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THE IMPLICATIONS OF MINORITY INTEREST AND STOCK RESTRICTIONS IN VALUING CLOSELY-HELD SHARES

ALAN L. FELD†

INTRODUCTION

The federal estate and gift taxes levy on the gratuitous transfer of wealth by both testamentary and lifetime disposition. The amount of the tax depends on the value placed on the property transferred by the decedent or donor. When the property transferred consists of shares of stock in a closely held corporation, there often exists no ready market to help in valuation. As a result, the value of the shares used to compute the federal estate or gift tax must be determined first by appraising the value of the enterprise, and then by allocating some portion of that value to the shares in question. Occasionally, the value placed on these shares will differ from the proportionate value of the enterprise represented by them.

This article deals with two instances of such variation in value from the proportionate interest of the shares in the closely held enterprise. One concerns the minority position of the recipient relative to other stockholders. The other concerns shares which are not freely transferable. Since both of these factors limit the shareholder's ability to realize fully on the value of the shares, a discount is frequently applied to such stock when computing gift and estate taxes.

I. MINORITY INTEREST

For both the estate and gift tax, the tax base is determined by the fair market value of the property transferred. For estate tax purposes, section 2031(a) of the Internal Revenue Code[1] (Code) and its associated regulations[2] require the inclusion in the gross estate of the fair market value of all property held at the time of death, to the extent that the property is swept into the

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[1] INT. REV. CODE OF 1954, § 2031(a).

[2] Treas. Reg. § 20.2031-1(b) (1958).

gross estate.[3] The gift tax[4] and its associated regulations[5] similarly provide that the amount of a gift of property is its fair market value on the date of gift. Fair market value is defined generally 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 to sell and both having reasonable knowledge of relevant facts."[6]

In the case of corporate stock, the regulations state that market price is the best proof of value.[7] But where reliable market prices or bid and asked prices are lacking, the stock must be valued with reference to the corporation's net worth, prospective earning power, dividend-paying capacity and other relevant factors.[8]

Once the value of the corporation as a whole has been determined, it is necessary to appraise the value of the shares being transferred. The regulations, in addition to the obvious factors, refer to the degree of control of the business represented by the block of stock transferred as relevant to its valuation.[9] In the most recent elaboration of its position regarding valuation of stock in closely held corporations, the Internal Revenue Service (Service) listed a series of factors to be taken into account, one of which is the size of the block to be valued.[10] The ruling states that a minority interest, which is not defined, in the stock of an unlisted corporation is more difficult to sell than a similar block of listed stock. It adds that it is equally true that control of a corporation, representing an additional element of value, may justify a higher value for a specific block of stock,[11] so that minority interest presumably is intended to be linked to control.

The principle that there should be a discount for a minority interest is entirely appropriate in a proper case. A minority

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[3] Section 2032 of the Code, which permits the executor to elect the alternate valuation date, incorporates like concepts of value, but may present special problems. INT. REV. CODE OF 1954, § 2032. *See* Rev. Rul. 68-154, 1968-1 CUM. BULL. 395.

[4] INT. REV. CODE OF 1954, § 2512(a).

[5] Treas. Reg. § 25.2512-2(a) (1958).

[6] Treas. Reg. § 20.2031-1(b) (1965); Treas. Reg. § 25.2512-2(a) (1958).

[7] Treas. Reg. § 20.2031-2(b-d) (1958); Treas. Reg. § 25.2512-2(b-d) (1958).

[8] Treas. Reg. § 20.2031-2(f) (1958); Treas. Reg. § 25.2512-2(f) (1958). This initial valuation of the corporation is not itself an easy task. *See, e.g.*, Lamson, *Factors That Will Substantiate the Valuation of a Closely Held Corporation*, 34 J. TAX. 226 (1971); Vass, *Factors that Are Presently Being Emphasized in Valuing a Closely-Held Corporation*, 34 J. TAX. 226 (1971).

[9] Treas. Reg. § 20.2031-2(f) (1958); Treas. Reg. § 25.2512-2(f) (1958). *Cf.* Treas. Reg. § 20.2031-2(e) (1958); Treas. Reg. § 25.2512-2(e) (1958).

[10] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 239.

[11] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 242.

interest in a corporation controlled by others may be worth significantly less than the liquidation value of the shares. Ownership of shares in a closely held corporation may conveniently be analyzed as composed of three elements of value: the right to a proportionate share of the net wealth of the corporation, or asset value; the right to a proportionate share of distributions from the corporation, or income value; and proportionate participation in the management of the enterprise, or control value. The minority shareholder enjoys the asset value and income value of the shares. But if he is an outsider, he may not enjoy the control value attaching to the shares.

The outsider may have no part in making determinations regarding the day-to-day operating policies of the corporation. This type of operational control is important in determining what assets to buy and sell for the corporation, with whom the corporation does business, and what operations and projects the corporation should engage in. A frequently occurring example of the value of participation in operational control is the power of the controlling shareholders to cause the corporation to employ them at reasonable salaries and to refuse to employ the minority shareholders on a similar basis.[12]

Another element of control concerns the extent to which a shareholder can realize immediately on the asset and income values of his shares. A corporation generally cannot be compelled by a minority shareholder to pay dividends or to distribute assets to a shareholder in redemption of his shares,[13] nor can it be forced to dissolve. The controlling shareholders may restrict or enhance the flow of dividends as the flow benefits them. To the extent they find their control position in the corporation agreeable, they can prevent dissolution of the corporation. If their controlling interest is great enough they may have the power to cause dissolution, should they desire to do so.

Assuming that the majority shareholders will not dissolve the company, the minority shareholder who is an outsider can retire from his undesirable corporate position and realize on his stock in two ways. He can sell the stock to another outsider, in which event the price is likely to reflect a substantial discount by reason of the "captive" position of the investment in the corpora-

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[12] *See generally* F. O'NEAL & DERWIN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES (1961).

[13] *Compare* Gottfried v. Gottfried, 73 N.Y.S.2d 692 (Sup. Ct. 1947), *with* Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919). *See, e.g.*, Note, *Minority Shareholder Suits to Compel Declaration of Dividends*, 64 HARV. L. REV. 299 (1950); Note, *The Shareholders Right to Compel Declaration of a Dividend*, 10 ROCKY MT. L. REV. 201 (1938).

tion, or he can sell to the insiders.[14] While there may be buyers at a favorable price if the insiders regard it as desirable to eliminate outside participation in the affairs of the corporation, the insider market is normally restricted. On balance it is fair to conclude that the price obtainable by the outsider for the minority shares normally will be substantially less than the pro rata asset and income values.

If, however, the minority shareholder is not an outsider but is part of the group which has effective control over the corporation's activities, the value of his shares is quite different. Not only will the minority shareholder enjoy the asset and income values of his stock in the corporation, but he will also participate in the decisionmaking processes of the corporation. He may help to determine the corporation's day-to-day policies. His needs will be taken into account in framing dividend policy. It may be understood that if the other shareholders in the control group sell to an outsider, he will have the right to have his shares included in the block of stock to be sold. To the extent that there are other minority shareholders who are not participants in the control group, the value of his shares will be enhanced by the premium attributable to control over their investment. In any event, the value of the shares to the inside minority shareholder is far more likely to approach his proportionate interest in the enterprise than if he were an outsider. Accordingly, little or no minority interest discount is appropriate in such a case.

As noted, the regulations include "the degree of control of the business represented" by the shares as a relevant factor in their valuation.[15] This might be taken as an invitation to analyze the reality of participation in control of the corporation which the shares confer on their new holder. Attention has focused instead on an inadvertent semantic formulation suggesting that a minority shareholding generally should be treated as if held by an outsider. As the general definition of fair market value, the regulations adopt the widely accepted statement that it is the price at which property would change hands between a willing buyer and a willing seller.[16] When applied to stock in a closely held corporation, however, this general statement can be misleading. Does it suggest that the value put on the shares received

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[14] Sale to the corporation may be viewed for this purpose as having the same effects as a pro rata sale to the other shareholders.

[15] Treas. Reg. § 20.2031-2(f) (1958); Treas. Reg. § 25.2512-2(f) (1958).

[16] Treas. Reg. § 20.2031-1(b) (1965); Treas. Reg. § 25.2512-1 (1965).

by an "insider" donee or legatee should be limited to what a willing outsider would pay for them?[17] If so, the control value of the shares will be ignored and a substantial minority discount applied, although the new shareholder donee or legatee participates actively in control of the corporation. Yet, it is apparent that substantially more wealth has been conferred on the donee than he could obtain simply by reselling the stock interest to an outsider, because an element of the wealth conferred, participation in control, could not be conveyed to an outsider by conveying the shares.

Whittemore v. Fitzpatrick,[18] a suit to recover overpayment of gift tax, turned on the value of stock in a family holding company. The donor, Whittemore, owned all of the 820 outstanding shares of stock in the company. Whittemore transferred 600 shares to two co-trustees for the benefit of his three sons severally, retaining 220 shares. One of the trustees was the donor's son. Whittemore valued the stock on his gift tax return at $1,000 per share, but the Service asserted a value of $3,228 per share. The issue at trial was how the interest transferred in the company should be characterized. The Service argued that a controlling interest had been transferred and that the shares should be valued proportionally. The taxpayer argued that he had made three separate transfers of a minority interest, each of which should enjoy a minority discount.

The court stressed that the number of shares transferred constituted less than the seventy-five percent needed to liquidate the corporation, and that the holders of this block of stock did not have the power to realize immediately on the liquidation value. As a result, the block of 600 shares transferred was preliminarily valued at a fifty percent discount from the per share liquidation value. Then, after analyzing conflicting expert testimony regarding the nature of the 600-share block transferred, the court determined that the individual gifts should be valued as separate 200-share lots rather than as part of a single 600-share block. To take account of the difficulty in marketing such a 200-share minority interest, the court applied a further discount. The aggregate discount applied was sixty-six percent below the liquidation value per share.

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[17] The Service has sometimes argued, largely unsuccessfully, that the willing buyer to whom the new donee would sell would be the controlling family group, an argument which suggests that the hypothetical buyer be treated as a non-outsider. Marian Otis Chandler, 10 P-H B.T.A. Mem. 387, 392 (1941). *But see* Bartram v. Graham, 157 F. Supp. 757 (D. Conn. 1957).

[18] 127 F. Supp. 710 (D. Conn. 1954).

If we view each of the 200-share blocks in the *Whittemore* case as having been the subject of a separate sale to an outside party, the discount used by the court was entirely appropriate, because the market for minority shareholdings without proportionate control of the enterprise is extremely limited. But in *Whittemore*, the new beneficial owners of the shares had significant participation in control of the corporation. The three blocks of stock, representing more than seventy-three percent of the voting power of the corporation, were under common voting control. One of the two trustees was himself a beneficiary.[19] Also there was no evidence that the donor, who retained 220 shares, and the donees, who together held the remaining 600 shares, were in an adversary relationship with one another. To the contrary, the mutuality of interest among them, which may be inferred from the gift, is likely to have continued. Control of the corporation remained in the family group. There was no evidence that any block of stock was deprived of its proportionate participation in corporate control. Accordingly, no significant discount for minority interest should have been taken on these gifts. Similarly, a minority discount would be inappropriate if the donor later passed his remaining 220 shares to family members by gift or bequest.

The *Whittemore* court rejected the Service's argument that the taxpayer, in ascertaining the price at which the donee would sell the stock to a willing buyer, underemphasized the higher value which the donee would demand.[20] The court properly argued that subjective factors, such as sentimental attachment to a corporation which had long been in the family, should be ignored in fixing the value of the gift. Participation in control of the corporation, however, is not an irrational element in determining value to be lightly set aside as subjective. The problem was not that the donee's evaluation of the shares was idiosyncratic, but that an element of value transferred from the donor could not be retransferred to another. It is nevertheless an element by which the donor enriched the donee, and the court erred in disregarding it.

When there are special factors demonstrating this value to the donee or legatee, the potential discount for minority shares has been ignored. In *Blanchard v. United States*,[21] the donor

[19] Moreover, the trustees were under a fiduciary obligation not to injure any beneficiary by favoring another. *See* RESTATEMENT (SECOND) OF TRUSTS § 170, comment r, at 371 (1959). *Cf.* United States v. Byrum, 408 U.S. 125, 136-40 (1972).

[20] 127 F. Supp. at 715.

[21] 291 F. Supp. 348 (S.D. Iowa 1968).

owned 22.9 percent of the shares of a bank. The members of the donor's family owned an additional 29.5 percent of the stock when the donor transferred her shares to six family trusts. Three weeks later an unrelated party, Life Investors of Iowa, bought the Blanchard family stock, including the stock held by the trusts, at a price in excess of $700 per share. Subsequent to this sale, Life Investors bought stock from nonfamily shareholders, paying $315 a share. The donor contended that, for gift tax purposes, the blocks placed in each of the six trusts should be viewed as four percent stock interests, and valued at the price paid to the small interests in the subsequent sale. The court properly held the stock to be part of the controlling Blanchard family block, to be valued as part of the majority interest in the bank.[22]

A particularly doubtful application of the minority discount in the face of the realities of control occurred in *Obermer v. United States.*[23] Husband and wife each owned half of the stock of a personal holding company. The husband died, leaving the stock to his wife. The estate contended for a minority-interest discount of one-third of the per-share liquidation value and the district court agreed. The court stressed the fact that a fifty percent interest in the company would not permit an outside purchaser of the stock to liquidate the corporation in order to reach the underlying assets, which consisted of readily marketable securities. This solution, however, ignored the fact that the stock had been held by the husband, and would be held by the wife, with control of the corporation held at all times within the intimate family group.[24]

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[22] The Government's position was also supported by evidence that at the time of the transfer negotiations for the sale to Life Investors had progressed sufficiently that the donor had ample expectations of the price eventually paid. *Id.*

[23] 238 F. Supp. 29 (D. Hawaii 1964).

[24] Another problem which concerned the *Obermer* court was that the corporation's securities had appreciated so that, on sale by the corporation, substantial capital gains tax would be incurred. It has been held that the hypothetical expenses of converting investment assets into cash, such as selling commissions and taxes on appreciation, are not to be taken into account. Estate of Frank A. Cruikshank, 9 T.C. 162 (1947). *See* United States v. Cartwright, 411 U.S. 546, 561-2 (1973) (Stewart, J., dissenting). Moreover, it is possible for a shareholder to realize on investment assets without incurring capital gains tax at the corporate level by way of dividend distributions, most redemptions, and liquidations. INT. REV. CODE OF 1954, §§ 311(a), 336.

Finally, the court considered the corporation's status as a personal holding company, potentially subject to personal holding company tax, INT. REV. CODE OF 1954, § 541 *et seq.*, as further justification for a discount. In the case of a minority shareholder, however, this potential tax could be more than offset by the impetus it creates to distribute earnings to the shareholders, thereby obtaining the benefits of the dividends-paid deduction, INT. REV. CODE OF 1954, §§ 561 & 545(a). An outsider, thus, has greater assurance than he ordinarily does that he will realize the income value of the shares.

An example of minority discount correctly applied to a minority shareholder is *Estate of Lillian May Schroeder.*[25] At her death, the decedent owned 750 of the 10,000 outstanding shares in a company, in which a corporation unrelated to the decedent had a controlling interest. The asset value was $41.84 per share. While there was virtually no market in the stock, one sale of 100 shares to an insider had recently taken place, in which the price paid was $25 per share. The Tax Court, finding a value of $25 per share, held that the sale was the best available indicator of the value of the stock. Although an isolated sale would generally be given limited weight in a determination of value, it was dispositive in this case. While the finding represented a substantial discount from asset value, it properly reflected the true minority position of the shares bequeathed.

Schroeder represents the exceptional case where the shareholder was frozen out of control of the corporation and when an actual sale of shares held by an outsider at a time near the valuation date resolved the question directly. More typically, however, the discount is applied without examining whether the transferee suffers the lack of participation in control which is the rationale for minority discount. *Whittemore* and *Obermer* are not atypical of the decisions concerning minority discount.[26] The courts generally have determined whether the interest transferred is arithmetically a minority interest and then, based on conflicting testimony offered by expert witnesses, have applied some discount from proportionate asset value.

Consider the implications of this legal pattern in the context of a transfer of wealth from one generation to another within a family. Suppose that a parent concerned with the transfer tax seeks to transfer $1,000,000 to his three children. Assume further that both his specific lifetime gift tax exemption of $30,000 and his annual $3,000 exclusion for each child have

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[25] 13 T.C. 259 (1949), *acquiesced in,* 1949-2 CUM. BULL. 3.

[26] *See, e.g.,* Righter v. United States, 439 F.2d 1204 (Ct. Cl. 1971); Drybrough v. United States, 208 F. Supp. 279 (W.D. Ky. 1962); Bartram v. Graham, 157 F. Supp. 757 (D. Conn. 1959); Estate of Gregg Maxcy, 28 CCH Tax Ct. Mem. 783 (1969); Estate of Harry Stoll Leyman, 40 T.C. 100 (1963), *rev'd on other grounds,* 344 F.2d 763 (6th Cir. 1965), *vacated,* 383 U.S. 832 (1966); Paulina DuPont Dean v. Commissioner, 19 CCH Tax Ct. Mem. 281 (1960); Estate of Charles W. Heppenstall, 18 P-H Tax Ct. Mem. 115 (1949); Marian Otis Chandler, 10 P-H B.T.A. Mem. 387 (1941). *But see* Hamm v. Commissioner, 325 F.2d 934 (8th Cir. 1963) (court refuses to interfere with Tax Court's affirmance of Commissioner's valuation, which included some discount from asset value per share). Especially instructive is the contrast between the Tax Court and the Second Circuit opinions in H. Smith Richardson, 12 P-H Tax Ct. Mem. 1577 (1943), *aff'd,* 151 F.2d 102 (2d Cir. 1945), *cert. denied,* 326 U.S. 796 (1946).

otherwise been exhausted. If the parent gave each child one-third of the $1,000,000 he would have aggregate gifts of $1,000,000 on which gift tax would be incurred.

Suppose instead that the donor uses the $1,000,000 to provide the capital for a new corporation in exchange for all of its outstanding stock. If he then transfers one-third of the stock to each child, each gift, under the *Whittemore* view, should be entitled to a discount for minority interest. If the discount is a conservative twenty percent, each gift would be valued at $266,666, resulting in total taxable gifts of $800,000. Assuming that there are no other taxable gifts and that the "split gift" provision[27] is not elected or is inapplicable, the gift tax saving from this change in form would be $55,500.[28]

Are the differences in the two gifts great enough to warrant this difference in tax treatment? In one sense, each child will have received something quite different in the two transfers: in the first, $333,333; in the second, a one-third interest in a corporation capitalized with the donor's $1,000,000. This distinction could be significant if there were disagreement as to the management of the corporation, because the interest in the corporation would be worth less than $333,333 to a child who lacked control over the business.

If the family were close, however, each child might enjoy the advantage of consolidated management and might also be able to realize on the funds as needed. In such a case a shareholder who needed money could expect to have his shares either redeemed by the corporation or purchased by the other two shareholders for his proportionate share of the underlying asset value. Alternatively, the shareholders could liquidate the corporation and each would attain directly one-third of $1,000,000.

While the transfer of shares in a corporation holding nothing but cash may seem fanciful, it is entirely probable that a parent may wish to transfer an investment portfolio to his children. The comparison between a transfer of investment securities to the children directly and a transfer to a corporation followed by a transfer of the stock of the new corporation to the

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[27] INT. REV. CODE OF 1954, § 2513.

[28] If this most extreme of cases, a corporation whose sole asset is cash, concerned an income tax benefit to the donor rather than a transfer tax benefit, the Commissioner might have a range of arguments open to him. He might, for example, seek to deny the claimed benefit under INT. REV. CODE OF 1954, § 269. There is no analogous statutory provision under the estate and gift tax. Nor does the Commissioner have specific power to make adjustments to clearly reflect value, similar to that granted under the income tax by INT. REV. CODE OF 1954, § 482, to make adjustments so as to clearly reflect income.

children would appear to be subject to the same analysis.[29] Similarly, if the asset to be transferred is a family business, the application of minority discount when the business is incorporated would seem to be unjustified. To be sure, in the latter case the corporation may be less liquid than in the other cases, and therefore less able to allow the shareholders to realize immediately on the underlying value. But this would also be true of a transfer of undivided interests in the family business directly to the children.

Analysis of a minority interest in the corporation might be further refined by examining the relationship of the new owner of the minority interest with the other ownership interests in the corporation. If the others also hold minority interests, no one block of stock has a special control position in the corporation. To the extent that differences arise, the shareholder alliance representing control in the corporation may shift from issue to issue. Each shareholder can, with the aid of others, check the control sought to be exerted by any other shareholder. Minority discount would appear particularly inappropriate here, where the minority "disability" is reciprocal.

But the holder of less than a majority of shares may be a part of a control group which would have control of the corporation even without his participation, *i.e.*, a minority insider. In the event of a dispute between the shareholder and the control group, the group could overrule him. The opportunity to sell his shares may be more limited than in the all-minority interest case. This would appear to be the most appealing case for application of the discount to shares which are held by a member of the controlling group.

Neither the regulations and rulings on the one hand, nor the decided cases on the other, are a substantial help in dealing with these problems. The former touch on the relationship between value and control only in an oblique and general fashion. The latter use what can best be termed elusive standards when applying the minority discount. It has been applied when it is determined that the block of stock transferred does not consti-

[29] An incorporated portfolio has the income tax disadvantage of coming within the personal holding company provisions. INT. REV. CODE OF 1954, § 541 *et seq*. Yet the penalty tax can be avoided by making distributions of the corporation's undistributed income. INT. REV. CODE OF 1954, § 561. A further disadvantage is that an additional income tax on the investment income will be incurred at the corporate level. This tax burden would be greatly reduced by the availability of the dividends received deduction, which reduces the effective corporate income tax on dividend income from a maximum of 48 percent to a maximum of 7.2 percent. INT. REV. CODE OF 1954, § 243(a).

tute more than either fifty percent of the stock of the corporation, or occasionally, the percentage required to force liquidation. This has resulted in discounting value in cases where the obvious link between the size of the block and control suggested by the ruling was absent, but where control was nonetheless transferred. The holdings of the cases fail to clarify the principles involved.

The potential avoidance of transfer tax, given the confusion in this area, is substantial. It may be illustrated as follows. To return to the father who owns all of the stock of a family holding company, suppose that his gifts are spread over time. He first gives a third of the stock to one son and retains the other two-thirds. The recipient has a minority insider interest of the kind described above. If a minority discount is applied, the shares will be valued at some amount less than one-third of the value of the whole corporation.[30]

Thereafter, in a separate transaction, the father transfers a second one-third interest in the stock of the corporation to another son. Now the shares are held in equal blocks by the three shareholders and should have equal value, one-third of the value of the corporation. The first son's shares have increased in value, to reflect the new dispersion of control in the corporation. By this second gift, then, the father has enriched the second son directly and the first son indirectly. Failure to treat the enhancement in value of the first son's shares as a taxable gift would result in permanent exclusion of the discount from both gift and estate taxes.

If this second gift could be taxed in the amount of both these elements of value, there would be no transfer tax avoidance. Although section 2511 construes "transfer" broadly, to be subject to gift tax the transfer must be of property,[31] and the amount of the gift is defined as the value of the property transferred.[32] The difficulty in taxing this increment of value at the time of the second transfer is that no "property" has been transferred to the first son, while the property transferred to the second son is limited in value to the one-third share given him. The cases appear to support this view in rejecting the notion that

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[30] Presumably, the two-thirds interest in the corporation retained by the father would now be worth a premium over two-thirds of the value of the whole corporation, the premium being equal to the discount, if the father's interest were valued on death or other transfer of the shares gratuitously as a block.

[31] INT. REV. CODE OF 1954, § 2501(a)(1).

[32] INT. REV. CODE OF 1954, § 2512(a).

transferring part of a control block results in a taxable gift greater than the value of the shares to the recipient.[33]

This result cannot be avoided by analyzing the later increase in value in the first son's shares as a transfer incident to the earlier gift. First, both the estate tax and the gift tax apply on a "now or never" basis, imposing tax on the value of the property as best as it can be determined at the time of the transfer. Adjustments at later dates have not become a part of the transfer tax system[34] even where the income tax recognizes such adjustments. Second, the augmentation in the value of the first son's shares by reason of fragmentation of the control held by the father need not occur incident to a transaction which would otherwise be subject to estate or gift tax. It could as well derive from other kinds of transactions. For example, if the father sold a one-third interest in the corporation to a third party instead of making a gift of the shares to the second son, the control position previously held by the father would disappear, and the value of the shares held by the first son would rise, but with no resultant gift tax.

If no taxable transfer to the first son is deemed to occur when shares are given to the second son, the discount taken on the initial transfer to the first son will be permanently excluded from transfer taxation. This consideration should weigh heavily against applying a discount for minority interests in the case of the "minority insider" where the less than proportionate share of control in the corporation is contingent and uncertain.

The proper response to this situation may be a presumption that a donor or decedent, in making transfers of stock in a closely held corporation which he controls, makes them to transferees who will be a part of the control group of the corporation. In order to establish that a minority discount is appropriate, the proponent of the discount would have to come forward with evidence that the recipient who is claimed to be a minority shareholder actually will suffer the disabilities of an outsider. This burden would generally be difficult to carry where the minority position is reciprocal.

The presumption against minority discount should apply

[33] Estate of Charles W. Heppenstall, 18 P-H Tax Ct. Mem. 115 (1949); Marian Otis Chandler, 10 P-H B.T.A. Mem. 387 (1941).

[34] In Burnet v. Logan, 283 U.S. 404 (1931), the Supreme Court found consideration received on an exchange to be so contingent and difficult to value as to require the transaction to be kept open, deferring income taxation until cash or property actually was received. In the same case, however, there had been an estate tax proceeding in which the same rights were valued and the estate tax liability was finally determined.

even where participation in control may be limited by the concentration of a majority interest in other hands.[35] Minority discount under these circumstances is likely to result in permanent avoidance of estate and gift tax on the transfer of wealth within the family group. It is not unfair to require the proponent of a minority discount to justify it by more than pointing to percentages and claiming that they "prove" a lack of participation in control.

II. Restrictions on Stock

Shareholders in a closely held corporation frequently impose restrictions on the transferability of stock in the corporation. Such restrictions may serve a variety of purposes, for example, to keep ownership and control of the enterprise within a limited group and to assure that new entrants into the stockholding group are acceptable to the other owners.

The restrictions may be imposed by charter provision, bylaw provision, or separate agreement. They may bind future as well as current owners of the shares and, to ensure notice of the restrictions to any subsequent purchaser for value, may require that the certificates reflect the restriction.[36]

The character of the restriction will vary depending upon the purpose to be served. There may be an absolute prohibition against transfer of the stock for reasonable periods;[37] a requirement that consent of the other shareholders must be obtained before the shares may be transferred; an agreement that the corporation or the other shareholders will buy the shares on the death of a shareholder or on the occurrence of some other contingency; or an option which provides that another may purchase the stock. Frequently, the restriction takes the form of a right of first refusal, granting to the other shareholders, to the corporation, or to some other insider group the right to purchase the shares at a determinable price before they can be transferred.

When the restriction contemplates sale of the shares, the price may be stated or a formula for ascertaining the price may be provided. If the price is the fair market value of the shares, the restriction can hardly be said to affect value. But often the

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[35] *Cf.* Treas. Reg. § 25.2511-1(e) (1958).

[36] *See, e.g.*, Uniform Commercial Code §§ 8-204 & 8-301.

[37] A prohibition against transfer for an unreasonably long period would be invalid as constituting an undue restraint on the alienability of the stock. *See* Greene v. E.H. Rollins & Sons, Inc., 22 Del. Ch. 394, 2 A.2d 249 (1938).

price is lower than the proportionate interest in the entire enterprise represented by the shares.

If the shares are held subject to an option or contract to purchase, the estate tax regulations provide that the effect of the price on value depends on the circumstances of the case.[38] Little weight is given an option or contract taking effect only at death, if the decedent was free to dispose of the stock at any price during his lifetime. To prevent the use of an option or contract as a testamentary device, it is required that the restriction represent part of a bona fide business arrangement.

Published rulings have amplified the regulations in two respects. First, if the stock was acquired from the corporation subject to a charter restriction pursuant to which the corporation may purchase the stock at a specified price before any transfer, including a transfer at death, the option price generally will determine value for estate tax purposes.[39] The second provides that if the transferability of the stock was restricted during the lifetime of the decedent, but the shareholders entered into the option or agreement voluntarily, the agreement is but one factor to be considered in valuation and may or may not fix the estate tax value.[40]

With one exception, the Service applies similar rules for gift tax purposes, stating that a right of first refusal held by another is one factor to be taken into account, although it is not necessarily determinative of value.[41] The exception is that an option imposed by charter allowing the corporation to purchase the shares at a specified price before any other transfer can be made is not strictly determinative of value,[42] as it is in the case of estate taxes.

The form in which the restriction is applied—charter provision, bylaw or agreement—would seem to be largely a matter of convenience within the control of the shareholders. It should be irrelevant for tax purposes which of these forms is used by the shareholders, provided that the restriction is enforceable and that all due steps are taken to give prospective purchasers of the stock notice of the restriction.[43] The Service position generally

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[38] Treas. Reg. § 20.2031-2(h) (1958).

[39] Rev. Rul. 54-76, 1954-1 CUM. BULL. 194.

[40] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 244.

[41] Rev. Rul. 189, 1953-2 CUM. BULL. 294.

[42] *Compare* Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 243-44, *with* Rev. Rul. 54-76, 1954-1 CUM. BULL. 194.

[43] Insofar as a corporate charter may be amended by less than unanimous shareholder action, while a contract change requires unanimity, the latter might be thought more determinative of value.

reflects the decisional law, except for the preferred status which the estate tax regulations accord charter restrictions.[44]

In analyzing these rules it will be helpful to consider an example. Suppose that *A*, *B*, and *C* have equal interests in ABC, Inc. The stock is held subject to an agreement providing that no shares may be transferred without being offered first to the corporation and to the other shareholders at book value.[45] Further, any shares held by the estate of a deceased must be sold to the corporation at book value.[46] These restrictions bind transferees and assignees.

The restrictions do not affect the income value of the shares or their control value. Each shareholder receives the same proportionate share of dividends and participates in the control of the corporation as he would without the restrictions. They do, however, limit the asset value, the right to a proportionate share of the corporation's net wealth, by the difference between book value and the value of the same interest in the corporation without restriction. But the effect of this reduction on the current fair market value of the shares is less clear. It would appear to depend upon the importance to the shareholder of the ability to realize on the asset value.

Suppose, for example, that *A* and *B* have agreed to waive their right of first refusal on a proposed transfer by *C* of his stock to *D*, his son. Normally the value of the shares to *D* would

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[44] Thus, shares which are restricted during life and which must at death be offered to others at a fixed price are valued for estate tax purposes at the agreement price. *See, e.g.*, Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Commissioner v. Bensel, 100 F.2d 639 (3d Cir. 1938); Estate of Orville B. Littick, 31 T.C. 181 (1958), *acquiesced in*, 1959-2 CUM. BULL. 5. Where the shares are not required to be offered at death but are only subject to a right of first refusal, the restriction is but one factor to be taken account of in the valuation. *See, e.g.*, Estate of Ambrose Fry, 9 T.C. 503, 508 (1947). For gift tax purposes, the restrictions are not determinative, but must be taken into account. *See, e.g.*, Krauss v. United States, 140 F.2d 510 (5th Cir. 1944); James v. Commissioner, 148 F.2d 236 (2d Cir. 1945), *aff'g per curiam* 3 T.C. 1260 (1944). The Tax Court in *James* stressed the voluntary nature of the agreement and the fact that the option was not specifically enforceable. *Id.* at 1264.

[45] The income tax effect of this disposition may vary depending on the nature of the remaining shareholders' duty to purchase. The Service has litigated a number of cases concerning the redemption of stock by a corporation, in which the Service contended that the transaction should be analyzed as a dividend distribution to the shareholders continuing in the business, followed by a purchase by them of the departing shareholders' stock. *Compare* Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966), *cert. denied*, 387 U.S. 905 (1967), *with* Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958), *rev'g* 28 T.C. 962 (1957). The Service relied on the existence of an agreement or other duty on the part of the shareholders continuing as owners of the corporation to purchase the shares, which the corporation assumed instead. The Service has announced that it has abandoned this argument in all cases except those in which the corporation has assumed the remaining shareholders' "primary" and "unconditional" obligation to purchase the stock. Rev. Rul. 69-608, 1969-2 CUM. BULL. 42.

[46] Payments may be deferred because of the corporation's insufficient liquidity to meet so large an obligation all at once.

be substantially less than the fair market value of the shares without restriction because he could not be sure of realizing more than the book value on sale of the shares. But if *D* expects to participate in the corporation for the indefinite future, asset value may be relatively unimportant to him compared with the income value or the control value of the shares. Furthermore, though the difference between fair market value and the formula price is currently ascertainable, the size of this difference when the restriction becomes operative cannot be accurately forecast. This may render the reduction in asset value of relatively little consequence to the shareholder.[47]

As noted, the courts have taken the restriction into account as one factor, though not determinative, to be considered in valuation. They have attempted to weigh the reduction in asset value against the "retention value" of the shares to the shareholder. For example, *Estate of Pearl Gibbons Reynolds*[48] concerned estate and gift tax deficiencies in a number of related cases arising from transfers of voting trust certificates. The voting trust in question held more than fifty percent of the stock of an insurance company. The trust certificates were subject to a right of first refusal at a formula price on any sale or pledge of the stock. The formula produced a price of $317, while the value of the underlying stock per certificate was $2,300. The taxpayers relied exclusively on the formula price in valuing the certificates at $317, while the Commissioner's expert valued them at $1,800 each.[49] The Tax Court found a value of $1,600, holding the

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[47] Another factor that should be taken into account is the likelihood that the agreement in fact will operate to deprive a shareholder of the value represented by the difference between the fair market value of the unrestricted stock and the formula price. While it may be that the other shareholders would enforce the restriction to prevent a sale to an outside party, sale to the corporation at a price more closely reflective of fair market value by a retiring shareholder is not inconceivable. Gratuitous transfers by a shareholder within his own family group are likely to be permitted. *See, e.g.*, Raymond J. Moore, 3 T.C. 1205, 1207 (1944).

If the restriction is waived on a subsequent transfer by the shareholder a taxable gift might well result. *See generally* INT. REV. CODE OF 1954, § 83(d)(2), which taxes as income the increment of value resulting from the cancellation of a restriction, which by its terms will never lapse, on property received for services.

Cf. Hardenbergh v. Commissioner, 198 F.2d 63 (8th Cir.), *cert. denied*, 344 U.S. 836 (1952), taxing as a gift a purported renunciation by a wife and daughter of their intestate shares in an estate, so that the shares could pass to the son of the decedent. *Hardenbergh* distinguished Brown v. Routzahn, 63 F.2d 914 (6th Cir.), *cert. denied*, 290 U.S. 641 (1933), which had permitted renunciation of a testate interest without transfer tax consequences on the ground that the latter amounted to a refusal to accept a benefit, while an intestate interest vested by operation of law. *See generally* Feld, *Some Post-Mortem Planning Devices: Renunciations, Elections and Compromises*, 3 J. LASSER, ESTATE TAX TECHNIQUES 2191 (1973).

[48] 55 T.C. 172 (1970).

[49] Apparently, both the Commissioner's valuation expert and the Tax Court found the reduction in asset value produced by the restrictions to be greater than the premium

formula price to be relevant but not conclusive of value. The certificates had "retention value" which included, in addition to dividends and participation in control, rights to the underlying shares of the insurance company on liquidation of the trust, and rights to the value represented by the stock in the insurance company on its liquidation or mutualization.

In our example, the reduction in asset value may be limited both by the retention value of the stock, *i.e.*, the income value of the shares and participation in control which the shares carry, and by virtue of the restrictive agreement itself, since *D* will acquire reciprocal rights of first refusal in the shares held by the others. These rights are valuable. To the original shareholders, the power to restrict transfers probably outweighed the burden imposed upon their own shares. Otherwise the three shareholders initially would not have agreed to restrict their own shares in exchange for restrictions on the shares of the others. Similarly, if *D* intends to retain the shares, the reciprocal restrictions on the shares held by *A* and *B* may be more valuable than the restriction on his own shares. This suggests that when restrictions are reciprocal it should not be assumed that they reduce the value of the shares. On the contrary, they probably should be viewed as offsetting elements of value unless the taxpayer demonstrates otherwise. If *D* plans to dispose of the shares, however, the burden of the restriction on his shares is likely to outweigh the benefits of restricting the others' shares.

In applying the general definition of fair market value, the fact that the test is described as a sale could suggest that asset value rather than retention value should be emphasized. The decisions do not appear to have done so, but rather have given balanced weight to both asset and retention values. To a hypothetical buyer, the additional difficulty in disposing of the shares produced by the restriction should be offset by the assurance of some control over the entry of new participants into the venture. It may be that this is reflected in the Service's concern with the voluntary or involuntary nature of the restriction imposed on the shareholder making the gratuitous transfer.[50] This fact might be evidence that the benefit of restricting the shares owned by the other stockholders is outweighed by the burden of the restriction on one's own shares.

Some special problems arise in determining whether a re-

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which consolidation of control over the insurance company through the instrumentality of the voting trust might be thought to imply.

[50] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 244.

striction constitutes a disguised testamentary disposition. The regulations warn that an option or contract to purchase will be disregarded unless it is determined that the agreement represents a bona fide business arrangement rather than an attempt to pass the shares to natural subjects of the transferor's bounty at a tax discount.[51] Since family members frequently are associated with each other in corporate ownership, it is important that these devices be precluded.

Estate of Orville B. Littick[52] involved what appears to have been a restriction in contemplation of death. Three brothers owned all of the stock of a company. They agreed that the stock held by any of them at death would be sold to the corporation for $200,000, payable in eight percent corporate debentures. The agreement further provided that if Orville were the first to die, his son was to get some equity in the business, with Orville's estate getting debentures for the balance of his stock. Orville, who was suffering from cancer at the time of the agreement, died about a year later. The estate valued the stock at the agreement price of $200,000, while the Commissioner, arguing that the agreement transferred value in contemplation of death, arrived at a value of $257,000 for the stock.[53]

The Tax Court considered the agreement to have been entered into at arm's length and held that the agreement price controlled for estate tax purposes. The court argued that while it was likely that Orville would die first, it was not a foregone conclusion. The agreement was equally binding on the other brothers. If either of them had died first, his shares would have been sold to the corporation at the formula price. Yet the probability of Orville's predeceasing the others was sufficiently great that the agreement was probably not an approximately equal exchange of restrictions. It may be, however, that the Tax Court's finding of an arm's length agreement was justified by the relatively narrow variation of the agreement price from the fair market value determined a year later. If the disparity in price were much greater, courts would be far less likely to view the agreement as a product of arm's length bargaining.[54]

More generally, in determining whether mutual stock restrictions are entered into at arm's length it would be inappropriate to compute, based on mortality tables and life exxpectan-

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[51] Treas. Reg. § 20.2031-2(h) (1958).
[52] 31 T.C. 181 (1958), *acquiesced in,* 1959-2 CUM. BULL. 5.
[53] INT. REV. CODE OF 1954, § 2035.
[54] *See* Clair Giannini Hoffman, 2 T.C. 1160 (1943).

cies, the precise value to each shareholder of a right to purchase at death. It is perfectly credible for shareholders operating at arm's length to enter into arrangements which become operative on death, in order to obtain the assurance of sale at the formula price, even though they have disparate life expectancies. If, however, one shareholder is substantially older than the others, or if there is otherwise a substantially greater likelihood that he will predecease them, the transaction should be scrutinized closely for elements of gift.[55] Where, as in *Littick*, the gift arguably falls within the contemplation of death provisions, estate tax consequences might follow as well.

When, however, the factual pattern negates the inference of a gift or of an agreement in contemplation of death, and the shares were not transferable free of the option during the decedent's lifetime, the value of the shares for estate tax purposes should be limited by the option price. Such was the case in *Commissioner v. Bensel*,[56] where father and son had spent their lifetime at loggerheads, but the son was employed in the business. In order to induce him to continue in the business, it was agreed that upon his father's death he would have an option to buy the father's stock, which represented a controlling block in the corporation. The price was fair when agreed on. Before the father's death, however, the shares had appreciated in value to an amount far in excess of the option price. The court quite properly held that the option price prevailed.

III. CONCLUSION

The Service and the courts long have sanctioned discounts from proportionate value in valuing shares in closely held corporations. Discounts have been justified both for minority stock interests and for shares subject to restrictions. In many cases, the discounts are justified. The position of the minority stockholder in a corporation may prevent him from participating in control of the business and may adversely affect his ability to realize the full benefits of owning a proportionate interest in the corporation. Similarly, if stock is subject to restrictions on transfer, the shareholder may be unable to realize immediately on asset values.

Yet these discounts have been applied too broadly. In some cases, the supposed disability resulting from minority position or

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[55] *But cf.* Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955).

[56] 100 F.2d 639 (3d Cir. 1938).

restrictions on transfer may on balance not be a disability in fact, or may be of little or no consequence to the shareholder, and should not be taken into account in valuation. Minority discount in particular appears to have been applied mechanically, upon a determination that the shares transferred constitute an arithmetic minority of the stock of the corporation, without adequate consideration of the realities of the shareholder's participation in control of the corporation.

The Service's published rulings do not state clearly the principles which should distinguish the cases which are appropriate for discount from those which are not. This is especially regrettable in the setting in which the issue arises. First, the taxpayer in preparing an estate or gift tax return must report the value of the shares transferred. Without clearer published statements as to how these discounts are to be applied, genuine doubt may exist for the taxpayer, who understandably may resolve that doubt in his own favor. Second, upon audit of the return and upon judicial determination of any unresolved dispute as to value, the discount may be but one element among many in a difficult valuation case. Unless the principles for applying the discount are precisely articulated, the trier of fact may apply excessive or inappropriate discounts, yet ultimately determine a value which is not clearly unreasonable. Such imprecise analysis is not easily corrected. On appeal to a higher court the value fixed may well be within the range of values, which an appellate court is bound to accept.[57] Thus, unless the Service sets forth carefully articulated standards for applying discounts, additional confusion and imprecision will continue to be inculcated into this area of the law.

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[57] FED. R. CIV. P. 52(a); INT. REV. CODE OF 1954, § 7482(a).