1943); Commissioner v. McCann, 146 F. 2d 385 (C. C. A. 2d 1944).

of capital the optionee stands to benefit by price increases in the property without the corresponding risks of loss by decrease in value, which ownership of the property itself would entail.

CONCLUSION

Even when the owner of the property is the optionor, restrictive agreements are frequently motivated by business or family reasons wholly unrelated to tax consequences. And when tax considerations are present, the difficulty sought to be avoided is almost always the uncertainty as to the value which may be attributed to the property by the taxing authorities. Yet to use the option device effectively and avoid disastrous tax consequences one must be a skilled mariner, and since there are places along the way where the visibility is reminiscent of Nashville smog, even the expert may lose his bearings.

If he is wise he will chart a course wide of the rule of *Commissioner v. Smith.*[45] The arrangement must negative any implication that smacks of compensation for services or is otherwise a substitute for payments which would constitute taxable income to the recipient. Failing this the game will rarely be worth the candle, for the income tax incurred will generally be found to exceed any estate tax eliminated.

The conclusion is something of a paradox. If the estate tax objective is to be achieved, no gift tax must be incurred. Any inter vivos arrangement under which *A* may purchase an interest of *B* on the latter's death, unless the option is given in exchange for a full and adequate consideration in money or money's worth, will result in the imposition of gift tax and the subsequent inclusion of this property in *B*'s gross taxable estate at its full value at the date of death as though the option were non-existent. Conversely, an arrangement which escapes the gift tax will limit estate values to the option price no matter how wide the discrepancy at death between the option price and its real value. That the restrictive option device may be effectively used within the limits suggested finds support in the regulation dealing with the valuation of business interests. "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." [46]

45. 324 U. S. 177, 65 Sup. Ct. 591, 84 L. Ed. 646 (1945).
46. U. S. Treas. Reg. 105, § 81.10(d).